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Social Market Foundation

THE MARKET ECONOMY

Twenty-one years after the fall of the Berlin Wall

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THE SOCIAL MARKET FOUNDATION

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ABOUT THE AUTHOR

John Kay is one of Britain's leading economists. His interests focus on the relationships between economics and business. His career has spanned academic work and think tanks, business schools, company directorships, consultancies and investment companies.

John's main current interest is in writing and he publishes a weekly column in the *Financial Times*. His latest book, *Obliquity – how our goals are best pursued indirectly* – has just been published by Profile at the end of March 2010. *The Long and the Short of It – finance and investment for normally intelligent people who are not in the industry* was published in January 2009 and his major work on the operation of market economies, *The Truth about Markets*, appeared in 2003 (a US version, *Culture and Prosperity*, was published in 2004). Two collections of his FT columns are available – *Everlasting Light Bulbs* covers economic subjects, while *The Hare and the Tortoise* has a business focus.

INTRODUCTION

The triumph of the market system over the planned economy was probably the defining economic event of our lifetime, its symbol the collapse of the Berlin Wall in 1989. In the advanced economies of the West, increased government intervention, more or less unchecked through the twentieth century, was halted in 1980 by the ideologically conservative governments of Reagan and Thatcher. Their policy innovations were widely if often reluctantly imitated elsewhere. In Asia, China and India followed some of their smaller neighbours into the market economy and the global trading system.

These developments provoked the hubris famously framed as *The End of History* by Francis Fukuyama. Fukuyama argued that a combination of liberal democracy and lightly regulated capitalism was now an inevitable form of political and economic organisation. If one country was the standard bearer for that new vision of the twenty-first century, it was the United States: if one industry was the standard bearer for that new view of business, it was the financial services industry.

Today, Fukuyama's assertion lacks conviction. If there were defining events in that revisionism, analogous to the breaching of the Berlin Wall, this would be – for politics – the collapse of the Twin Towers and its bungled consequences, and for economics the bankruptcy of Lehman seven years later. There is, evidently, no end of history – as, indeed, Fukuyama today readily acknowledges.

It is time for a more nuanced view of the nature of markets and the merits of the market economy. The critique of the market economy today is, as it has been since the end of socialism, largely incoherent – an incoherence nicely captured in the demonstrator's slogan 'capitalism should be replaced by something nicer'.

But the defence of the market economy is often little more coherent. Supporters often do no more than point at the wealth of countries that have adopted the market economy – and to their own personal wealth. That isn't necessarily a bad argument. But it looks tarnished today. When those people who are the largest beneficiaries in terms of their own personal wealth have done substantial damage to the wealth of other people, that argument becomes more difficult to sustain.

I am going to argue that there are three elements to the triumph of the market economy. The first I will describe under the heading of 'prices as signals', the price mechanism is generally a better guide to resource allocation than central planning. The second element is 'markets as a process of discovery' – the chaotic process of experimentation through which a market

economy adapts to change. The third heading is 'diffusion of political and economic power'. The economic point here is that prosperity and growth require that entrepreneurial energy should be focussed on the creation of wealth, rather than the appropriation of the wealth of other people.

In what we teach, in what we say, in our economic research and most importantly in the policies we adopt – we put too much emphasis on the first of these elements – prices as signals to guide resource allocation – at the expense of the, possibly more important, second and third elements – markets as process of discovery, markets as mechanism for the diffusion of political and economic power.

The result is that both supporters and critics of the market economy have often confused policies that are pro-business with policies that are pro-market. That confusion has both undermined the social and political legitimacy of the market economy, and led to serious policy errors that follow from a mistaken, or at least incomplete, understanding of how a market economy works.

DISCIPLINED PLURALISM

One central theme runs through all three strands of argument, the theme of disciplined pluralism. When prices act as signals decentralised enterprises and decentralised information are brought together to create a coherent result. Markets as a process of discovery are based on freedom to experiment, combined with discipline: unsuccessful experiments acknowledged and terminated. The use of markets as a means of decentralising power determines the shape of the areas where politics and economics meet.

