

ARE FREE MARKETS
THE CAUSE OF FINANCIAL INSTABILITY?

ABSTRACT: *As the critics of global financial capitalism recognize, there is excessive financial instability in today's international economy. However, this instability is due not to laissez faire, but to its absence. Comparing the current world financial system to a laissez-faire benchmark highlights the very significant differences between the two.*

Most observers would agree that there is something wrong with the world financial system. There is far less agreement on what the problems are, but two claims in particular come up repeatedly whenever the subject is raised.

The first is that financial markets are in some sense excessively volatile: that financial prices fluctuate more than is socially desirable because of inherent weaknesses in how financial markets operate. Different arguments to this effect have been applied to many different financial markets—including the markets for bonds, equities, foreign exchange, commodities, derivatives, and the financial system generally—by many different writers, including H. P. Minsky (1972), Charles Kindleberger (1978), and, more recently, George Soros (1994, 1998).¹ To quote Soros (1994, 322–23):

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Instability . . . can give rise to sudden reversals that may take on catastrophic proportions. . . . The prevention of excessive instability is therefore a necessary condition for the smooth functioning of the market mechanism. It is not a condition that the market mechanism can ensure on its own. On the contrary . . . unregulated financial markets tend to become progressively more unstable. . . . Excessive instability can be prevented only by some sort of regulation. . . .

A second, related argument is that too many resources are used up in financial activities, relative to the broader social interest. This claim, too, comes in many different forms: that there is too much financial speculation, that there is too much financial trading activity, that too many resources are devoted to managing financial risk, that derivatives serve little or no socially useful purpose, and that the financial-services sector is too large relative to the real economy.

Both types of argument are couched as criticisms of financial-market failures; in reply, free-market economists often deny that there are any real problems at all. Both sides in these debates share an important, and usually hidden, assumption: that the global economy exemplifies financial *laissez faire*. To give but one example, Soros (1994, 323) characterizes a world financial system with the new regulations he would like to see enacted as “a nearly free-market system,” thereby suggesting that what we have now is a *totally* free one. For their part, free-market economists often respond to this sort of argument by defending a very questionable status quo. One side rushes to attack financial markets; the other side rushes to defend them; but both sides beg the key question: the extent to which the current world financial system is a genuine case of *laissez faire*.

A Laissez-Faire Financial “Architecture”

To answer this question intelligently requires picturing what a *laissez-faire* financial system would probably look like.² *Laissez faire* would mean no central banks, no financial regulatory agencies, and no other government intervention in the financial system anywhere in the world. There would be no international quasigovernmental financial agencies: no IMF, no World Bank, no Bank for International Settlements, and so forth. Market agents would be free to make whatever financial contracts they wanted, subject only to the general provisions of

contract and commercial law (i.e., there would be the usual enforcement of contracts, prohibitions against fraud, and the like).

Under *laissez faire*, banks would be free to issue whatever currencies they wished, but it is reasonable to assume that competition would force them to make their currencies convertible more or less on demand.³ For the same reason, it is likely that the values of different currencies would also be tied to the values of specific baskets of goods and services—“anchors” that would reassure consumers by tying down the value of the currencies they chose to use. The holders of bank currency would then have the right to convert their currency holdings not only into other currencies, but into redemption media of the same value. If a particular bank issued a note or made a deposit denominated in a unit called a dollar, the holder of this note or deposit would be able to require the bank to convert this holding into some other asset—a lump of gold, or whatever—of the same value. Banks that failed to provide this insurance against depreciation would be driven from the field.

Each anchor would likely be chosen to stabilize some target price index (such as the Consumer Price Index in the United States).⁴ The anchor would determine the currency’s price level and inflation rate, and would be a major influence on its exchange rates with other currencies.

The world monetary system might consist either of a single world currency or a group of different currencies, each dominant in some particular part of the world. Logically, there would have to be at least one primary currency unit tied to a commodity anchor; those units that were not specifically tied to such anchors would be tied to currency units that were so tied at fixed rates of exchange. All currency units would thus be directly or indirectly anchored. If there were only one primary currency unit, we would have a regime of permanently fixed exchange rates reminiscent of the postwar Bretton Woods system, in which other currencies were tied to the dollar, and the dollar was tied to a fixed quantity of gold.

If there were more than one primary currency unit, each fixed to its own commodity anchor, the exchange rates between the primary currency units would fluctuate with changes in the relative prices of the anchors. However, these anchors would tend to have fairly stable relative prices, if we assume that each anchor is chosen to stabilize some consumer price index. Exchange-rate shifts among anchored or primary currencies should therefore be relatively small and infrequent. Other currencies, if any, would, for just that reason, almost surely be

tioned to one of these primary currencies. The same competitive pressures that would tend to tie primary currencies to commodity anchors would tend to tie any satellite currencies to some primary currency—and also to any other satellite currencies tied to the same primary unit—by means of a fixed exchange rate. The result would probably be a series of currency blocs, each a network of fixed exchange rates based on a primary currency, with exchange rates between these various blocs fluctuating slightly against each other.

