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***SED PROFILE***

**TODAY'S *TRUE* BLACK SWAN**  
– **The Conceit of Bogus Capitalism** –

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## CHAPTER II: TODAY'S *TRUE* BLACK SWAN

### – The Conceit of Bogus Capitalism –

*Author's Note: If the essay in Chapter I reported on the good news about today's global economy, the present essay explores the principal threat to it in the longer term. It synthesizes a number of themes we have been developing for the past decade into a coherent whole. The fundamental message is that true capitalism is not being allowed to work in many quarters of our globalizing economy, and that because of this there will be hell to pay in the future.*

*But what exactly is "true capitalism?" We start off by defining what this concept actually means. This gives us a normative yardstick for assessing to what extent capitalism is not working as it should be, and thus how far the world economy has deviated from this ideal. Without understanding the magnitude of this deviation, it is well nigh impossible to determine suitable policies for dealing with such problems as energy and water shortages, financial market turmoil, and even today's growing inequality of wealth and income. We show that this is the case.*

### 1. Introduction

The concept of a "Black Swan" is now used to describe an event whose probability of occurrence is extremely low, but whose impact is enormous. In this essay, we argue that today's planetary Black Swan is the conceit that the longer-run future of the world economy will continue to be "goldilocks" because, as Francis Fukayama famously put it in his 1989 "The End of History?" article, we are all capitalists now. Fukayama's provocative point was that, with the fall of the Berlin Wall and the end of communism, the great 150 year old debate about the virtues of market capitalism *versus* socialism *versus* communitarianism *versus* dirigisme *versus* communism was dead. For the evidence of the 20<sup>th</sup> century made a convincing case that market capitalism alone could provide the rising living standards and economic progress that today's global, internet-savvy populace increasingly expect to enjoy. Moreover, when such expectations are disappointed, governments tend to fall, and politicians now know this.

Claims for the superiority of market capitalism were further strengthened by the discovery of the phenomenon now known as "the resource curse." Specifically, everyone noted that the greatest growth in wealth and living standards had occurred in resource-poor states like Hong Kong, Singapore, Taiwan, and even Japan. Conversely, many resource-rich OPEC oil states had fared quite badly for the simple reason that they squandered their newfound wealth.

Yet if this consensus view were true, why do we claim the conversion to market capitalism by almost everyone, almost everywhere, in recent years is a “conceit”? We do so firstly because of the reality that we are not all capitalists at all in any meaningful sense of that term. Indeed, the capitalism we embrace is bogus capitalism, deviating disturbingly from the set of preconditions which define capitalism in the first place. This will be shown just below. Moreover, the *ways* in which economic regimes are deviating from the canons of true capitalism foretell a future of grave and largely unrecognized problems—indeed catastrophes. Ironically, these problems would not, in fact, blight our future had we all become true capitalists.

A second reason why we deem today’s philosophical status quo a conceit is the degree to which economists, columnists, and politicians who should know better have accepted bogus capitalism as true capitalism. Because of this widespread confusion, the quality of their analyses of such issues as “energy policy,” “currency strategy,” “protectionism,” “financial reforms,” “inequality of wealth and income,” and “global imbalances” is most unsatisfactory—at least in our opinion.

*To conclude, we advance in this essay the case that our unwitting acceptance of bogus capitalism as true capitalism is the genuine Black Swan on today’s horizon. Given the failure of most commentators to discern the existence of this confusion, the probability of its occurrence is deemed very low by most people. Moreover, its impact will be very significant, given the catastrophes it portends. Thus, the concept of bogus capitalism passes the two tests required for a swan to be black.*

In Section 2, we define “true capitalism” and contrast it with what is being practiced today. In Sections 3-6, we then apply this critical paradigm to the four central issues of global imbalances, of energy policy, of financial market deregulation, and of inequality of income. These case studies will link our theoretically-motivated concerns to serious problems in the real world.

