No. 09-22
June 2009

WORKING PAPER

WHAT HAPPENED TO "EFFICIENT MARKETS"?

By Peter J. Boettke

MERCATUS CENTER
GEORGE MASON UNIVERSITY

What Happened to "Efficient Markets"?

Peter J. Boettke*
George Mason University

The financial crisis of 2008 has challenged the reputation of the free-market economy in the public imagination in a way that it hasn't been challenged since the Great Depression. The intellectual consensus after WWII was that markets are unstable and exploitive and thus in need of government action on a variety of fronts to counteract these undesirable characteristics. In the United States, this intellectual consensus did not result in nationalization of industry, but it did result in detailed regulation and heavy government involvement in economic life.

The stagnation of the 1970s reversed this trend in public policy at least in rhetoric. A new sense of reliance on the power of the market and a fear of the tyranny of government took hold of the public imagination. By the end of the 1980s, the collapse of communism throughout East and Central Europe and the former Soviet Union reinforced a sense of intellectual triumph for market-oriented thinking over the demands for government regulation and control. The consensus toward the free-market economy proved fleeting as the difficulties of transition, the plight of underdeveloped, and the tensions of globalization all came to represent, in the eyes of several pivotal intellectuals, the failings of the free market system.

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* The original version of this paper was presented at the Mont Pelerin Society Special Meeting, *The End of Globalizing Capitalism?: Classical Liberal Responses to the Global Financial Crisis* in New York, NY, March 5–7, 2009. The paper has also been presented at Loyola University New Orleans, March 10, 2009; James Madison University, March 20, 2009; Mercer University, March 30, 2009; Columbia University, April 16, 2009; and The University of Virginia, April 21, 2009.

With the stock market losing 50 percent of its value over the last year, major banks failing, real-estate values collapsing, and unemployment creeping toward double-digits, claims about the superiority of the market economy over government intervention are difficult for many to view with credibility. But this is due to earlier intellectual failings in the discourse concerning the nature of the market economy, the failings of socialism, the costs of government intervention, and the role of public policy. Simply put, we must always remember that bad economic ideas result in bad public policy that in turn produces bad economic outcomes. The role of the economist must be to counter the first step and defeat the promulgation of bad economic ideas. That is no easy task given the counter-intuitive nature of economic reasoning and the role of vested interests in the development of public policy in democratic systems. But if the economist does not do the job, there is the risk that market corrections can be transformed into economic crises through ill-fated government policies, and that economic crisis can be transformed into political and economic catastrophe as bad ideas are joined with opportunistic politicians who, in the name of meeting the challenge of the crisis, are able to persuade the public to trade off their liberties for security.

In a time of extreme economic adjustment, it is important to remind everyone how markets in fact work. Falling asset prices, businesses failing, resources (including workers) being reallocated are every bit an indication of efficient market adjustment to changing circumstances as the exploitation of profit opportunities and the exhaustion of mutual gains from exchange. In fact, they are the flip side of one another just as maximizing profits and minimizing costs are. The market process is a profit *and loss* system. Prudent economic decisions are rewarded while imprudent decisions are penalized. The market economy in this regard is indeed a ruthless, unrelenting, and ceaseless process of economic change.

Viewed in this light, "efficient" markets are evident everyday on Wall Street as well as on Main Street whether we are living through "good times" or "bad times." Resources are continually being shuffled and reshuffled so as to realize their greatest return. This version of the claim of efficient market adjustment through time follows simply from the basic economic insight that incentives matter and the proposition that individuals will discover that which is in their interest to discover. As Adam Smith ([1776] 1976, Book I, chapter V, 36) put it, the necessary adjustments are not accomplished by "accurate measure, but by the higgling and bargaining of the market" and while the result is not exact, it is "sufficient for carrying on the business of common life."[1]

The market theory of the classical economists did not provide a point prediction of exchange ratios except in the simplest of examples (e.g., Smith's deer/beaver model). Instead, the theory developed traced out tendencies and direction of changing to shifting conditions in supply and demand. The price system was depicted as one of adjustment to, and accommodation of, constantly changing tastes and technology. The classical theory was not one of zero errors in judgment by producers and consumers, but one that did say that persistent error would be weeded out as producers confronted resource