Laissez faire, then, would probably give us one of three possible monetary arrangements: a single currency used throughout the world, and tied to a specified commodity anchor; a system of fixed exchange rates, in which all other currencies are tied to one key currency anchored to a particular commodity; or a system of fixed-exchange-rate currency blocs fluctuating slightly against each other, each tethered to a particular anchor. All such currencies would tend to be fairly stable in value, because the anchor(s) would have to be chosen to minimize price-level instability if they were to gain customer loyalty.

Today's Global Capitalism Is Not Laissez Faire

The fact that a laissez-faire monetary system differs so radically from our own should demonstrate the inaccuracy of the notion that the status quo is a financial free market. The economic instability recently produced by violent exchange-rate movements can hardly be blamed on “the market” when it is governments that control monetary policy.

There are, of course, some similarities between contemporary financial capitalism and a laissez-faire global financial market. Several governmental currencies—the dollar, the yen, and the mark (and, more recently, the euro)—are widely used and are, to a certain extent, independent of each other. The remaining currencies tend to be aligned with one of these primary currencies, with degrees of alignment varying from fully fixed exchange rates to exchange rates that are kept within some target zone. However, none of the existing currencies is tied to any commodity anchor, so there is nothing to minimize price-level and exchange-rate instability. Instead, the price levels of these different currencies depend on the monetary policies of the central banks concerned, and the central banks and/or the governments that control them have considerable choice in the monetary policies they pursue.

Under *laissez faire*, there would be no link between a currency unit and a nation-state, and no reason for currency areas to match national territories. Since there are considerable benefits when people use the same currency unit (e.g., lower accounting costs and no currency-exchange costs), we might expect *laissez-faire* currency areas to be larger on average than present nation-states, and also better aligned with economic fundamentals such as trading patterns. This line of reasoning suggests that there would be fewer separate currencies under *laissez faire* and possibly a single currency area spanning the whole world.

Even if it fell short of cosmopolitanism, however, a global *laissez-faire* regime would tend to produce a high degree of price-level stability because the anchors would have to be chosen specifically for that purpose. It would thus tend to avoid the many (and very significant) costs of both inflation and inflation uncertainty.⁵ Interest rates freed of speculation about possible inflation would move only in response to perceived changes in “real” factors. A *laissez-faire* regime would therefore tend to deliver fairly stable interest rates and so lead to fairly stable bond prices. The absence of inflationary shocks and the greater stability of interest rates would make the prices of stocks, shares, real estate, and other assets more stable as well.

By contrast, the current regime, cut loose from any anchor, offers no safeguards against inflation. If anything, it appears to have a built-in inflationary bias,⁶ leading to erratic interest and inflation rates and very high levels of inflation uncertainty, especially over the long run.⁷ Shifts in central-bank monetary policy have sometimes led to major (and often unexpected) changes in inflation and interest rates, a case in point being the drastic rise in interest rates in the United States when Federal Reserve policy shifted abruptly in October 1979. Governments often have incentives—such as those created by workers locked into wage contracts based on particular inflation expectations—to renege on past inflation targets, so as to take advantage of private-sector agents (see, e.g., Barro and Gordon 1983a and 1983b). To make matters worse, once private agents anticipate that the central bank might later change its policy, the credibility of policy targets erodes and produces even greater inflation uncertainty.

Inflation also leads to considerable asset-price volatility, with longer-term assets particularly unstable due to their greater sensitivity to changes in interest rates. Frequently, inflation also leads people to switch from paper assets such as government debt to real assets such as equity and real estate, fueling boom-bust cycles in real assets. All these effects

have major (and often adverse) effects on investment, the capital structure, employment, and the economy more generally.

The stability of exchange rates under *laissez faire* contrasts sharply with the exchange-rate volatility experienced under current monetary arrangements, especially since the breakdown of the Bretton Woods system in the early 1970s. The adoption of the current fiat monetary arrangement has effectively made many exchange rates anchorless. Their value depends on monetary politics and expectations about it, both of which can be very unstable. As a result, exchange rates have often fluctuated very considerably, with adverse—and sometimes disastrous—economic consequences.

