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Old Socialists Never Die (And They Just Won't Fade Away)

It has become a hallmark of post-Cold War statist apologia to damn market processes with faint praise. Robert Kuttner's new book **Everything For Sale: The Virtues and Limits of Markets***, which finds in free markets few virtues but many limits, is no exception.* [1]

Just as Richard Nixon once declared that "we all are Keynesians now" so today we all are free marketeers. In recent years, it has seemed almost *de rigueur* even for the staunchest among the leftist intelligentsia to profess admiration for the virtues of a market-based economy.

One supposes that it could hardly be otherwise, given the metamorphosis of planned economies around the globe. Vietnamese communists now lust after venture capital; apparatchik bosses in the former Soviet Union have become gangster capitalists; Communist China's leaders praise the profit motive and encourage their subjects to accumulate wealth; and even Fidel Castro wants U.S. greenbacks and is willing to concede limited private enterprise to get them. In the only major command economy left, North Korea, the population is starving. In short, it is not an auspicious time to advance undisguisedly *any* dirigiste agenda (just ask Hillary Rodham Clinton).

For leftist intellectuals here at home, it is a world barren of virtually any successes that might redeem their discredited beliefs. Yet hope apparently springs eternal that the public may yet be convinced that, left to themselves, markets don't work. Robert Kuttner's recently published *Everything For Sale* is a case in point.

Kuttner's notions of economics, philosophy, politics, and public life are readily found in print, on television, and over the airwaves. His overarching message has been that in recent years, interest in his preferred "mixed system" — a blend of market forces and state intervention — has been derailed by right-wing zealots whose reckless devotion to laissez faire precepts has misled the public and threatened the common welfare. He hopes that ordinary people will rethink the public institutions and remedies that have tempered the vicissitudes of unbridled market behavior and embrace his "commonsense" call to rebuild these counterweights to unfettered laissez faire economics.

Although this latest book pays brief lip service to market-based economic systems (the small virtues of markets), it also thoroughly rehashes the customary socialistic charges against free-enterprise competitive market capitalism. According to Kuttner, the "commodification" of society is not sustainable environmentally, socially, or even economically. The "marketization" of society frays the collective fabric by devaluing and diminishing "extra-market" values and norms; competition results in distributive injustice; and unfettered markets are inefficient.

The stated purpose of the book is to restore faith in mixed economies. Kuttner believes that the balance between market, state, and civil society has been tilted in favor of markets as a result of an almost "religious" belief in laissez faire on the part of an influential coterie of political zealots. To restore balance government could and should, in Kuttner's opinion, override markets for a variety of purposes — to stabilize business activity, to promote growth, to limit detrimental side effects, to temper inequalities inherent in market-directed compensation, and to cultivate civic virtues.

He claims the book is a "careful sorting out." He's right. After acknowledging that, at least in the case of grocery stores, markets function well, Kuttner chronicles case after case where alleged "market failure" was the norm — most notably in employment, health care, banking, and deregulation. The cases he selects are, however, largely "straw men" that he fashions in order to conform to his call for extra-market counterbalance. He not only ignores obvious market successes (*e.g.*, the computer revolution), but more significantly also fails to recognize that many of the "failures" he describes have their roots in prior government tinkering. Confident of the state's ability to address these failures, he omits any serious discussion of state intervention gone awry.

Many of Kuttner's arguments for more government rely on what economists call the "theory of the second best." According to this line of thought, markets may be subject to impediments that can reduce efficiency, so that the question becomes: what is the "next best" thing to do? The second best solution (again, according to this theory) may require introducing extra-market measures rather than attempting to eliminate the original obstructions. Kuttner's use of this theory is convenient, if misdirected: in examining instances where government itself created and institutionalized many of the distortions cited, he diagnoses dysfunctional markets; then, after a thorough waxing, he prescribes the remedy — more government presence and taxpayer largesse. Of course, this is merely socialism repackaged. The underlying notion remains, as it does in all such thought, that the allocation of resources must be guided by an elite group with the power to override the decisions of ordinary people.

It is beyond the scope of this discussion to consider every issue that Kuttner addresses, but it may be useful to comment at some length on two of his most prominent examples, namely: banking and dynamic efficiency.

