THE WALL STREET JOURNAL.
WSJ.com
APRIL 20, 2010

An Economy of Liars

When government and business collude, it's called crony capitalism. Expect more of this from the financial reforms contemplated in Washington.

By GERALD P. O'DRISCOLL JR.

Free markets depend on truth telling. Prices must reflect the valuations of consumers; interest rates must be reliable guides to entrepreneurs allocating capital across time; and a firm's accounts must reflect the true value of the business. Rather than truth telling, we are becoming an economy of liars. The cause is straightforward: crony capitalism.

Thomas Carlyle, the 19th century Victorian essayist, unflatteringly described classical liberalism as "anarchy plus a constable." As a romanticist, Carlyle hated the system—but described it accurately.

Classical liberals, whose modern counterparts are libertarians and small-government conservatives, believed that the state's duties should be limited (1) to provide for the national defense; (2) to protect persons and property against force and fraud; and (3) to provide public goods that markets cannot. That conception of government and its duties was articulated by the Declaration of Independence and embodied in the U.S. Constitution.

Chad Crowe

Modern liberals have greatly expanded the list of government functions, but, aside from totalitarian regimes, I know of no modern political movement that has shortened it. While protecting citizens a gainst force, both at home and abroad, is the government's most basic function, protecting them against fraud is closely allied. By the use of force, a thief takes by arms what is not rightfully his; he who commits fraud takes secretly what is not rightfully his. It is the difference between a robber stealing brazenly on the street and a burglar stealing by stealth at night. The result is the same: the loss of property by its owner and the disordering of civil society. And government has failed miserably to perform this basic function.

Why has this happened? Financial services regulators failed to enforce laws and regulations

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against fraud. Bernie Madoff is the paradigmatic case and the Securities and Exchange Commission the paradigmatic failed regulator. Fraud is famously difficult to uncover, but as we now know, not Madoff's. The SEC chose to ignore the evidence brought to its attention. Banking regulators allowed a kind of mortgage dubbed "liar loans" to flourish. And so on.

We have now learned of the creative way Lehman Brothers hid its leverage (how much money it was borrowing) by the use of a Repo 105. The Repo 105 meant Lehman temporarily swapped assets (such as bonds) for cash. A Repo, or repurchasing agreement, is a way to borrow money. But an accounting rule allowed Lehman to book the transaction as a sale and reduce its reported borrowings, according to a report by the court-appointed Lehman bankruptcy examiner, a former federal prosecutor, last month.

Are we to believe that regulators were unaware? Last week Goldman Sachs was accused in a civil fraud suit of deceiving many clients for the benefit of another, hedge-fund operator John Paulson.

The idea that multiplying rules and statutes can protect consumers and investors is surely one of the great intellectual failures of the 20th century. Any static rule will be circumvented or manipulated to evade its application. Better than multiplying rules, financial accounting should be governed by the traditional principle that one has an affirmative duty to present the true condition fairly and accurately—not withstanding what any rule might otherwise allow. And financial institutions should have a duty of care to their customers. Lawyers tell me that would get us closer to the common law approach to fraud and bad dealing.

Public choice theory has identified the root causes of regulatory failure as the capture of regulators by the industry being regulated. Regulatory agencies begin to identify with the interests of the regulated rather than the public they are charged to protect. In a paper for the Federal Reserve's Jackson Hole Conference in 2008, economist Willem Buiter described "cognitive capture," by which regulators become incapable of thinking in terms other than that of the industry. On April 5 of this year, The Wall Street Journal chronicled the revolving door between industry and regulator in "Staffer One Day, Opponent the Next."

Congressional committees overseeing industries succumb to the allure of campaign contributions, the solicitations of industry lobbyists, and the siren song of experts whose livelihood is beholden to the industry. The interests of industry and government become intertwined and it is regulation that binds those interests together. Business succeeds by getting along with politicians and regulators. And vice-versa through the revolving door.

We call that system not the free-market, but crony capitalism. It owes more to Benito Mussolini than to Adam Smith.

Nobel laureate Friedrich Hayek described the price system as an information-transmission mechanism. The interplay of producers and consumers establishes prices that reflect relative valuations of goods and services. Subsidies distort prices and lead to misallocation of resources (judged by the preferences of consumers and the opportunity costs of producers). Prices no longer convey true values but distorted ones.

Hayek's mentor, Ludwig von Mises, predicted in the 1930s that communism would eventually fail because it did not rely on prices to allocate resources. He predicted that the wrong goods would be produced: too many of some, too few of others. He was proven correct.

In the U.S today, we are moving away from reliance on honest pricing. The federal government controls 90% of housing finance. Policies to encourage home ownership remain on the books, and more have been added. Fed policies of low interest rates result in capital being misallocated across time. Low interest rates particularly impact housing because a home is a pre-eminent long-lived asset whose value is enhanced by low interest rates.

Distorted prices and interest rates no longer serve as accurate indicators of the relative importance of

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goods. Crony capitalism ensures the special access of protected firms and industries to capital. Businesses that stumble in the process of doing what is politically favored are bailed out. That leads to moral hazard and more bailouts in the future. And those losing money may be enabled to hide it by accounting chicanery.

If we want to restore our economic freedom and recover the wonderfully productive free market, we must restore truth-telling on markets. That means the end to price-distorting subsidies, which include artificially low interest rates. No one admits to preferring crony capitalism, but an expansive regulatory state undergirds it in practice.

Piling on more rules and statutes will not produce something different than it has in the past. Reliance on affirmative principles of truth-telling in accounting statements and a duty of care would be preferable. Deregulation is not some kind of libertarian mantra but an absolute necessity if we are to exit crony capitalism.

Mr. O'Driscoll is a senior fellow at the Cato Institute. He has been a vice president at Citigroup and a vice president at the Federal Reserve Bank of Dallas.