Pegasus

A newsletter for the Caux Round Table Network
looking at business above the clutter and confetti

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Moral Capitalism At Work

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Pegasus

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INTRODUCTION

For this month's issue of Pegasus, I am imposing on your good will with several comments that have been on my mind recently as a result of events here in America and discussions at our October meetings in Bangkok.

I have been reflecting on what becomes "misfitting" about markets. When do they inherently serve us well and when not so well?

A consistent challenge for markets is the provision of public goods. How should they be priced? Who will produce them? A kind of public good that we don't often think about in connection with markets is art - even though prices for some works of art are going through the roof, as they say. How do we value aesthetics?

Aesthetics and ethics are at least kissing cousins. They both delight in form and proportion, arrangement and balance and can provide inspiration towards deeper (or for some, higher) realities. They move the human soul beyond the merely material and the selfish into the perspectives of others, binding us to larger visions of what is meaningful.

We have tried to illustrate this issue with examples of art that stand out in the moral experience of many over the centuries.

Markets and trading - economic behavior that preceded systemic capitalism - offer another arena where market making may not always lead to optimal outcomes. I put before you in another comment some thoughts in that regard.

Finally, markets are driven by our powers of ownership. Legally, we can only buy and sell what we have some title to. But rights to property, or rights to anything, can confer power that we might well abuse. Markets, therefore, can succor abuse as they permit us to concentrate our power or use it economically against the well-being of others.

I hope you will find these comments of mine worthy of your time and reflection.

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TRADING AND SPECULATION IN FINANCIAL CONTRACTS – A BOON OR BANE FOR CAPITALISM?

BY **STEPHEN B. YOUNG**
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No systemic change in the business model of large financial service firms has occurred during the last five years since they acted with fundamental irrationality to overestimate the real value of certain financial contracts to cause a collapse of credit markets when the scale of their mistake become evident. Small regulatory steps have been taken, among them the imposition of greater capital requirements, so that "next time," public funds will not be used to prevent their bankruptcies and some firms have given up or realigned their proprietary trading operations.

The separation of core banking functions from speculative profit seeking has not been required by governments. No serious limits on the degree to which such firms, which include depository and commercial lending functions vital to economic growth, can leverage their assets for speculative purposes. Trading in complex securities is still opaque and not tied to clearing house reserve requirements. The financial industry opposes reform to money market funds. Lending to the real economy still takes second place to high frequency trading and other global arbitrage opportunities.

The misjudgment on the part of large financial houses which triggered the crisis of 2008 was placing too much faith in spot market pricing and ignoring long-term realities. From the point of view of statistical modeling, their oversight left them very vulnerable to long tail or fat tail contingencies (so-called "black swan events").

Contributing to the misapprehension of risk was the prominent role given to trading as a driver of profits and bonus compensation by these large firms.

> Without dignity, our lives are only blinks of duration. But if we manage to lead a good life well, we create something more. We write a subscript to our mortality. We make our lives tiny diamonds in the cosmic sands.
>
> *Ronald Dworkin, Justice for Hedgehogs*

The issue for a moral capitalism is what might justify trading in financial instruments as a major component of banking, both commercial and fundraising for investment in productive enterprise.

The starting point for consideration is that markets owe no one a living and no business a profit. Markets are cold-hearted machines that respond without a conscience to the pushes and pulls of buyers and sellers. In the words of the *Tao Te Jing*, markets look upon all things as "straw dogs." Whatever value is there is brought to markets by human intermediaries.

Joseph Mallord William Turner, Snow Storm - Steam-Boat off a Harbour's Mouth, 1842

Thus, no one can have a claim that markets create a right to profit. Profit is a return on pleasing others by giving them goods or services at a price they like, but obtained at a lower cost.

Actually, profits are not even the object of a claim. They are only a mathematical by-product of the transaction. Therefore, the argument that financial firms "need" trading in order to make profits is spurious. The claim that profits justify activity puts the cart before the horse. Claiming a right to profit can justify all kinds of misfeasance or malfeasance. The only just demand is for wholesome opportunity.

The claim would be for freedom to offer the good or service. Profit or loss would then follow as a consequence. But even this claim to act has its pre-conditions. More freedom is justified when consequences are beneficial to others or limited in their impacts. Where an act spreads its consequences widely, especially where such consequences are harmful or restrictive of the rights and well-being of others, the act comes under social scrutiny and the actor is held accountable for results. The more narrow the effects, the more private the transaction and the greater its claim to freedom.

Second, when a business endeavor asks for public support, its claim thereto must be deserving as a result of what it will contribute to the common good. For the government to help an industry or a business out of friendship or some particular arrangement would be cronyism inconsistent with free market principles and an abuse of public power for personal satisfaction.

In financial intermediation, large firms look to the government for help when the going gets rough. Just by becoming "too big to fail" they intrude themselves into an arena where government will come to their rescue. They benefit from public insurance of their deposits and from regulation of the industry to save them from losses in falling markets brought on by imprudent competitors.

