Impending Economic Crisis: The Myth that Markets Get It Right and Operate Efficiently

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You know the story triumphantly heard in the West. Markets work best when governments let them operate freely – unconstrained by rules, regulations and taxes about which noted economist Milton Friedman once said in an interview he was "in favor of cutting….under any circumstances and for any excuse, for any reason, whenever it's possible (because) the big problem is not taxes (but government) spending.

Friedman is no longer with us, but by his reasoning, the solution to curbing it is "to hold down the amount of income (government) has (and presto) the way to do it is to cut taxes." He seemed to forget about borrowing and the Federal Reserve's ability to print limitless amounts of ready cash the way it's been doing for years and during the current credit squeeze. Friedman further added in the same interchange "If the White House were under (GW) Bush, and House and Senate….under the Democrats, I do not believe there would be much spending."

Clearly, either the Nobel laureate wasn't paying attention or age was taking its toll late in his life. Since 2001, Democrats embraced tax cutting and overspending policies as enthusiastically as Republicans with both parties directing the benefits hugely to the right pockets. They're on Wall Street and in corporate boardrooms where recipients know "free markets" work great with a little creative resource directing from Washington.

Financial Market Efficiency

In investment finance, Eugene Fama is generally regarded as the father of efficient market theory, also known as the "efficient market hypothesis (EMH)." He wrote his 1964 doctoral dissertation on it titled "The Behavior of Stock Market Prices" in which he concluded stock (and by implication other financial market) price movements are unpredictable and follow a "random walk" reflecting all available information known at the time. Thus, no one, in theory, has an advantage over another as everyone has equal access to everything publicly known (aside from "insiders" with a huge advantage). That includes rumored and actual financial, economic, political, social and all other information, all of which is reflected in asset prices at any given time.

Those buying this theory believe Milton Friedman knew best. He became the modern-day godfather of "free market" capitalism and leading exponent that markets work efficiently and best when unfettered by government intervention that generally gets things wrong. In 1958, Friedman explained it in his famous "I, Pencil" essay. In it, he illustrated the notion of Adam Smith's invisible hand and conservative economist Friedrich Hayek's teachings on the importance of "dispersed knowledge" and how the price system communicates information to “make (people) do desirable things without anyone having to tell them what to do.”

Friedman’s “pencil” story explained “a complex combination of miracles: a tree, zinc, copper, graphite, and so on.” Added to these ingredients from nature is “an even more extraordinary miracle: the configuration of creative human energies – millions of tiny know-hows configuring naturally and spontaneously (responding to) human necessity and desire and in the absence of any human master-minding.” None of them working independently was trying to make a pencil. No one directed them from a central office. They didn’t know each other, lived in many countries, spoke different languages, practiced different religions, and may have even hated each other. Yet, their unrelated contributions produced a pencil.

By Friedman’s reasoning, this could never happen through central planning. It sounds good in theory, but how does it jibe with reality. The Soviets split the atom, were first in space ahead of the US with Sputnik 1, and developed many advanced technologies even though they were outclassed and outspent by the West overall with greater resources to do it.

In practical reality, governments, like individuals operating freely in the marketplace, can succeed or fail. It comes down to people skills and how well they do their jobs. Top down or bottom up has little final effect on the end result, but does direct what’s undertaken and what isn’t. Top down in Canada, Western Europe and Venezuela delivers excellent state-funded health care to everyone. Bottom up in America offers it to anyone who can pay, but if not, you’re out of luck if your employer won’t provide it. Forty-seven million and counting had their luck run out, and Friedman’s pencil making miracle won’t treat them when they’ll ill.

Put another way, if “free market” capitalism works best and America is its lead exponent, why then:

— is poverty high and rising in the world’s richest country;

— incomes stagnating;

— higher education becoming unaffordable for the majority;

— public education crumbling;

— jobs at all levels disappearing to low-wage countries;

— the nation’s vital infrastructure in a deplorable state;

— 3.5 million or more homeless and heading higher in the wake of subprime defaults;

— the standard of living of most in the country declining; and,

— the nation, in fact, bankrupt according to a 2006 study for the St. Louis Fed.

Clearly, something is wrong with the “pencil miracle” working for some but not for most. Friedman no longer can respond and his acolytes won’t.

The Myth that Markets Get It Right and Operate Efficiently

Economist Hyman Minsky was mostly ignored while he lived, but his star may be rising 11 years after his death in 1996. Some described him as a radical Keynesian based on the theories of economist John Maynard Keynes who taught economies operate best when mixed. He believed state and private sectors both play important roles with government stepping in to stimulate or constrain economic activity whenever private sector forces aren't able to do it best alone.

It's the opposite of "supply-side" Reaganomics and its illusory "trickle down" notion that economic growth works best through stimulative tax cuts its proponents claim promote investment that benefits everyone. It was Reagan-baloney then and now, and so is the notion markets are efficient and work best when left alone.

