

## **Capitalism still the only game in town**

### ***BUSINESS CYCLES***

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A Business Week article in 1979 proclaimed "The Death of Equities". A few years later, a vast, long-running bull market in stocks began. In 1997, the Financial Times similarly announced "The Death of Gold". Our current decade, needless to say, has brought a giant bull market in the shining metal, "barbarous relic" though it was claimed to be.

With the financial crisis of 2007-09, we were treated to announcements of "The Death of Capitalism". This is just as hopeless a prediction as the other two were. The bull market in capitalism also will return, because it will continue to be unmatched at creating economic well-being for ordinary people on the trend - but it will not do so without its inevitable cycles of booms and busts.

The future of capitalism, which is better thought of as economies based on enterprise, market competition and uncertainty, is robust on the trend line, but volatile, as always. People who think capitalism is about equilibrium, who value above all stability and theorise that markets will create it, are shocked by this volatility. This is to miss the essence of the matter.

The great economist, Joseph Schumpeter, rightly told us:

"Economic progress, in capitalist society, means turmoil."

"The capitalist process progressively raises the standard of life of the masses. It does so through a sequence of vicissitudes."

"Capitalism not only never is, but never can be, stationary."

This explains why capitalism is distrusted by both traditionalist lovers of order and decorum, and by academics who want economic affairs to be governed by mechanisms of their own design, operated according to known rules by enlightened bureaucrats.

In contrast, capitalism accepts uncertainty. Not only do we not know the future, but when it comes to economics and finance, we cannot know the future. We do not even know the odds of future outcomes, and moreover, as Frank Knight famously defined uncertainty, we cannot know the odds.

This is why we have to understand, in the telling phrase of Friedrich Hayek, that capitalism involves "competition as a discovery procedure". Capitalist enterprise and market competition discover what was not, and could not be, previously known.

As John Kay said in his 2009 Wincott Lecture, "Determining the future is a matter of perpetual small-scale experiment, mostly unsuccessful, and we will all be surprised to discover which developments turn out to be seminal". He reflects further, "Market economies thrive on a continued supply of unreasonable optimism".

Indeed, they do - and so do booms and financial bubbles.

Jesse Jones, who ran the Reconstruction Finance Corporation (the US bail-out operation of the 1930s), observed "the wreckage of the banks which had died of exposure to optimism". So they did and so they do. But pessimists never create the great entrepreneurial advances. The optimists own the trend, but the pessimists are right once a cycle.

Thus with some historical and theoretical perspective, we should not be surprised by financial travails. The economic historian Charles Kindleberger, considering three centuries of financial history, concluded there was a crisis about every 10 years. The International Monetary Fund recently identified 88 banking crises in

countries during the past four decades. Carmen Reinhart and Kenneth Rogoff, in their new book, *This Time Is Different* include an instructive list of banking crises since 1800. The list is 45 pages long.

Former Federal Reserve chairman Paul Volcker wittily summed it up: "About every 10 years, we have the biggest crisis in 50 years."

Having lived through the memorable 21st century bubble and the ensuing bust and crisis, people might be forgiven for thinking they were experiencing something unique. They weren't.

The long record of cycles in financial markets will continue into the future. These cycles reflect fundamental uncertainty, and the limitations of human minds in dealing with it.

We need this perspective provided by Warren Buffett:

"Never forget that our country has faced far worse travails in the past. In the 20th century alone, we dealt with two great wars, a dozen or so panics and recessions, virulent inflation that led to a 21 per cent prime rate in 1980, and the Great Depression of the 1930s. In the face of these obstacles - and many others - the real standard of living for Americans improved nearly sevenfold during the 1900s."

The recurring financial cycles cycle around a rising trend of greater and greater overall economic well-being, the bubbles and crises notwithstanding. This can only happen when capitalism releases the energy of enterprise with its unreasonable optimism, entrepreneurship, the creation of new knowledge, and investment in experiments, many of which will fail.

The future of capitalism is to continue the natural progress of opulence. But can't we have the wonderful trend without the cycles? No, we can't. The turmoil, vicissitudes and fundamental uncertainty are part of the package, as Schumpeter taught.

"If the law of change is known," Frank Knight wrote, "no profits can arise." Likewise: If the law of change is known, no financial crises can arise. But the law of change is never known, because there is no law of change.

The future of capitalism is to continue making uncertainty productive, on average.

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