## **2. True versus Bogus Capitalism**

When Bill Clinton went to pursue his degree at Oxford as a Rhodes Scholar, he studied the traditional moral tripos known as PPE (moral philosophy, politics, and economics). There, he and his fellow Rhodes Scholars learned that market capitalism, as originally introduced by Adam Smith, was in fact an investigation into moral theory. Indeed, the ideas underlying Smith’s *Wealth of Nations* of 1776 were rooted in his predecessor treatise *A Theory of Moral Sentiments* of 1759. Accordingly, as economic theory developed during the next two centuries, emphasis was always put upon such morally pregnant concepts as non-wastefulness (now known as “efficiency”), distributional equity, stability, privacy (decisional and informational decentralization), and even the more abstract concept of the Public Good in Aristotle’s sense.

In short, the links between capitalism, viewed as the study of optimal resource allocation systems and moral philosophy, were deep and abiding. It is easy to overlook this tradition when, in today’s ideological environment, a belief in capitalism has morphed into a belief that “markets know best,” that “the virtue of free markets is that they result in maximal efficiency,” and that “the role of government should be as limited as possible.” The idea that government should actively redistribute income (e.g., Ricardian side payments to those who inevitably lose from free

trade) and should intervene to remedy a plethora of “market failures” (externalities such as pollution and excessive leverage) is acknowledged by most people who have studied and understood ECON 101. Nonetheless, it is acknowledged in an increasingly grudging manner—as an agenda best left aside while we attend to the “true” agenda of capitalism—letting free markets augment the efficiency of the resource allocation process. This represents a complete misconception about the nature and justification of true capitalism, a philosophy in which government *and* businesses *and* consumers work hand in hand in the right way and under the constraints necessary to optimize the Public Good.

In short, an understanding of true capitalist theory entails an appreciation of the limited conditions under which the unfettered play of free markets is justified by its contribution to efficiency, equity, stability, and other aspects of the Public Good. As the late conservative economist Milton Friedman always pointed out, the theorems that make clear the conditions under which decentralized market behavior *does* promote the Public Good, are the same theorems that spell out the conditions under which such behavior does *not* do so.

In this vein, when we speak of true capitalism, we refer to the *set of conditions* under which the capitalist resource allocation system will allocate resources efficiently, equitably, etc., and in doing so will promote the Public Good. To summarize these conditions:

**A. The Underlying Social and Political Preconditions:** For free markets to function correctly, it is well known that the rule of law must prevail. In particular, citizens must enjoy sanctity of contracts, non-bribable judges, transparency in commercial relations, and the protection of intellectual property rights. Without such protections, crony capitalism prevails, and talk of “free markets” usually proves vacuous.

**B. Economic and Market Preconditions for Decentralized Free Market Transactions to Maximize the Public Good in a World of Uncertainty about the Future:** As students learn in their textbooks, the following five requirements must be met:

- (i) Perfect competition—in particular the absence of any bargaining power by any group whatsoever whether cartels, labor unions, or oligopolies. This first assumption implies that product, capital, and labor markets must be fully deregulated. It implies in tandem that every individual producer and consumer “takes prices as given by the invisible hand” and has no ability to impact, much less manipulate prices of anything;
- (ii) Risk aversion on the part of all consumers, or equivalently, diminishing marginal utility for goods;
- (iii) Complete hedging markets—risk averse agents must be able to hedge every and any risk by creating appropriate portfolios of derivative securities;
- (iv) Absence of non-market phenomena or “externalities” such as pollution, where the price system either fails to exist or else misallocates resources; and
- (v) Diminishing returns to scale in most (but not all) industries.

### C. Economic Preconditions Mandating Legitimate Government Intervention:

- (i) Need to regulate business cycles and financial market crises via appropriate fiscal and monetary policies;
- (ii) Need to redress market externalities (e.g., pollution) and to provide basic public goods (e.g., a legal system, a military, etc.); and
- (iii) Need to address the issue of distributional justice, e.g., determining the optimal rate of progressivity of the tax code. [This axiom surprises many people who believe that pure capitalism focuses on economic efficiency, but not equity. This is false, as even Adam Smith understood. True capitalist theory requires that government confront the issue of fairness, and for highly important reasons reviewed in Section 3.D below.]

