

## [Markets don't fail](#) [1]

Written by [Jan Boucek](#) [2] | Monday 23 January 2012



Led by the UK's own prime minister, markets are under assault for causing all our current economic woes. Blaming 'market failure', David Cameron is trying to outbid Nick Clegg and Ed Miliband for policies to reform the market system.

But markets don't 'fail'. They respond rationally, quickly and often brutally to conditions as they find them. If they see a shortage of supply or an excess of demand, they'll drive prices higher. Conversely, excess supply or falling demand drives prices lower. If you're looking for villains, examine why supply is constricted or inflated or why demand is stifled or encouraged. But don't blame the markets for responding accordingly.

For example, the onset of the financial crisis three or four years ago was largely due in the US and the UK to excessive demand for mortgages from people who couldn't afford them. In the US, this was driven by government mandates to Fannie Mae and Freddie Mac to do just that 'pump up demand for housing'. In the UK, tight restrictions on construction limited supply to a market that quite rationally came to believe home ownership was a sound substitute for more productive investment.

In both cases, the bankers' cost of funding was distorted by deliberately low official interest-rate policies, the implicit knowledge they wouldn't be allowed to fail and lax competition enforcement that led to the likes of Royal Bank of Scotland swallowing up competitors. The logical response by the markets was to divert money to housing, just as the politicians wanted. As soon as this folly became apparent, the banks bailed out as did the humble folk queued outside branches of Northern Rock, much to the dismay of policymakers.

In the current sovereign debt crisis, the financial system was actively steered into purchasing more government debt than they otherwise would have by distorting regulations. Big banks are given privileged and lucrative roles as primary dealers in the initial distribution of new bond issues as long as they buy consistent amounts. Pension schemes are often required to hold a sizeable chunk of 'safe' government bonds while minimum capital ratios for banks specifically require such bond holdings.

This reliably inflated demand facilitated and encouraged ever increasing issuance of government bonds. Lo and behold what happened when the markets said enough is enough. They had been responding rationally to conditions as they found them and were quickest off the mark to realise the game was up. They didn't 'fail' - they just didn't deliver what the policymakers had wanted.

In the greater scheme of things, the past week's agonising about executive pay and bank bonuses is pretty minor except for the fact it's generating yet more silly ideas. Everybody now wants to encourage 'co-operative' groups to create a 'John Lewis economy' whereby employees are also big shareholders. Talk about putting all your eggs in one basket. Not only does your income depend on the success of your

employer but so do your investments and your pension. Isn't that what the Robert Maxwell fiasco was all about? Just ask any former Lehman Brothers employee how it feels to have all your compensation from salary to bonus to pension dependent on your employer.

John Lewis, for now, appears to be a well-run company and God bless them. But imagine the unintended consequences if all companies, good and bad, were steered into a similar structure and some go bust as they will and should ? more bailouts, more regulation, less mobility, less creativity. If the John Lewis model is so obviously successful, it would be more widespread naturally ? there's nothing to prevent workers or unions from buying into their publicly-listed employers' shares. They don't need government instructions to make them do so.

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