[1] Mises ([1922] 1981, 100) makes a similar point about economic calculation not being "perfect" but nevertheless both necessary and sufficient for the practical demands of commercial life. The deficiency of monetary calculation often highlighted by critics of economics are real, but misplaced because within the specified limits (and Mises argues within practical life these limits are never overstepped) "monetary calculation does all that we are entitled to ask of it. It provides a guide amid the bewildering throng of economic possibilities."

constraints and consumers were presented with alternatives. The buying and abstaining from buying by consumers as they seek satisfaction ultimately directs resource use, and the striving for profit will ensure that least-cost methods are employed by producers in their attempts to meet consumer demand. Any position short of this end point will mean that consumers and producers could both be made better off by changing their behavior and realizing the mutual gains. The classical theory of the market economy was a theory of economic activity, not a theory of a state of affairs, and relied not only on the individuals currently populating the market to correct previous errors but also perceptive entrepreneurs who could enter the market to eradicate error. Property, prices, and profit/loss cajole and discipline market participants to act in a way to realize gains from trade and create wealth.

The depiction of *economic activity* is less analytically precise than a theory of a settled state of affairs. As the scientific demands on economic theory shifted from a theory of price formation to a theory of price determination in the late 19th century, the analytical focus centered on the settled state of affairs rather than economic activity. Previously, this state of affairs was described using simple examples and was intended only to highlight the central tendencies of the market-exchange process. The value theory and cost theory of the classical economists could not explain several paradoxes that demanded resolution for scientific refinement. In a fundamental sense, however, it must be stressed that the classical economists of the 18th and 19th century were correct in their understanding of market theory and the price system. The big picture understanding of the classical economists was correct, but they were wrong on the particulars of value and cost. In resolving the paradoxes in value theory and cost theory, the emerging neoclassical economics at times, unfortunately, lost sight of the big-picture understanding of the market system as an active process of higgling and bargaining that was evident in Hume, Smith, Say, Ricardo and even Mill. This is not to say that classical economics was not in need of repair—it certainly was. But it was not the case that the great discovery of the self-regulating properties of a market economy and the central importance of private property, free pricing, and the lure of pure profit and the penalty of loss in explaining the self-regulation of the market were in need of repair as much as refinement in explanation.

In striving to provide a formally rigorous explanation of self-regulation, neoclassical models tended to focus not on the adjustments to changing conditions, but the settled state of affairs that results when all change had ceased. The equilibrium condition occupied center stage, and the idea of an "efficient market" came to mean something entirely different. It took decades for this transformation to fully take hold of the imagination of economists, but the analytical roots are found in the effort to depict the economic system as a set of simultaneous equations that had a unique P and Q vector that would clear the market. For mathematical tractability, the model relied on a pre-reconciliation of economic plans prior to the posting of bids and asks. Since no "false trades" were allowed in the market, the precision of the mathematical solution to a system of simultaneous equations meant that the higgling and bargaining process that Smith had described as the core of the market economy was formally suppressed in the neoclassical model of the market. In this model, the current market price not only clears the market, but it also fully reflects opportunity costs. Firms would produce the quantity of output that minimized average cost of production—in other words, the least-cost technology available would be employed in production. With proof of the existence of a unique P and Q vector, not only would supply and demand be equated and the market clear, but such a state of economic affairs would also possess simultaneously the desirable welfare properties of achieving exchange efficiency, production efficiency, and product mix efficiency. In other words, such a world could not be improved upon as all gains from trade would be realized, and they would be realized in the most efficient way possible.

This quick detour through close to 250 years of intellectual history in economics was to provide background for the three competing hypotheses about "efficient markets" that exist to this day in economic discourse.