### D. Extension of these Preconditions to the Case of Multiple Nations with Trade:

- (i) The economies of every nation that trades with other nations must possess an economy meeting the above “domestic desiderata,” *and additionally* all currencies must be market determined (except in times of crisis), and all capital accounts must be open and transparent. *This is the fundamental symmetry axiom across nations that defines “true global capitalism.”* It gives meaning to the concept of “a level playing field” for trade. Without an understanding of these particular preconditions, it is impossible to make sense of today’s global imbalances, of who is to blame for them, and of what should be done about them. It is very important to understand this last axiom up front, since a failure to understand it is why most discussions of global imbalances have turned into unconstructive blame games, and little more. To be fair, the axiom is not well known and is thus often overlooked.

**Summary Definition of the Public Good:** To recap, a world in which “we are now all true capitalists” is one in which all four of the above sets of conditions, **(A)** through **(D)**, are satisfied. Specifically, assuming that the rule of law is in place **(A)**, unfettered free market behavior should prevail within each nation if and only if preconditions **(B)** are met. Where they are not met, government must redress the failings of the free market with the appropriate remedies **(C)**. This includes dealing with, rather than dodging, the issue of the distribution of income. Finally, in the context of international economics and trade, the symmetry axiom of a level playing field for all must hold true **(D)**—and in particular, *all* currency values must be market determined (except in periods of crisis), and *all* capital accounts must be open and transparent.

Adherence to these sets of desiderata *by all trading nations* is what we mean in speaking of an idealized global economic order, or more abstractly the Global Public Good. This concept provides the yardstick by which we can assess how far we have deviated from the optimal, and by which we can know how to improve matters in a constructive manner. Be sure to note how far this ideal lies from presumptions that “capitalism” is about the unfettered play of free markets. It is not, and never was, even though the healthy functioning of markets is central to it.

### 3. The Four Case Studies

We have discussed each of the following four case studies (energy, leverage, global imbalances, and income inequality) from several different standpoints over the years. We shall probably continue to do so since each keeps bobbing up to the surface like a dead corpse. Below, however, we treat all four from a new and unified standpoint that asks: “To what extent are today’s problems in each of these areas reflections of the fact that true capitalism fails to work?”

#### A. Energy

**The Consensus Forecast During Past Years:** It was eminently understandable that the consensus was caught off guard by the rapid rise in oil prices between 2003–2005. It was also understandable that many commentators attributed the price rise to tightening of production by OPEC, and/or to leveraged speculators (hedge funds) pushing the price way up, and/or to rapidly rising Chindian demand, and/or to the growing awareness that “oil is getting more difficult to find” as Shell CEO Jeroen van der Veer recently pointed out.

Finally, it was understandable that observers buying into these arguments expected that the oil price would by now have fallen back to somewhere between \$25–\$45 per barrel by now, well below its “bubble peak” of \$70. After all, cartels always collapse, and price bubbles driven by leveraged speculation always burst. Moreover, Chindian demand growth was surely unsustainable (it has since increased). Finally, the “feedback effects” from the classical commodity cycle always kick in: Very high prices discourage demand, and encourage substitution and new exploration. The result is lower prices, after an appropriate lag. Indeed, the dynamics of precisely such cycles in the past gave rise to the widespread view that the five most dangerous words in resource economics are, “It’s different this time around.”

Yet if such consensus views might have been understandable in the past, how can they remain so today? Are people blind? What additional evidence will it take to convince people that we are in a completely new regime? After all, prices not only did not fall back, but surged higher and stayed far higher than expected—and for longer. Moreover, the copper price followed suit. This was surely a signal-on-stilts that things were different this time around since copper never before mimicked oil as it has this time. After all, there never was a copper cartel, and copper has never been decreed “difficult to find.” So what in the world is afoot?

