The limits to the market – lessons from the financial crisis

The 2012 Keith Joseph Memorial Lecture

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I am greatly honoured to have been asked to give this year's Keith Joseph Memorial lecture to such a distinguished gathering. I am also somewhat daunted.

And that feeling, in part at least, derives directly from what I remember about Sir Keith. I well recall the effect that he had on me – even though I never met him. As a young, wet-behind-the-ears economist, I came to listen to him speak on several occasions. He had a unique intellectual presence: a mind of startling acuity; that much was clear to all. But what impressed me most was his complete intellectual honesty, matched with a fearlessness to follow an argument wherever it led, even if it led him into trouble – which it frequently did.

I cannot hope to do full justice to Sir Keith. And I am not at all sure that he would agree with much of what I have to say tonight. But I hope that at least in that quality of being prepared to follow an argument wherever it leads, I may do some justice to his memory.

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The case for markets

At the outset, let me put my cards on the table. I am a supporter of markets. I believe that much of what went wrong in the economy over the last sixty years results directly from their suppression, and from the excessive size of the state. In the early part of the lives of everyone here tonight, there was an alternative to the market economy, in the shape of the planned economies of the communist bloc. The choice between economic and political systems found expression in the conflict that we all know as the Cold War.

For most of this time, there was a corresponding intellectual battle – fought in the pages of economics journals! The subject of this conflict was essentially whether self-interested behaviour by individuals and firms, freed of all government interference, could produce the best results for society. In the dominant school of thought, the answer was yes. So, as in all the best fairytales, this one had a happy ending. Greed is good.

Thankfully, we have now got beyond this stuff. The collapse of communism has made it clear that there is no alternative to the market economy. Surely, we can now examine the limits to markets without believing, or being thought to believe, that the market system is intrinsically evil, or that there is in fact any viable alternative.

More markets

In my view, we need more of the market, not less, in healthcare, education and transport – particularly travel by road. Equally, we need less of the state, not only in these activities, but also in the redistribution of incomes, the provision of "social security" and countless other areas. And we surely need lower levels of taxation.

But that does not mean that markets can and should be left well alone in all parts of the economy. There are some areas where the state needs to be more involved in order to make markets work better. If supporters of markets fail to acknowledge their limitations and fail to address the areas of market failure, then they will undermine the case for markets overall and risk losing the wider battle against the champions of egalitarianism and state bureaucracy.

A prime example comes from the furore over the 50% tax rate. The reason why this tax is so popular – and accordingly so difficult to abolish – is not so much a widespread antipathy towards the rich but rather an almost universal loathing of "those b……… bankers". It may be a blunt instrument, but a large part of the population sees the 50% tax rate as a way of penalising the undeserving plutocrats in the financial sector. This is a prime example of the costs of not facing up to the need to make markets work well and thereby ensuring a modicum of common sense – if not justice – in the system of remuneration.

Market failure

There are many market failures which can affect the capitalist system. Tonight, I am going to confine myself to the failings that arise in the financial part of it. But again, please do not think that this means that I believe that finance is the root of all evil, or that we should aim to squash the City of London, and still less that we should sign up to whatever madcap scheme is dreamt up in Brussels for bringing financial markets to heel. If I concentrate tonight on the failings of finance rather than its essential contributions to our economy, that is because I am assuming that the latter can be taken for granted.

The financial crisis revealed three sorts of failing: defects of detail; defects of structure and defects of nature. An example of a defect of detail is the fact that bankers' success was measured by the return on equity, whereas it could and should be measured by the return on assets, and measured over a considerable run of years, not just one calendar year.

Defects of detail do not indicate any fundamental failings of the capitalist system. They can be put right; indeed, in many cases they are being put right. Other than in the textbooks, the market system is not perfect, but is rather on a constant regime of self-improvement.

But defects of structure and defects of nature are a different matter. They reveal fundamental failings in the system and lay bare the limits to free markets. This evening I will not dwell on defects of detail but rather comment on what I see as 5 key defects of structure and nature.

Financial stability – a public good

The financial crisis has now become all things to all men. To many on the left, it surely revealed the defects of markets. To many on the right, however, it did no such thing, because the villains in the piece were the regulators and the central bankers. Banking was one of the most highly regulated of all activities. Partly because of this, everyone involved with banking was insufficiently circumspect.

The widespread belief that the public authorities would not allow any bank to fail encouraged bankers to take excessive risks. And it led bank shareholders and bank customers not to notice or, if they did notice, not to care. Meanwhile, all of this was underwritten by the most lax monetary policy since Adam and Eve.

Who is correct? There clearly were massive errors of public policy. I, among many others, and from some way back, criticised the excessive emphasis on short-term inflation targeting and urged that greater attention be given to asset prices in the setting of interest rates. As for the system of regulation, it is now widely acknowledged, not least by many of the regulators, that it was a sick joke.