H_1 – Markets are efficient and there are no unexploited opportunities for mutual gain. (Neoclassical perfect competition perspective)

H_2 – Markets are imperfect and inefficient, and government must step in to be a necessary corrective. (Neo-Keynesian synthesis market failure perspective)

H_3 – Markets are at any point in time full of unexploited opportunities for mutual gain, but this fact drives the market system to effectively mobilize individual initiative and utilize the dispersed knowledge in the system to realize gains from trade and gains from innovation and in so doing making systemic adjustments that promote wealth creation and produce generalized prosperity. (Classical and New Institutional market-process perspective)

The intellectual problem that economists face, especially in our current context of economic woe, is that H_3 is too subtle to capture in a formally precise model, and thus scientific debate, let alone public debate, tends to focus on the clash of H_1 and H_2 and too often leaves the proposition of government as an agent of correction unexamined.[2] The

[2] It is for this reason that I have argued (e.g., 1997) that economics during the 20th century for the most part engaged in an intellectual detour where economists became increasingly precise about irrelevant points—precisely irrelevant. This was a fate of the

result is that we simultaneously fail to understand how markets actually work to coordinate economic life and underestimate the costs of government intervention into economic affairs. The consequence of this sad dual state of intellectual affairs is that economics as a discipline loses its ability to ward off public fallacy, and public policies are thus more likely to be adopted which undermine long-term wealth creation (and in the extreme limit the economic viability of a nation).[3]

This obviously has relevance for current policy debates over the role of the market economy in generating long-term prosperity. Efficient markets came to mean in the scientific and public imagination that at any point in time the current market arrangement was the best of all possible worlds. Even the most ardent defenders of the efficient-market hypothesis were usually more subtle than that in their verbal presentation, but this was glossed over due to the primacy placed on the formal model for assessment. Eugene Fama in his *Foundations of Finance* (1976, 132) argued that: “An efficient capital market is a market that is efficient in processing information. . . . In an efficient market, prices “fully reflect” available information.” Fama and Merton Miller in *The Theory of Finance* (1972, 335) explain that: “Such a market has a very desirable feature. In particular, at any point in time market prices of securities provide accurate signals for resource allocation; that is, firms can make production-investment decisions, and consumers can choose among the securities that represent ownership of firms’

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discipline that was predicted by Kenneth Boulding (1948) in his review of Samuelson’s *Foundations*. The flawless precision of mathematical economics, Boulding argued, may prove incapable of matching the insights of the literary vagueness of classical political economy and sociology.

[3] Henry Simons (1983, 3) taught a generation of students in the 1930s–1940s at the University of Chicago that: “Academic economics is primarily useful, both to the student and to the political leader, as a prophylactic against popular fallacy."

activities under the presumption that security prices at any time "fully reflect" all available information. A market in which prices fully reflect available information is called efficient."

As we said earlier, such a market simultaneously achieves exchange efficiency, production efficiency, and product-mix efficiency. The proofs are elegant and the implications are astonishing in that under such market conditions there would be no need for government action other than at the level of the framework—law and order, monetary framework, and international peace. In the public imagination, this is the modern rendition of Adam Smith's "invisible hand" and thus provided the technical argument for laissez-faire economic policy.

The market economy would truly be self-correcting—in point of theoretical fact because no errors would be made. There would be no $20 bills lying on the sidewalk that either haven't already been picked up, or otherwise would cost at least $21 to pick up. The only change to the system would be the exogenous change to a shift in tastes or technology, but then the market would adapt to this change instantaneously and the prices in the economy would reflect fully the relevant information.

In contrast to Fama and Miller (and others), theorists such as Joseph Stiglitz (following up on earlier ideas of market failure found in Samuelson, Bator, and Arrow) set out to offer the alternative to the efficient market hypothesis. Stiglitz built his career on showing how fragile the neoclassical model of market efficiency in the wake of slight deviations from the restrictive assumptions. Stiglitz stressed imperfections in information that actors possessed, and deviations from the perfectly competitive market conditions in which actors interacted. In the face of asymmetric information and within a monopolistically competitive environment, Stiglitz argued, and market perversities rather than market perfection were likely to result. Summarizing his contribution to the literature on market efficiency in *Whither Socialism?* (1994, 43–4), Stiglitz writes:

> One of the claims frequently made of the price system is its informational efficiency. . . . To be sure, there is great informational efficiency. Under the idealized conditions of the Arrow-Debreu model, prices do convey information efficiently from producers to consumers, and vice versa. Yet this is an extremely limited information problem. When a heavier informational burden is placed on markets—when it must sort among workers of different ability or securities of different qualities, when it must provide incentives to workers in the presence of imperfect monitoring, when it must obtain and process new information about an ever changing environment—markets do not perform so well, even in terms of our limited welfare criterion of constrained Pareto efficiency.

Between Fama and Stiglitz, it would seem that Stiglitz would have the upper-hand in the debate in our current context. The reason for the verdict is simple—the informational burden of the investment market during the 2000s obviously seemed to be greater than what the efficient market hypothesis could bear. But this is only an artifact of the model fetishism of 20th-century economics. First, even the strictest model of competitive equilibrium would not contend that government policy could not derail the operation of the market economy. To use an analogy, if Michael Phelps was thrown into a pool of water with his hands tied and his legs shackled with a weighted ball, he would still be the world's best swimmer even if he sank. He just would have been prevented from swimming. The problem isn't swimmer failure, it was that the rope and shackle with weighted ball prevented him from making the very movements required to effectively swim. So if government interventions distort information and provide perverse incentives, when economic actors make mistakes it is not the market leading them astray but the government interventions that have caused the problems with the performance of the market to weed out error. Second, the market failure criticism fails to appreciate how the historical argument in favor of markets from Adam Smith to F. A. Hayek did not focus on the equilibrium properties of the market, but on the adjustment properties of the market system. Today's inefficiency represents tomorrow's profit for the entrepreneur who recognizes and grasps the opportunity. The strength of the market economy in this rendering is its dynamic adjustment to constantly changing circumstances. Entrepreneurs react to the existing array of prices to realize gains from trade through arbitrage, and the lure of pure profits spur entrepreneurs to realize the gains from innovation through the introduction of new products or discovering better ways to produce and/or deliver existing products.

Hayek warned his fellow economists of the misleading standard of perfect competition and static efficiency when it comes to assessing the market economy in the 1940s. As he wrote in *Individualism and Economic Order* (1948, 87): "[T]hese adjustments are probably never 'perfect' in the sense which the economist conceives them in his equilibrium analysis. But I fear that our theoretical habits of approaching the problem with the assumption of more or less perfect knowledge on the part of almost everyone has made us somewhat blind to the true function of the price mechanism and led us to apply rather misleading standards in judging its efficiency."

Theoretically, the efficient market hypothesis represented a misplaced concreteness as the formal model was confused with the reality of the market process. The "true function" of the price system is to guide entrepreneurial discovery and adjustment. Practically, Hayek also recognized the robustness of markets in the face of numerous interventions. In *The Constitution of Liberty* (1960, 228) he points out that: "A free system can adapt itself to almost any set of data, almost any general prohibition or regulation, so long as the adjusting mechanism itself is kept functioning. And it is mainly changes in prices that bring about the necessary adjustments. This means that, for it to function properly, it is not sufficient that the rules of law under which it operates be general rules, but their content must be such that the market will work tolerably well."

Making a similar point close to two centuries earlier, Adam Smith ([1776] 1976, Book IV, chapter V, 49–50) argued that: "The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is so powerful a principle, that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often incumbers its operations." To use my earlier analogy, Michael Phelps certainly could still swim with hands tied and feet shackled (he did win the gold in the butterfly so he could do some sort of kick to get across the pool), but when the weighted ball was added to drag him down the prohibitions on his movement and the obstacle of weight simply proved to be too much. Similarly, government policies can reach a point where they obstruct the market from working effectively to make the accommodating changes. This is not evidence of inefficiency of the market economy, it is evidence of obstructive government intervention.[4]

