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Editorial

Taking Stock: What Ever Happened to the "Invisible Hand"?

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In high school I was taught about the principles of communism and capitalism. As I recall, communism was labelled a command economy where most decisions were centralized and planned by officials in government, whereas capitalism functioned freely with little to no government intervention. Capitalism was considered a more efficient system. I learned about the "invisible hand" of capitalism and how communism did not function effectively because its principles and policies would impede the invisible hand from operating.

One definition of the invisible hand is as follows: "The invisible hand refers to the self-regulating nature of the marketplace in determining how resources are allocated based on individuals acting in their own self-interest."[1] This online dictionary further explains how this works:

> "Coined by classical economist Adam Smith in *The Wealth of Nations*, the invisible hand refers to an unseen mechanism that maintains equilibrium between the supply and demand of resources. Smith states that the invisible hand functions by virtue of the innate inclination among free market participants to maximize their well-being. As market participants compete, driven by their own needs and wants, they involuntarily benefit society at large.
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> "Smith envisioned the invisible hand as eliminating the need for market intervention on the part of government. Moreover, such regulatory action, Smith believed, would only be detrimental to market efficiency."[2]

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In the past two decades, our western capitalism has changed significantly. The scale of government in our democratic societies was always much larger than what Mr. Smith envisioned (his book was first published in 1776), but our governments have become much more interventionist in recent years, either directly or through their various agencies. It sometimes seems to me that what we used to call capitalism is now only a sideshow, not the main event, in terms of what is happening in our economy and financial system.

Our level of regulation has mushroomed since the global financial crisis of 2008–09. Government bodies have added a considerable amount of complexity to the way we do business. And as some may argue, the do-gooders who behaved properly all along have likely suffered more than those who did not, because of the costs imposed upon them either through regulation or by having to absorb the costs either directly or indirectly, of the financial damages others had caused.

Central bank interest rate policy in the last decade also played a role in the financial crisis. The fluctuating interest rate policy of the prior decade (managed through such agencies as the U.S. Federal Reserve) did create financial imbalances and many institutions, investors and consumers found themselves caught. Low interest rates were brought about after the 2000–2002 recession (a recession spurred on by the collapse of the dot-com or Internet bubble). These low interest rates encouraged real estate investment to increase substantially (as equities were no longer considered as safe or attractive) and this investment rose to a point where suppliers were bringing all sorts of unsound and misrepresented real estate "junk" to market. The historically low rates, irrational exuberance from buyers, the lax standards and poor ethics of suppliers, and government policy and legislation (and, yes, admittedly, prior deregulation) encouraged high levels of home buying that ultimately proved to be unsound.[3] The Fed has also been accused of not paying sufficient attention to the emerging dilemma, despite claims from its leadership that the Fed was to a large extent ignorant of the problems.[4] We should not assume that the invisible hand acts right away to correct mispricings or to punish unsound consumer and corporate business practices, but was biding its time as to when to strike, and the longer it takes to do so (or is hindered from doing so), the more severe the consequences become.

As inflation began to appear, interest rates were then raised, that helped spur mortgage defaults during 2004–2006, particularly in the sub-prime space (and lo, the invisible hand came out with full force). Then as a response to the global financial crisis, rates were lowered to near zero to minimize the financial fallout.

Central banks for the most part have skirted much of the criticism for the issues plaguing their respective economies that they are supposed to be guarding, and oftentimes capitalism and

private enterprise is blamed. Yes, we can argue that our world today is very complex and it is hard to navigate and monitor a major company, especially when it trades in exotic products and derivatives (and so it may be claimed that the invisible hand does not work effectively anymore, since capitalism and the financial system is much more complicated)—but I would argue that the compensating actions of the invisible hand may sometimes just take longer to play out.

Today, we have monumental/gargantuan central bank activity and few want to question the omniscience or wisdom of central banks. Perhaps we also want to feel this way because we know that central banks are here to stay, and we have tremendous hope that they will do a better job the next time around, since we see no plausible solution otherwise. A person can be severely attacked if they even suggest that they have the ability to market time and predict the future occasionally. But we want to believe that central banks can do just that (or perhaps it is because they can sometimes create the environment they choose, through a force of will and their policy).