Accordingly, it seems to me that large financial firms do not have a strong ethical case that they be permitted to engage in speculative trading in financial instruments. Those activities should be spun off and left with firms that are completely removed from public solicitude. Traders and speculators strike me as similar to mercenaries – he who lives by the sword should die by the sword.

What you give to others, you must be prepared to accept for yourself. Turnabout is fair play. If you are in for the profit for yourself alone, you are also in for the loss as your portion of market freedom.

Trading behaviors in financial markets seem to slide into dysfunctionality more readily than other free market forms of profiting from enterprise.

The first thing to note about much trading of financial instruments in secondary markets is that no new net value is created for society in the transactions. Profits from successful trades are just existing money moved from one player to another. But more than that, much trading is done with credit so trading losses must be made up with funds taken from other activity. To the extent losses in trading are funded by withdrawal of funds from productive enterprise, such enterprise becomes marginalized in its access to capital.

When buying and selling of financial contracts is essentially a gamble on a future occurrence, what one gambler wins is taken from other players. And gambles do not always pay off, as Jon Corzine learned in the collapse of ML Global and J.P. Morgan's London Whale demonstrated when he bet wrong in a thin market.

Recently, we have learned that several significant "too big to fail" financial houses are owners and keepers of commodities in order to be able to issue securities that can be traded. Capital was diverted from lending to buy and hold stocks that supported other speculative bets. J.P. Morgan held US$16.17 billion in physical commodity assets, according to the *Wall Street Journal*. A bad bet on the direction of prices in commodities could result in big losses for such firms. Should they even be in lines of business that put lending to the real economy in jeopardy or run the risk of forcing taxpayers to pick up their losses?

Speculation, as John Maynard Keynes famously noted in chapter 12 of his book, *The General Theory of Employment, Interest and Money*, looks not to the real economy, but only to the perceptions of others about whatever it is that moves their cheese. If others think the sky is red and so invest with that thought in mind, it matters not that the sky is really blue if you want to make money off their market activity. Bet on it being red. Correctly guessing where market prices will move as a result of what other traders believe to be true gives an edge over them in buying or selling whatever it is they seek. George Soros in his 1998 book, *The Crisis of Global Capitalism*, made a similar point when he called the workings of financial trading markets "reflexivity." He noted that you made money in trading not by betting on fundamentals, but by close study of biases, or theories, in the minds of other traders. There was always a gap, he argued, between reality and theory. Spotting the gap permitted a judgment as to when to buy and sell and at what prices. But theories can become reality if enough market participants act accordingly, but only for a time.

Joseph Mallord William Turner, The Slave Ship, 1840

When reality overtakes theory, large losses can occur. As a cost of substantial involvement in sub-prime mortgage originations, securitizations and the selling of CDOS and CDS guarantees of CDOs, major U.S. financial firms lost US$66.5 billion in penalties, fines and restitution payments to customers to compensate them for their losses. In retrospect, the passion for trading profits was only a fixation on illusory promises of profit. The passion was only a market theory that was badly grounded in reality.

Thus, divorced from real economic forces and subject to a lot of market noise, trading activity lends itself to mispricing of assets. Speculation supported the asset bubbles from the Tulip Mania through the South Sea Bubble and the Mississippi Company in France down to the crash of 1929 and the collapse of credit markets in 2008. In each case, underlying assets were overly valued and money was borrowed against those irrational values.

> I am only one, but still I am one. I cannot do everything, but still I can do something; and because I cannot do everything, I will not refuse to do something that I can do.
>
> *Edward Everett Hale*

An argument for the social advantages of trading financial instruments is to provide price discovery. But that case was pretty nearly disproven by the 2008 crisis in credit markets. Then, the prices produced by financial markets were vulnerable to collapse, which they finally did. Such prices were not reliable and so financial markets contributed to a wasteful misallocation of funds in the economy.

In his 1766 lectures on wealth creation, Adam Smith had noted this tendency of financial markets to play fast and loose with pricing. Then, speculation on the future price of stocks was called "stockjobbing." A speculator could subscribe to stock to be issued and paid for on a future date. To buy at the subscription price, but resell at a higher price for a profit, the stockjobber, according to Smith, would circulate reports as to the reasons for the price to rise. At the same time, those who wanted to buy the stock after issuance would circulate counter-reports as to its likely fall in price. There ensued, said Smith, a "war" between "bulls" – the buyers - and "bears" – the sellers. The market price was driven by unsubstantiated beliefs and, accordingly, could be disconnected from any dependence on tangible factors and realistic future probabilities.

After the dramatic bubble and following crash in the price of shares in the South Sea Company, the government passed a law to prevent such trading practices.

Trading is a pre-capitalist behavior. It is not a differentiator of systemic wealth creation and economic growth. Only production of goods and services to bring to markets can do that. Trading is a market function, but capitalism is far more than markets. Capitalism is not just buying and selling what is already made. It is risk-taking and investment of today's funds in the creation of goods and services for a future return. It is innovation in technology. It is assembly of investment capital. It is governance of division of labor. It is more demanding than arbitrage between sellers and buyers who have different price points.