Socialized Credit

Kuttner begins his analysis of the banking industry with the passage of the Glass-Steagall Act of 1933. Glass-Steagall instituted federal deposit insurance, separated commercial and investment banking, restricted banks' securities activities, and capped the rate of interest that could be paid on deposits. Predictably, Kuttner argues that this legislation was needed to

[1] This is a review of Robert Kuttner's *Everything for Sale: The Virtues and Limits of Markets*, New York: Alfred A. Knopf, 1997, 410 pp., $27.50.

repair a financial system left in disarray by roguish bankers. Predictably too, Kuttner believes it should remain in tact and be buttressed when and where needed.

The popular belief is that Glass-Steagall restored sound banking. This assessment is consistent with the notion that markets do not, in general, function properly and more regulation is better than less (again, the "second best" outcome). The actuality is far more complex.

Much involved with banking is a juggling act to reconcile three competing objectives: risk, return, and liquidity. During the free banking era, bankers successfully met this challenge by adhering to the so-called real bills doctrine. A real bill is a short-term, self-liquidating note that arises in the course of commerce. Real bills foster sound banking by forcing bankers to attain appropriate levels of liquidity, safety, and profitability. Unadulterated free banking also results in an elastic currency that meets the needs of commerce.

What often is overlooked is that regulation was the historical source of market failure in free banking, not the cure. The industry that failed and was subsequently regulated was not self-regulating free banking. Free banking (and sound banking) in a genuine sense began to erode when first states and later the federal government began to regulate bank activities. By the 1930s, the fundamental elements of free banking — a decentralized, market provision of specie money and credit; a system of private clearing houses; an absence of geographical and product-line restrictions; and a reliance on sound interbank lending of reserves — had been legislated away. What remained was a legal monopoly on note issue, a centralized reserve system, and policy-determined interest rates. The collapse of the banking system and the economy was not a failure of free banking but rather a failure of policy to preserve free banking.

Once policy distorts individual decision making, it is often perceived that even more intervention is required. Deposit insurance, it was argued, was needed to protect the depositor; restrictions on banking activities were needed to protect the taxpayer. These extra-market measures were, in the eyes of Kuttner, successful for 50 years, inasmuch as bank failures were few and insignificant. What he fails to realize is that, as a matter of policy, banks were not allowed to fail. In practice, Glass-Steagall instituted a banking system that privatized profits and socialized losses.

Socialized Entrepreneurship

Kuttner then proceeds to what is arguably the most important facet of the economy — growth. Although he initially invokes the ideas of the free-market Austrian thinker Joseph Schumpeter, Kuttner soon returns to form. One can only surmise how Schumpeter, a strong proponent of free-enterprise market capitalism and laissezfaire, might have reacted to such sub-headings as "Economic Development" and the "State, Intervention and Innovation", and "From Industrial Policy to Research Partnership?" But he almost surely would have objected.

Schumpeter began his story with a static economy where growth and profits are absent. He then introduced an entrepreneur — a person with the unique ability to develop new products, new production methods or new systems of organization — the one who ignites a spark. It is from entrepreneurial beginnings, said Schumpeter, that progress and change commence and sweep through the industry and economy. For his part, the entrepreneur is duly rewarded by the market. Such profit and progress, however, is only transient. Imitators subsequently fill the vacuum created by the innovation until competition eventually removes every exploitable advantage. The entrepreneurial cycle then repeats itself. Schumpeter called this process "creative destruction."

It is at this point in the story that Kuttner pitches his line: Since competitive markets tend to underinvest in research and development — important factors in innovation — why not socialize entrepreneurship? One supposes Schumpeter would wince. In his view, corporate managers, antagonistic intellectuals, and government bureaucrats dedicated to stability, equality, and mediocrity suffocate the entrepreneur and stifle innovation.

In fact, Kuttner nowhere refers to the costs of his proposed partnership between business and government, but some are obvious. In 1995, for example, Amtrak (a premier business-government partnership) reported an operating deficit of $600 million — after subsidies. Overinvestment in NASA, with a 1996 budget of $14.4 billion, has created a great white elephant. It remains to be demonstrated what benefits may accrue from the current U.S. taxpayer funding of roughly 40 percent of the Russian space program.