The reality is that everything really *is* different this time around, and what is truly dangerous is our failure to understand this. We at SED predicted that what has happened would happen in a series of essays commencing four years ago. We summarize in a footnote below the logic we set forth as to *how and why* everything was changing. Our analysis was centered around five structural changes that have since occurred. Of these, only two have yet to enter consensus views

notwithstanding all that has happened.<sup>1</sup> Herein, we simply wish to discuss the one structural change that is consistent with the thesis of this essay: namely, that the amount of new oil supply that should have been forthcoming in the past two years and would be forthcoming in the future were true capitalism in play is a *small fraction* of that amount. The reason is that true capitalism is no longer being allowed to work—either in oil, or in copper (and even in other cases).

**The True Supply-Side Crisis:** High prices no longer provide the necessary incentive for the major oil companies (working with the independents) to make those very long-term investments necessary to ensure future supplies. The IEA estimates that some \$20 trillion must be invested in oil and gas during the next 15-20 years for supply to equal demand at reasonable prices. Yet the rate of investment has recently been just one tenth of that amount at an annualized rate, and private forecasts that we respect indicate little improvement to come in this rate. A very similar story is unfolding in the copper market, where not one single greenfield project is under way. Industry veterans say that at least four should be given past, present, and prospective market conditions.

What has happened, of course, is that capitalism is not being allowed to work for the first time—high prices notwithstanding. More specifically, the nations in which the most promising oil reserves are to be found are increasingly thugocratic. Few rational capitalist firms are thus willing to make those very long-run commitments for exploration and developments in such thugocracies as Russia, many central Asian states, Venezuela, Nigeria, Chad, the Sudan, and Ecuador to name a few. Yet very long-run investments are *exactly* what are called for in developing new sources of production (as opposed to marginally expanding declining old fields), and they were made for eight decades in the past. To restate this point, the incentive structure required for capitalism to deliver the goods that it has during the past eight decades has changed and is now pathological. Worse, levels of investment are hindered by yet another structural change: The need of large firms to invest huge sums to buy back shares to please short-term investors and/or to ward off takeovers.

Implicitly, therefore, global consumers must hope that today's ever more powerful state-owned "oil authorities" in developing nations will take over the former role of the Seven Sisters and the independents in identifying and developing large new oil fields. Regrettably, the evidence is that

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<sup>1</sup> *First*, on the demand side, there has been the ongoing explosion of demand from China and other newly emerging nations. This development *is* in the market. More generally, with aggregate global growth having nearly doubled, demand growth has been notable. *Second*, on the supply side, we supported the "peak oil" view that output at most of the existing large oil fields would be lower than expected in the future, and would in fact, begin to decline. Such peaking is increasingly acknowledged to be taking place, as even the recent General Accounting Office study conceded. People who deny the peak oil hypothesis usually point to the large amount of "reserves" that exist. But this is, in fact, a red herring having nothing to do with peak oil. Old oil fields do and indeed must decline geologically and rapidly at the end. Happily, large new reserves do exist, but this is irrelevant to peaking *per se*. *Third*, while large new oil reserves do exist (as in the case of gas and copper, as well), capitalism is not being let loose to identify and develop them. This is the main point to be discussed in the main text above. *Fourth*, there is the reality that alternative energy sources will emerge far too slowly to plug the energy gap. *Fifth*, both the supply and demand curves for energy are increasingly price inelastic (vertical). As we have shown both mathematically and diagrammatically, this development causes slight changes in supply/demand conditions to translate into *very* large changes in price. A failure to understand this phenomenon leads many investors to believe that conspiracies of some kind (e.g., hedge fund strategies) must underlie the unfathomable price changes of the past ten years, when oil increased from just under \$10 to \$75 per barrel.

they are incapable of doing so. The reason, once again, is a pathological incentive structure. Indeed, consider how an exodus of talented engineers, along with black market theft of refinery equipment within Iran, has precipitated rioting in the streets during the past two months. Welcome to the future: Street riots within the nation with the second highest reserves in the world, due to the inability of citizens to obtain enough gas to fill up their cars! Even worse, this is occurring in a nation that is relatively stable and enlightened compared with, say, the Sudan or Nigeria. Why has this happened? Once again, the answer lies in the problematic incentive structure within the Iranian oil authority.

