

# Why Is It That Financial Markets May Not Be Self- Stabilizing?:

*How the Market's "Gatekeepers" Came to be Neutralized:  
Including Counterparties and the Ratings Agencies*

By

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### *Market Price and Natural Price*

A long-standing tradition in economic thought -- one that has persisted through the Classical, Neoclassical, and Neoclassical Synthesis schools -- claims that markets in general, and financial markets in particular, are self-stabilizing. The core proposition is that the "market price" -- that is to say the market price of any given commodity on any given day -- can not and will not deviate for any significant period of time from its natural price (in the language of Adam Smith and David Ricardo). Within each of these traditions debates have emerged over how long it would take for a market to achieve its natural price. Additionally, there have been discussions over how disruptive the transition would be and whether or not policies should be put in place to facilitate the transition (For example, Adam Smith thought that tariffs and bounties should be repealed gradually so as to minimize the disruption of the domestic market and everyone who depended upon it for their work or livelihood).

That a natural or stable equilibrium price existed, and that a freely operating market system could and would bring adjust the market price to it, was a notion that has

rarely been subject to question. According to the neoclassical tradition that is now dominant in American economic thought relative prices ably manage this adjustment in the markets for goods and services. Interest rates and asset prices guide financial markets. Relative wages guide labor markets. The balance of trade is assured by changes in the exchange rate. If any component of this system of flexible and adaptable markets is not in balance at any given moment, the discrepancy is explained by an appeal to the existence of "government interference," "exogenous shocks," or "adjustment lags." The latter being, notoriously, "long and variable."

### *The Theory of Efficient Markets*

That was then, this is now. By the mid-1970s most mainstream macroeconomists and virtually all finance economists came to believe that -- by contrast to the markets for goods, services, and labor -- financial markets were highly "efficient."<sup>1</sup> This idea came to be formalized

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<sup>1</sup>I am aware that soon thereafter a variant of this approach emerged under the name of the Real Business Cycle (RBC) approach. This maintained that efficient markets theory should be the baseline assumption in all macroeconomic theory. Consequently we should assume that ALL markets were in full equilibrium at ALL times. Henceforth no distinction would have to be made between the short and long run, nor would any distinction have to be made concerning adjustments in financial markets vs. goods markets or labor markets. Frankly, it is hard to take this

as the "theory of efficient markets." Echoing the earlier claims of the Austrian school and Friedrich von Hayek, its core notion was that prices are efficient aggregators and indices of the real conditions, trends, and expectations that exist at any given moment. Every interested parties is making trades that reflects their own resources, constraints, knowledge, needs, and concerns. Stated simply the price of an asset at any instant in time is the best available reflection of all available information. It follows that the prevailing prices in financial markets at any given juncture are, and must be, the best possible reflection of the "true" or "fundamental" value of the underlying assets. This proposition is defended through the claim that anyone with access to reliable information that the prevailing prices were "wrong" could and likely would purchase or sell, for a nice profit, the asset in question. Their success would draw the attention of imitators, volumes would grow, and the price of the mispriced asset, or class of assets, would adjust until the opportunity in question vanished.

A corollary was that no one could systematically beat the market as current prices represented an "efficient" aggregate of all available knowledge concerning the asset in question. The only thing that could move the market was

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view seriously, so it will not be addressed in this paper. I will only note that my students are simply incredulous when I present the RBC approach in my Macroeconomic Theory class.

"news" and this, by definition, was not yet known. Consequently, asset prices were said to follow a "random walk" in the sense that their course could not be predicted *a priori*.

The previous paragraph reveals that an "efficient market" depends critically upon the existence and free play of "smart money." The profit-seeking actions of able, willing, and well-informed traders is the engine behind the market's rapid adjustment to equilibrium. These traders, and the broader society, are each and severally the beneficiaries of this profit-oriented action. The drive by traders to enrich themselves also works to efficiently allocate the nation's financial assets. That traders and arbitrageurs make substantial and sustained contributions to economic efficiency and therefore economic growth is a proposition that is, at least among themselves and their legions of allies among mainstream economists, too obvious to even argue. Here, however, is the problem. It is my belief -- one that was instilled in me long ago by Professors Tracy Mott and David K. Levine -- that the greatest errors of economic thought are almost always embedded in what is taken to be obvious. Following their method of inquiry, one that asks questions of core categories and assumptions, rather than econometric results and tests, let us ask ourselves if it is plausible that "smart money" is always and everywhere a stabilizing force in our financial system.

