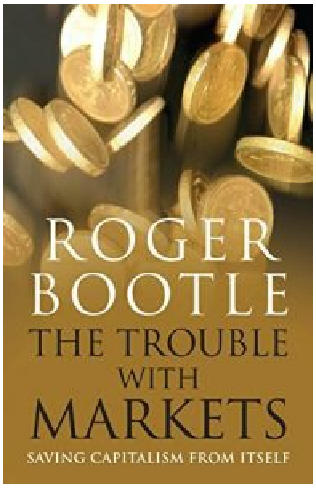

Book The Trouble with Markets

Saving Capitalism from Itself

Roger Bootle
Nicholas Brealey Publishing, 2009
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Recommendation

You could call Roger Bootle a self-hating economist. In this trenchant study, he takes ruthless aim at fellow economists and financial professionals for allowing the financial markets to run amok. Despite his status as a City of London insider, Bootle mauls bankers for collecting overly rich paychecks and bashes investment advisers for their general cluelessness. While Bootle isn't the only observer to arrive at the conclusion that the markets are broken and that free-market ideology is wrong, his sophisticated understanding of finance makes his arguments especially astute. *BooksInShort* recommends this intriguing book to investors and policy makers seeking a thoughtful prescription for Wall Street and the City.

Take-Aways

- The "Great Implosion" of 2007-2009 proved that business as usual is no longer feasible.
- The collapse showed that "Efficient Market Theory" is incorrect and that unfettered capitalism is a recipe for chaos.
- In financial markets, conventional wisdom is like currency, so insiders ignore and belittle those with contrarian views.
- Bankers are paid far more than they're worth.
- Financial markets are a zero-sum game in which one person's gains are another person's losses.
- While investors fear inflation, deflation is the greater threat in the post-Implosion years.
- Massive government stimulus packages are unlikely to spark inflation because public spending won't increase the aggregate demand beyond normal levels.
- Housing prices in the U.S., U.K., France, Spain and Ireland won't return to boom levels until 2020.
- Investors should be wary of brokerage fees, which can decimate their returns.
- As the financial markets recover, regulators must use stricter, more effective oversight.

Summary

The "Great Implosion" Collapses Conventional Wisdom

Financial markets have much to recommend them. Free markets have spread prosperity across the developed world. Yet free markets also are prone to excess. In boom times, the markets' worship of profit at any cost distorts business relationships. The misguided belief that markets offer a model for society at large has affected social policy.

> "The 1930s had seen the Great Depression and the 1970s the Great Inflation. The 1990s had seen the Great Moderation. This was the Great Implosion."

During the boom, people came to accept that markets mitigated risk and created stability. Conventional wisdom held that society should exalt the markets, while governments should simply get out of the way. The "Great Implosion" of 2007-2009 proved the ridiculousness of that belief. Financial engineering made mortgages too readily available and caused housing prices to soar. When the bubble burst, the effects were surreal. Subprime mortgages backed by assets like the putative value of mobile homes in Arkansas felled seemingly safe institutions like Germany's Landesbanks. But subprime loans were only part of the problem; Lehman Brothers collapsed because it took on too much risk and lacked liquidity, among other factors. Worldwide, unchecked risk ran rampant. Any pretensions by regulators that they could ensure economic safety and soundness proved little more than "a sick joke." At the nadir of the collapse, some 60% of the world's stock market wealth disappeared. And the much-maligned government had little choice but to bail out the once-infallible markets.

> "The Great Implosion, and the possible deflationary, or inflationary, dangers yet to come, are the direct result of a profound weakness in our economic system – the trouble with markets."

The Great Implosion showed that the classic version of capitalism is little more than a fairytale. Many villains bear responsibility for this collapse, but one little-noticed group can step into the spotlight: economists who espouse free market theory. Ayn Rand acolyte Alan Greenspan and the late economist Milton Friedman were among the most prominent proponents of the ideas that markets are infallibly efficient, investors always behave rationally and bubbles are impossible. In this context, regulation was not just misguided but foolish. Supporters of laissez-faire economics considered Keynesian ideas to be simple-minded and archaic. Free-market ideology took root in academia, then spread throughout boardrooms. Questioning the "Efficient-markets Theory" meant running afoul of "the dictatorship of the professoriat" that said free markets are the natural order of things.

> "From the events of 2007-2009, it seems plain that the financial markets have not worked to promote the common weal, and they have caused, rather than absorbed, chaos and instability."

