Funding the Future

The efficient market hypothesis and secrecy jurisdictio...

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Tom Worstall has been enjoying himself in the comments section of this blog promoting the merits of the Efficient Market Hypothesis (EMH).

As he has noted the Guardian has looked at this issue - Aditya Chakrabortty, its economics leader writer having blogged on the issue. As he says:

Today we will examine an idea that provokes fights between economists and City-types — and which can help you make money (or, at least, lose less). We'll come back to your savings; first let's cover the theoreticians' fisticuffs.

A year ago today, the Wall Street bank Lehman Brothers went belly-up, taking with it many of the big ideas about how markets worked. As Alan Greenspan, former head of the US central bank, said last year: "The whole intellectual edifice collapsed." And the cornerstone of that edifice was the efficient-markets hypothesis (EMH).

The basic concepts were codified in 1969 by a 30-year-old Chicago economist called Eugene Fama. For all its formulae, EMH can be broken down into two parts — and summed up by a cliche and the name of a gameshow. The cliche is If You Can't Beat Them, Join Them: Fama believed investors couldn't beat the market, since all known facts and opinion about a company were instantly reflected in its share price. And the gameshow? The Price is Right. Finance theorists believed fully priced assets were traded by rational people acting in their self-interest, so it followed that the market price was correct.

But as he notes:

There was just one problem: the theory worked better than the messy reality. Investors aren't always rational, brokers sometimes overhype assets, and huge bubbles can result — as we have just seen in the housing market. So *The Price Can Be Wrong. Trouble is, economists do not have a handy substitute narrative.*

But that still leaves the first part of EMH intact; that you can't beat the market unless *you have insider information. It implies that most of us are better off [stowing our savings] in a cheap fund that tracks the stock market, rather than with some expensive smarty-pants fund manager. There you go, an idea from economics that might save you money: who'd have thought it?*

Tim argues this means the EMH survives. But note the caveat the Guardian adds: it does unless you have insider information.

Now some might have noted that I mention secrecy jurisdictions on this blog every now and again. I define secrecy jurisdictions as:

Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain that is designed to undermine the legislation or regulation of another jurisdiction. They do in addition create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so.

Yesterday at the World Bank this was applauded as a major contribution ot thinking in this area. I'll take others word for it, but for this purpose let's assume it's fair. And note that this means that these places primarily exist to promote secrecy that allows regulatory abuse. One of those abuses, without doubt, is the deliberate asymmetric creation of data for the use of some which is not available to all. This is done by hiding critical data on traded entities from view: the creation of offshore entities, offshore off balance sheet entities, SPVs and more which deliberately create market misinformation about which a selected few have information and the rest of the market is unaware. The EMH fails in that case: the use of secrecy jurisdictions is, in this case a deliberate attempt to abuse the market. If this is known to happen (and it obviously is happening) and yet regulators turn a blind eye to it — and they have when they have assumed the EMH works when created their regulatory models — then the result is obvious: risk is mispriced by the market with adverse affect to the non-insider. Mervyn King and many others agree that the cause of the current financial was the mispricing of risk. Secrecy jurisdictions deliberately facilitate this process, I suggest.

And of course they provide the secrecy to facilitate the resulting insider trading.

In that case the EMH is a fantasy construction: it assumes a world that secrecy jurisdictions guarantee cannot exist. That destroys any chance that it is useful. Worse than that, the failure to build secrecy jurisdictions into financial regulation may in that case be a major contribution to the regulatory failure that created our crisis. That is something the current debate on regulation has not taken into account. And this suggests that some, like me, who have argued secrecy jurisdictions did not create this crisis but just facilitated it may be wrong. I think I might now be at risk of having seriously understated the role of secrecy jurisdictions. It may be that belief in EMH and ignoring the deliberate turning of a blind eye to the abuse of it from the use of secrecy jurisdictions is key to understanding on both how to rebuild regulation, and to the demand to the end of secrecy jurisdiction secrecy, completely and utterly.