**The Implications: Wars?** The flip side of the failure of capitalism to function properly is the outright *politicization* of the energy market. Simply note the tactics China has been using to scour the world and cut reciprocal deals with thugs throughout Africa and Latin America to secure its own future supplies. Or recall the energy market tactics utilized by Russia to control neighboring central Asian states, and to influence Europe as well. Adam Smith would turn in his grave to think that pundits hail such developments as proof of “the advent of global capitalism.”

What should the oil-consuming states do in the face of the politicization of this all-important market? They must do the only thing they can do, namely play hardball in return: *They must adopt a rational bargaining strategy with appropriate threats if they are to obtain the energy supplies they will need for the future.* At present, most consuming nations have adopted no bargaining strategy at all, other than to oblige the Chinese, Russians, and Venezuelans at every turn.<sup>2</sup> In the next chapter, we will explain exactly what we mean by a rational bargaining strategy, and will demonstrate that the consuming nations hold trump cards that they could be utilizing, but are not. Additionally, consuming nations need immediate energy market reforms to curb consumption of fossil fuels, for purposes of national security more than to combat global warming. Hoping that fuel cells and ethanol will one day save the day is clearly not enough.<sup>3</sup>

Along with water, oil is perhaps the one commodity that could lead to a significant war between nations in the future. We have already witnessed how oil shortages wrecked the US and world economy *twice* in the decade of the 1970s. Our current blindness to the realities set forth above is thus extremely worrisome. Most disturbing, perhaps, is the failure of almost every observer to identify the failure of capitalism as the most serious structural development of all. After all, it is capitalism that has brought the world the energy supplies it has needed for over a century. Even nay-sayers have always existed, claiming that “we are going to run out of oil.” And just as in the past, only capitalism can secure our future.

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<sup>2</sup> To be sure, the oil market has often been politicized in the past. The formation and subsequent behavior of OPEC in the 1970s is a case in point. However, there never was a fundamental shortage of energy back then. The cartel simply reduced output for its own purposes. Moreover, game theory teaches us that cartels almost always collapse, and this happened to OPEC in the winter of 1986, when oil fell from \$34 to \$9 per barrel after Saudi Arabia discovered that fellow cartel member Iran was cheating on its quotas, and flooded the market with oil in retaliation. The story today is altogether different. The necessary oil is simply not being pumped, and in the future will not be barring those massive investments in exploration and development that we should have been making for the past five years. Even if a huge exploration and development programme were belatedly to be undertaken, the *cumulative* lack of investment in recent years will continue to haunt and hurt us.

<sup>3</sup> In this regard, a measure of the true magnitude of the US energy crisis is that the nation now imports 64% of its oil, and up to one third of that now comes from nations that are very anti-US. The supine US response to this reality has been to do nothing. Scarcely a complaint from anyone, much less a substantive policy other than the wimpy proposal that utilities substitute alternative energy sources for 15% of their fossil fuel consumption over time.

Additionally, there is a widespread failure to realize the *cumulative effects* of ever-delayed investment in new oil fields. The impact of this cumulative shortfall gets magnified by the inelasticity of supply and demand, as was stressed in the lengthy footnote above. The result of all this could be a sequence of global crises in the future, and possibly wars.

**Note:** For those who may have forgotten, we have already identified the opportunities that these developments pose for investors in our essay, “Prospects for the Prices of Oil and Metals” appearing as Chapter IV in our September 2006 report.

## **B. Global Imbalances**

The Chinese trade surplus with the world, reported for July 2007, rose 64% from its level a year earlier. Note that this is seven years after China “promised to curtail its surpluses significantly,” five years after more strenuous such promises, and two years after it “generously” offered to begin to let the Yuan/Dollar rise. While it has indeed risen by about 8% against the dollar, the depreciation of the dollar implied that its trade-weighted value barely changed at all.