The age of pure capitalism lasted less than a century, from the mid-1800s until World War I. At that time, taxes were low, monetary policy was nonexistent and regulations were light. Yet during this apparent Golden Age, growth in the U.S. and Europe lagged the growth they later experienced, when taxation and central banking helped manage capitalism. Blinded by faith in free-market thinking, this dictatorship continues to resist constructive, meaningful changes to capitalism. It still espouses the now-shaky tenet that society should be structured like free markets. Free-marketeers ignore many of the downsides of unfettered capitalism. For instance, truly free markets tend to be uncompetitive and to allow dominant players to have monopolies and charge whatever they want. Free-market theory ignores the fact that only government intervention can assure the effective delivery of services such as rail lines and water utilities.

Six Things that Are Wrong with Markets

Financial markets, for all their attributes, are prone to six shortcomings:

1. **Conventional wisdom rules** – Human nature programs each person to think just like everyone else. Contrarians break the rules, but any executive or analyst who disagrees with common wisdom is lucky to remain employed, let alone respected. A financial executive who pronounced in 2005 that the economy was in a bubble would probably have been fired. Economic groupthink means that expert predictions "tend to huddle round the consensus like tramps around a fire." Thus, markets are susceptible to bubbles.
2. **Social benefit is an afterthought** – Financial markets by definition are "zero-sum games," where one person's gain is another's loss. Contrast the "distributive" nature of financial markets with the "creative" activity elsewhere in the economy. Subsistence workers who fish or farm create something of value at work each day, but even the most profitable hedge fund or investment bank adds little to society's greater good.
3. **Bankers make too much money** – Top financial professionals earn much more than top achievers in medicine, law, accounting and other professions. Bankers' paychecks are out of proportion to their contribution to society. Take Dick Grasso. His compensation as head of the New York Stock Exchange from 1995 to 2003 included a pension payout of $139.5 million. The exchange also promised him a $48 million bonus, but the uproar that ensued when his pay package became public forced him to forego that payday. Some hedge fund managers collect more; John Paulson received $1.9 billion in 2008. These examples are egregious, but, in general, financial executives are significantly overpaid.
4. **Finance drains too many resources** – Big Wall Street and City of London paychecks demonstrate that the markets use "enormous resources of effort and talent" in a zero-sum game. Financial markets are like racetracks and casinos: One person's gain is another's loss. Yet in the markets, the winners' paydays are large enough to attract lots of players, though they know losses are just as likely as gains.
5. **Fraud is a fact of life** – Given the intangible end product, the potential billion dollar paydays and the complexity of financial instruments, markets lend themselves to fraud and fraudsters. Bernie Madoff, whose $50 billion Ponzi scheme exposed weaknesses in the financial system, is just one example.
6. **Financial markets distort the rest of the economy** – Citigroup's CEO Chuck Prince left in 2007 with a $68 million golden parachute; Merrill Lynch's former head got a $161 million send-off. Other corporate heads see these spectacular paydays and expect similar sums, hence Lawrence Ellison's $556 million Oracle paycheck and the $65 million that Monsanto, an agricultural company, paid its former head. Led by financial market CEOs, executive pay has skyrocketed to many times the typical worker's compensation.

Deflation, Not Inflation, Is the Real Threat

As central banks fire up their printing presses, many observers worry about inflation. In fact, deflation is the more pressing menace. The world is likely to remain in a low-inflation era for years to come. For 30 years, central bankers in Europe and the U.S. have made low inflation their primary goal; stopping bubbles was only a secondary concern. Despite the Great Implosion, investors fear inflation and central bankers remain hardwired to resist it. A meteoric rise in public spending and borrowing typically portends inflation. After all, the government stimulus is designed to increase aggregate demand. But if government bailouts simply return aggregate demand to normal levels, the inflationary effect is muted. And if spending fails to revert to normal levels despite government bailouts, the overall effect is deflationary.

> "I have been troubled by the increasing dominance of markets over business relationships, liquidity over commitment, and greed over public purpose."

Oil and commodity prices rose in 2008, causing many to fear a return of the 1970's oil-led inflation. Yet even as oil's price doubled in a year, and agricultural and metal commodities' prices doubled in two years, inflation remained a modest 3%, partly because oil's significance in the economy diminished. Oil spending as a percentage of the gross domestic product has halved since the 1970s. Those who fear that increasing oil prices would spark inflation are engaging in the classic mistake of trying to find the future in a rearview mirror. Conventional wisdom holds that if deflation were a real threat, it would have set in soon after the Great Implosion. But history shows that deflation can take a while to emerge. Japan's economy entered recession in 1991, but deflation emerged only three years later and became a serious threat in six years.

> "What was true for Japan in the 1990s could easily apply to most of the rest of us in the decade ahead."