Nevertheless, the idea that the crisis revealed nothing ill about financial markets I find incredible. Why were boards so reckless? Why did so few banks and bank managements stand out against the crowd?

It is all very well criticising the system of regulation. But the important question to ask is why the system of regulation was so inept. The fundamental answer is that even the regulators themselves did not believe in what they were doing – and neither did anyone else. They may not have realised it, but they all believed in some version of the efficient markets hypothesis – as well as all the other hogwash that goes with it: liquidity crises are a thing of the past; and macro behaviour is not a subject in itself but is rather just the result of adding up all of the micro elements, which are all appropriately profit-maximising in the usual way – and with all the usual fairytale results.

This crisis arose from many causes but prime among them was that financial market participants were thoroughly human, in the time-honoured way of financial markets. Specifically:

- They were short-sighted;
- They were over-optimistic about sustainable returns; and
- They displayed herd behaviour.

It was these distinctly human failings that were responsible for the huge levels of leverage; and the inflation of bubbles in whole asset classes, notably real estate and its derivatives. Human failings governments can do nothing about; nor should they try. But they can and should make policy recognising them to be true, rather than pushing them to one side and ploughing on as though everyone was like the *homo economicus* of the textbooks.

Nevertheless, the free market fundamentalists have an answer to such misbehaviour, namely, in so far as it exists, to let it bring on financial disaster and then to rely on the concomitant appalling experiences to teach people to behave differently in future. I understand that such a view is termed Austrian. I believe, though, that it should rather be regarded as Martian. People don't take the lessons from events that they necessarily should – and certainly not the lessons that Economics professors think they should. In inter-war Germany, for instance, they drew lessons which had profoundly damaging consequences. It would be wise not to rely on people drawing the right conclusions next time.

Herein lies a boundary of the market: key aspects of money and finance are different. The simple fact is that money is a social phenomenon and monetary stability is a public good. You cannot expect normally self-serving agents to take account of this in their actions but you can expect public agencies to restrain their actions for the public good. The financial system is the economic equivalent of nuclear power. The market cannot be allowed to play out a discovery process with such dangerous material.

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The creative and the distributive

Despite spending much of my career in the City, and despite being an ardent admirer of it in many ways, I am far from alone in wondering about the wider economic benefit of so much of what goes on in modern financial markets. My own catchphrase for describing what Lord Turner dubbed "socially useless activity" is "trading options on the volatility of the Dingbat".

But to describe a financial activity as useless does not go quite far enough. For, on the whole, financial activities are profitable – often hugely so. But if they aren't yielding any benefit overall, then such profit must come at someone else's expense.

This leads to the profoundly unsettling possibility that the financial markets are an extremely effective machine for redistributing wealth within society: to the quick, the clever and the money-obsessive; and from everyone else.

This is one reason why the financialisation of society can go too far, to the point where it can be positively dangerous. I suspect that this point was reached some time ago. Albert Wojnilower, a veteran economic and financial commentator, who is still a legend on Wall Street, put it well:

> *The economic growth of the US depends on a system that rewards long-term risk-taking, hard work and perseverance. Such a system cannot survive the competition for talent and capital that comes from an industry addicted to high-stakes short-term betting on the price of the lottery tickets we call securities.*

Too much liquidity

One of the essential contributions of this huge financial industry is to create liquidity, that is to say, the ability to realise investments at short notice and minimum expense. This it has accomplished brilliantly well – though at a cost, which I will discuss in a moment.

In many ways, liquidity is a trick of the financial system. It is not possible for the resources invested in factories and bridges to be turned overnight into haircuts and holidays. But the financial system enables people to believe that this can happen - and it can actually make it happen for a few individuals at a time.

But whereas liquidity is a boon for financial investors, it is a curse for real investors. What yields results in the world of real investment, and indeed in most human endeavours, is liquidity's polar opposite – commitment; the patience to see something through to its conclusion; to allow it to bear fruit in the fullness of time. Any real investment cannot hope to succeed if it is constantly being torn up by the roots.

Indeed, in some aspects of life, it proves to be useful to dispense with liquidity altogether. We have in English the expression "to burn your boats." It has a rather pejorative meaning. It suggests that you have wilfully thrown away any alternative strategy. But it derives from Alexander the Great's decision, having landed on the shores of Anatolia, to order the burning of his boats so that his men knew that there was no escape from battle, and no way back to their homes in Macedonia, without victory. Alexander discarded liquidity and embraced – indeed enforced – absolute commitment.

In our financial system, we have put enormous resources into the improvement of liquidity yet there is no evidence that the real economy is in any less need of commitment than it was before.

