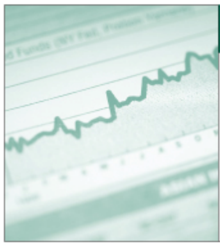

Insights on...

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YOUR ALTERNATIVE TO THE ECONSENSUS

All We Are Sayin' Is Give Free Markets a Chance

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Given the economic and financial market "challenges" of the past year, some pundits and politicians are concluding that these challenges are the result of the failure of free markets. I would respond that we cannot determine whether free markets have failed unless we have *had* free markets. I do not think we have.

One of the most important markets in an economy is the market for credit. We do not have free markets in credit in the U.S. or anywhere else that I know of. The price of short-term credit is fixed by central banks. It would only be by accident that a central bank would fix the price of short-term credit at a level that would obtain if a free market in credit were allowed. It is beyond me why most economists would view with horror some government agency fixing the price of say, copper, but view the fixing of the price of short-term credit by central banks as nothing to be alarmed at.

There is at least one group of economists that realizes the economic mischief *caused* by central banks – economists who belong to the Austrian school. (For information about Austrian economics, click on this link to the Ludwig von Mises Institute, http://mises.org/ or this link to Leithner and Company, a private investment firm located not in Austria, but in Australia, http://www.leithner.com.au/. I am not endorsing the political views or the investment advice of either of these entities, but I am endorsing their approach to economic analysis.) By holding a key short-term interest rate below or above the unobservable free-market equilibrium level of this rate, the central bank creates credit, much as does a counterfeiter, or destroys credit, which leads to distortions in the economy and financial markets. Typically, the central bank starts out by preventing the short term interest rate from rising to its equilibrium level. This leads to central bank credit creation. In turn, this encourages investments which are profitable only so long as the central bank prevents the interest rate structure from rising to its free-market equilibrium level. All of this manifests itself in the form of higher prices – higher prices of goods/services and/or the higher prices of assets. At some point, the central bank can no longer tolerate what it has wrought, and raises the level of the short-term interest rate above its free-market equilibrium. This precipitates a decline in asset prices, an economic recession and, later, a decline in goods/services prices (or a slowing in their rate of increase). It was recognized by Austrian economists during the sharp run-up in U.S. stock prices in the late 1990s and the subsequent housing boom that the Greenspan-led Fed was especially egregious in keeping the federal funds rate far below its equilibrium level too long. We are now experiencing the economic and financial market fallout from Greenspan's interference with the free market.

In free markets, risk-takers get rewarded if they are correct in the risks they take, but are punished if they are incorrect. Here, too, Greenspan intervened in the free markets. When it turned out some risk-takers had erred, Greenspan cushioned their losses by slashing the federal funds rate and creating central bank (counterfeit) credit. This central bank intervention in free markets encouraged risk-takers to take on even more risk inasmuch as their upside rewards would seem to be unlimited but their downside punishment would be limited.

The lack of a free market in credit-risk assessment also played a role in today's economic and financial market turmoil. According to a *Business Week* April 8, 2002 article (http://www.businessweek.com/magazine/content/02_14/b3777054.htm), "In 1936, the Comptroller of the Currency decreed that banks could hold only investment-grade securities. Ever since, regulators have been delegating risk assessment to the rating agencies. A rising tide of regulatory requirements has forced banks, insurers, mutual funds, and other financial institutions to pay attention to bond ratings. The upshot: Companies, municipalities, and governments that want to tap the U.S. capital markets need credit ratings." So, fiduciary institutions are required by law to invest only in instruments stamped "investment-grade" by ratings agencies. This does not mean that fiduciary institutions cannot do their own credit analysis, but why incur the extra cost when the regulators implicitly are endorsing the credit analysis being done by the credit rating agencies.

Is there a free market in regulator "approved" credit rating agencies? The *Business Week* article continues, "To prevent unscrupulous outfits from selling triple-A ratings to the highest bidders, the Securities & Exchange Commission in 1975 designated the ratings of Moody's, S&P, and Fitch as the only ones that may be used to satisfy creditworthiness regulations. The SEC later anointed four more as Nationally Recognized Statistical Ratings Organizations. Mergers have left just the original three." So, no, there is not a free market in approved credit rating agencies.

Prior to the 1970s, credit rating agencies were compensated by the investor in securities, not the issuer, as is the case now. There is an obvious conflict of interest when the issuer compensates the rating agency. Of course, investors are not precluded from doing its own credit analysis or paying another firm for its analysis. I suspect that a free-market response to the erroneous credit analysis performed by the Big Three rating agencies will lead to more independent credit analysis on the part of investors going forward. But prior to the recent episode, regulation did not encourage such independent analysis. Had the regulatory-anointed Big Three not slapped "investment-grade" on so much dubious product in this past credit cycle, there would have been less demand for the product. With less demand, there would have been less product originated and fewer credit problems to deal with today.

Lastly, at least for this essay, I come to Fannie and Freddie, hybrid financial institutions. They are hybrid institutions in that they have a federal government mandate, up until recently, their debt had an implicit guarantee by the federal government (now it is explicit given that they can go the Fed's discount window) and they are a publicly-owned company traded on the New York Stock Exchange. Without their debt being implicitly guaranteed by the federal government, Fannie and Freddie would not have been able to have consistently fund themselves at interest rates below other financial institutions. Given that Fannie and Freddie are publicly-traded companies, their shareholders, quite naturally, wanted their managements to maximize shareholder value. This meant that Fannie and Freddie were incented to take on extreme leverage – because they could as a result of their debt being implicitly guaranteed. If Fannie and Freddie had not had their hybrid status, they could not have taken on as much leverage as they did. This means that they probably would not have needed the lifeline that has been thrown them by the Fed and, soon, the Treasury. And this means that taxpayers would not now be picking up the tab for this lifeline (see July 16, 2008 Daily Global Economic Commentary, "Why Buy Treasuries When You Will Be Able to Buy Fed/Treasury-Guaranteed GSEs?"**)**.

So, we do not know definitively whether free markets have failed because we have not had free markets. And given that the response to recent events is and will be increased regulation and continued Federal Reserve intervention in the market for credit, we will be moving even further away from free markets.

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy