Inappropriate Replacement of Human Judgment: The CASE for Decentralization

Profiling Amar Bhidé’s recent book:
A Call for Judgment: Sensible Finance for a Dynamic Economy

It is impossible to dispute that technology, innovation and the growth of the modern capitalist economy has had a massive effect on the way humans interact with the world. Much of this innovation comes from individuals discerning the appropriate balance between top-down command and control, on the one hand, and individual initiative and judgment, on the other. While individual judgment and initiative is central to the success of the modern capitalist economy, rules and centralized systems are needed to ensure order and to prevent fraud and waste. The negative impact of free-riding and the exploitation of natural and man-made ecosystems warrant a certain degree of top-down management.

In recent times, however, a new form of centralized control has taken root – one that is not the product of old-fashioned autocrats, committees or rule-books but of statistical models and algorithms. Applying this premise to the world of modern finance lies at the heart of Amar Bhidé’s recent book entitled A Call for Judgment: Sensible Finance for a Dynamic Economy (Oxford University Press, 2010). Bhidé focuses on a seldom discussed component of the recent financial crisis: what was the decision-making technology behind the crisis?

Bhidé begins his discussion with an overview of the steps leading to the financial crisis. He then sets forth a systematic plan with respect to how we can overcome the crisis and establish the appropriate balance, not just between centralization and decentralization, but also between case-by-case individual judgment and standardized rules. He advocates what he calls the venturesome economy – a balanced economic approach that provides ample space for independent initiative and judgment.

The Judgment Deficit: Centralization and the Rise of Mechanistic Decision-Making

Recent decades have seen a marked shift away from individual initiative and judgment and towards the use of statistical models and algorithms in modern finance. Information technology has been a key driver for innovation and change. Information technology has also created a rush to automate and centralize. Bhidé does not suggest that automation through technology is necessarily a bad thing. Computers permit the cutting of fabric with less waste, facilitate the routing of large fleets of trucks, and lay out circuits in chip design. However, because they are based on statistical models and mathematical calculations, they cannot predict behavior. Despite their econometric sophistication, statistical models are ultimately a simplified version of history. These models package a wide range of risk and vulnerability into a set of broad tendencies and recurring patterns. However, in a dynamic society, driven by individuals with charisma and fallibility, statistical models cannot make reliable predictions. Bhidé uses the recent experience of the financial crisis to remind his readers of one of the root causes of the crisis: top down packages of risk management tools called Credit Default Swaps (CDSes). CDSes gave purchasers of bundles of subprime
mortgages a false sense of security, and thereby enabled the spectacular and ultimately disastrous growth of the subprime mortgage market. CDSes represent a pointed example of an attempt to use a top down statistical tool to manage risk. The model simplified analysis and managed a wide range of activities with little knowledge of the details of any one specific factor, thereby reducing risk to a single number whose value could be derived from statistical analysis of historical data.

CDSes are just one component of a housing market that has become extremely mechanized and centralized. Bhidé presents the startling statistic that at the height of the housing boom, in 2004, less than a third of all loans were originated by an actual lender. The brokers' role was to help loan applicants fill out forms. This contrasts starkly with the traditional case-by-case loan model that was the norm up until the early 2000s. Similar to CDSes, mortgages are granted or denied based upon complex models that provide little room for consideration of the specific situation of the borrower or the particular requirements of the lender. This dispensing with judgment in the loan process helped to funnel the mass production of securities and mortgages into a few mega-institutions, posing a systemic risk to the economy that top executives and regulators could not control. We all know that this substitution of mechanized arms-length contracting for regular, ongoing personal relationships created a situation of immense risk for the entire mortgage origination and distribution process.

The Case for Decentralization and Individual Judgment

Bhidé presents a compelling alternative to the current seemingly unstoppable growth of these mechanistic statistical models. He calls for a balance between top-down and case-by-case approaches to modern finance. Using the ideas of the great twentieth-century thinker Friedrich Hayek, Bhidé focuses on the importance of adaptation to change and innovation. First, he points out, knowledge is widely dispersed among individuals and is extremely difficult to translate into a single model or statistical approach. Second, a dynamic economy relies on independent case-by-case judgments – the ability to adapt to changing market dynamics and conditions. Third, the success of the modern economy depends on spontaneous innovation – the ability to combine facts, past experiences and imagination in making informed decisions. Effective decentralization demands mechanisms to coordinate independent initiatives. Established relationships provide a forum for dialogue and promote the sharing of knowledge. Without an established relationship in place, a buyer is less likely to accurately analyze the situation and is more likely to default to a prescribed response that may be completely invalid and incorrect.

Bhidé seeks a balance that will foster a dynamic global economy by taking advantage of technology and statistical models but also recognizes the supremacy of individual judgment in business decision-making. As Bhidé concludes, “if we are to preserve the primacy of human judgment, we must learn to harness and control these models, not to submit to them.”

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