### *Speculation is Not Arbitrage*

Let us begin with an important conflation of categories. This is a pronounced tendency to perceive speculation as merely a form of arbitrage and, on the basis of this analogy, find that it is inherently benign, even a force for good (Friedman 1953). Stated simply, they are not the same and evening thinking of them as analogous is also an error. Arbitrage, to review, is a trade across space or different markets. So, for example, if grain is selling for a higher price in market A than in market B an arbitrageur can earn a virtually risk-free profit by simultaneously buying in market B and selling in market A. The only substantial risk such a trader undertakes is that a counterparty may fail to meet their obligations.

By contrast, speculation is an exchange that takes place over time. That is to say that a firm buys or sells an asset in time A with the intention of profitably selling or buying it at time B. Because the future is uncertain, it should be evident that the risk undertaken by a speculator is qualitatively different. For this reason arbitrage is not speculation and vice-versa (Kregel 2007). Treating, and regulating, speculation as *if* it were merely a form of arbitrage misses this most critical point. It ignores the fact that an arbitrageur knows the conditions

of the markets within which they are trading. A speculator does not know the future. Rather the latter is making educated, perhaps even highly educated, guesses concerning future market conditions. Ignored in this conflation is the fact that the future is inherently uncertain in the Knightian sense of the term.<sup>2</sup> This means that speculators are working with risks that they can not fully understand. Moreover, knowing that they do not know, and suspecting that someone else may actually know, these expectations are subject to rather violent swings over fairly short periods of time. Indeed, Post Keynesian economists should as Hyman Minsky and Jan Kregel have long noted that the assessment of risk is itself pro-cyclical. After all, an extended boom reduces the frequency and size of defaults and hence the observed counter-party risk in the system. This can be exacerbated to the extent that recent events are implicitly or explicitly given more weight in a firm's assessment of systemic and counter-party risk. Such swings in assessments can create "exuberance" over the course of an upswing, but these problems are most painfully evident in the economic turmoil that occurs in the wake of a crash (Kregel 2007).<sup>3</sup>

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<sup>2</sup>Implied in the text are all the issues associated with uncertainty (See Keynes 1937 and Minsky 1975, Chs. 3 & 4; for an accessible and interesting historical treatment see the various essays in Schmidt 1996).

<sup>3</sup>The discerning reader may notice that I have focused my attention on the structural characteristics of firms and markets that tend to undermine the "smart money" traders that are presumed to exist. Of course, this begs the

Giving due consideration to the actual structure of markets suggests another limitation on the effectiveness of the "smart money." Being contrarians, and being subject to losses in the short term, it is unlikely that they will have access to enough financing to leverage their system-stabilizing trades. Indeed, they may not even have enough financing to remain viable over the short term. Here an old adage comes to mind, "The market can remain irrational for longer than you can remain solvent." The experience of Long-Term Capital Management (LTCM) is a vivid reminder of its accuracy. It took highly a leveraged -- and over the long-term highly plausible -- bet that the spread between several European bonds would close as the Euro came closer to being formally adopted. Nevertheless, these spreads widened as panic took hold in the wake of Russia's default on its sovereign debt. Mark-to-market accounting showed enormous losses in their portfolio and LTCM could not raise

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question as to their actual existence, or at least their existence in adequate numbers with adequate financial backing. With this emphasis it follows that Robert Shiller (2005) and the several authors who make up the relatively recent literature that goes by the name "behavior finance" have been largely ignored. This implies no disrespect for their work. I have read it and taught it and believe it to be a genuine contribution to our understanding of financial markets. The reason I have neglected it in this paper is that the behavior finance literature has a tendency to *imply* that the core problem is in the psychology of traders, considered as individuals, rather than in the actual structure of markets. As a consequence their work leaves one with the *impression*, for better or worse, that the solution is to make ourselves less irrational, rather than fix the structural problems inherent in the organization of our financial markets.

enough outside financing to cover its positions. While it was true that in the long-run LTCM was "in the money," it was equally true that they were finished as an ongoing enterprise (Lowenstein 2000).