If the essence of markets is their pluralist character, then there is an inevitable association between the successful market economy and other components of an open society – freedom of expression, and democratic institutions. While it is evident that authoritarian regimes have operated market economies, at least for a bit, the combination is probably not sustainable in the long run. There is an important corollary: political freedom is jeopardised by excessive concentrations of economic power. Even if Fukuyama was wrong in his assertion of inevitability, the identification of an elective affinity between liberal democracy and lightly regulated capitalism was entirely appropriate.

'THE MODEL' AS ECONOMIC THEORY

The model of 'prices as signals' describes how self-interested agents – individuals or firms – might, through independent decisions, make consistent and efficient choices about how to organise production and distribution and the allocation of capital, labour and other resources. In a loose formulation, this idea has been around since the beginnings of economics. Many people interpret in this way Adam Smith's famous remark about 'the invisible hand', and his observation that it was not the benevolence of the baker, but his self-love, that furnished our table. In an astonishing demonstration of the power of spontaneous order, decentralised markets manage the process of coordinating complex production systems better than centralised direction.

Although it appears to be an empirical fact that markets achieve such coordination, economists did not offer a comprehensive explanation of why until the 1950s. The explanation they gave then proved both that a competitive equilibrium might exist, and that, if it did exist, it could be efficient. That general equilibrium model (concisely 'the model') proved largely influential, both in shaping the research agenda of the economic profession and in providing an intellectual basis for economic policy among people who may know nothing of the underlying arguments.

The implication is that profitable transactions are socially beneficial: indeed that their social benefit is demonstrated by their profitability. A corollary is of the 'market failure doctrine', which is central today in economic policy in Britain and Brussels: intervention in markets is justifiable only in the light of a narrowly defined list of market failures, which is generated by deviations between the world and the assumptions of the model.

The model also provides a rationale for a certain kind of market fundamentalism. Not only is interference with market forces usually inappropriate, but market outcomes are efficient, even morally justifiable, simply by virtue of being market outcomes. Not only are markets good, but more markets are better than fewer markets. The emergence of new markets for financial products, for example, is presumptively beneficial.

Among economists, the popularity of this approach is in large part the result of physics envy: the general equilibrium model provides a universal explanation of economic affairs which resembles in many ways the equilibrium models that have proved so powerful in the natural sciences. Rigour has become the measure of the quality of a theoretical economic argument, where rigour means the logical consistency which readily finds mathematical expression.

THE OMISSION OF SOCIETY

Among practical people, the simple message that government should go away and leave business alone has wide appeal to business: and the simple message that greed can serve a constructive social role also has wide appeal to greedy people. The claim that profitability demonstrates, is even the measure of, public benefit relieves people of any worries they might have harboured about the utility of their profitable activities. These worries are not common, but one does occasionally encounter them.

These messages, however, angrily resisted by the broader intellectual community, which finds both the assumed motivation and the conclusions unappealing. These messages are also resistible to the population at large, which does not run business, benefits only indirectly from the activities of business, and is not necessarily enamoured of greed. The political world today is one in which both parties and voters acknowledge the empirical success of the market, but dislike almost every aspect of it. 'The market' and 'market forces' are the source of our prosperity, but are also terms of abuse. We have succeeded in providing a description of how markets work that is at once repulsive and substantially false.

The model probably contributes something to our understanding of how markets work. But that contribution is largely misunderstood and grossly over-emphasised. One problem is that there is no real acknowledgement of uncertainty in the model, or, to be more precise, uncertainty is acknowledged only in essentially formal ways. This omission is of fundamental importance when the model is used to describe financial markets, in which trading in risk is the essence of the transaction. In these markets, the means of incorporating uncertainty into the model requires, in effect, that there is some true underlying value of an asset, which is independent of beliefs about that value, and that market transactions involve a process of convergence towards the true value. Experience has demonstrated clearly that this claim is a hopelessly inadequate account of market behaviour.

A larger problem is that the model fails to recognise the extent to which a functioning market economy is embedded in the society of which it forms part. Property rights are not a fact, but a social construction: and there are many alternative ways in which these rights could be constructed. In a modern economy characterised by complex products, sellers generally know more about what they are selling than buyers about what they are buying. Trust relationships and supplier reputation are the market's mechanisms for handling this problem.

