
The Idle Speculator™

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On Distortions Public and Private

Since credit markets began to seize up in 2007, columnist Martin Wolf of the Financial Times has pulled no punches in assessing the causative role that the banking industry continues to play in financial crises, pointing to the conflicts of interest and distorted financial incentives that exist in the industry. As always, Wolf's main objective is to support continued growth of the global economy. And as usual, it's an interesting column, and he finishes by pointing to a possible solution. However, we argue that in attacking the private incentives and disincentives at work, he leaves out the equally important ones that emanate from policymakers in the public sector.

Like Bankers, Hate Banks

Wolf begins his column by saying, "I may like many bankers, but I rather dislike banks. I recognise their necessity, but fear their irresponsibility." He goes on:

The world has witnessed well over 100 significant banking crises over the past three decades. The authorities have even had to rescue important parts of the US financial system – on most counts, the world's most sophisticated – four times during the same period: from the developing country debt and "savings and loan" crises of the 1980s to the commercial property crisis of the early 1990s and now the subprime and securitised-credit crisis of 2007-08. No industry has a comparable talent for privatising gains and socialising losses.

By "privatising gains and socialising losses", Wolf means that industry insiders reap most of the financial windfall when things are going well, while pushing much of the damage onto the public sector when things go badly (for example, through the expenses borne by taxpayers for an industry specific bailout). Of course, the ultimate cost borne by taxpayers has a great deal to do with how well designed and executed a government intervention is, which leads us to think that the industry actually tries to socialize *risk* rather than losses per se. Returning to Wolf's argument, he outlines why he believes the industry is so effective at socializing its losses:

...the conflicts of interest created by large financial institutions are far harder to manage than in any other industry. That is so for three fundamental reasons: first, these are virtually the only businesses able to devastate entire economies; second, in no other industry is uncertainty so pervasive; and, finally, in no other industry is it as hard for outsiders to judge the quality of decision-making, at least in the short run...

Because finance involves leverage, it certainly is capable of causing economic devastation. The tradeoff is that it more often creates the potential for significantly higher rates of growth and development. Given leverage and reliance upon expected outcomes of an uncertain future, uncertainty is pervasive and inevitable. As for the black box effect, I don't know that finance is

any more difficult to comprehend than nuclear power production or space travel. But to be fair, finance is far more pervasive than either.

Finally, Wolf ties these concerns to his passion for global economic integration and growth:

I now fear that the combination of the fragility of the financial system with the huge rewards it generates for insiders will destroy something even more important – the political legitimacy of the market economy itself – across the globe. So it is time to start thinking radical thoughts about how to fix the problems.

Wolf goes on to voice his support for a proposal by IMF economist Raghuram Rajan for regulating incentive structures in the industry through the use of longer term restricted stock awards. Fair enough. As Rajan points out, there are plenty of bogus claims to alpha production in the industry, and those claims sometimes lead to compensation that is way out of line with actual value creation. And if more people understood the asymmetric risks assumed (enjoyed) by most financial professionals, the incentive structure of the industry would certainly change. But whether the incentive structure of the industry is best addressed through public or private action is still very much open to debate.

Disincentives and Distortions Come in Many Flavors

While Wolf does a fine job outlining the disincentives and distortions in the banking industry, he left another important set of factors out entirely: the shifting incentives created by public, or in the case of some central banks, "quasi-public" institutions.

Wolf referred to four U.S. financial crises: the emerging market debt crisis, the Savings & Loan crisis, the commercial property crisis, and the current residential property crisis. All four of these arose from more than just industry conflicts of interest and greed. They also arose from policy errors, including fiscal and regulatory measures that distorted or disincentivized investment, and monetary policy errors that distorted growth and inflation expectations. For example:

- The conditions for the emerging market debt crisis were fostered by a toxic combination of Federal Reserve profligacy and anti-growth policy errors by the federal government in the 1970s (sound familiar?), and by a subsequent correction of policies in the U.S., especially by the over-correction of monetary errors by the Volcker Fed. Anti-growth developments in some emerging markets during the 1980s worsened the collapse.
- Similar distortions and policy shifts were also at work in the S&L crisis.
- The commercial property crisis of the early 1990s was precipitated by relatively high real interest rates from the Greenspan Fed, against lowered growth expectations and investment distortions resulting from the fiscal errors that occurred under the first President Bush.
- In the current crisis, distortions arose from the following: private residences received more favorable tax treatment than other investments since the late 1990s; in the early 2000s, a panicky Greenspan Fed pushed interest rates into negative territory for the first time since the 1970s; and securitization and other financial innovations incentivized a massive overinvestment and leveraging up in the residential sector. The unfolding of this boom was and is inevitable, but we believe that the process has been exacerbated by expectations that U.S. policy could take an increasingly anti-growth tack since the Democratic Congress took over following the 2006

elections, and by some of the rhetoric emanating from the Clinton and Obama campaigns.

- In addition, the Asian Flu and the Russian and Argentinian implosions of 1997-2002 were caused to a significant degree by a misalignment of growth expectations in the U.S. and emerging markets, and the relative position of U.S. monetary policy.

Wolf and Rajan are right to question the incentive structure of the financial industry, and to ask whether the value received by executives and managers is aligned with the value they've created (or destroyed). But clearly, factors of political economy also play a huge role in the uncertainty that hangs over financial market outcomes. Should industry insiders be forced to bear the cost of those as well? And to what extent do policymakers' errors and rhetoric also undermine the legitimacy of the global market economy? Should we not ask who is bearing those costs, or who should?

History as a Guide

Using history as a guide, the world last witnessed a collapse of the global market economy in 1929-1932. It did not significantly recover until the 1950s-1960s. The Depression arose from a series of errors: World War I led to abandonment of the gold standard and global hyperinflation; central bank policies in the 1920s prevented a realignment between the real and nominal values of gold; a concerted global return to gold at its prewar parity led to a dramatic increase in real interest rates, while a coincident tariff war lowered global growth expectations significantly. Shortly afterward, a series of tax hikes and economic interventions led to even lower growth expectations in the U.S. The eventual outcome was domestic unemployment of nearly 25%. Greed and distorted incentives may have played a minor role in the crisis. But it clearly had far more to do with the errors of governments than the actions of private market participants.

It's our belief that the greatest risks to the political credibility of the global market economy emanate from governments, politicians, and policymakers.

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