Minsky explained it, and people are now taking note in the wake of current market turbulence. His work showed financial market exuberance often becomes excessive, especially if no regulatory constraints are in place to curb it. He developed his theories in two books – "John Maynard Keynes" and "Stabilizing an Unstable Economy" as well as in numerous articles and essays.

In them, he constructed a "financial instability hypothesis" building on the work of Keynes' "General Theory of Employment, Interest and Money." He provided a framework for distinguishing between stabilizing and destabilizing free market debt structures he summarized as follows:

"Three distinct income-debt relations for economic units….labeled as hedge, speculative and Ponzi finance, can be identified."

— "Hedge financing units are those which can fulfill all of their contractual payment obligations by their cash flows: the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit."

— "Speculative finance units are units that can meet their payment commitments on 'income account' on their liabilities, even as they cannot repay the principle out of income cash flows. Such units need to 'roll over' their liabilities – issue new debt to meet commitments on maturing debt."

— "For Ponzi units, the cash flows from operations are (insufficient)….either (to repay)….principle or interest on outstanding debts by their cash flows from operations. Such units can sell assets or borrow. Borrowing to pay interest….lowers the equity of a unit, even as it increases liabilities and the prior commitment of future incomes."

"….if hedge financing dominates….the economy may….be (in) equilibrium. In contrast, the greater the weight of speculative (and/or) Ponzi finance, the greater the likelihood that the economy is a deviation-amplifying system….(based on) the financial instability hypothesis (and) over periods of prolonged prosperity, the economy transits from financial relations (creating stability) to financial relations (creating) an unstable system."

"….over a protracted period of good times, capitalist economies (trend toward) a large weight (of) units engaged in speculative and Ponzi finance. (If this happens when) an economy is (experiencing inflation and the Federal Reserve tries) to exorcise (it) by monetary constraint….speculative units will become Ponzi (ones) and the net worth of previous Ponzi units will quickly evaporate. Consequently, units with cash flow shortfalls will be forced to (sell out). This is likely to lead to a collapse of asset values."

Minsky developed a seven stage framework showing how this works:

Stage One – Displacement

Disturbances of various kinds change investor perceptions and disrupt markets. It may be a tightened economic policy from higher interest rates or investors and lenders retrenching in reaction to:

— a housing bubble, credit squeeze, and growing subprime mortgage delinquencies and defaults with spreading contagion affecting:

— other mortgages, and the toxic waste derivative alchemy of:

— collateralized debt obligation (CDO) instruments (packages of mostly risky junk and other debt),

–commercial and residential mortgage-backed securities (CMBS and RBMS – asset backed by mortgage principle and interest payments), and even

— commercial and AAA paper; plus

— home equity loans harder to service after mortgage reset increases.

Stage Two – Prices start to rise

Following displacement, markets bottom and prices begin rising as fundamentals improve. Investors start noticing as it becomes evident and gains momentum.

Stage Three – Easy credit

Recovery needs help and plentiful easy credit provides it. As conditions improve, it fuels speculation enticing more investors to jump in for financial opportunities or to borrow for a new home or other consumer spending. The easier and more plentiful credit gets, the more willing lenders are to give it including to borrowers with questionable credit ratings. Yale Economist Robert Shiller shares the view that "booms….generate laxity in standards for loans because there a general sense of optimism (like) what we saw in the late 80s" preceding the 1987 crash that doesn't necessarily signal an imminent one now.

New type financial instruments and arrangements also arise as lenders find creative and risky ways to make more money. In recent years, sharply rising housing prices enticed more buyers, and lenders got sloppy and greedy by providing interest-only mortgages to marginal buyers unable to make a down payment.

Stage Four – Overtrading

The cheaper and easier credit is, the greater the incentive to overtrade to cash in. Trading volume rises and shortages emerge. Prices begin accelerating and easy profits are made creating more greed and foolish behavior.

Stage Five – Euphoria

This is the most dangerous phase. Cooler heads are worried but fraudsters prevail claiming this time is different, and markets have a long way to go before topping out. Greed trumps good sense and investors foolishly think they're safe and can get out in time. Stories of easy riches abound, so why miss out. Into the fire they go, often after the easy money was made, and the outcome is predictable. The fraudsters sell at the top to small investors mistakenly buying at the wrong time and getting burned.

Stage Six – Insider profit taking

The pros have seen it before, understand things have gone too far, and quietly sell to the greater fools buying all they can. It's the beginning of the end.

Stage Seven – Revulsion

When cheap credit ends, enough insiders sell, or an unexpected piece of bad news roils markets, it becomes infectious. It can happen quickly turning euphoria into revulsion panicking investors to sell. They begin outnumbering buyers and prices tumble. Downward momentum is far greater and faster than when heading up.

Sound familiar? It's a "Minsky Moment," and the irony is most investors know easy credit, overtrading and euphoria create bubbles that always burst. The internet and tech one did in March, 2000, and since mid-July, reality caught up with excess speculation in equity prices, the housing bubble, growing mortgage delinquencies and subprime defaults. Goldilocks awoke and sought shelter as lenders remembered how to say "no." This time, central banks rode to the rescue (they hope) with huge cash infusions, the Fed cut its discount rate a half point August 17, and it signaled lower "fed funds" rates ahead if markets remain tight.

Intervention may reignite "animal spirits" and work short-term but won't easily band-aid over what noted investor Jeremy Grantham calls "the broadest overpricing of financial assets – equities, real estate, and fixed income – ever recorded" with the financial system dangerously "overstretched (and) overleveraged." His view is that current conditions have "almost never been this dire," and we're "watching a (too late to stop) very slow motion train wreck." Minsky would have noticed, too.

Grantham's exhaustive research shows all markets revert to their mean values, and all bubbles burst as the greatest Fed-engineered equity one ever in US history did in 2000 but didn't complete its corrective work. In Grantham's view, lots more pain is coming and before it's over, it will be mean, nasty and long, affecting everyone. Minsky saw it earlier, studied it, and wrote about it exhaustively when no one noticed. If he were living today, he'd say "I told you so."

Federal Reserve Engineered Housing Bubble and Resultant Financial Market Turmoil

Astute observers continue to speculate and comment that the housing bubble and resultant current financial market turmoil came from deliberate widespread malfeasance aided by considerable cash infusion help from the Federal Reserve in the lead on the scheme.

Economist Paul Krugman is one of the latest with his views expressed in an August 16 New York Times op ed piece titled "Workouts, Not Bailouts." He began by debunking Wall Streeter Treasury Secretary Henry Paulson's ludicrous April claim that the housing market was "at or near the bottom" followed by his equally absurd August view that subprime mortgages were "largely contained." Krugman's response: "the time for denial is past….housing starts and applications for building permits have fallen to their lowest levels in a decade, showing that home construction is still in free fall….home prices are still way too high (at 70% above their long-term trend values according to the Center for Economic and Policy Research, and) the housing slump (will be around) for years, not months" with all those empty unbought homes needing hard to find buyers to fill them.

In addition, mortgage problems are "anything but contained" and aren't confined to the subprime category. Krugman believes current real estate troubles and mortgage fallout bear similarity to the late 1990s stock bubble. Like today, they were accompanied by market manipulation and scandalous fraud at companies like Enron and WorldCom. In his view, "it is becoming increasingly clear that the real-estate bubble of recent years (like the 1990s stock bubble)….caused and was fed by widespread malfeasance." He left out the Fed but named co-conspiratorial players like Moody's Investors Service and other rating agencies getting paid lots of money to claim "dubious mortgage-backed securities to be highest-quality, AAA assets." In this role, they're no different than were "complaisant accountants" like Arthur Andersen that lost its license to practice from its role in the Enron fallout.

In the end, this scandal may be more far-reaching than earlier ones because so many underwriters and other firms are part of the fraud or are seeking to profit from it. At this point, it's hard separating villains from victims as, in some cases, they may be one in the same. They're all involved in dispersing up to trillions of dollars of risks through the derivative alchemy of highly complex, hard to value, packages of mostly subprime CDO and various other type debt instruments that may even end up in so-called safe money market funds unbeknownst to their unsuspecting owners.

Before this scandal ends, they'll be plenty of pain to go around, but as always, small investors and low income subprime and other mortgage homeowners will be hurt most. Krugman says this is "a clear case for government intervention," but it won't be the kind he wants. He cites a "serious market failure (needing fixing to) help (as many as) hundreds of thousands" of Americans who otherwise may lose their homes and/or financial nest eggs. Faced with this problem, "The federal government shouldn't be providing bailouts, (it should) arrange workouts….we've done (it) before (and it worked) – for third-world countries, not for US citizens." It helped both debtors escape default and creditors get back most of their money.

By providing huge cash infusions to ease credit and reignite "animal spirits," the Fed and other central banks showed they aren't listening. It proves what Ralph Nader said in his August 19 Countercurrents article called "Corporate Capitalists: Government Comes To The Rescue" that's also on CounterPunch titled "Greed and Folly on Wall Street." With "corporate capitalists' knees" a bit shaky, Nader recalled what his father once explained years ago when he asked and then told his children: "Why will capitalism always survive? Because socialism will always be used to save it." Put another way, the American business ethic has always been socialism for the rich, and, sink or swim, free market capitalism for the rest of us.

As the housing slump deepens and many tens of thousands of subprime and other mortgage holders default, vulture investors will profit hugely buying troubled assets at a fraction of their value as they always do in troubled economic times. Writer Danny Schechter calls the current subprime credit squeeze debacle a "sub-crime ponzi scheme (in a) highly rigged casino-like market system" targeting unsuspecting victims. Schechter wants a "jailout" for "criminal….financial institutions (posing) as respectable players." Krugman, on the other hand, wants a "workout" for the victims. Neither will get what he wants. In the end, as ordinary people lose out, big government will again rescue “corporate capitalism” (at least in the short-term) the way it always does when it gets in trouble. It’s the “American way.” It’ll be no different this time.

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