These are not theoretical quibbles: they are problems at the centre of recent events. There were always two broad accounts of the reasons for the explosion of trade in complex structured products in the financial sector over the last decade. In one, these developments

represented a more sophisticated form of risk sharing and risk transfer, an exemplification of the benefit of the creation of new markets. In another, the trade was mainly driven by information asymmetry: the products were bought by people who overestimated their value.

The consequences of these two explanations are very different. When complex products bring about more efficient risk allocation, the private profitability is mirrored by public benefits in the form of lower costs of risk. When such products are bought by people who do not understand them, private profitability overall is illusory and disappears when asset prices ultimately revert to the underlying value of the asset.

In retrospect, it is evident that this latter explanation is closer to the truth. Trade was driven by differences of information and interpretation and the profits from it evaporated when these errors were revealed. That is why Adair Turner is right when he invites us to query the social value of current trading values, and when he suggests that its extent goes far beyond what is needed to serve its economic function.

MARKETS EXPLORE, THEY DON'T PREDICT

There is a good deal more to the power of markets than the description of prices as signals contains. The world is uncertain: not just risky, but uncertain, in the sense used by Keynes and Knight. Not only do we not know which future outcomes will happen: we are unable to specify at all fully what these possible outcomes will be. If we could predict or anticipate the invention of the wheel, we would have already invented it. Market economies do not predict the future, they explore it. That is a fundamental – perhaps the fundamental – difference between a planned and a market economy.

Hayek continues to be the most eloquent expositor of the concept of the market as a process of discovery. His argument was *a priori* , but vindicated by the failures of the eastern bloc in the post-war era. These planned economies failed in the development, not just of consumer products, but of business methods. Their technological development was disappointing in almost all not related to military hardware. Centralised systems experiment too little. They find reasons why new proposals will fail – and mostly they are right in finding reasons why they will fail. Most experiments do fail. Market economies thrive on a continued supply of unreasonable optimism. And when, occasionally, the experiments of entrepreneurs succeed, they are quickly imitated. It is a sad fact of the market economy that even for innovations that are commercially successful, few are commercially successful for the innovator.

If market economies are better than planned societies at the origination and diffusion of new ideas, they are also better at disposing of failed ideas. Honest feedback is not welcome in large bureaucracies. In authoritarian regimes, such feedback can be fatal to the person who delivers it. In less draconian contexts, unwanted messages can be fatal to careers. And when I describe large bureaucracies here, I refer just as much about large private bureaucracies as large public ones. Disruptive innovations most often come to market through new entrants – from Google, EasyJet, Amazon. Incumbents have good reasons to be suspicious of novelty and protective of their established markets and activities.

The health of the market economy depends, therefore, on constant replenishment of the business sector by new entry. If, as planner or sponsoring department, you had been planning the future of the computer industry in the 1970s, would you have asked Bill Gates and Paul Allen?, If, as planner or sponsoring department, you had been planning the future of aviation in the 1980s, would you have asked Stelios Haji-Ioannou? If, as planner or sponsoring department, you had been planning the future of retailing in the 1990s would you have asked Jeff Bezos? Of course not: whether you were the politburo or permanent secretary you would have asked men in suits like yourself.

Watching the impact of electronics and the internet on children and grandchildren, makers of business and public policy have at least understood these issues. Committees of the middle-aged Twitter about technology like embarrassing adults trying to have fun at the teenagers' disco. But, like those adults at the party, we are not really serious. Whether planners or governments of a market economy, we see industries through the eyes of established firms in the industry. And in doing so miss the pluralism that is the market economy's central dynamic.

MARKETS RESTRAIN CONCENTRATIONS OF POWER

That leads directly to the third group of reasons for the superior performance of market economies. If I were to offer a one sentence description of why some countries are poor and others rich, it would be that the politics and economics of poor countries are dominated by rent-seeking and the politics and economics of rich countries are not. Rent seeking is the process by which the ambitious find it more rewarding to batten on the wealth created by other people than to create it themselves.

Rent seeking takes, and has taken, many forms – castles on the Rhine, the Wars of the Roses; ten per cent on arms sales, or seven per cent on new issues: awarding yourself control over former state assets, stealing the revenues from your country's resources deposits, seeking protection from foreign competition, blocking market access by new entrants; winning

sinecures or overpaid positions by ingratiating oneself with public servants or corporate employees. The mechanisms of rent-seeking range from the application of armed force to victory in democratic election; the methods pursued range from lobbying on Capitol Hill and in the restaurants of Brussels, through access to the King or the Chief Executive.