*Does the "Smart Money" Correct Prices?*

As mentioned above, economists have long cherished the belief that any "market anomaly" in the form of "incorrect" prices or quantities can and will be readily corrected through the self-interested trades of "better informed" market actors searching for easy profits. This is the time-honored role of what is conventionally called the "smart money." Indeed, the existence and self-interested action of this smart money is critical to the claim that a free market economy -- and especially its financial sector -- is self-correcting and self-stabilizing. An important corollary is, of course, that a system featuring such well-informed arbitrage neither needs nor desires intervention by government regulators (Galbraith 2009; Prasch 2008, Conclusion). The primary flaw in this argument is that our repeated experience with financial booms and crashes over thirty years of much-vaunted deregulation obliges us to ask whether the smart money actually is engaged in stabilizing the market system.

*Why the "Smart Money" May Also Be Destabilizing*

In a most insightful chapter on the subject of expectations formation and the organization of asset markets, John Maynard Keynes argued that unless a trader is operating independently, with his or her own funds, they will soon discover that it is difficult to take a contrarian position in the financial markets. He gave several reasons to support his conclusion.

One was the outlook and disposition of the vast majority of traders:

It needs *more* intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover, life is not long enough; -- human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate (Keynes 1936, p. 157; Keynes' italics).

While such *bon mots* on the human condition are interesting, and have been verified by behavioral economists, Keynes' case does not rest solely upon them. On the contrary, he made a *structural* argument for the institutionalization and dominance of myopic investing.

Alarming, the myopia-promoting and supporting structures he identified over seventy years ago are even more prominent in today's financial system.

A crucial consideration is whether the trader works for himself or others. Specifically, is he or she trading with other people's money? This question matters because the performance of an employee or agent investing other people's money will inevitably be compared their peers. Contrarian investing, if it is an idea with any meaning at all, means accepting the substantial probability that for several consecutive short periods our (presumably "smart" or better informed) trader will underperform his or her peers. In the 'real world' such an observed underperformance will induce a degree of unease or nervousness among members of the board to which the trader reports (or outside investors if the trader is the manager of a fund). Since we can expect that these board members or outside investors are less informed or "smart" than the person they have hired to manage their portfolio (otherwise, why would they be hired?), they might be forgiven if they begin to wonder if the maverick in their employ will really win out in the end. Human nature, self-interest, and a fairly normal degree of risk-aversion will likely induce them to become impatient before too long, and our insightful but contrarian trader will find him or herself without a portfolio to manage -- perhaps even out of a job. Keynes makes the case rather succinctly, "an

investor who proposes to ignore near-term market fluctuations needs greater resources for safety and must not operate on so large a scale, if at all, with borrowed money ..." This observation leads to another insightful aspect of how groups come to judge contrarians:

For it is the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally (Keynes, 1936, pp. 157-8).

In light of the above, it should not surprise us that the most important "contrarian" investors of our era are to be found among individuals with sufficient wealth to trade largely on their own account. George Soros and Warren Buffett come to mind. Under normal conditions those making purchase and sale decisions feel that they cannot act with such a level of independence. Even someone as prominent and powerful as the CEO of Citigroup, Charles Prince, indicated that he felt highly constrained by market conditions and the conventional wisdom, "As long as the

music is still playing, we are still dancing -- and the music is still playing" (Tett 2009, p. 148).

