
**A Unified Solution to 4 Global Economic Problems
– Adherence to *True* Capitalism –**

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Definition of True Capitalism

A decentralized system of resource allocation *and* of income generation *and* of equitable distribution in which decentralized micro-decisions lead to the greatest possible level of output and income *provided* the following five caveats hold true:

“The Five Caveats”

- Caveat 1:** Rule of Law and Sanctity of Contracts
- Caveat 2:** Recognition and Regulation of non-market “Externalities”
- Caveat 3:** Existence of an incentive-compatible and equitable tax regime
- Caveat 4:** Perfect competition —no Putins, no Thugs, no Cartels
- Caveat 5:** Symmetry in international trade with *all* nations possessing open capital accounts and floating exchange rates

Problem 1: The Curse of “Resource Nationalism”

– Putin, Chavez, High Prices, Stagnant Supply –

Violation: Lack of perfect competition and sanctity of contract leads to pathological incentive structures for industry.

Result: An increasingly inefficient allocation system with very high prices and high price volatility.

Proposal: Reign in the role of Thugocrats via sophisticated multi-lateral bargaining strategies—including “optimal threats.”

Relevance to Today's Oil Crisis

Virtually all aspects of our forecasts seem to have materialized.

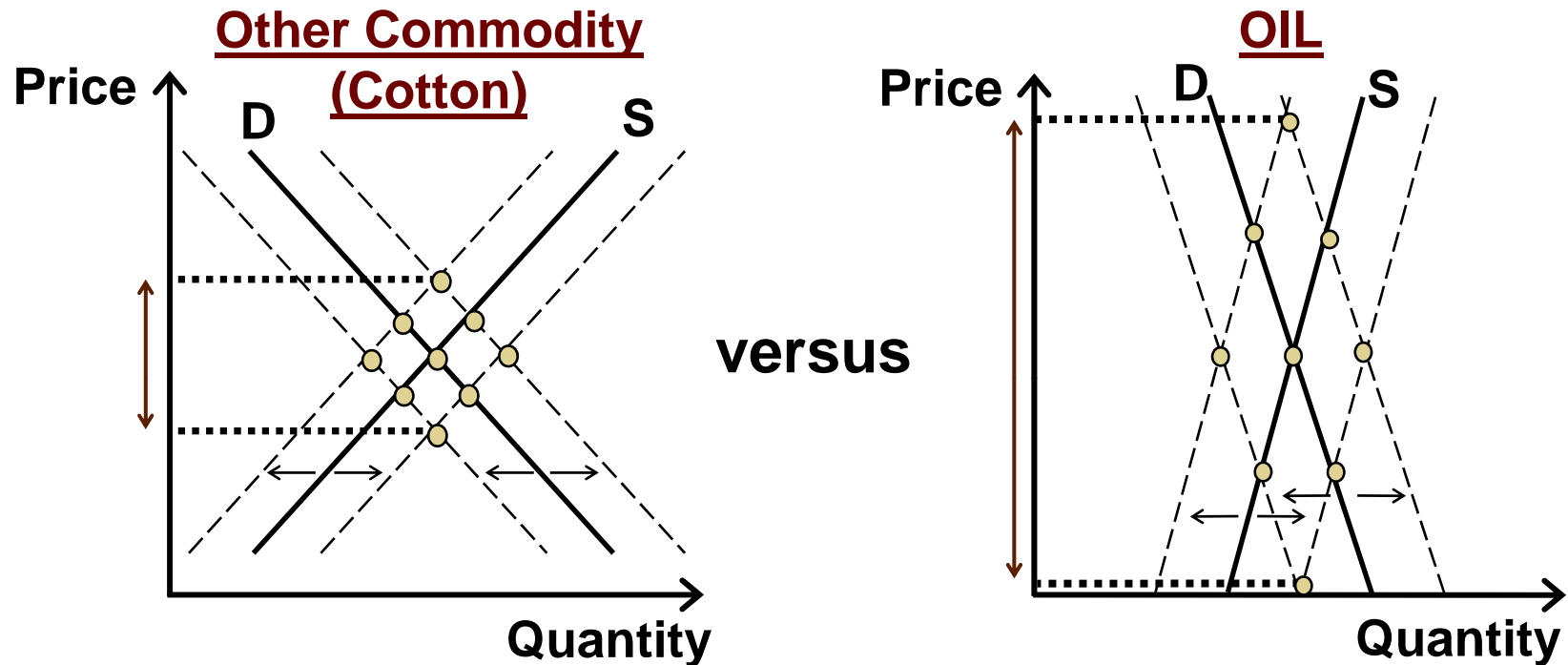
Supply

- **Output of old oil did peak about two years ago and is declining—and by more than pessimists expected**
- **Additionally, the rise of thugocracy and the death of an oil “market” in any meaningful sense of that word has been even worse than we expected**

