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Where Markets Fail: Markets Assume a Context

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In the premiere edition of the Where Markets Fail series, I pointed out that markets are imperfect discounting mechanisms. In this installment, I demonstrate that markets assume a context entirely out of view of their participants, which can have deleterious effects for both suppliers and demanders.

Let me lead with an example: In 1994 there was a price for camera film as well as a price for developing that film into photographs. These markets functioned exceptionally well and many companies made money producing film, especially Kodak and Fuji. Many local shops, in turn, made money in film development by creating photographic images.

Yet these two markets had suppliers that assumed incorrect contexts, specifically film and processing. The true context was photographic images — the ends — and not film and processing — the means.

Even on the demand side, consumers did not understand their market either. They thought they were consumers of film and processing. Only when digital cameras overtook the market for the creation of photographic images did the old implicit assumption look strange and backward.

You may believe this is simply the destructive end of Joseph Schumpeter's famous "creative destruction," but something more important is hidden here. By taking a context for granted, markets do something else: They presuppose their own legitimacy and, therefore, only discount affirmations of that legitimacy.

The film and processing markets developed when products were offered up for sale to consumers back in the 1800's. Thereafter, every transaction involving those products qualified as a tacit "yes" vote for those markets. So long as demand is strong enough for a good or service to generate profits, that market's underlying premise is that "yes" rules the day.

But what about all of the "no" votes for that good or service? How does the market register them? Only on the margin. That is, only if enough participants exit the market and marginal profits dip below marginal costs are the "no" votes counted.

This can take a very long time. Yet, the underlying assumption is that the market is viable and that it is manifest destiny to seek out additional "yes" votes, to expand, and search for growth opportunities.

Again, you may think this is benign. But because markets assume a context — usually that the market is legitimate and that "yes" votes are what matters — systemic outcomes can result — securities market bubbles, for example. Here the assumed premise is that a market's activity is legitimate just because there are participants in that market. "Yes" votes (bidders) are happily filled by suppliers (askers). Both bidders and suppliers believe prices are legitimate simply because bids and asks lead to clearance.

In the market for mortgage-backed securities circa 2004, bidders and suppliers took for granted that prices for the bundling of subprime mortgages into supposedly risk-reducing portfolios were fair. But this was the incorrect context and incorrect assumption, and the market had no way of explicitly recognizing "no" votes (except for shorting) so long as marginal supply and marginal demand met.

This demonstrates another problem created because markets presuppose a context. If a market forms and persists, if marginal revenues exceed marginal costs and generate profits, then its activity is implicitly accepted as legitimate. But is it? After all, there are markets for many illegal and unethical activities, from drug dealing to murder.

Put another way, markets are not meant to be ethical. Instead, they are mechanisms for establishing clearing prices that match supply and demand.

But in the modern world, where capitalism is triumphant in so many spectacular ways, we have come to believe markets can improve behavior and ethics. After all, when outcomes and ethics in our culture are seen as wayward, we frequently default to discussions about “incentives” as the missing ingredient.

What do we mean by this? That if we alter the underlying economics of “a market,” we can drive behaviors.

This infatuation with the resource allocation benefits of capitalism is a misguided conflation of these conversations that have nothing to do with markets. Why? Because if something can be priced, we assume that it is a legitimate activity.

How is this made manifest? One example is how we seek to price externalities, such as polluting the air or water, as a way of driving change and behavioral outcomes. The implicit assumption is that polluting the air or water are legitimate activities, if only to the degree that marginal benefits still exceed marginal costs. Lost in that assumed context is how to log the “no” votes.

Yes, license terms on the part of market makers are designed to reduce volumes of externalities to “acceptable” levels. But what happens when our future discounting abilities are faulty? We end up legitimizing activities — pollution and weapons manufacturing, for example — that can potentially undermine all other markets.

In finance, many practitioners bristle at industry regulations. I am no apologist for overregulation — though I was quite happy under Glass-Steagall. But perhaps we arch-capitalists in finance should see the regulation now in place in our industry as the “no” votes registered — you guessed it — out of context.

Why? Because our assumed context is that our activities are legitimate, but the public and their elected officials may not necessarily agree.

Possible Remedies

- Study and understand the assumed contexts of the markets in which you place your confidence, especially if you are a capital allocator, that is, a capitalist or investor. Are these activities properly demarcated by suppliers . . . and demanders? Or is your version of “film and processing” about to be supplanted by something with a better understanding of the context?
- Ask yourself whether and how the “no” votes are counted in the markets in which you participate. If there is no mechanism for logging those votes, then your markets have unpriced risk.
- Ask yourself if the entire context of a market is illegitimate, or nearly so. Understand the ethics of incentives. I interviewed the world’s foremost expert on the subject, Ruth W. Grant, a few years back and her work is instructive.

Here is the future trajectory of this series:

- Markets assume fungibility.
- Markets are not systemic.
- Markets have “visible hands.”