Don't Buy It

In theory, markets provide an ideal mechanism for mediating scarcity. But in practice, even the most fervent free marketeer has no certain knowledge of whether markets might ever approach the textbook ideal. The reason is simple: genuinely free markets have never developed — anywhere. To one extent or another, any variety of distortions have confounded market processes throughout the world for centuries.

For this reason alone, it is difficult to accept the notions of "market failure" that propel arguments such as Kuttner's — or to sign on to the panoply of "corrective" measures he and others endorse. What experience does suggest, however, is that even imperfect and highly distorted market processes have yielded more favorable outcomes than those proposed by government central planners. In the attempt to better mediate scarcity, more government has led to more inefficiency, more instability, more stagnation, and more detrimental side-effects than have quasi-free markets. Markets may not be perfect (nothing is) — but so far they have bested the bureaucrats at virtually every turn. ❑

WHITHER EXCHANGE RATES?

A regression analysis based on differences in the domestic inflation rates and real interest rates between countries suggests that these variables have accounted statistically for about 70 to 81 percent of the observed variations in the exchange rates of the major currencies since 1971. These historical relationships may or may not persist. But if they do, at some point current exchange rates could be in for marked adjustment.

Exchange rate movements are largely influenced by differences in inflation rates and real interest rates between countries. Over long periods, differences in domestic inflation rates are the largest influences on changes in exchange rates but in the short run, differences in real interest rates seem to have significant effect. Relatively higher real interest rates, such as those in the United States recently, tend to attract foreign capital (and hence increase the demand for dollars). However, many other factors, including speculative activities in the currency futures markets, also are involved.

Chart 1 shows the consumer price indexes for five countries: the United Kingdom, the United States, Japan, Switzerland, and Germany, from 1971 to April 1997. The United Kingdom experienced

the highest rates of inflation during this period, with the United States next, followed by Japan, Switzerland and Germany. As a result of the volatility of inflation rates, the relative performances may look somewhat different depending upon which base year is used for the indexes. Chart 2 compares indexes of the dollar costs of the currencies of the other four countries. The British pound got cheaper for Americans to buy but the other currencies got more expensive. One might expect the sequence, top to bottom, in the second chart to be the reverse of the sequence in Chart 1, but it is not. The reason is that exchange rates in the base year, 1971, or in the current year may reflect very different combinations of market factors from one country to another. For example, the yen's value was much lower in dollar terms in 1971 than that of the other currencies, so that its dollar cost has risen more than either the German mark or the Swiss franc even though the inflation rate in Japan was higher than in those two countries from 1971 to 1997.

Charts 3 through 6 present the exchange rates for the four foreign currencies along with forecasts based on regression analysis and "residuals." A regression is a statistical analysis that correlates the values of one series — the dependent variable — with the values of other "independent" variables. In this case we attempted to correlate the exchange rates with the ratios of consumer price indexes and the differences in real interest rates. These regressions yielded surprisingly strong results in the sense that the R^2 ranged between .70 and .81, meaning that differences in the independent variables accounted statistically for 70 percent to 81 percent of the variations in exchange rates. This statistical analysis does not necessarily mean that the correlation between a forecast and actual data shows that the changes in the independent variables *caused* the changes in the dependent variable. Correlation does not prove causation. However, in this case, it is fair to say that the apparent relationship at least makes logical sense.

The "residual" in each chart is the difference between the actual and the forecast exchange rate. To the extent that the forecast can be considered the "expected" value of the exchange rate, based on the other variables, the residual is the "error term" or measure of "over" or "under" valuation of the particular currency. For example, in Chart 5 the dollar price of the yen is now well below forecast. This makes the residual negative. This can be interpreted as saying that the yen costs less than "expected," or is, according to this statistical test, "under" valued. This does not mean that it may not become more so, with the dollar rising further against the yen, but it implies that at some point the relationship is likely to return to the historical norm. According to these charts, the Swiss franc is also "under" valued, the German mark valued as "expected," and the pound slightly "over" valued, as of April 1997. ❑