Unsurprisingly, the effect of this emphasis on liquidity has been to spread short-termism. When fund managers are judged on the short-term performance of the shares they have invested in, they will put pressure on company managements accordingly. And those managements will themselves be paying close attention to the short-term performance of the share price. Moreover, as and when a fund manager becomes disillusioned with the shares that he holds, a liquid market gives the opportunity to deal with this problem just by disposing of the shares. A committed owner, by contrast, would be obliged to seek to improve the performance of the firm by active involvement.

The agency problem

At the centre of what went wrong in the financial crisis was the relationship between the boards of banks and the investing institutions which owned shares in the banks. I believe that the malfunctioning of this relationship has come to be the leading market failure, not just in banking, but in modern capitalism itself.

This failure has crept up on us. The classic age of capitalism, which gave rise to both so many of its successes and our theory of how capitalism is meant to work, was dominated by owner-managers. In Britain, it wasn't until the 1880s that joint stock companies became the dominant form of corporate organisation.

Even then, the corporate scene was very different from today, for at first shares in the new joint stock companies were predominantly owned by individuals. The predominance of institutional ownership did not really begin to be established until well after the Second World War. At the war's end, the proportion of shares in America owned by individuals was 90%. In the UK, the percentage was still 60% in 1957. Since then, the proportions have dwindled. In the UK, individual ownership now accounts for only about 15% of shares.

And a further major change has occurred. Whereas at one point it might have been possible to have seen institutional shareholders as mere corporate functionaries - the investing arms of corporate pension funds or insurance companies – now, thanks to the "professionalisation" of fund management, frequently firms of fund managers are themselves quoted on the stock exchange, and hence subject to the same market pressures as the companies that they own. So it is a case of "*Quis custodiet ipsos custodes?*" Who guards the guards?

Consequences of a malfunctioning ownership structure

The failure of this relationship had two key results that are now widely acknowledged:

1) Bankers' pay became excessive and badly structured. Institutional fund managers were largely supine.

2) Given the nature of their business, banks' balance sheets were excessively leveraged, with the result that the institutions' holdings were distinctively shaky. Yet the institutions rarely if ever intervened to try to restrain bank managements. Indeed, there are several examples of their influence being in exactly the opposite direction.

I don't wish to downplay the significance of either of these. On pay, I have long argued that within corporations the market for people does not work very well.

Pay is determined as the result of a sociological and political process. When this process goes badly wrong, a substantial distortion results. But this should not be of concern only for distributional or “fairness” reasons. It also affects market efficiency. For bad pay practices drive out good. How are we to face down aggressive trade union groups, such as the tube-train drivers, if we do not similarly face down the aggressive rent-seeking behaviour of corporate executives?

Yet if the interaction between corporate boards and institutional shareholders can be so harmful in these ways then it can also be harmful in others. I believe it has been extremely harmful in a third way which may well have been even more significant, that is the determination of the level of real investment in the economy. Amidst all the sound and fury about the two effects described above, this third effect has been allowed to slip by largely unnoticed.

For large public companies, how much to invest and on what projects are bureaucratic decisions, about which remarkably little is known by the outside world. We have little basis for judging whether the amount of resources put into making these decisions has increased or decreased over the years – although we can observe the results.

With financial investment, however, we have much more information. Although breaking this down between the parts concerned with financial investment, as distinct from the delivery of other financial services, is nigh-on impossible, we know that in the US and the UK the relative size of the financial sector has risen significantly.

The function of such a sophisticated and expensive financial sector standing between ultimate savers and ultimate investors is partly to provide liquidity for investors. But, in the process of doing this, the purpose is also to improve the quality and quantity of the real investment made by the ultimate investors, thereby improving the returns to savers and society at large.

But is this what has happened? The gap that has opened up between what real investors demand from their investments and what savers receive beggars belief. For a saver today, the choice is between various instruments yielding next to nothing in nominal terms and often producing a negative return in real terms.

Meanwhile, what are the investment criteria employed by companies to judge prospective investments? Companies regularly seek real returns of 10%, and often more, from their investment projects. The reason is supposedly that this reflects their "cost of capital".

The result is that, in the west over the last several years the rate of real investment has been extremely low. In many ways what has come to be described as a savings glut is more appropriately described as an investment dearth. Here we have some of the lowest interest rates and bond yields ever in human history and with the surplus countries of Asia and elsewhere obliged to pour their countless billions back into western markets, and yet we find that investment, real investment, is pitifully low as a share of GDP, even as the financial industry which stands between savers and real investors grows like topsy and pays itself filmstar salaries for the privilege.

Something has gone wrong with the intermediation between ultimate savers and how their money is deployed for real investment. Specifically:

1) The cost of capital should be forward looking. It is the return that investors expect now. But because this is unobservable, in trying to estimate it, the natural response is to look back. When circumstances change, as they surely have today, the result is to ask for too high a return from investment.
2) Corporate executives typically then add a substantial risk premium on top of this cost of capital to reach an investment hurdle rate. And then they demand that projects not merely meet this hurdle rate but beat it by a significant margin – in order to cover risk. Yet the cost of capital is already constructed to take account of risk. So what exactly is the extra risk that corporate executives are building in protection against? It is probably the risk that if the project goes wrong they personally will suffer.
3) The financial services industry increases this tendency by emphasising short-term performance and by adding enormous costs to the process.