But while rent seeking is ineradicable, we can have more of it, or less. Politics everywhere used to be dominated by rent seeking; factions would battle for control of the state and when they won such control would use it to steal as much as they could get their hands on. In much of the world, it is like that still. 'It's Our Turn to Eat' is the stomach churning title of one fascinating recent book about the corrupt – and moderately - democratic politics of modern Kenya. We have come to recognise the resource curse – wealth from national resources does more harm than good in many countries because of the rent-seeking it attracts – and foreign aid may have some of the same characteristics. But in Western Europe, at least, corrupt politics has ceased to be an avenue for rent-seeking.

The ability of a political/economic system to resist rent seeking depends on the degree of economic decentralisation. Individuals will try to get their hands on the rents which concentrations of power attract whether they are found in the public sector, in private businesses, or in groups of private business. The wider the extent of the opportunities this created, the greater the tendency for individuals to gain wealth and influence for themselves by attaching themselves to power rather than exploiting their own individual talents and by developing distinctive capabilities in their own economic activities.

There is a strong tendency for private concentration of economic power to be self-reinforcing. This problem was widely recognised in America's 'gilded age' at the end of the nineteenth century. The well-founded fear was that the new mega-rich – the Rockefellers, the Carnegies, the Vanderbilts – would use their wealth to enhance their political influence and hence enhance their economic power still further, subverting both the market economy and the democratic process. These concerns were the origin of anti-trust legislation, a point today often forgotten. The process that concerned Americans then is the problem we see in Russia – and elsewhere in the world – today.

The ability of a market economy to channel the desire for acquisition into channels that create wealth rather than extract it, depends on measures both to prevent the concentration of economic power and to limit the terms of access to such concentration. These are constraints on the economic power of the state: constraint on the concentration of economic power in large businesses: constant vigilance at the boundaries between the state and business: and a mixture of external supervision and internal restraint which prevents individuals who pull levers of economic power from using these levers to direct renting to themselves.

