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In praise of free markets

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Published: September 25 2008 19:02 | Last updated: September 25 2008 19:02

The financial system has reached the point of maximum peril. After years of profligacy, banks have all but stopped lending to each other as the US Congress decides whether to extend support. If the unravelling of the banking system continues, the economic consequences will be dire. Yet there is an even greater risk: that the politicians now contemplating Wall Street's follies draw the wrong conclusions and take the wrong decisions, losing their confidence in markets altogether.

It would not be the first time. After the Wall Street Crash, markets were deemed to have failed and US lawmakers attempted to regulate short-cuts through the crisis. The widely-copied Smoot-Hawley Tariff Act quadrupled the effective tax rate on thousands of imports and deepened the "Great Contraction" of 1929 to 1933. The price of popular anti-market sentiment was much higher in some of Europe's fledgling democracies: fascism.

Despite the severity of the current crisis, such extreme reactions remain very unlikely. Yet there is plenty of room for policymakers to compound the damage already inflicted by the irresponsible conduct of the financial sector. It is time, then, to remember what open markets have achieved, and what lies in wait for societies that suppress them.

It is no help that some of the loudest critics have little interest in what went wrong, less in how to fix it, and none at all in safeguarding against problems in future. Rowan Williams, the archbishop of Canterbury, this week applauded the UK government's ban on short selling. His colleague, John Sentamu, declared that the short sellers of bank shares were "clearly bank robbers and asset strippers". These are the words of a well-meaning man who can see no moral or practical difference between a car thief, a scrap-yard mechanic, and a person who insures a car and thus profits if it is stolen.

Andrew Cuomo, New York's Attorney General, went one step further – "looters after a hurricane" was his ill-judged analogy. Are short sellers also to be shot by the National Guard?

The trouble with such sentiments is that they solve nothing. Criticise in metaphors – "unbridled capitalism"; "unfettered greed" – and you duck the tiresome task of specifying what bridles and fetters you have in mind.

Consider the Washington **rescue package** first. Why should taxpayers bail-out millionaire bankers, and what should we force them to give back in return? Those are natural questions but not the only ones. We should also ask whether taxpayers will profit, directly or indirectly, from spending money to shore up the banking system. The answer is "yes". The system is close to collapse, and the consequences of collapse would be misery for Main Street. Profitable businesses and creditworthy consumers would suffer. A successful rescue would prevent that and there is even a small chance that it would be profitable in its own right. That is the justification for the rescue. Congress was right to scrutinise it – especially its lack of oversight – but has become distracted by a desire to clip Wall Street's wings.

The case for more effective regulation is nevertheless undeniable. It is hard to defend a system where top banking executives walk away with millions in compensation when their businesses are, in retrospect, fundamentally flawed. This looks like a reward for failure. We have witnessed two financial crises – the dotcom crash and the current banking disaster – in the first decade of this century. That is hardly a record which inspires confidence in the current efficiency of capital markets or their transparency.

The current crisis is routinely described as a symptom of deregulation, but it is equally the child of earlier, ill-fated interventions. Subprime mortgages grew because the prime mortgage sector was dominated by **Fannie Mae** and **Freddie Mac**, two institutions founded, regulated and effectively underwritten by the government. Securitisation was an effort to sidestep capital requirements. But it also created **instruments** that few could understand and, in Warren Buffett's prophetic words, really were "financial weapons of mass destruction".

Capital markets clearly need better regulation but policymakers should guard against unintended consequences. Markets are places of trial and, very frequently, error. Their genius is not perfect efficiency, but the rewarding of success and the weeding out of failure. No better alternative has ever presented itself.

This is a difficult time to defend free markets. Nevertheless they must be defended, not only on their matchless record when it comes to raising living standards, but on the maxim that it is wise to let adults exercise their own judgment.

Market freedom is not a "fundamentalist religion". It is a mechanism, not an ideology, and one that has proved its value again and again over the past 200 years. The Financial Times is proud to defend it – even today.