[4] To illustrate both the robustness of markets and yet the vulnerability of economies to sabotage by obtrusive government I often use the metaphor of a horse race between Smith (who is realizing the gains from trade), Schumpeter (who is realizing the gains from innovation) and Stupidity (who is pursuing government power)—as long as Smith and Schumpeter stay slightly ahead of stupidity, tomorrow's trough will be higher than today's peak in terms of economic performance, but if Stupidity starts to get ahead of Smith and Schumpeter, then the trend will be reverse and economic performance will not improve through time. In other words, we can economically speaking put up with a lot of government stupidity provided there is still freedom of price fluctuations so arbitrage

The critical question we must ask is what are the government policies that represent the tipping point where market forces cannot overcome the obstruction? Let me suggest three: inflation, price controls, and regime (or rule) uncertainty. Each of these government policies undermine the basic functions of the market economy. Inflation threatens to destroy the meaningfulness of capital and cost accounting that provide the basis for commercial decisions. Price controls block the ability of markets to adjust to changing circumstances in supply and demand. And, regime uncertainty by shifting the ground on which economic actors make decisions on savings, investment, and consumption cloud an already murky economic landscape and thus distort choices and shorten time horizons. All three policies curtail the ability of the market to muddle through the trials and tribulations of ordinary politics.

The case for laissez-faire is often difficult to communicate if the obstructions of government are overcome and the economy muddles through and the society materially progresses because it ultimately relies on a counter-factual claim. Economy X had this 10-year period of growth with a, b, c, and d government interventions, but had there been no interventions the decade would have experienced greater growth. How much great growth nobody knows because, well, that world wasn't experienced. This is, of course, not new to economic reasoning. Bastiat described it as the "what is seen" versus the "what is unseen," and warned that bad economics results from focusing only on the "what is seen." Hayek, similarly, argued that due to the intellectual prejudices of scientism, expediency will always win out over principle in public policy because the benefits are identifiable with respect to specific parties, whereas with principle the

opportunities are able to be pursued, and freedom of entry so entrepreneurial discovery and innovation can be pursued.

benefits are dispersed and not identified by any specific party but enjoyed by all. In fact, economic reasoning may be so counterintuitive that ignoring its teachings lead policy intellectuals to conclude that the government interventions were the source of the good economic performance (rather than a hindrance) that was experienced for the simple reason that growth was experienced after the interventions were instituted—after this, therefore because of this, is a logical fallacy that rears its ugly head too often in economic policy discussions.

This is the situation we find ourselves in today. Intellectually, the debate over the merits of the market misses the main merit of the price system and the market economy—its dynamic adjustment ability and how prices and profit/loss both continuously adapt to and accommodate whatever changes in tastes and technology occur. Politically, the public policy debate assumes that the "efficient market" theory has been found wanting and that government must be the only viable corrective. Both "right" and "left" call for activist government to stem the economic crisis; they just differ on the details. The cost of government intervention is either unexamined or understated throughout the debate.[5] In short, the current intellectual consensus on economic policy fails to understand how markets work and why they are the source of prosperity and social harmony and underestimates how political control of economic life distorts incentives and information and results in social disharmony.

[5] A classic example of this is the discussion of nationalization of financial institutions and the idea that they can be nationalized, restructured, and then sold off at a profit so as to minimize the cost of the nationalization. No serious effort to account for the vested interests that will form around the nationalized entity is made. It is as if public policy was done in a vacuum and the actors were all economic eunuchs.

The public policy reality is that laissez-faire economics was not the policy norm in the United States over the past 25 years. Keynesian economics might have been intellectually defeated in the 1970s among academic economists, but in practice Keynesianism was the core public policy intellectual framework and even guidepost for data collection and analysis. The main shift in “paradigm” spearheaded in the 1970s was actually an oscillation between “conservative” and “liberal” Keynesianism; *not* between laissez-faire and Keynesianism. Reagan’s supply-side policies were “conservative” Keynesianism, while Obama’s fiscal stimulus is “liberal” Keynesianism. But both are fundamentally Keynesian policies and suffer from the same fundamental problems that all Keynesian policies suffer from as pointed out over 50 years ago by economists such as W. H. Hutt, F. A. Hayek, and James Buchanan. In fact, if I could choose a quick and easy set of mandatory readings for all politicians and policy advisers to offer caution concerning our current path, it would be Hayek’s *A Tiger By the Tail: The Keynesian Legacy of Inflation* (1979) and Buchanan and Wagner’s *Democracy in Deficit: The Political Legacy of Lord Keynes* ([1977] 2000). Both of these books explain how once all restrictions (formal and informal) on government interference in economic life are lifted, the natural policy path of democratic governments is deficits, debt, and debasement.