THE CURRENT POLITICS OF THE MARKETPLACE

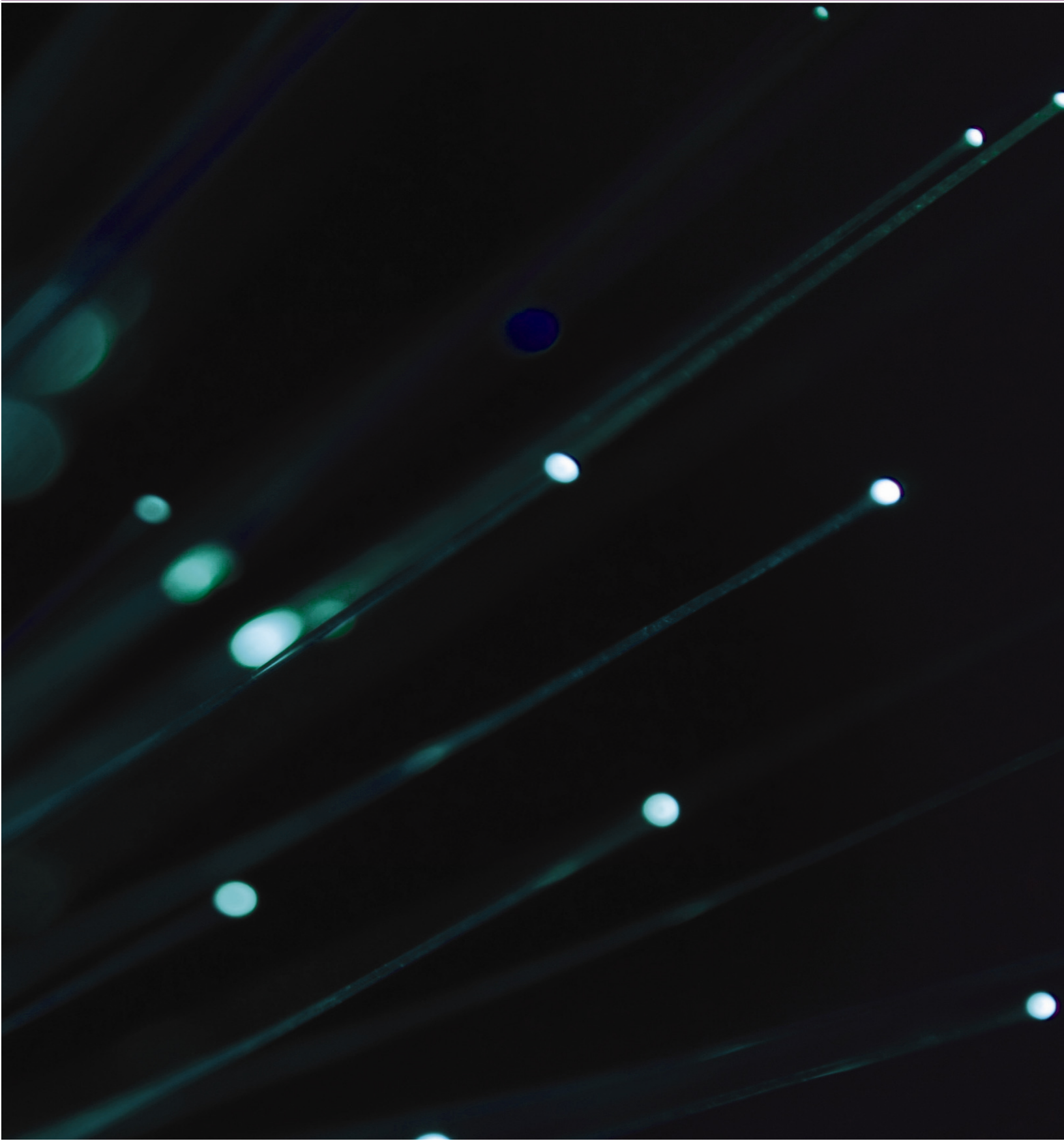
Because the last decades have confused a pro-business stance with a pro-market stance, we have emphasised some of these conditions at the expense of others. Western – and especially Anglo-Saxon societies - have constrained the economic role of the state. These measures have reduced the scope of one focus of rent-seeking, that by organised groups of public employees. A substantial element of such rent-seeking remains in areas that remain inescapably within the public sector.

But the larger issue is the concentration of power of large business, or groups of large businesses, and the use of the leverage that power gives to strengthen established positions and enhance that economic and political power still further. The topical – and most important example is the financial services industry.

The problems of that industry are too familiar to require much elaboration. The governments of the world have pumped unbelievably large amounts of money into the system. Directly through recapitalisation and purchase or underwriting of so-called toxic assets: more substantially if indirectly through wide-ranging implicit and explicit guarantees of liabilities. Even if these explicit guarantees expire, a 'too big to fail' doctrine has been established which means that implicit guarantees persist indefinitely. The criteria needed to qualify for these guarantees are, essentially, that the firm is large, well established, and unsuccessful commercially. It is difficult to think of a policy more directly contradictory to the dynamic of the market economy.

Behind that lies the central fact of modern political life – that the financial services industry, and particularly its investment banking arm, has become the most powerful political force in Britain and the United States. The reasons are clear enough: the rents available in the financial sector have attracted much of the ablest talent in the two countries and created a generation of financiers who are both smart and wealthy.

Our policies err focussing on the first pillar – prices as signals. They underestimate the strength of markets as a process of discovery, and the vital political and economic role of markets in restraining concentrations of economic power. Markets are not a well oiled physical machine: they are a constantly changing, adaptive biological system. Pluralism is their motive force, their essence chaotic, their development inherently uncertain. If we could predict the evolution of markets, we would not need markets in the first place.



In the second of a series of essays to mark the 21st anniversary of the Social Market Foundation, John Kay looks back at the triumph of the market economy since the fall of the Berlin Wall. Kay attributes this triumph to the role of the price mechanism, 'markets as a process of discovery', and the diffusion of political and economic power with which markets are associated.

Kay argues that too much emphasis has been placed on the first of these elements with the result that both supporters and critics of the market economy have often confused policies that are pro-business with policies that are pro-market. That confusion has both undermined the social and political legitimacy of the market economy, and led to serious policy errors that follow from a mistaken and incomplete understanding of how a market economy works.

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