Chart 1
Consumer Price Indexes for Selected Countries
(1971 = 100)

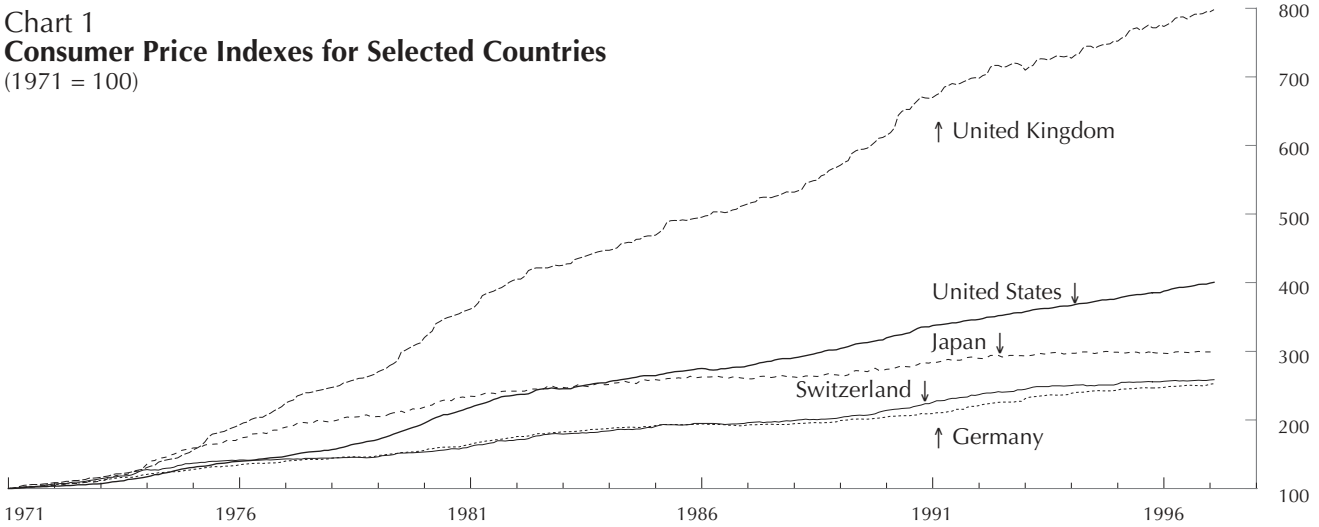


Chart 2
Exchange Rate Indexes
(1971 = 100)