There is some good news: "The Great Implosion was a purely financial event. No productive assets were destroyed; no people were killed; no knowledge was lost." Yet the real fallout from the Great Implosion all but guarantees a lost decade (or more) for the world's housing prices. Optimists think residential prices will simply bounce back to their 2005 levels in a few years. This is a foolish assumption. For starters, the post-Implosion years promise a long stretch of weak labor markets and tight mortgage markets. Housing prices rose to ridiculous heights during the boom. No reason exists to believe they'll return to those levels before 2020 in the U.S., the U.K., France, Spain and Ireland. Prices might not rebound in Holland until 2030. If deflation occurs, prices for houses would be further depressed, because real interest rates would rise.

> "The people employed in financial services are, by and large, paid far too much."

Given such dour news, what's an investor to do? For starters, be wary of financial advisers. Too many are incompetent. They believe they can time the market or pick stocks. They dote on star fund managers. They think their success comes from their expertise, rather than their habit of combining luck with too much risk. And they still believe excessive trading is a moneymaker.

> "You have to realize that if I had been paid 50% more, I would not have done it better. If I had been paid 50% less, I would not have done it worse."
> (Shell's ex-CEO, Jeroen van der Veer, of his €10.3 million 2008 salary)

To protect yourself when investing, heed six get-rich-slowly rules:

1. **Don't be overly pessimistic** – A recovery presents opportunities, as shown by the rebound in stocks in 2009. Yet be warned that a strong recovery could kill bond returns.
2. **But don't be too optimistic, either** – As the recovery progresses, the strong returns enjoyed early in the rebound will become more modest.
3. **Take your time** – Excessive trading does little to increase returns but it does boost costs.
4. **Don't overpay your broker** – Commissions and fees can destroy your returns. If Warren Buffett charged normal hedge fund costs, a 2% yearly fee plus 20% of gains, Berkshire Hathaway investors' $62 billion gains over the past 42 years would have been $5 billion.
5. **Watch out for "cascading structures"** – If your money is funneled from one fund to a series of other funds, you'll rack up excessive fees.
6. **If you don't understand it, don't invest in it** – And if your financial adviser doesn't understand it, don't invest in it.

Reforming Markets

Guarding against future implosions requires more effective banking regulation. Hedge funds and private equity funds played a tangential role in the crash, but banks were the primary players. Stricter, more competent banking regulation is clearly in order. The public will accept nothing less, and the systemic significance of banks dictates it. Policy makers should look at:

- **Capital requirements** – Bankers often underestimate the amount of capital they need. Regulators must impose cautious capital requirements that would allow banks to survive downturns. These rules should account for all bank liabilities. Considering that government support saved the banking industry from collapse, it's only fair for the government to impose tougher capital requirements. These rules should be flexible, so that capital requirements rise as bank balances expand and fall as balances shrink. This would avoid lending gridlock in a weak economy.
- **Liquidity** – Just as bankers tend to hold too little capital, they also prefer to minimize liquid assets to avoid low returns. The Great Implosion showed that liquidity is precious in a crash. Banks must be required to hold government debt and other easily sold assets.
- **Compensation** – To tie bankers' compensation to their performance, pay their bonuses in stock, not cash. Let individual bankers sell their stock only after a set period of time and take the stock back if the performance that earned the bonus proves illusory.
- **Derivatives** – Regulators must rein in these arcane instruments, which played a central role in the Great Implosion. Some derivatives should be restricted, if not barred altogether. Both Warren Buffett and George Soros have criticized them as dangerous. Soros has argued also for banning credit default swaps.
- Regulators should reconsider the crucial divide between commercial banking and investment banking. For decades, the U.S. separated banks into these two categories. Commercial banks engaged in low-risk activities: holding deposits, making loans and processing payments. Investment banks specialized in the sexier business of creating and brokering investments, and advising corporations and investors. Then, the 1999 repeal of the Glass-Steagall Act lowered the regulatory barriers between the two types of banks. Now, the Great Implosion demonstrates how fraught investment banking can be. Lehman Brothers' meltdown illustrated the need for firewalls between commercial and investment banks. Perhaps a three-tiered banking system is the answer. The first tier would be plain banks offering only basic services and holding only certain types of assets. In the second tier, commercial banks could offer a wider array of services and hold a broader range of assets. Investment banks would sit in the third tier. Such a system would make it absolutely clear which types of banks taxpayer bailouts can save and which types they can't.

About the Author

Roger Bootle is one of the City of London's top economists. His other books include *The Death of Inflation* and *Money for Nothing*.