Hail market process for outing the truth

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THIS extraordinary year is most unlikely to be widely hailed in quite this way, but 2008 really did demonstrate the benefit of market process.

We can be thankful for few things out of the past 12 months.

That, if not the only one, is arguably the most significant.

It is an important lesson to be appreciated and even more, to be applied, into a cacophony of claims of "market failure" and the need for at least much greater regulation, if not more active governmental and bureaucratic intervention and even management.

In the very big picture, now well and truly painted over by a Pollock-like kaleidoscope of financial disaster and self-interested buck-passing, it was exactly such "non-market" intervention that sowed the original seed for the GFC or Global Financial Crisis.

The force-feeding by the Clinton Administration of mortgage lending to disadvantaged minorities by Fannie Mae and Freddie Mac. With, in due course, those sub-prime mortgages enthusiastically bundled together – securitized – by all-too-willing masters of the Wall Street universe and sold to casually uninterested and inept investors.

And the rest, a few trillions of dollars and Wall Street itself, in the form of investment banking and extreme financial engineering, would be history.

For at least some period into the future, to borrow a concept from Henry Ford, you'll be able to have any "flavour" of financial accommodation you want, provided it is plain vanilla.

So how do I conclude, that out of all this wreckage, we can salute the effectiveness of market process? The two words are chosen advisedly. This is not some bombastic claim that "markets work". In the sense that people, proponents and opponents alike, tend to mean. In terms of outcomes. To the former obviously, positive outcomes.

Generally, either that you get more of whatever, or you get outcomes more attuned to wants.

So we don't end up with the classic Soviet-era supermarket with plenty of what people don't want and nothing of what they do.
I'd generally agree with that while also recognising that it doesn't necessarily mean outcomes are always "desirable".

This though, is about a lesser if still critically important, dynamic: the outing of information and even "truth" by the market process. What we saw over the course of the year was the market process continually exposing information.

Albeit mostly in uncomfortable and even painful ways. From the big picture: the various bubbles; to specifics such h as bank bad debts and overvalued corporates; to even the flakiness of financial instruments and structures.

The best way to appreciate the value of this is to contemplate the counter-factual. Would we really be better off if this process of information discovery had been prevented? Either by government fiat, market manipulation, or simply not choosing to look?

That sub-prime loans and the securitised instruments were still "valued" at their issue values; that bank balance sheets around the world were still pristine, unsullied by write-offs; that all that entrenched corruption and instability was to be left to continue to fester and grow. Apart from the utter unreality of such a thought, it would have required everyone to "be in on it". Simply, that no one looking into one or more of the bubbles could have been allowed to sell, long or short.

Now this is not to particularly endorse the specifics of that "market process". For example, short-selling -whether "fair" or predatory.

Simply that, however unattractively, the "sausage" ended up getting made. The information was outed. This, though, brings with it an uncomfortable challenge. We are now exiting the year with a structure which works to, indeed is specifically designed to, roll back the market process of information discovery.

And which is a major distortion in its own right.

Indeed one that promises to "restart" something akin to the whole sub-prime disaster, albeit on a much more modest scale. The bank deposit guarantee.

The guarantee ruptured the risk-reward spectrum. And as we can increasingly see, in a range of unpredictable ways. Because it rendered all debt either triple-A or triple-Z.

Indeed even triple-A debt has been rendered triple-Z. That's non-Commonwealth government triple-A state debt.

When the world is prepared to take zero per cent interest to invest in US government debt, why would anyone invest in triple-A state debt when they get real – Commonwealth – triple-A from a bank?

Now yes, the Commonwealth Government can, and presumably will, borrow on its credit on behalf of the states. But what about everybody else?

There is a reason for the risk spectrum. So that riskier credits can be obtained but at an appropriately higher interest rate.

One of the key lessons out of the financial debacle is that too many undeserving borrowers were being enabled to borrow effectively at Triple-A by the securitisation and financial engineering. Or at worst, at far too-small margins over Triple-A.

We only got to "find out" thanks to the market process ultimately working.

Now we have double-A borrowers being enabled to borrow on an unlimited basis as if they were triple-A. Not just the big four banks, but all the banks and all the building societies and credit unions. Worse, they are being so enabled when nobody else can borrow at all.

Not even single-As borrowing as single-As and paying the – an – appropriate margin.

In short we have the re-intermediation of the banking system. Not just in an artificial way but one that permits no alternative at all.

The most obvious, and "best", outcome will be if we simply re-feed lending into property, restarting the property boom. And I do mean property, not new buildings.

This is where banks lend the majority of their money; it is the easiest and, to them, the safest.

Lending money even to the biggest corporates (did anyone mention OZ Minerals or Rio Tinto?) is difficult and even dangerous.

The "worse" outcome is precisely if they do the job we want them to. Instead of pouring money into more and more property; because no one else can borrow, they go back to being the prime financiers of corporate activity. So we end up with, say, Single-A and Double-B corporates borrowing via banks as if they were triple-A.

Paying a heavy penalty for the privilege, but not a penalty that goes to the end-lender.

At best this is not healthy financial intermediation. At worst, it will build the potential for another form of sub-prime implosion.

Let us at least hope that market process works to keep us informed on a timely basis.