If It Works, It Won’t

As the world ponders market interventionist bail outs and mass nationalizations we risk abandoning the free market which has created the prosperity of the last 100 years. Yet even the experts, and that champion of free markets himself Alan Greenspan advocates a temporary detour from free markets to save the current situation.

The first priority is to save the patient. We can worry about holistic medicine later. That seems to be the consensus view among market participants, academics and the general public, to varying degrees. Some would have less intervention, some more, some would have a one step throw everything at the problem approach while others advocate a more gradual and measured approach.

As we almost surely will walk down the path of central planning, let us not forget the strengths and weaknesses of free markets that have recommended it to us for so long, and which has resulted in over 100 years of progress.

Unbridled Capitalism is the tyranny of the majority. Protection of minority rights and a just and lawful legal system is necessary for the market mechanism to function. A totally unregulated free market quickly descends into anarchy and chaos.

Free markets don’t imply the best economic outcome, it only implies the best possible and practical economic outcome.

I contend that the current crisis is not the result of unbridled Capitalism but a failure of upholding the basic principles of free market economics, and to a certain extent, a failure of regulation. The reasons for this failure are manifold and complex but they can be simplified (or oversimplified) to illustrate the principles.

Short term interest rates are unilaterally set by a lender of last resort whose influence goes beyond its remit of price and economic growth stability. The signalling power of the Fed has become too strong and people have begun to second guess Fed policy. By holding interest rates too low for too long, the Fed signalled an environment of low risk and low inflation and encouraged accessive risk taking.

The financial system with its financial innovation such as derivatives like mortgage backed securities and CDOs were simply a facilitator. Investors were drawn to these complex products by their relentless pursuit of yield as yields across all products from government bonds to corporate bonds fell in sympathy with the Fed funds target rate.

And the banking system. Where is the capitalist model if the reward system fails to punish. Managerial compensation embeds optionality and asymmetry in payoffs. A manager who does well gets a bonus, and if he does poorly, at worst he gets fired. There is no way for him to lose money. The standard bonus scheme does not allow a manager to lose any bonus that has already been paid in previous years. And bonuses get paid out every year so that a manager's reward is locked in each year end. This doesn't encourage a balance between risk and reward.

The capital rules for banks are pro cyclical. Basel 2, the rules which govern how banks account and provide for risks which they hold are pro cyclical, magnifying the swings in the credit cycle. These need to be re-examined.

Trade is not free. It has never really been free as long as it has been transparent enough for governments to tax them and for interested parties to thus lobby government for differential treatment. Tariffs, barriers, subsidies all serve to distort price discovery in world trade.

Capital markets (in the broadest sense, or otherwise) are not free. The Chinese Yuan is not freely floating for example. Middle Eastern currencies are similarly pegged.

For these distortions to the free market and other reasons, a credit crisis is upon us. The solution is not the abandoning of Capitalism in favour of some Socialist or centrally planned alternative. An interim solution may involve the suspension of capitalist structures and mechanisms. However, any long term solution must build upon the free market system. And here is why we are in such dire straits:

The current ‘free market’, which is not really a very free market, has failed us. The immediate solutions are all market intervention solutions which take us further from our ideal of a free market. If these measures succeed, it will be argued by the opponents of free market economics that Capitalism has failed and that the world should move further away from free markets. And they may win.

A long term solution is so difficult to find because it involves a one time, drastic abandoning of free market economics, and the shorter the duration of the suspension, the more drastic must be the detour, followed by a restructuring of market structures and institutions towards a system even freer than the one with which we lurched into 2008. Such twists and turns seem beyond us, and we can only hope and pray.