***What of Gatekeepers Such as the Credit Ratings Agencies?***

The above argument that financial markets can be expected to be "efficient" depends upon a second long-standing tenant of mainstream economic thinking -- although this is an idea with greater merit. This is the proposition that persistent market failures (such as the misrepresentation of the quality of a product or service) create a business opportunity for anyone who can develop a viable and affordable solution. These can take the form of a pre-commitment to a business code that nurtures a reputation for ethical behavior and fair dealing. More often, it suggests the opportunity to profit by providing a service that improves the efficiency of the market. If self-interested firms caught up in the competitive pressures of the marketplace have an incentive to sell bonds that are riskier than represented, then there such be an opportunity to profit by providing objective assessments of these risky assets. Over a hundred years ago credit rating firms emerged, and were paid, to present a disinterested perspective on the riskiness of various forms of debt, especially bonds. Such agencies would, one might

reasonably suppose, succeed or fail on the basis of their reputation for providing accurate assessments of risk.

While in the past these firms were more or less successful in creating and applying ratings, it is now widely understood that disinterested ratings have been increasingly less likely to emerge from the ratings process. The reason is that over the past several decades the business of rating bonds has undergone a dramatic change. Sadly, these changes have compromised the capacity of these agencies to act as independent evaluators with the direct consequence of diminishing their value as market gatekeepers. As with the housing bubble this unfortunate outcome was both predictable and predicted (Partnoy 1999, 2006; Muolo and Padilla 2008, Ch. 12). What happened?

Thirty years ago, the select firms that the Security and Exchange Commission identified as Nationally Recognized Statistical Rating Organizations (NRSROs) earned their relatively modest, but comfortable, incomes by formulating and selling ratings to prospective bond *buyers*. Depending on buyers for their incomes, firms such as Moody's, Standard & Poor's, and Fitch had a clear incentive to accurately assess the underlying quality of the assets they rated. This should not imply that they always got it right, but rather that one could reasonably suppose that what economists call "an alignment of incentives" existed between these firms and their clients -- the aforementioned buyers of bonds.

That was then, but this is now. For a variety of reasons that need not detain us, by the mid-1990s these agencies had come to be increasingly in the business of rating the quality of debt at the behest of *underwriters* -- the banks. Competing with one another for the lucrative repeat patronage of the major banks issuing the bulk of the new mortgage- and asset-backed securities and other increasingly exotic financial instruments, induced the NRSROs to give ever-higher ratings to these assets. They were materially assisted in this effort by the increasing complexity of these assets and the fact that, as innovations, there was little solid historical data available with which to rate prospective performance. Indeed, because of the uncertainty surrounding the underlying value of these assets and the absence of organized markets, buyers and even regulators came to be increasingly reliant on the evaluations of the NRSCOs to assess risk or -- in the case of regulation -- to make determinations of capital adequacy (Partnoy 1999, 2006; Crotty 2008).

As ratings came to be more important to the banks, and repeat patronage in an increasingly competitive environment came to be more important to the NRSROs (who by this time had all abandoned their partnership structure to become publicly traded corporations), the latter firms became both more profitable and more subject to systemic bias. Indeed, the major banks let it be know that they were "shopping for

ratings" among the agencies. But it would be a stretch to suggest that the agencies were aggressively resisting these pressures. Indeed, in a move seemingly designed to compound these already-powerful conflicts of interest, ratings agencies set up consulting branches to work with bond issuers to devise the optimal structure of debt, and thereby enhance the assigned rating. While the ratings agencies would like us to believe that this new business model embodied creative "synergies" that added value, it is now evident that what was being exploited was a substantial and irresolvable conflict of interest (Partnoy 2006; Muolo and Padilla 2008, Ch. 12; Crotty 2008).

Such a performance might appear to be unethical, but let us recall that, as corporations, NRSROs have a fiduciary responsibility to their shareholders to maximize profits by every legal means. While one might point out that once-upon-a-time they built their business on their reputation for disinterested research, this says nothing about a legal duty to be or to remain disinterested. Indeed, the affirmation of the absence of any legal duty to bond buyers has been underscored by the NRSROs themselves, in an argument thus far upheld by the courts, that their ratings are merely a form of "journalism" and for that reason a form of "protected speech." Such an argument, so long as it is accepted, protects the NRSROs from lawsuits claiming damages from the biased ratings inevitably flow from their inherently conflicted business model. Frank

Partnoy has argued that it is essential that this ruling be changed if these agencies are to fulfill their role as disinterested intermediaries (Partnoy 2006).

