Asset prices and Obama
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Re-regulating financial markets to reduce their vulnerability to crisis is a priority of President-elect Barack Obama. But how can he achieve this and yet recognise that markets are vastly superior to state regulators in allocating scarce financial capital?

The hallmark of capitalist economies is that they provide powerful incentives for individuals to seek new ways of doing things. Asset prices fluctuate as markets assess the values of such innovative activities. But movements away from historical benchmark values sometimes become excessive, setting the stage for sharp reversals. Such reversals cause crises in the financial system that threaten the economy’s overall health.

To develop the appropriate regulatory response to today’s crisis, we need a better understanding of boom-and-bust fluctuations. Prevailing economic theory, which views financial markets as normally being in equilibrium, offers little guidance on how policy can limit excessive fluctuations without undermining markets.

Conventional economic models portray large upward price swings as bubbles that are primarily driven by non-fundamental factors – irrationality or market psychology – over which only God may have control. This bubble view suggests that little can or should be done to limit excessive fluctuations, other than using policy instruments, such as interest rates, to prick bubbles as soon as they arise.

The idea of pricking bubbles early is misguided. When stock prices began to move away from benchmark values in the 1990s, nobody could know whether this was the beginning of a bubble or if the market’s search for higher values reflected productivity gains from the IT revolution. Had interest rates been raised to reduce the price swings early, the market’s price discovery process, as well as a great deal of productivity improvement, would have been cut short.

Although cutting off potential swings early is neither desirable nor practical, this does not preclude policies aimed at limiting the excessive price swings that are so costly when they are reversed. Such “limit the swings” measures follow from a new approach to modelling asset markets that places the imperfection of knowledge at the centre of analysis.

This approach, called Imperfect Knowledge Economics (IKE), does not presume that individuals are irrational. Although interest rates, earnings and other market fundamentals move markets, once one recognises that upswings and downswings in asset prices depend on how market participants, with their imperfect knowledge, interpret fundamentals, new channels for policy action open up.

To institutionalise the importance of acknowledging imperfect knowledge, new regulations should be adopted that require every rating agency to issue multiple ratings for each security, which would make explicit the fact that the risk of default depends crucially on the magnitude and duration of departures from historical benchmarks.

Beyond rating reforms, central banks should announce on a regular basis – as some now do with regard to inflation – a range of benchmark values for key asset markets. The idea behind these announcements is to make it more risky for market participants to continue to place too little weight on departures from the benchmark in their trading. This would moderate their willingness to bet on greater departures, thereby limiting the magnitude of price swings.

But governments can do even more. As an asset price moves beyond the non-excessive range, margin and other capital requirements should increase for those who want to take positions that
push the price farther away from the benchmark.

Since every long swing is different – the benchmark itself can change over time due to changes in technology and the social context – the central bank should be given discretion to widen or narrow the range as our imperfect knowledge unfolds. Such decisions should be accompanied by detailed explanations of the central bank’s assessment, which would enable quality control by the public.

Limiting excessive swings does not call for central banks to confine asset prices to a pre-specified target zone. Given the enormous size of daily volumes in asset markets, such attempts almost always fail. Instead, the limit-the-swings changes in capital requirements and central banks’ regular announcements of a range of benchmark values aim to increase the risk of capital losses from betting on greater departures.

Our view may seem contradictory. On the one hand, we argue that policy officials have imperfect knowledge, and that we therefore must rely on markets to set values. Yet, on the other hand, we argue that policy intervention is needed because knowledge is imperfect.

But policy intervention is needed because the sharp reversals that follow excessive fluctuations have substantial costs, which are not internalised by market participants. Owing to corporate control arrangements, they place too much weight on short-term considerations, which sometimes leads them to push asset prices away from benchmarks, despite being aware that they are already too far. Therefore, the state must attempt to limit the social costs of this externality.

The danger today is that the rush to re-regulate financial markets may go too far. As Alan Greenspan belatedly acknowledged, what the current crisis exposed is a serious flaw in the ideological view that markets will limit their excesses on their own. It is no less obvious that the same flaw afflicts contemporary economic models that aspire to give this extreme view a scientific underpinning, and that are still used to frame policy.

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