Demand

- **Despite an increase in prices from \$10 in 1999 to \$140 in 2008, the demand for oil increased. [Technically, this is a “backward-bending” demand curve.]**
- US consumption is finally falling a bit, but consumption elsewhere is rising.**

The Truth About Commodity Price Volatility



- The volatility of price increases non-linearly as a function of the steepness of *both* the supply *and* the demand functions
- Most everyone understands why demand is price inelastic, but few can explain why the *supply* curve can also be very steep

Problem 2: The Global Financial Crisis

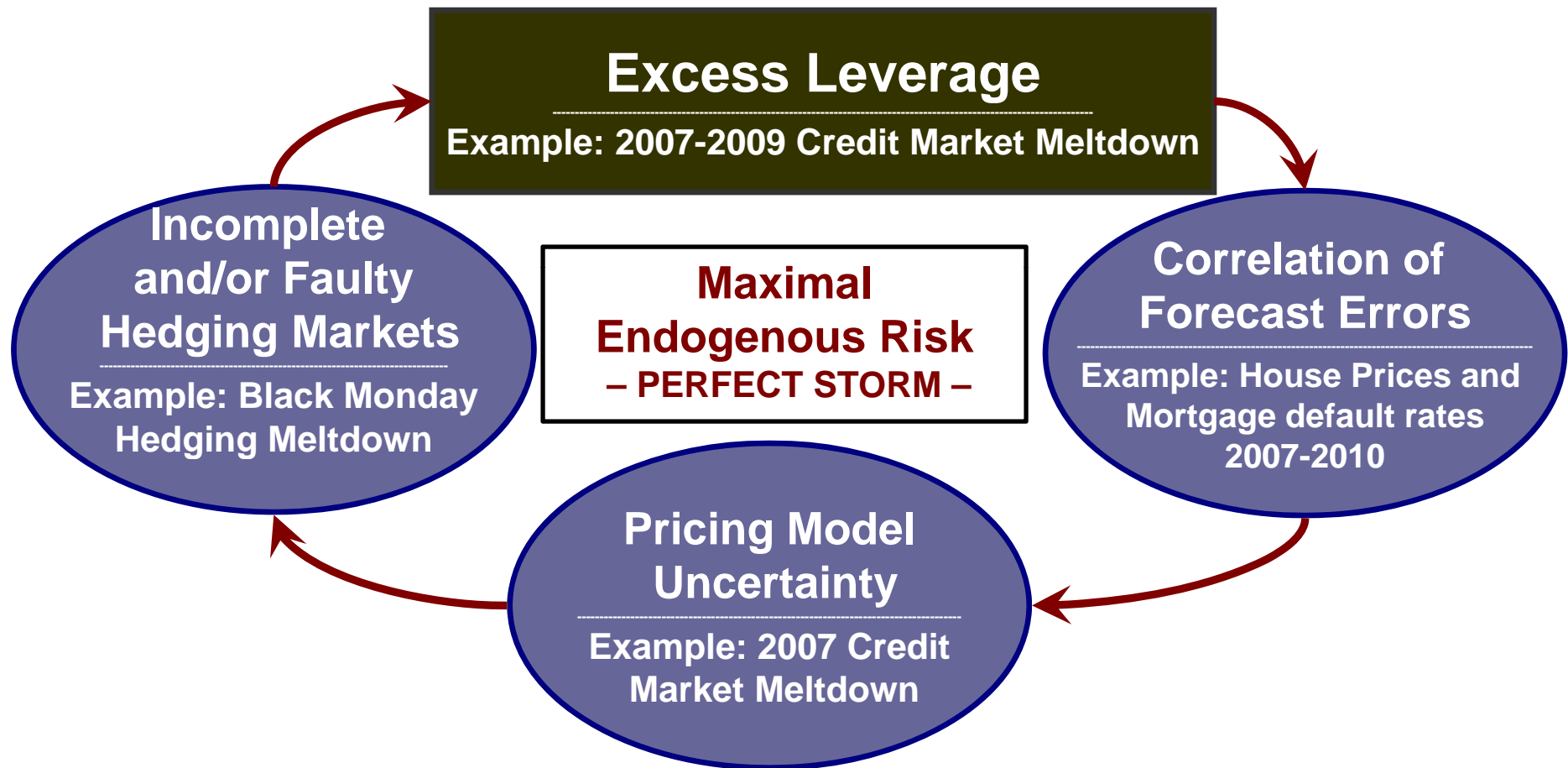
Violation: Failure to recognize that excess leverage is an externality that must be regulated.