Interventionist Instability

The excessive instability created by the current monetary regime has many harmful consequences. It exposes almost everyone to unnecessary risks from price-level volatility (e.g., the risk of being locked into longer-term contracts at inappropriate prices); interest-rate volatility (e.g., the risk of losses on bond and bond-derivative positions, and the risks associated with the prospect of obtaining future financing at uncertain interest rates); exchange-rate volatility (e.g., the risk of losses on positions denominated in foreign currencies, and the risk of shocks to the domestic economy occasioned by exchange-rate changes); and asset-price volatility (e.g., excessively volatile stock and real-estate markets). The extra volatility of the current system also leads people to renegotiate contracts more frequently; to make contracts more complex; to shorten contract maturity; to try to avoid, *ceteris paribus*, longer-term commitments; and to alter their financial and investment strategies to guard against uncertainty. These responses increase negotiation and transaction costs, make it more difficult to plan for the longer term, and preclude otherwise worthwhile investment opportunities. Excessive volatility also disrupts cash flows and undermines liquidity—making planning more difficult, counterparties more likely to default, longer-term finance harder to obtain; and overall, rendering everyone less secure about their financial futures.

Inflation-induced uncertainty undermines “real” productive activity in other ways as well. As Peter Howitt (1990, 93–94) has observed,

It is no accident that finance was among the sectors with the most noticeable innovations during the 1970s and 1980s. The need to protect against inflation uncertainty, and the opportunity to take advantage of others' inability to do so, diverted a lot of innovative thinking away from creating new goods and processes and into the invention of new financial contracts, new banking techniques, and new corporate financial strategies. Young people on Wall Street were paid huge salaries, but the cost of those salaries was paid by the rest of us, who were deprived of the medical services, scientific research, and so on that the financial whiz kids could have been producing.

Critics of financial markets therefore have a good case when they argue that productive resources are being wasted on these activities. But they are mistaken when they attribute this problem to the operation of financial markets as such, rather than to governmental and central-bank policies that create unnecessary uncertainty. Private-sector parties justifiably feel obliged to spend resources to deal with this uncertainty; we should focus on why they feel obliged to react this way rather than criticize them for doing so. Of course, there will always be *some* volatility in financial markets, but one cannot conclude that all or even most of the risks and associated problems we observe in the contemporary world economy are the products of a laissez-faire regime—since such a regime does not currently exist. The real problem is too much state involvement in finance, not (as the critics maintain) too little.

Globalization and Instability

Fortunately, increases in capital mobility, lower transaction costs, improving information technology, and further developments in financial markets themselves—most notably, continuing developments in derivatives markets—will make it increasingly difficult for central banks to maintain policies that participants in markets perceive as indefensible.⁸ These developments will therefore significantly reduce central banks' policy options. Markets now have little difficulty undermining crawling-peg exchange-rate policies, because these involve predictable exchange-rate changes that speculators can anticipate and so place bets on. Similarly, target-zone policies will become increasingly hard to maintain, particularly when markets perceive monetary policy makers as lacking the will or the resources to make the politically difficult decisions sometimes needed to keep exchange rates within target ranges.

The same applies to “fixed” exchange-rate regimes,⁹ even though they are usually perceived as involving a stronger and more credible exchange-rate commitment. For even fixed-rate regimes are dependent on long-run policy credibility, which is inevitably limited by the political context within which policy makers operate. Consequently, these regimes are also likely to be destroyed by speculative attacks once their credibility is undermined.

These factors are likely to drive central banks away from the middle ground between the extremes of zero intervention in foreign-exchange markets, on the one hand, and full currency union, on the other.¹⁰ Each central bank will eventually need to decide whether to abstain entirely from intervention in foreign-exchange markets, or else tie itself ever more closely to one or more other currencies and eventually join a currency union. Faced with this choice, some of the more important central banks will probably choose the first option, and many of the smaller ones will probably choose the latter. The result will be the emergence of a small number of monetary unions, each based on some existing key currency, with relatively freely floating exchange rates between them.

Yet even this arrangement may only be an interim one. As the world economy becomes more integrated and remaining barriers between financial markets dissolve, the remaining currencies should become increasingly close substitutes for each other. However, currency substitution theory then suggests that exchange rates should become more and more volatile.¹¹ My guess is that the various governments and central banks involved will eventually feel obliged to intervene to counteract this increasing exchange-rate instability. However, exchange-rate intervention still raises the same old problems—crawling pegs are predictable, target zones are difficult to maintain over time, and so on—making this middle ground, too, unsustainable in the long run. Attempts to intervene in foreign-exchange markets to harmonize exchange rates are again doomed to eventual failure. But if monetary policy makers cannot live with freely floating exchange rates, their only logical alternative is to go to the other extreme, full monetary union.

And so we arrive at a fairly strong conclusion—the world monetary system appears to be headed for full monetary union—and the only question is how long it will take to get there. Monetary policy makers might resist it, and in the process create a great deal of exchange-rate volatility and associated problems for the private sector (and, of course,

mountains of profits for speculators who bet against them), but the outcome itself appears to hard to resist.¹² Exchange-rate volatility should, therefore, *eventually* disappear. When it does, we might arrive at a financial system that is, in some respects at least, a reasonably close approximation to *laissez faire*.¹³ But in the meantime, we will have to live with continued state intervention and the many problems it creates, and we should not misconstrue these problems as stemming from “unregulated” financial markets rather than from an overabundance of regulatory intervention.

