Theories of Financial Disturbance: An Examination of Critical Theories of Finance from Adam Smith to the Present Day | Book Reviews

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Jan Toporowski, *Theories of Financial Disturbance: An Examination of Critical Theories of Finance from Adam Smith to the Present Day*. Cheltenham, UK: Edward Elgar, 2005. viii + 195 pp. $90 (cloth), ISBN: 1-84376-477-6.

Reviewed for EH.NET by Gerald P. O'Driscoll, Jr., Cato Institute.

Jan Toporowski presents us with an eclectic treatment of heterodox theories of financial disturbance, beginning with Adam Smith and ending with Hyman Minsky. In between, a diverse cast of characters appears on stage, including, among others, Rosa Luxembourg, Ralph Hawtrey, Irving Fisher, and, in a leading role, John Maynard Keynes. Toporowski himself stays mainly in the background, but is very much in charge.

The economists have been selected for their contributions to the tradition of "critical finance," a view that sees finance as a force "systematically" disturbing "the functioning of the modern capitalist economy" and aggravating economic fluctuations (p. 3). Toporowski observes that critical finance is defined more by contrast with "*reflective* finance," which views "financial markets as being determined by circumstances in the real economy, that is, outside the financial sector" (p. 2). He identifies Joseph Schumpeter as an early exponent of reflective finance in his *Theory of Economic Development*.

More generally, the efficient market hypothesis and like-minded stock pricing models are the modern-day examples of the reflective approach to finance. In Toporowski's view, they all maintain that any instability in financial markets is temporary and affirm that a new equilibrium will be established, one reflecting underlying changes in the real economy (p.3). He does not view modern finance as being Walrasian, that is, a theory of mutual determination of markets, real and financial. Indeed, he contrasts reflective theory with such a view (p. 2).

Readers will search in vain for any formal modeling in this book. It is a book that relies on the insights of (mostly) dead economists and historical examples to make its points. That approach will delight some readers as it frustrates others. The book will likely appeal to practitioners of critical finance, who want better to understand its history. The book may also serve as an overview of a subset of heterodox theories of finance for those wanting a basic understanding of them. Mainstream theorists of finance are unlikely to be convinced by the arguments against orthodoxy presented in the book.

The book is not history: the author treats historical episodes anecdotally rather than systematically. Nor is the book history of thought. What can one make of an author who admits that he has "not done full justice to the totality of the ideas of many of the writers discussed here"; and who acknowledges "my willful distortion of the works of these great writers [which is] compounded by several omissions" (p. 5)? That is both a shame and unnecessary. Toporowski evidences a keen understanding of the central ideas of many of the writers he discusses. In that regard, I particularly commend his chapter on Ralph Hawtrey (pp. 61-74). One can only wish he had been more systematic in his treatment of both ideas and facts. Instead, he is tendentious in both his selection and presentation of them.

Many readers will wonder at Toporowski's decision to begin with Adam Smith. That choice was sensible, however, given his plot for the book. Smith's case against usury has always seemed a strange lapse in his general case for prices and markets. Smith argued that those willing to pay higher rates of interest would crowd out borrowers unable to do so. For Smith, that would mean that capital would flow to "prodigals and projectors," rather than to "sober people" (quoted at p. 16).

In Toporowski's financial topography, Smith becomes a precursor of modern theories of the inherent instability of finance. It is not clear, however, that Smith's views fit neatly into a macroeconomic theory of financial instability. They likely reflect Smith's distinction between productive and unproductive labor. Nonetheless, Toporowski gets the reader's attention by linking his ideas to the father of classical economics. And that was probably his goal.

As one gets closer to the present, the more familiar the ground gets. The treatment of Keynes is good. Toporowski quite correctly identifies the "ambiguity at the heart of his work," the tension between a disequilibrium theory presented in equilibrium terms (p. 88). Toporowski introduces the reader to some unrecognized Polish theorists of the interwar years. And he focuses on the importance of Michael Kalecki in the evolution of Post-Keynesian thought.

As noted above, Toporowski is highly selective in his choice of economists to highlight and in his choice of what part of their ideas to present to the reader. That results in distorted view of the evolution of both orthodox and heterodox theory. Consider the following observation, made after a lengthy quotation from Minsky. "The reference to time and expectations here is clear evidence of Minsky's studies of the works of Keynes and Shackle" (p. 145). If emphasis on time and expectations is a defining characteristic, then there are an embarrassingly large number of antecedents. They would include, among others, the Austrians (Mises, Hayek, et al.); the Swedes (Wicksell, Myrdal, et al.); and a diverse group of individuals, among whom Frank Knight would be notable.

Just about every interwar theorist worth his salt was focused on the issues of time and expectations. The interesting question is why some were led to theories of endogenous financial instability and others, like Hayek, identified policy not institutions as the source of economic fluctuations. Answering that question would have been a genuine contribution.

The issues in this book are truly important and the discussion of them often interesting. The heterodox views presented are generally worthy of presentation. One can only wish that issues, discussions, and ideas had been presented more systematically. The great failing of the book is in what it could have been but is not.

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- Geographic area: Europe (4), North America (7)
- Time period: 18th Century (6), 19th Century (7), 20th Century: Pre WWII (8), 20th Century: WWII and post-WWII (9)
- Subject: Financial Markets, Financial Institutions, and Monetary History (H), History of Economic Thought; Methodology (L)

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