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No reason to assume she'll be right, mate

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THOSE who have much at stake in the current stock market shakedown employ an interesting, if self-defeating strategy to mask a financial system that seems crisis-prone.

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The subprime mortgage meltdown in the US triggered a liquidity crisis in markets that are not even exposed to its bad debts or irresponsible lending practices, including Australia. Recent central bank interventions in the US and Europe may have only delayed the inevitable reckoning, which at worst could result in highly leveraged hedge funds tipping over, dragging the whole financial system down.

And yet the mantra of most analysts is that we are only witnessing a "market correction" - an idea that is as wishful as it is misleading.

Belief in a self-correcting market has a long and mythical status in liberal economic thinking, something approaching a law of nature. It is based on two false assumptions.

The first is that the involvement of the state isn't required when markets fail - or that markets never really fail. And yet this occurs even in the US, where the Savings and Loan scandal (in the early 1980s) and Long Term Capital Management crisis (1998) were only cauterised by federal government interventions.

The second assumption is that the world economy, despite its volatility, is inherently rational and therefore manageable. There is little evidence to support such a belief.

According to economic historian Gabriel Kolko, it is a mistake to postulate a coherence and rationality to the world economy that assumes it is deliberately integrated and viable, so that a functionalist vision of it emerges. According to this view, there are few mistakes or failures. Someone is always in control and directing. Failsafe mechanisms built into the world's financial structures will ultimately avert a "great unwind".

Kolko argues that the problem with such a vision is that it takes little account of accidents, stupidity, or failures of intelligence due to bureaucratic players. It cannot explain confusion or why things regularly and suddenly go wrong. Most importantly, it mistakenly assumes there is a higher capitalist intelligence or "logic" that directs and controls events. This may be reassuring, and even necessary to maintain confidence in the system, but it is an illusion.

Kolko claims the greatest single error in assessing the world economy is to assume that systems with such diverse political, economic and ideological components are capable of being rationally managed. They cannot. The world economy is becoming increasingly anarchic, partly as a consequence of deregulation and liberalisation, and in part because of the bewildering array of mysterious financial strategies devised to enrich the greedy and impatient. Threats to the stability of the world's financial sector are now a major concern for conservative economists, central bankers and the IMF.

Opaque and complex financial instruments such as credit derivatives, collateralised debt obligations, credit default swaps and binary options - which few people can explain - are the lifeblood of hedge funds that spread financial panic whenever they collapse.

Enron used them extensively, collapsing into bankruptcy in 2001 with losses of $US100 billion ($A121 billion). In September last year Amaranth Advisory lost $US6 billion, or over 60 per cent of its assets, in a single week. The recent collapse of two hedge funds at Bear Stearns Asset Management has still not been costed.

Hedge funds now hold assets of over $US1500 billion, a figure that has trebled in less than seven years. Moody's credit ratings agency now thinks there is a 50-50 chance of a major fund collapsing in the wake of subprime losses.

Exotic securities, such as structured investment vehicles that employ short-term borrowing to fund investments in illiquid long-term investments, pose a challenge to the integrity of the world's financial system. Few, including their designers, understand how they work.

Those who seek to regulate these products are either intimidated into silence or simply unable to keep pace with such an innovative and sophisticated industry. Prudence and long-term investment strategies by establishment bankers have given way to speculation and gambling for instant profits by private equity groups.

What concerns many observers is that some of these hedge funds are now too large to be saved by government intervention if they collapse. The next stage after that is system failure.

"Market corrections" and "risk management" give a veneer of rationality to a financial jungle undeserving of such a description. If the bubble bursts they will provide little comfort to those who have lost their homes, retirement benefits or life savings.

As Kolko notes, those who "manage" capitalism cannot convincingly explain it or describe how it functions. Worse, they are unable to maintain the system on a stable basis, periodically leaving distress and inequities in its wake. This is the first lesson of the subprime debacle.

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