



Bookstaber on the Limits of Capitalism

By Sam Parl
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What can we do so that we're not fighting yesterday's war?

That was the question posed by Richard Bookstaber when he spoke at the sixth annual MIT Sloan Investment Management Conference on April 29. Bookstaber, a Senior Policy advisor to the SEC and to the Financial Security Oversight Council, offered an elucidating perspective on the origins of economic crises and the proper role of regulation.

Bookstaber's main assertion was that unrestrained capitalism, contrary to classical economic theory, creates incentives that fail to optimize social welfare and ultimately devolve into socialism— as he put it, that “unrestrained capitalism ultimately isn't capitalism,” because these misaligned incentives force governments to intervene in order to optimize the well-being of their citizenry.

While we cannot predict the source of our next financial crisis, Bookstaber said – although he expressed no doubt that it was coming – we should look towards unregulated industries. Banks, he said, are currently under too much scrutiny to pose much risk to the economy. The warning sign that Bookstaber most emphasized was the complexity of a system.

Bookstaber laid the blame for the 2008 crash on two factors: complexity and “tight coupling.” In this context, tight coupling is the “causal relationships” we tend to create with ETFs and globalized market interactions. It serves to increase complexity and to propagate the shock of crisis much more quickly and widely than it otherwise could spread. Ultimately, however, Bookstaber said complexity is the real villain.

Bookstaber's primary concern with complex markets is that they are difficult to understand. While some may understand what is happening in a highly complex system, the vast majority of participants are unlikely to fully grasp its dynamics, which weakens the assumption of perfect information used by classical economists to justify the free market. When market participants act in an effective state of ignorance, there is a high likelihood that they will make suboptimal decisions. This is what happened with risk allocation in our recent recession.

Bookstaber took special note of so-called “financial engineers” in his talk. To call them “engineers,” he claimed, was misleading. Engineers design bridges and stable structures. In contrast, he declared, “financial engineers are going to war instead of building hospitals.” The use of risk management tools developed in scientific fields, such as physics, engineering and biology, is inappropriate in finance, said Bookstaber. The origin



of the risk in the former professions is entirely different from that of financial risk. This assertion ultimately stems from Bookstaber's description of financial activities as "war."

Early in his talk, Bookstaber remarked that "whatever we are doing, we tend to do more of it." It soon became plain that he was referring to capitalism. Capitalism, Bookstaber said, creates a feedback cycle that encourages no goal beyond profit, regardless of social consequences. Sometimes capitalism has a positive effect, driving down prices and reducing arbitrage opportunities. Unfortunately, these reduced arbitrage opportunities can inspire investors to greatly increase their leverage in order to make decent profit. When no arbitrage opportunities exist, he said, the "main instrument in financial warfare is to create informational asymmetries."

Bookstaber began to elaborate on the problems with correcting these unfortunate tendencies, but he ultimately declared that to do so completely is impossible. If the free market is the problem, then the solution would be regulation, but regulation comes with its own caveats. That some regulation is necessary was plain in Bookstaber's earlier analysis, but he warned that interventions can easily become problematic. Bookstaber cited the nuclear meltdown at Chernobyl as a historic example of disaster resulting from regulatory obfuscation. Regulation is effectively another layer of complexity for the market, and so it can become another source of the problem that it was instated to solve. We cannot perfectly protect ourselves from what Bookstaber termed "normal accidents," because the harder we try, the deeper the hole we dig ourselves.

The proper role of regulation is to reduce the sources of crisis, namely tight coupling and complexity. The best way to do this, Bookstaber said, is to focus legislation on transparency and simplification. This would require a reformulation of the system, rather than additional layers of bureaucratic complexity. A properly formulated system should realign market and social incentives while reducing complexity, facilitating the involvement of market participants.

The system we have in place today is clearly not that system. Bookstaber displayed a fair degree of discomfort with the lengths to which the government has been forced to go in order to protect the economy from the effects of this crisis. The badly considered deregulation of the marketplace has left us touting the glories of capitalist freedom as long as the boom continues, but it has forced us to take refuge under the government's socialist umbrella as soon as the rain starts. Operating in a capitalist system without fully appreciating its constraints has finally ruined the ideals on which we proudly built our lives. Perhaps now we can carefully consider the consequences of regulation and deregulation, coming to an appropriate balance. Until the next crisis disrupts the equilibrium, that is.



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