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Did the free markets fail us in this meltdown?

This morning on my way into the office, I was listening to CIUT, as I often do. Nena Baker was on Alternative Radio talking up her book The Body Toxic, and she cited the case of an herbacide called Atrazine. It seems to seriously mess up some frogs in lab tests, and from many indications is highly toxic. The chemical is already banned in European Union, where Syngenta, the company that manufactures it, is based.

It got me thinking. How on earth can anybody be expected to keep on top of this stuff? The next thought was "only a government could undertake it", and then I thought, as I normally do when I arrive at this type of conclusion: private companies can do anything a government bureaucracy can do, only better, faster, cheaper, more effectively.

Sure enough, by this time Baker was describing the inadequacies of the EPA's efforts at getting noxious chemicals banned. So if there were private companies who were conducting these watchdog functions under contract to agricultural businesses and consumer stakeholders, they'd do a much better job at shedding light on these problems, wouldn't they?

My free market uber alles mentality seemed vindicated. But.... Then I turned by attention to the bond ratings agencies. If the free market always sorts out the bad from the good with the relentless efficiency of that Invisible Hand, then why is every financial institution, pension fund, hedge fund and even sovereign wealth fund on the planet totally overweight in toxic sub-prime derivatives bearing the label AAA investment grade paper?

Instead of some horridly inefficient government bureaucracy dictating bond and debt paper ratings from a cubicle in the capital city right, let the market do its thing and these instruments will be marked to perfection by Moody's and S&P. Right?

Well, as experience has taught us quite painfully, not quite. Moody's and S&P have been revealed to be negligent to the point of complicit in rating subprime sludge as investment grade paper. Both privately owned, and presumably the market's self regulating counterforce to debt issuer overreach.

It didn't happen. They failed us big time. The only bright spot in the debt rating debacle is an almost unheard of bond rating agency called Egan Jones Ratings Co., whom nobody who is anybody on Wall Street takes seriously, who are practically laughed at when they downgrade anybody, and who seem to be right about things months or years before S&P or Moody's admit it.

This could be because Egan-Jones are paid by investors, those who buy debt paper, and probably the prescient minority of those, while S&P and Moody's are paid by the debt issuers, the geniuses who packaged together all this crap and sold it off. Egan Jones president Sean Jones, quoted in Bloomberg described it as:

"You have rating firms acting as meat inspectors, and unfortunately the rating firms are being paid by the meat producers. It underscores the severely flawed structure of the industry."

It finally occurred to me what the fundamental difference is between the two ideologies of government vs free market.

The government tries to prevent bad things from happening in advance. When this goes too far, it becomes a hopeless nanny state, top heavy with welfare and entitlements.

The free market sorts it all perfectly, but it does so after the fact. I.e Don't buy Ford Pintos. It's ruthlessly efficient, but does it's job, in extreme cases, by sorting out the corpses.

Over the long run, the free market's wisdom always prevails. Egan-Jones star is rising, Moody's is waning. Doesn't help us now, but the quants and bankers will hopefully be more risk averse next time out (unless of course they are completely insulated from their own blunders by government bailouts....here we go again)

But the long run doesn't help us out when we need it, now (and this is the justification for all this nonsense about these banks being "too big to fail"). The main thing Keynes got right was about the long run. Our entire economic system is built on the stuff he got wrong (Keynesian Economics), but about the long run he was spot on. He said "In the long run, we're all dead".

Posted by Mark Jeftovic in Armchair Analysis at 14:39