A great gift given to central bankers today has been the ability to increase liquidity in the financial system without causing inflation. It has helped governments continue without any serious fiscal challenges (or the need to implement reform) since their debt (if no one else wanted it) was ultimately bought by central banks, while offering yields that have remained historically low. But how long can this environment continue?

Most central bankers admit that they do not know what to do next. How do they reduce their balance sheets? How can they raise rates without creating fear and financial disruption? Could we conclude that what central banks have done so far has been truly beneficial? The evaluation of former Fed chairman Ben Bernanke's inspired policies and whether they were truly successful is still probably a decade away, since we still do not know what the ultimate consequences of his actions will be.

We have other troubles on the horizon if we have not experienced them significantly already. We have a very large welfare state in the western world that we can no longer afford. Demographics (low birth rates), longevity and mispricing (government politics) have all played a role, and reforms have been slow in coming.

CAN THE INVISIBLE HAND COME BACK TO PUNISH US?

We are still feeling the effects of the global financial crisis today, and we continue to see it discussed in many conferences and forums, as though it was just yesterday. Admittedly, it often becomes a complicated discussion and void of clear insights.

Our government agencies have attempted to tie up the invisible hand through intervention and it seems to have worked, but this can only be temporary. The invisible hand is waiting to strike, knowing that unnatural economic forces have been introduced into capitalism, and the financial system needs to come back to equilibrium. Here is where the invisible hand will someday appear:

a. **Overpriced assets –** Speaking to any professional money manager today will convey the same story— most if not all assets are expensive today. Yet there is still a compulsion to buy (even though under historical circumstances, investors would not) given the prevailing atmosphere of stability reinforced by central bank activity. In the past, the invisible hand would want to move to safety such as cash.

b. **The non-producing or welfare economy –** Can the working population and corporate community continue to be able to pay for benefits to the non-producing? Can our burgeoning welfare state still last into perpetuity and be supported by current levels of contributions/financing (which are now seen as too low and thus unsustainable) without introducing any new and meaningful reforms?

   The pay-as-you-go framework was so compelling in past generations, but demographics has changed that (we cannot push the obligations to the next generation). We have not saved enough for the future. When reforms do take place today, they are often too little and too late. At least in the private sector companies do recognize the issues regarding their own benefit programs and therefore make modifications, but this is not always true at the national or federal level. The invisible hand will not let our broken social system and safety net continue forever.

c. **Sovereign debt, fiscal imbalances and a currency bust –** Could governments afford their current debts if interest rates had been higher? Can they afford these debts when interest rates begin to move higher? Why have there been no changes or reforms made to cut fiscal spending in the meantime? The tenuous balance between government revenues and outflows is not being seriously discussed (or perhaps because it is an unpleasant discussion with no easy solution in sight). The invisible hand will ultimately show governments no mercy here, but unfortunately this problem will be primarily passed onto taxpayers and others.

   And who may want to hold a particular currency when the underlying economy has too many issues to deal with? So far that question has remained moot, or perhaps it is because major currencies, whether it be the U.S. dollar, the Euro, the British Pound, or Japanese Yen (and alas, also the

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Canadian and Australian dollar), all face the same issues, so it is a relative value game in the fiat currency space.

d. **Interest rates (negative interest rates) –** Interest rates globally are artificially low, and most would admit that central bankers (e.g., Fed, Bank of England) are behind the curve (i.e., short-term rates should already have been raised by now and should be at higher levels than is currently the case—similar economic statistics to what we are witnessing today have historically existed alongside higher rates).

   If we are sceptical about the merits of the invisible hand taking vengeance in the other points discussed above, at least the matter of negative interest rates should get you thinking. Who would buy a bond that pays you back less than what you paid? Does this make any sense? The only argument to buy such securities is the belief that some other entity (the greater fool theory) will want your bond, making it even more valuable than before you bought it (some arguments to buy these fixed income securities could include the anticipated currency gains on the bond, continued more demand than supply for the bond making the interest rates even more negative, or perceived safety—but this charade eventually ends). In the case of negative interest rates, the invisible hand should come down like an invisible fist when the time comes.