Hayek (1979, 110) says of the situation of attempting to control inflation within our current monetary system is analogous to holding a tiger by the tail, if we let it go it will eat us up; if instead the tiger runs faster and faster and yet we attempt to desperately hold on, we are still finished. Buchanan and Wagner ([1977] 2000, 57) sum up the dire situation on the fiscal side less colorfully but every bit as desperately: “Sober assessment suggests that, politically, Keynesianism may represent a substantial disease, one that can, over the long-run, prove fatal for a functioning democracy."

The natural proclivity of democratic government is for public policy to concentrate benefits on the well-organized and well-informed interest groups in the short-run and disperse the costs on the ill-organized and ill-informed mass of voters over the long-run. Fiscal responsibility is relaxed not just in times of war or crisis, but permanently as part of ordinary politics. Deficits finance the concentration of benefits; these deficits translate into accumulated public debt. This public debt, in turn, is paid down through monetization. Keynesianism unleashes the natural proclivities of electoral politics and debt; deficits and debasement follow. Only through institutional innovations that minimize the role of government in the economy and the introduction of binding restrictions on the natural proclivities of electoral politics will fiscal responsibility and monetary stability have a chance of being established.[6] But this is not the policy direction we are heading.

As I am writing this (February/March 2009), the Obama administration is both pursuing a continuation of the activist agenda begun under the Bush administration and distancing itself from the previous administration. It is quite a political balancing act. We are told that only bold and decisive action by the government can stave off catastrophe. When pushed during a House Ways and Means Committee hearing (2009), Secretary of the Treasury Geithner claimed that the drastic actions by the government

[6] Hayek argued for the denationalization of money to eliminate the ability of countries to fuel their governmental habit through inflation; Buchanan has argued for a constitutional amendment for a balanced budget; and both Hayek and Buchanan argued for a constitutional rule to force democratic policy to pass a generality test to curb the interest group politics that drives the governmental habit of deficits, debts, and debasement.

taken during the fall 2008 were essential to stop a complete collapse of all financial institutions in the United States, and the aggressive steps taken now are fiscally responsible given the magnitude of the economic challenges the administration is facing. Geithner defended not only the fiscal stimulus, but TARP and the bail-out—the entire set of policies followed since September. And he clearly laid the blame on the policy regime of the previous eight years which he claimed had both engaged in reckless fiscal policy and gutted regulations let loose Wall Street greed. Geithner also repeated the standard line nowadays that all the income growth over the past eight years was experienced by the top 2 percent of the U.S. economy while the middle class showed little to no income growth. The rhetoric of Geithner and others is class warfare; the reality is reckless spending and credit expansion and the consequences are disincentives to work and invest, unsustainable public debt, and long-term inflation. Repeat: deficits, debt, debasement.

The Bush administration is at fault, but the roots of our current crisis go even deeper in U.S. history. The housing bubble, for example, owes much to policy initiatives that were introduced in the 1990s. The 1996 Community Reinvestment Act effectively lowered lending standards of banks so as to encourage home ownership. At the same time, government-sponsored agencies (FANNIE and FREDDIE) were pressured by the Clinton Administration to expand mortgage loans to low-income borrowers. These policies perverted incentives and distorted the economic signals that individuals faced in making choices.