Let us be very clear about what is happening here. To begin with, were we in a regime of true global capitalism (recall axiom sets **(A)** and **(D)** in particular, to understand analytically how anti-capitalist China has proven), the Chinese currency in the past two decades would have risen by several hundred percent according to the modern theory of asset market equilibrium, as we have demonstrated in past reports. Yet it is currently *half* of what it was two decades ago—a point that seems to have been overlooked by virtually every commentator. Ironically, the same observers are now most concerned, lest the US (and other nations) become “protectionist” and inaugurate a trade war with a nation that itself launched a massive trade war against the West when it dramatically *devalued* its currency in the early 1990s, and then pegged it! One result of all this is that China now has \$1.3 trillion dollars of foreign exchange reserves that are apparently growing at one million dollars per hour.

The blunt reality is that an ever growing number of nations are outraged by China’s behavior, and are finally gearing up to do something about it. However, China is not the sole culprit here. Asian nations, as a whole, have been mercantilist for nearly four decades and have accumulated foreign exchange reserves of over \$3 trillion. Japan, for its part, was particularly egregious as it has belatedly admitted. But as a close US ally in the Cold War, it could get away with its currency manipulation, its mercantilism, and its large trade surpluses.

Of course, today’s global imbalances far transcend the issue of Asian trade surpluses. To begin with, there is the alleged “over-consumption” by the US that is always cited as the source of all imbalances. But what does this claim really add up to? *First*, the US can hardly be blamed for Asia’s mercantilist policies. And these Asian trade surpluses partly explained the high consumption/low savings of the US as follows from National Income Accounting identities. *Second*, the US consumer did indeed consume more and save less than its counterparts in Europe and Japan—but why? Surely this imbalance was not due to Asian policies? The reality is that this differential reflected the fact that the US grew much faster than the other two during the past

fifteen years, and outperformed both in ways that boosted its growth rate of consumption and in turn, its trade deficit.

*But why did the US outperform other nations during this era?* The main reason is that with only 5% of the world's population, and 25% of global GDP, the nation walked off with 89% of the fruits of the Third Industrial Revolution. Conversely, Europe stagnated during a never-ending debate about the need to “deregulate its highly regulated factor markets” that McKinsey & Company's Global Institute revealed to be the principal source of Eurosclerosis. At the same time, Japan fell off the map, not because of its real estate bubble, but rather because the chickens came home to roost as a result of four decades of a misallocation of capital (e.g., the postal savings system and its corollary of crony capitalism).

What this all adds up to is that the US was not the principal miscreant on the global stage, and the sole source of global imbalances, as many wish to believe. True global capitalism (recall Axiom sets **(A)** and **(D)**) implies that every nation must possess fully deregulated and transparent factor markets. Thus, the reason that the US walked away with the fruits of the industrial revolution and thus grew faster lay largely in the failure of *other* countries to meet the criteria set forth in the introduction. This *asymmetry*, in turn, led not only to greater growth but also to an unexpected explosion of family net worth in the US, unmatched elsewhere. This wealth growth, in turn, led to a corresponding reduction in the need to save, according to the logic of Franco Modigliani's Life Cycle Savings Hypothesis.

To sum up, the people of the US became highly optimistic, let the growth of the value of their assets do their savings for them—and thus ended up saving less, and consuming more than others. To claim that all of this is the “fault” of the US is preposterous. The true fault lies in the growth-retarding policies of nations that failed to act in accord with the canons of true capitalism.