e. **Inflation –** Can all of this liquidity eventually move inflation higher? In theory yes, but we have not truly seen inflation at all anywhere (in fact, we have often seen the spectre of deflation). There is still unused industrial capacity and a host of other factors that have accounted for lower inflation. But it is hard to see inflation continue to be muted if the monetary base continues to expand or if it reaches levels that are just mind boggling (and we could already be there—having $4.5 trillion in assets on deposit at the Fed is a huge number). Money velocity has been low (i.e., less money has been changing hands than had been the case only a short time ago, perhaps in part because of uncertainty, but also lingering fear), but if people become scared of losing purchasing power and thereby start spending, then the invisible hand will not have to do anything, inflation will rise quickly and significantly as demand will outpace supply. And what could central banks do without killing the economy?

f. **An unrelenting recession –** If it is true that our (rather anaemic) global economy has been driven recently by monetary expansion, what happens when this stops? The U.S. economy was doing fine in 2015 even though the Fed stopped its quantitative easing (QE) program in 2014, so it can be argued that monetary expansion was not necessary or no longer needed. Then again, maybe other QE programs will pinch hit and take the Fed's place in 2015, such as the European Central Bank's QE version introduced in early 2015, helping to buoy not only Eurozone markets, but in the process, will help other international markets as well. How long can intervention continue?

g. **Liquidity and defaults –** All of the liquidity introduced into the financial system by central banks has helped to cover lower quality investment choices. Weak corporations and governments may have gotten a free ride by being able to rollover and issue new debt, due to a financial community eager and willing to gobble up any new investment opportunities. Sometimes lower quality investments can be masked in a portfolio through the argument of "diversification," the claim that not all bad investments will turn out bad, so the portfolio overall will do just fine (the same argument that was once used to package a large variety of sub-par subprime mortgages and CDOs together). But as we saw in the global financial crisis, quality was far worse than expected, and many bad assets were highly correlated with each other. The invisible hand can just sit back here and let natural market forces operate when liquidity begins to wane.

h. **Efficient markets –** Can we really argue based on the above, that we have efficient markets operating today? In many facets of the financial markets it seems that market forces are currently suspended—no one, for example, wants to fight a central bank or short equity/bond markets just yet. Many want to just ride the wave even if it otherwise does not make any financial sense right now. But the invisible hand married with efficient market principles will have to surface at some point.

CONCLUDING REMARKS

Our economic theory has been developed over hundreds of years. We have been taught what was considered to be well-established and sound financial and economic principles that have

been proven and have worked over and over again. This includes beliefs such as the following:

- That we cannot expand the monetary base (or its equivalent) too fast without creating inflation.
- Interest rates will never go negative.
- If debt cannot be repaid, then it has to be devalued or one has to default.
- An underlying currency is in jeopardy if the domestic economy or the financial health of its government is questionable.

So far all these beliefs among others have proven false (lately)—or have these "laws" of sound economics just been temporarily put on hold? Sometimes our economy does need to take a breather (which may include a mild recession) to alleviate some of the excesses created during the economic boom, in order to bring things back into a healthy balance. But now the principle of "no pain, no gain" has been replaced by the principle of "no pain, no pain" and various non-free-market entities are trying to achieve just that.

The new policy innovations have not solved problems, but just bought time (and that time will run out in the next few years), but most have not figured that out. The invisible hand does not have to act quickly or right away, but by not seeing it operate within a short span of time, some unfortunately assume it is not active anymore.

The former Soviet Union crumbled because its leaders and officials were not able to outsmart the invisible hand. A similar fate could await our western society, as we keep trying to suspend the natural forces in our economy and financial system from taking shape. ■

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ENDNOTES

[1] "Invisible Hand," Financial Dictionary, <http://www.investinganswers.com/> [path: http://www.investinganswers.com/financial-dictionary/economics/invisible-hand-771]

[2] Ibid.

[3] "Causes of the United States housing bubble" <https://en.wikipedia.org> [path: https://en.wikipedia.org/wiki/Causes_of_the_United_States_housing_bubble]

[4] Baker, Dean. "Alan Greenspan owes America an apology" <http://www.theguardian.com > [path: http://www.theguardian.com/commentisfree/2013/oct/28/alan-greenspan-housing-market-crisis]