NOTES

1. Soros is even more critical of free markets in his later (1998) book, *The Crisis of Global Capitalism*, the main argument of which is that “market forces, if they are given complete authority even in the purely economic and financial arenas, produce chaos and could ultimately lead to the downfall of the global capitalist system” (xxvii).
2. Any discussion of what a *laissez-faire* system might look like is inevitably speculative, and there is more than one version of such a system. The best-known of these is Hayek’s vision of competition among floating fiat monies (Hayek 1976), but Hayek’s proposal overlooks the likelihood that consumers would demand guarantees about both the convertibility of bank currency and the value of the unit of account, such that competition would force banks to provide such guarantees. In my view, a genuinely *laissez-faire* system would therefore tend to produce convertible currencies and a commodity “anchor” for their units of account.
3. Convertibility provides an assurance that bank currency will retain its value. It would tend to arise because consumers would want such assurance, setting in motion competition to provide it.
4. If consumers want price stability, as they evidently do, then competition (or the threat of it) should ensure that banks choose anchors that maximize price-level stability: banks that issue currency against anchors the public disliked would lose market share to banks that issued currency against anchors the public preferred. This competitive process would tend to converge on an anchor chosen to maximize the stability of a target price-index, and is discussed in more detail in Dowd 1996, 286–91.
5. For more on these, see, e.g., Leijonhufvud 1981, ch. 9 and Dowd 1996, ch. 16.
6. There are several reasons for such bias. One is that the seignorage revenue from inflation gives the central bank (and/or government) an incentive to inflate; another is that a government gains if inflation is higher than expected (e.g., Barro and Gordon 1983a and 1983b). The existence of this bias appears to be confirmed by the historical experience of the past 40 years: most coun-

tries have experienced inflation most years, and there were few years in which prices anywhere actually fell.

7. See, e.g., Ball and Cecchetti 1990 and Evans 1991.
8. Indeed, financial markets already have considerable power over central banks and governments. Even the government of the United States is not immune. Thus, a contemporary remarked that

President Clinton's friends complain that their tax and spend policies were frustrated by the "bond market vigilantes," who fear the federal government's multi-trillion dollar debt growing even more gargantuan. James Carville, the talented Clinton spin-doctor, remarked: "I used to think that if there was re-incarnation, I wanted to come back as the president or the Pope . . . but now I want to come back as the bond market. You can intimidate everybody." The fear of Wall Street's vigilantes is clearly a powerful constraint on Clinton's latent profligacy. . . . Clinton is reported to have raged against the constraints imposed by the bond markets on U.S. economic policy. (Staines 1996, 1)

9. Strictly speaking, so-called "fixed" exchange rate regimes are really only fixed-but-adjustable regimes, since central banks retain the power to make changes in exchange rates. It is the potential for exchange-rate adjustment that is the main problem here.
10. This argument is developed in much greater detail in Eichengreen 1984.
11. The claim that increasing currency substitution makes freely floating exchange rates more volatile is a well-known theoretical result in the currency substitution literature (see, e.g., Girton and Roper 1981).
12. There is nonetheless a qualification. A single currency is inevitable if the central bank(s) concerned stick with a fiat monetary regime, but if central banks restore commodity-based anchors, they should be able to prevent any further slide to a single world currency. We would then get a situation reminiscent of the *laissez-faire* arrangement in which there is some, but not much, volatility in exchange rates due to volatility in the relative price(s) of the anchors.
13. There is also the question of whether the underlying monetary regime will continue to be an anchorless fiat system. My own belief is that the fiat system is unsustainable in the longer term, and that some form of commodity-based anchor will eventually be restored. This will happen because the fiat monetary system will become unmanageable at some point. The problem is that a central bank's leverage over the monetary system—its ability to influence interest rates, exchange rates, and the money supply—hinges on the demand for central-bank "base" money, which is likely to fall very substantially, and perhaps even disappear outright. The declining demand for base money will cause major problems for central banks attempting to manage a fiat monetary system, but perhaps the most serious problem is that it will make prices and interest rates increasingly vulnerable to external shocks, especially changes in the technological and other factors that influence the demand for base

money. A fiat system that ties the value of a currency to the demand for base money cannot be expected to deliver nominal-value stability in the face of major declines in the demand for base money, particularly if this demand disappears altogether. If these conjectures are correct, fiat monetary systems should produce increasing instability in nominal values, and central banks will find such systems more and more difficult to manage. The only way out would be to end fiat money altogether and tie currencies once again to some commodity anchor.

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