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Rules vs. Prices

I'm reading Bionomics: Economy as Ecosystem, by Michael Rothschild. It's interesting but light reading. Being ten years old, some of the stuff is slightly dated.

I found the chapter on Rules vs. Prices very interesting. Here is an abridged extract:

[The comments in square brackets are mine]

"Already the study of chaos is becoming an across-the-board scientific enterprise. Barriers that have long isolated the disciplines are beginning to erode. In economics, equilibrium orthodoxy is just starting to give way to the ecological view. In late 1987, the first conference dedicated to 'the economy as an evolving complex system' attracted economists, biologists, and physicists. In 1989, a journal entitled Ecological Economics started up. In the coming years, as computers and chaos offer new insights, much of ecology and economics will blend into a field that might well be called bionomics.

"...The classical ideal of predictable, equilibrium prices will be abandoned. Instead of regarding erratic price swings and unpredictable business cycles as indicators of economic weakness, the chaos of the marketplace will be seen for what it is -- a sign of vitality.

"Of course, knowing that chaos is healthy for the overall economy is small solace to someone who has just lost a bundle in a deal turned sour. If markets were 'fair,' a farm family's years of struggle could not be wiped out by an inexplicable plunge in the price of soybeans [if markets were 'fair,' a GTR subscriber could not be wiped out by an inexplicable plunge in the price of Telecosmic shares]. In the abstract we may applaud the concept of erratically fluctuating prices, but in our personal affairs, we seek order and security. Everyone wants the prosperity that free markets yield, but no one wants to bear the risks implicit in market chaos.

"At bottom, that is why popular support for free markets is so weak. The tiny efficiency gains achieved by learning organizations seep into the markets in the form of price cuts and product improvements. These gains are diffuse, however, spread far and wide by billions of transactions. Everyone in society benefits in incremental, unnoticed ways. But the losses experienced by those on the wrong side of a market swing are obvious and often quite painful. No constituency exists for widespread, invisible gains, but plenty of influential groups demand government protection from the vagaries of free markets. [Didn't Soros recently do that?]

"In its most extreme form, the suppression of market chaos creates a black market. Of course, banning markets never seems to achieve the desired effect. Several analysts now argue that America's illegal drug market is so enormous largely because the illegality of drugs drives their prices far above production costs. High prices create fantastic profit margins in the illicit distribution network.

"In effect, banning cocaine is like setting its price at infinity. No amount of money is enough to permit a legal transaction. Operating beneath the government's 'price umbrella,' black marketeers willing to bear the risks of the drug trade enjoy profit margins unmatched by any free-market activity. High profits draw in more sellers, who in turn work hard to expand the base of addicted customers. By setting a drug's price at infinity, government policy achieves precisely the opposite of its intended effect.

"Whenever a society bans a product, it must be prepared to expend whatever resources are necessary to stifle the black market made so profitable by its rules. But experience shows that even under the harshest penalties, black markets persist. A seller is drawn to the smell of money much as an amoeba is lured by the taste of cyclic AMP. Profit-seeking is a self-organizing phenomenon, impossible to eradicate. This is as true on the streets of Moscow as it is in Washington.

"Although black markets are rare in the capitalist West, 'gray' markets are quite common. In 'gray' markets, the products are not illegal, but their prices are not allowed to fluctuate. Instead, a law prescribes a fixed price. Throughout the West, the politically powerful use such laws to insulate themselves from the discipline of free prices. Domestic manufacturers demand tariffs to make imports more expensive. Farmers demand guaranteed price floors for their crops. City dwellers demand rent control for their apartments. Credit-card borrowers demand interest ceilings. Every special interest has its own bone to pick with free prices. [California energy consumers?]

"Whether a market is black, gray or white is a matter of politics, not economics. In deciding where to draw the lines separating these market types, every society faces the same basic questions: When should rules replace prices? Who should hold decision-making power -- buyers and sellers or government officials? Where should economics end and politics begin

"Responding to the distortions caused by fixed price, the adjacent feedback loops spontaneously adjust the economic network to its next most efficient solution. But the adjustment -- millions of pounds of U.S. government cheese stacked in warehouses, or apartment buildings abandoned by their owners -- never yield a net economic gain. Rules cannot create value. Value is simply transferred from taxpayers to dairy farmers or from the owners of rent-controlled apartments to their tenants.

"Of course, if the economy were machinelike, social engineers could write laws that always achieved the desired results. Unwanted side effects would be unknown. But because an economy is a fabulously complex web of feedback loops, simpleminded 'solutions' ricochet through the network in unpredictable ways. [What has the FED done for you lately?]

"By contrast, free markets work because they allow society to communicate honestly with itself. market prices emerge democratically. They express a tentative, collective view of relative values. No product has an intrinsic or fixed value. No one 'knows' what something is 'really' worth.

What does this mean to us as GTR subscribers?

Stock prices will rise and fall as they always have and they always will. Just because GG talks about a stock, that is not enough to change that stock's price performance for ever. Just because a company is listed on page 8 is not a guarantee that its stock price will only rise. As much as most people intuitively know this, their actions and bitching say the opposite: first they buy recklessly without proper due diligence, then they expect the market to suspend its rules for their stocks and lastly, they blame GG for not preventing the price drops.

We need to become firm believers of free market economics. Once we do this, we should understand that the market will do whatever it wants to do. And once we understand that this is an immutable principle of free markets, we might learn how to take advantage of it.

The third lesson is that we should not aid and abet people like Scott McNealy of Sun Microsystems and Larry Ellison of Oracle. They are damaging the free market system with their government backed war against Bill Gates. Just because we cannot trace their actions to a specific harm, you can be certain that any government imposed rule on Microsoft will reduce Microsoft's efficiency and hence the efficiency of the market as a whole. I applaud McNealy and Ellison taking on Gates in the market, that creates healthy competition, it forces all three to become more efficient. But seeking government intervention is harmful for the economy and for all of us. My way of opposing McNealy and Ellison is by way of a boycott on their company's shares.

Denny
"Demand creates queues. Supply gets rid of them."
Software Times