The theory that financial markets are self-stabilizing depends upon the self-interest of individuals and firms, the existence of "smart money" that is ready and able to profitably trade on deviations from correct underlying values, and the emergence of intermediary institutions to provide a check on any market failures that might emerge as a consequence of inadequate information or other systemic faults. As indicated, there are substantial reasons to believe that these solutions either do not exist, or do exist but in a profoundly flawed form. Given the sums at stake, it should come as no surprise to find that intermediary institutions such as credit ratings agencies can be compromised by major clients. At one time, in the early 1930s, such pitfalls were well-understood. The chronic instability we have seen in the financial markets over the past thirty years has not been the consequence of some mysterious cause, change of technical conditions, a lack of experience, or a lack of understanding (Aside from those who are paid not to understand). Rather the core issue is that the banks never accommodated themselves to the regulatory structure of the New Deal and have worked tirelessly for decades to undermine or repeal it (Helleiner 1994). By the latter 1970s resistance to their agenda had eroded to the degree that they could begin to count on bi-

partisan support for their deregulatory agenda. By the 1980s both political parties were competing with one another to better serve the needs of the financial sector with the blessings of mainstream economists and the bulk of the financial press. The only remaining obstacle was Rep. Henry B. Gonzalez of the House Banking Committee and he passed away in the mid-1990s. After that, organized resistance to the machinations of the financial sector was no longer a part of American political life. This, probably more than anything else, has been the most extraordinary development in light of American intellectual and political history (Johnson 2009).

### ***Conclusion***

As the reader most likely knows, the ratings agencies were far from the only instance of institutional failure. Other substantial failures occurred in both the political and regulatory process. Reflecting a potent mix of ideological beliefs and material motivations, since at least the early 1980s both major political parties have been essentially "captured" by Wall Street interests (Baker 2009, Ch. 2; Frank 2008, Ch. 8). As a consequence we have witnessed a bi-partisan and sustained effort to deregulate the financial sector in exchange for campaign contributions. Politicians who have rotated out of office,

or are "between positions" now-routinely enjoy lucrative speakers' fees and "consulting" jobs.

But let us not overlook the purely ideological aspects of contemporary economic policy-making. Among other things, it led the Federal Reserve under its much vaunted "maestro" Chairman Alan Greenspan failed in its most elementary function -- to protect Americans from a systemic financial collapse. This failure is exacerbated by what has now become a bi-partisan push to reward the Fed with an even greater regulatory role! The Securities and Exchange Commission, also "captured" by Wall Street, also has failed to perform its most elementary task as a watchdog. In addition to ignoring repeated warnings over growing Ponzi-schemes such as that by Bernie Madoff, they have rewritten rules so that investment banks could legally work with breath-taking degrees of leverage. Each of these actions, and many others besides, have worked to ensure that many Americans are fleeced of their wealth. While several noteworthy exceptions can be identified, the business press has failed to keep voters and investors informed of important trends and risks in the financial system and have often trumpeted very dubious regulatory schemes as "moderizations" or "improvements." The only agency that we might completely exonerate from blame is the Office of the Comptroller of the Currency. Ostensibly, they are in charge of overseeing federally chartered commercial banks. But since there is little record of them ever having

provided such oversight, the public cannot be disappointed by their neglect of their official duties.

Detailing the specific failures of each of these institutions would require a treatise, and I do not doubt that several are now being written. But least we lose hope in our fellow man, let us recall that there were also many instances of individuals or even small groups of individuals, with a sense of integrity and intellectual honesty who, often at great risk to their own careers and incomes, "did the right thing" and directed our attention, or the attention of their firms' management, to the alarming trends and mounting risks. It is now evident that they were unable to make much of an impact on the collective psyche or the political institutions of the nation. Some of them were dismissed from their jobs, and few of them are recognized today. Even fewer of them have been asked to participate in the reconstructing our financial system (See G. Morgenstern New York Times Sept 13, 2009).

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