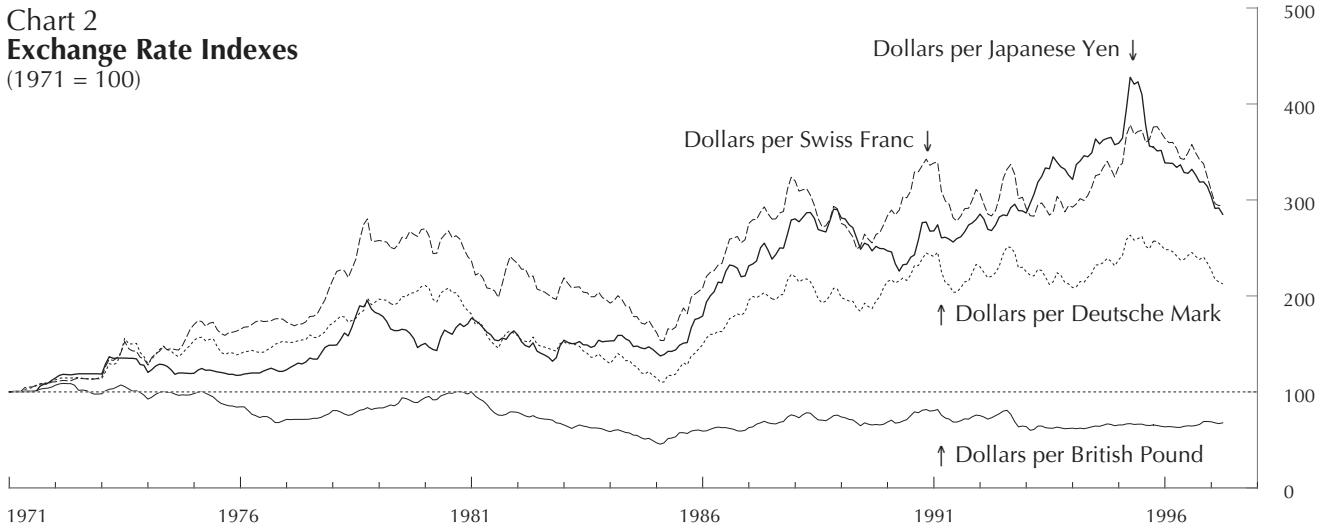


Chart 3
Dollars per Deutsche Mark

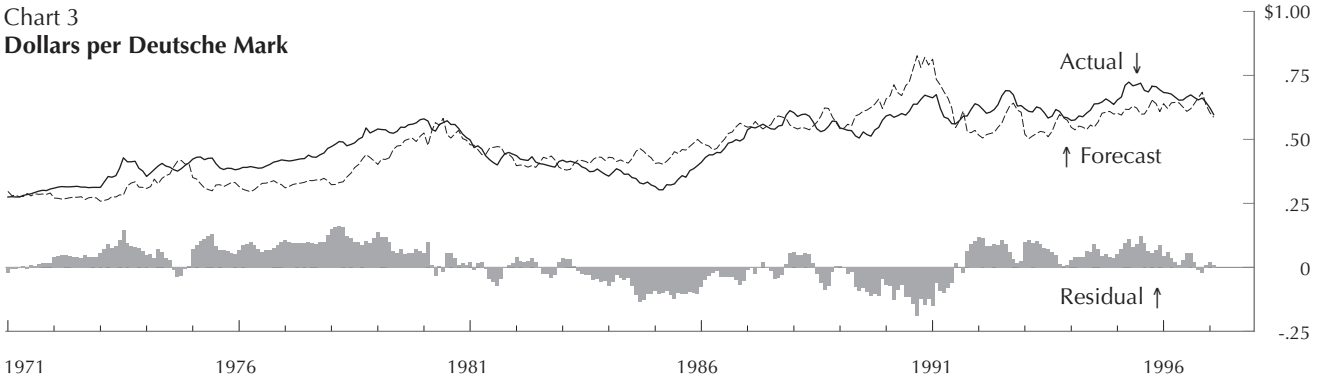


Chart 4
Dollars per Swiss Franc

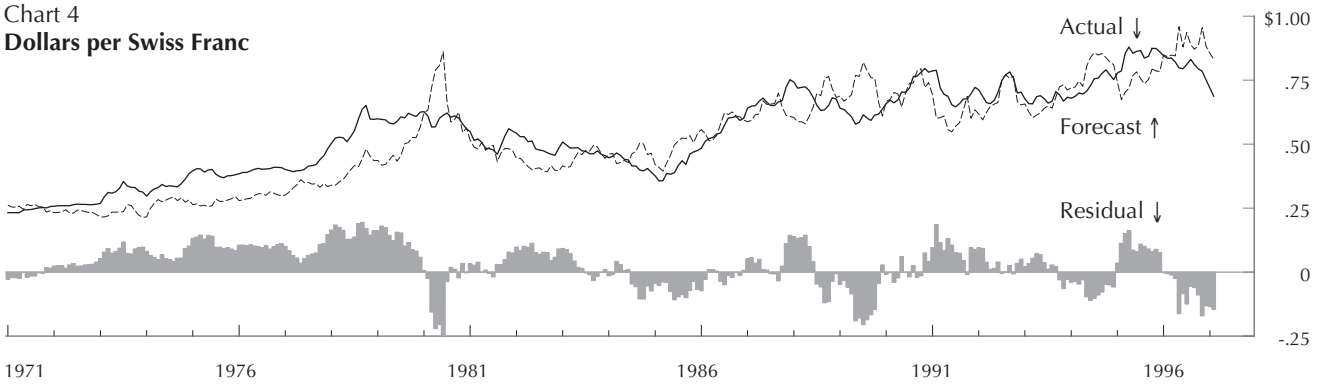


Chart 5
Dollars per Japanese Yen

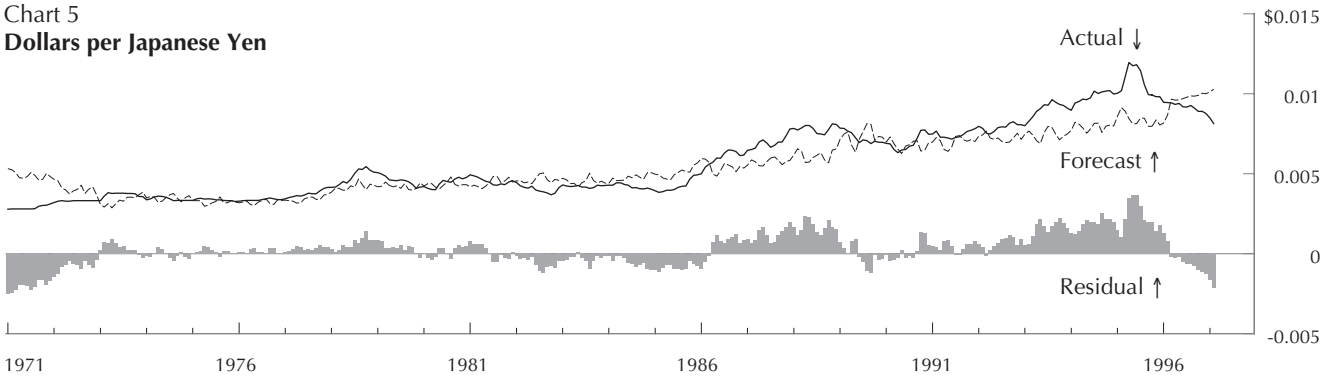
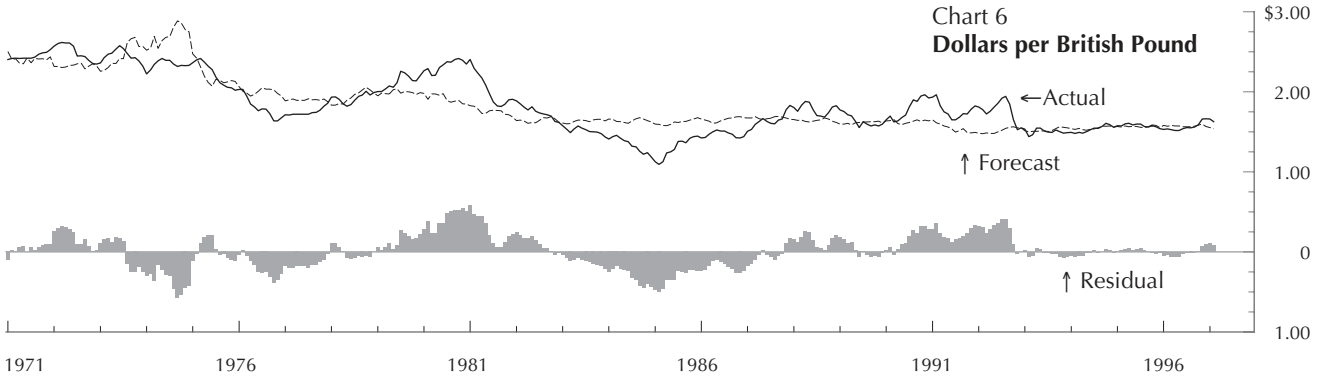


Chart 6
Dollars per British Pound



Sources: OECD, Federal Reserve, AIER Statistical Analysis.
Note: Regressions are in the form:
Exchange rate ($/Foreign currency) =
(U.S. CPI - Foreign CPI) +
(U.S. real bond rate - Foreign bond rate).
Regressions are based on monthly data, 1961 to 1997, except for Japan, 1971 to 1997.
Data is charted for 1971 to 1997 only.

PRICE OF GOLD

	1995	*1996*	*—— 1997 ——*	
	June 8	*June 6*	*May 29*	*June 5*
Final fixing in London	$385.05	$384.85	$343.90	$340.50

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