In addition, while the practice of central banking seemed to have become "perfected" during the post-WWII and in particular post-Bretton Woods era and settled on a Milton Friedman-inspired "inflation targeting" policy rule. Friedman's explanation of the Great Depression as one of a series of policy errors, most notably monetary contraction and deflation, seemed to be victorious among central bankers. Ben Bernanke wrote in 2002 on the occasion of Milton Friedman's 90th birthday these fateful words: "Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

Little did Bernanke know that he would be the Federal Reserve Chairman when the bank confronted an economic crisis some are claiming is the greatest challenge to the U.S. economy since the Great Depression. But it is important to note that Bernanke has definitely not allowed a "great contraction" during this period, and instead has everything in his power to respond to the credit crunch with expansionary monetary policy.

To my mind, this is Hayek's Tiger by the Tail. Because of Friedman's concern with deflation, monetary policy in practice was one which fought inflation in theory, but feared deflation in practice. The result was that Volker, Greenspan, and now Bernanke speak out about controlling inflation, but their monetary policy is expansionary whenever economic times turn bad. The monetary base expanded tremendously under Greenspan in response to the dot.com, Y2K, 9/11, and the housing bubble. Market corrections take the form of falling prices, businesses failing, and resources being reshuffled (including labor) to higher-valued uses. But if each time a market correction is taking place, the monetary authorities ease credit in the attempt to minimize the pain of the market correction they result in further distorting the pattern of economic activity and putting off the needed market adjustments.

We can sum up our current policy path as follows. A future of microeconomic distortions with the bank nationalizations, proposed restrictions on compensation, talk of financial re-regulation, and changes in the tax structure. Ill-designed and ill-thought macroeconomic policies that are justified by analogy with the claim that our policy makers are throwing water to stop a burning fire, when to push the analogy the counter-claim is that it isn't water but gasoline that is being thrown on the fire. Expansionary monetary policy to address the credit crunch is inflationary, and fiscal policy that doesn't address the microeconomic realities of the needed market corrections to the previous pattern of misallocation. There is also a fundamental semantic issue because much of these proposed policies confuse credit with capital. Capital requires savings, not credit expansion. Recapitalization of the banks will not be accomplished through easy credit, but through increased savings. The relationship between savings and investment is distorted, not aided, by credit expansion. Similarly, if fiscal stimulus further distorts the process of market correction to the previous misallocation of resources then the public spending will be counter-productive. Let me repeat, a set of policies which unleash the governmental habit rather than constrain it do not create wealth. Deficits, debts, and debasement do not promote long-term economic prosperity. But this is the path we are on and in fact accelerating with the policy choices under the Bush and now Obama administration.

To return to our opening question—what happened to efficient markets—they are alive and kicking to survive. The "bad news" we often hear is in fact evidence of the market working to correct for previous errors in the pattern of exchange, production, and distribution. But if every time the market attempts to adapt to changing circumstances and correct for previous errors, government policies are enacted to stop the adjustments and correction—this is not a failure of "efficient markets" but instead a failure of government. Some of the propositions that follow from this perspective are hard to swallow. Unemployment, for example, is the market working to reallocate a scarce resource in a more productive direction. Idle resources may very well be idle for a reason —in other words it is more valuable for those resources to not be allocated as they previously were. The resource must be reshuffled in the process of economic value creation. Wage rigidities, unemployment compensation, etc. prevent labor from being reallocated as quickly as normal market pressures would suggest.

So, if by "efficient market" we mean the sort of dynamic adjustment to changing conditions that I identified with the classical and new institutional/market process schools of economics, they are evident throughout the economy. Markets work through a process of entrepreneurial discovery and competitive selection. But if by "efficient market" we mean no errors are ever made and that adjustments are made instantaneously so that a perfect pattern of resource allocation exists on the market at any point in time, then we have to reject this standard. This is not what thinkers from Smith to Hayek ever argued was the comparative advantage of the market economy over alternative economic systems. Instead, the claim was more dynamic in nature and humble in policy prescription. It was the advocates of government intervention that committed a "pretense of knowledge" and the "arrogance of power." Perhaps the most timely passage written in classical political economy on this point belongs to Adam Smith, and it is fitting that I end with it:

> What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every

individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it. ([1776] 1976, Book IV, Chapter 2, 478)

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