I often ask myself what the great Victorian entrepreneurs would have done if they had been confronted by interest rates and bond yields as low as we have today. I think the answer is that they would have rebuilt the world.

Motivation and values

In the boom years, it was possible to see the financial markets as leading the charge for free markets across the economy as a whole. If only the rest of the economy could be like them! Things look rather different now.

It is necessary that many of those who operate in financial markets should be driven purely by a very narrow concept of self-interest. I am certainly not suggesting that the foreign exchange trader should be expected to take into account the full social impact of what he does – even if that were possible. But it is most certainly not true that self-interest is the only human motivation, nor that all other parts of the economic and social system need to be structured and driven the same way as the foreign exchange markets. Indeed, not all parts of the financial markets need to be driven this way.

The key to success for any society lies in achieving the right balance between the pursuit of individual success and pursuit of the common good. Get that balance wrong and economic disaster may ensue.

For all the bluster from free market fundamentalists about the superiority of the competitive individualistic model, what lies right at the heart of the market economy is a collective, namely the firm. Although it is possible to imagine all the parts of Adam Smith's famous pin factory working separately and contracting with each other, it is more likely to be efficient for them to work together in a co-operative, or even a command and control, framework. As Ronald Coase pointed out many years ago, the efficient boundary of the firm is described by the point at which market, exchange relations *between* firms become more efficient than co-operative, or command and control, relations *within* them.

Nor is this only a matter of technical issues. It is also about motivation. Units that work together as a team - rather than each for himself – often work better. This is why businesses spend so much effort and money in trying to foster group morale and team spirit. They aren't being touchy feely for the sake of it; this is good business.

Equally, for the real individuals who drive the capitalist economy, the entrepreneurs, it is seldom the pursuit of money, pure and simple, which motivates them. Usually, it is the burning desire, often felt to the point of fanaticism, to make a product or deliver a service the way they have envisaged, and to see it successful against the competition. Usually, money is just a way of keeping score.

The defenders of naked self-interest as the essential driving force behind economically successful societies often quote a classic passage from Adam Smith's *The Wealth of Nations*:

> *It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity, but to their self-love, and never talk to them of our own necessities, but of their advantage.*

It is less well known, however, that in *The Theory of Moral Sentiments* Smith wrote that although "prudence" was "of all the virtues that which is most helpful to the individual" yet "humanity, justice, generosity, and public spirit are the qualities most useful to others." He also argued for the importance of mutual trust in society and for a mixture of institutions and motivations. Although he trumpeted the virtues of markets, this did not amount even to the advocacy of a wholly free market economy, let alone a market society.

The question I always wanted to ask Milton Friedman, the high priest of free market fundamentalism, is: "Why are you putting in such effort, indeed making it your whole career, to spread the doctrine of competitive free market capitalism? Is it that you feel that you have discovered a gap in the market and believe that you can gain maximum personal financial advantage this way; or do you genuinely believe in this doctrine and, in seeking to convince people of its truth you are acting out of a sense of public service?" I know that the answer is the latter. But then what does this imply about the ubiquity of self-seeking behaviour that Friedman's economic theories presume?

Conclusion

There are five key failings of financial markets:

- As a direct result of people's very humanity, financial markets are prone to bubbles that, when they burst, can endanger the stability of the whole financial system. Only some outside body, acting in the public interest, can fully appreciate these stability risks. It is incumbent upon such a body to make these risks evident in the incentives which face market actors.

- Financial markets engage in too much activity that is purely distributive. This effectively constitutes a tax levied on the rest of us.
- They push up the pay of financial professionals to levels out of all proportion to the value their work contributes to society.
- Consequently, they have a natural tendency to take up too many resources.
- The increased cost of this, allied to the over-emphasis on liquidity, leads to economic short-termism and a diminished rate of real investment.

The above failings imply that the apparent success of financial markets is not a clear index of their contribution to society. Most importantly, the financial markets do not represent some ideal model of markets to which the rest of society should aspire in the purity of its self-seeking behaviour. Societies work best when they achieve the right balance of the competitive and the co-operative urges in humankind. The dog-eat-dog competitive self-seeking world of the foreign exchange market may be the best way of trading foreign exchange. But it is at one extreme of the market spectrum. Neither its strategy, nor its attitudes, nor its motivations should be duplicated elsewhere in the economy.

Indeed, an economy without effective limits to self-seeking behaviour ends up as Upper Volta – without the rockets.

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