Result: Excess leverage when coupled with endogenous risk generates “Financial Perfect Storms” like that of today. Everyone is hurt for no reason.

Proposal: Develop a counter-cyclical leverage policy, a generalized “Taylor Rule.”

The True Origins of “Endogenous Risk”

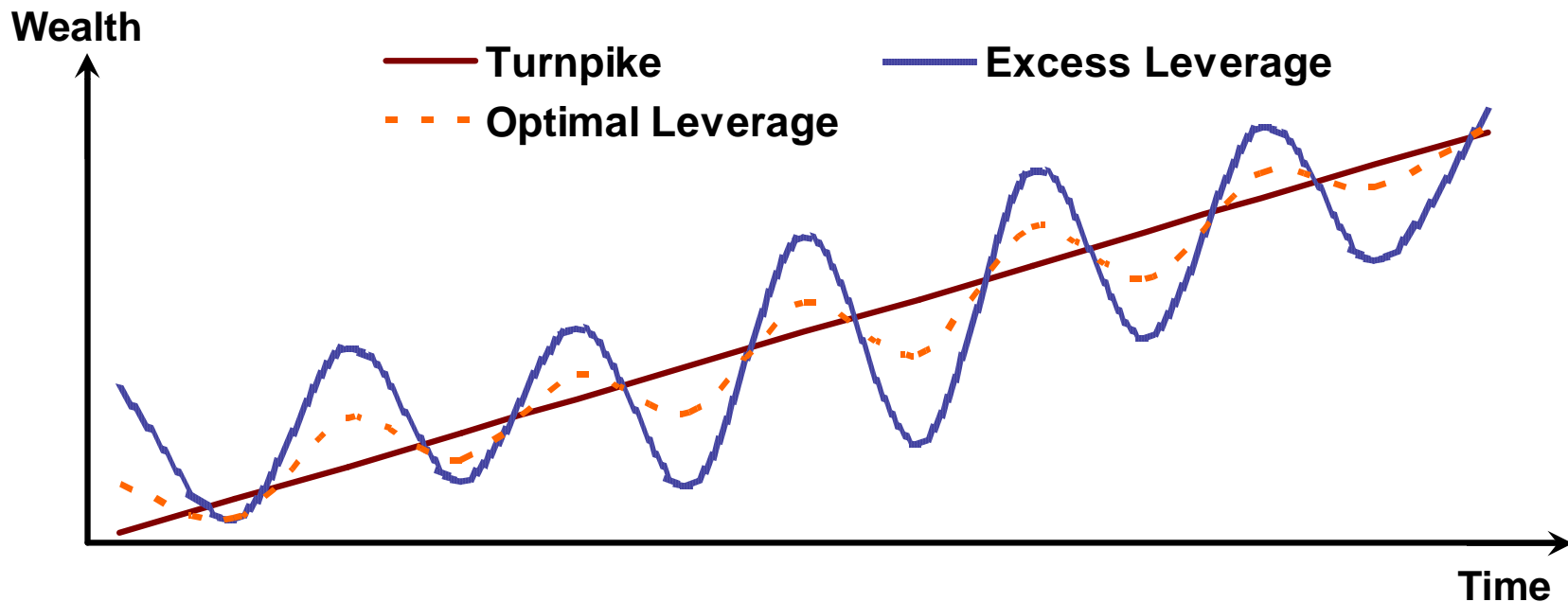
– The Story of Financial Market “Perfect Storms” and “Meltdowns” –



Note: In the figure above, leverage is in a rectangular box as opposed to an oval to emphasize that it is a *policy* variable that can be changed and not a *state* variable.

Excess Leverage as a Non-Market Externality – The Case for Government Intervention –

The Wealth Growth Paradox



Problem 3: Global Trade Imbalances

Violation: Four decades in which Asian nations (not exclusively) imposed capital controls, import restrictions, and currency controls. The “Symmetry” caveat was violated.

Result: Nearly \$4 trillion of foreign exchange reserves in Asian central banks, huge trade imbalances, unstable and mispriced currencies.

Proposal: WTO nations either play in accord with the Symmetry caveat, or they are chucked out.

Problem 4: Maldistribution of Income

Violation: Failure to understand and/or to implement the distributional logic of capitalism. This was introduced by Adam Smith in 1776, and formalized via the 2nd Fundamental Theorem of Welfare Economics.

Result: A climate where self-styled “conservatives” are blind to distributional logic, and where Warren Buffet rightly declaims: “My receptionist pays a much higher tax rate than I do.”

Proposal: Don't just blather about “fairness.” Do something about to achieve it.

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