*Enough! We have hopefully made the point that once again a major problem (global imbalances) stemmed largely from a failure of true capitalism to work symmetrically across the nations of the world. This is a radically different diagnosis of today's imbalances from others we know of. Yet our account is completely consistent both with economic theory and with the logic of the charter amendments to the World Trade Organization. Other accounts decidedly are not.*

### **C. Leverage and Today's Financial Crises**

At this writing, this topic has suddenly become so important that it will be discussed on its own in Chapter IV. Briefly, there are two kinds of risk that bedevil financial markets. First, there is classical textbook “exogenous risk.” This refers to the movement in asset prices that is caused by *and is in proportion to* the amount of exogenous “news” in the market at any given time. Then there is the tendency for markets to overshoot this fundamentally-based benchmark of volatility. This extra risk is now known as “endogenous risk” and it results from **(i)** correlated mistakes about the likelihood of news (as in most investors' failure to anticipate the magnitude of the subprime default crisis), **(ii)** the inability of agents to properly hedge such risk, **(iii)** the extent of

leverage, and (iv) the degree of “Pricing Model Uncertainty.” The latter refers to the degree to which investors do not and indeed, cannot predict the new price of an asset, even if they were to learn the “news” ahead of time. Total market volatility or risk is the sum of both exogenous and endogenous risk.

Now the way in which true capitalism has failed to work in this third case study becomes clear from the following chain of reasoning. To begin with, the magnitude of endogenous risk simply cannot be assessed. This being true, it *cannot* be correctly priced by the market and as a result, it cannot be optimally hedged. What this means is, quite simply, that endogenous risk is an “externality” or “market failure” calling for government supervision of some kind (recall Axiom set (C)). Our own view of this matter is that government should have as little involvement as possible with individual transactions within financial markets. However, given the role of leverage in exponentially amplifying endogenous risk, it must limit leverage when markets get too frothy.

This can be achieved by a fixed and transparent set of rules that let investors know in advance when and why leverage will become more limited. Government used to regulate leverage, as when the US Fed would increase the reserve requirement for the overall banking system, or when the authorities would raise the stock market margin requirement as during the “Nifty-Fifty” stock market bubble of the 1960s. But government no longer does so in today’s extreme free market environment wherein whatever is good for Goldman Sachs, is deemed good for all.

The important point here is that, via Axiom set (C) above, true capitalism would have witnessed a curtailment of leverage both in the housing market by 2004 *and* in the issuance and trading of several new financial market securities. The market distress at this writing constitutes endogenous risk of a magnitude that would not exist were true capitalism in play. The same goes for the leverage structures in many developing world nations, where the problem is compounded by crony capitalist loans that are all too readily forgiven when they crater.

## **D. Distributional Equity**

If one were to cite the single most significant driver of global politics during the past century—and the source of the rise of communism and socialism in particular—it would be the exploitable conviction of most Have-Nots that they were being taken advantage of by the Haves. Their misconceived notions of how to rectify the situation culminated in the rise of communism and its ultimate collapse. This age-old redistributive impulse is far from dead. Indeed, the outcome of the next US presidential election will revolve as much around the recent stagnation of living standards of the bottom 60% of the American people, as around the fiasco in Iraq.

It is often forgotten, however, that the issue of distributional equity falls under the purview of economic theory, as much as under political and moral theory. Specifically, as was made clear in Axiom set (C), true capitalist theory simply cannot sidestep this politically charged issue, despite the belief by most self-styled free-marketeers that it can. The issue usually takes the form of how progressive the income tax and inheritance tax rates ought to be. We now spell out the subtle

relationship of this issue to true capitalism, and emphasize that the points we are making are Democrat-versus-Republican neutral when properly understood:

- *First*, some rate of tax code progressivity (including negative income taxes for the ill or the very poor) must be selected by government, and is, so in principle it ought to be the “correct” one. The issue simply cannot be dodged.
- *Second*, the Second Fundamental Theorem of Welfare Economics demonstrates that either a redistribution of endowments or equivalently, a progressive tax code, is completely compatible with the concepts of market price systems of economic efficiency, contrary to what is generally believed. [Recall that the two Arrow-Debreu theorems of Welfare Economics are the theorems that finally confirmed Adam Smith’s faith in true capitalism.]
- *Third*, one role of a progressive tax codes is to compensate for the absence of those markets that make possible the level of optimal risk-sharing *required* by true capitalism for true economic efficiency to exist (recall Axiom **B. iii** above). Scholars such as Robert Shiller have estimated that over 90% of risk-hedging markets that *should* in principle, exist, do not exist.<sup>4</sup> As a result of the widespread lack of insurance transfers from the lucky to the unlucky, the *ex post* distribution of wealth and income in the real world is far more unequal and skewed towards the rich than it would be under true capitalism. A progressive tax code can be viewed as a *remedy* for this deficiency of real world capitalism, just as fines for polluting and the provision of the military are in a different vein.<sup>5,6,7</sup>
- *Fourth*, elementary ethical as well as economic considerations imply the need for progressivity of the tax code—issues of “missing insurance markets” and efficiency aside. Adam Smith himself was well aware of this moral dimension of economics, and abhorred highly unequal distributions of income and wealth. He was also opposed to the “uselessness” of people living off of unearned wealth. Virtually no one who cites Smith seems to be aware of these facts.

Suffice it to say that, when Warren Buffet has to point out that the tax rate on his receptionist’s income is nearly double that on his own, we in the US are falling embarrassingly short of the ideal postulated by capitalist theory. Regrettably, the US is not alone in this regard.

*This concludes the discussion of four case studies in which the true explanation for the problems we are experiencing in today’s global economy stem from a failure of all nations to symmetrically embrace true capitalism. Once this point is properly apprehended, completely new and different remedies are called for.*

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<sup>4</sup> Shiller, R.J., *Macro Markets: Creating Institutions for Managing Society’s Largest Economic Risks*, Oxford University Press, 1993.

<sup>5</sup> Arrow, K.J., “The Role of Securities in the Optimal Allocation of Risk-Bearing”, *Econometrie*, 1953.

<sup>6</sup> Brock, H.W., “Social Choice, Distributive Justice, and the Theory of Games with non-Linearly Transferable Utility”, Ph.D. Dissertation, Princeton University, 1975.

<sup>7</sup> Zeckhauser, R.J., *Benefit Cost and Policy Analysis*, Chicago: Aldine Publishing Company, 1974.

## E. Conclusion

This chapter has proposed the possibility that today's true Black Swan is the fact that many nations now talking the game of capitalism, have not in fact converted to true capitalism at all—*and that this point is not well understood*. Moreover, the ways in which national policies now deviate from the canons of true capitalism presage very serious problems in the near and far future: The energy market will become an unholy mess, when it need not be; global imbalances will continue to be misdiagnosed and little will be done about them, when much could be done; excessive leverage will continue to create financial crises, when such crises could be successfully mitigated in the interests of all; and issues of fairness now being sidestepped will probably become politically explosive, whereas they could be suitably redressed.

But the situation is in fact worse than these comments alone suggest. That is because by their very nature, once imbalances and distortions of capitalism of this kind become embedded in the system, they tend to endure and indeed, to become worse over time. For absent the “spankings” that truly capitalists markets award all of us every Tuesday and Thursday afternoon, the more the underlying plaque builds up. Things get ever worse until the day of reckoning finally arrives.

Japan's misallocation of capital for nearly forty years ultimately brought the nation down for fifteen years. No one had dreamed that this might happen. The constipation of Europe's factor markets became an entrenched way of life, and it has taken two decades of wrenching changes to partially resolve problems that, under true capitalism, would never have needed to be resolved. In precisely the same manner, China's current misallocation of capital and labor will eventually cost it dearly.

What is frightening is how long the frog can be parboiled before it dies. We are reminded of Mancur Olson's brilliant explanation in his 1982 *Rise and Decline of Nations* why great nations inevitably collapse: Pathological status quos become embedded in the culture, as do those entrenched groups of players who end up benefiting from their continuance. This prolongs and exacerbates the underlying problems so that, when the day of reckoning arrives, it is too late. Under true capitalism, the nature of the system prevents the underlying imbalances from arising in the first place. For by the axioms of the rule of law, zero bargaining power, transparency, and symmetry, the troublesome special interests groups preying upon the imbalances cannot arise in the first place.