Engaging in trading is retrogression away from sustainable wealth creation back towards more zero/sum confrontations and exploitation. The trader is a hard bargainer and manipulator of prices and information. Trading in financial instruments has a very short-term time horizon; it is a business where profit and loss statements can divert attention away from balance sheet valuations. It is expressly not buying to hold for the long-term awaiting appreciation in underlying values.

Trading in anonymous public financial markets depends less than does capitalist production on maintaining good relationships with customers and suppliers. Market competition is very much about price only and becomes very adversarial and at arms-length. Traders have no fiduciary obligations to their counterparts. In addition, they need few stakeholders to keep them in business. Give them money and they are happy. They are not stewards and often think of others as road kill, as suckers and marks for exploitation. Such practices undermine trust and reliance and corrode social capital. This kind of trading destroys ethical standards.

Recent examples of such behaviors include the fixing of LIBOR interest rates to assist traders to be “in the money” on their options and derivative contracts that gambled on certain rates as of certain dates and the possibility of similar fixing of currency exchange rates by large trading houses now under investigation.

To recall the categories of Martin Buber, financial trading is very “I/It” and not very “I/Thou.”

Caspar David Friedrich, Wanderer above the Sea of Fog, 1818

Across from the trader in most every transaction is only an “it” – an object that flits in and then out of focus.

In all these ways, financial trading undermines capitalist well-being. It is a troublemaker as a rule. Its claim for understanding and support from public regulation is very weak.

MARKETS & **ART**

BY **STEPHEN B. YOUNG**
GLOBAL EXECUTIVE DIRECTOR
THE CAUX ROUND TABLE

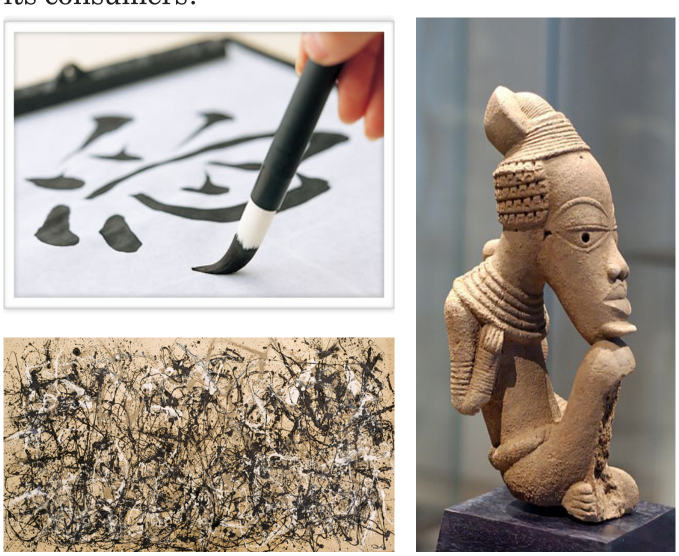
I recently enjoyed a stimulating conversation as to how to measure the value of artistic creation. Should artists be subsidized or should they be subjected to the power of consumers?

If no one buys their works – consider Van Gogh – do they have a claim for mistreatment at the hands of boorish, vulgar philistines?

Or do all of us have some moral duty to buy what we don't like? To attend concerts that give us no pleasure? To buy books or poems which don't speak to us at all?

To what extent might artists of all genres have a claim on society to provide them with a living in order that they can freely produce what they please?

Who should set value on art – its creators or its consumers?



Upper left to right: Detail of calligraphy; Jackson Pollock, Autumn Rhythm (Number 30), 1950; Nok Terracotta, Nigeria, 6th century B.C.E.

Objects of art distinct from live performances can become items for sale. Van Gogh did not live long enough to enjoy connoisseur appreciation of his creations on canvas, but in time, great monetary value was placed on his efforts to paint pictures. Thus, during his life, he could not support himself with his special genius.

Works of art, once created, whether merely utilitarian or impulses of purely personal indulgence or products of the most refined sophistication, can attract monetary value in the eyes of buyers who find them pleasing. But here, it is the buyers, not the sellers, who set the valuations.

This is quandary for modern society when there is a gap between the valuations artists place upon their own works and what others may think of such products. With the emergence of the avant-garde in art, a cultural gap emerged between the sensibilities of the innovators in art and mass taste, which tended to be less sophisticated and more commercial and of entertaining reassurance. Elite art became more conceptual and message-bearing and less commonplace. It thrived on defiance of conventions, especially middle-class conventions. Painting, prose, poetry, music, dance and film divided into highbrow and lowbrow formats.

Especially with lowbrow formats, markets seem to work very well. What earns a profit, sustains itself. Selling entertainment to mass markets made many artists very well-to-do. Giving customers what they were willing to pay for worked fine for consumers and for such artists gifted with the ability to read what their audiences desired.

But highbrow formats don't thrive under free market conditions. They need sponsorship. The market for their products is limited to a small range of customers.

Should these artists be subsidized? What value do they bring to the common weal? Do they produce public goods of sufficient specificity and importance that they can claim a share of society's wealth?

What about Van Gogh? Would we be worse off without his paintings? Should he have just given up when no one wanted to buy his oils?

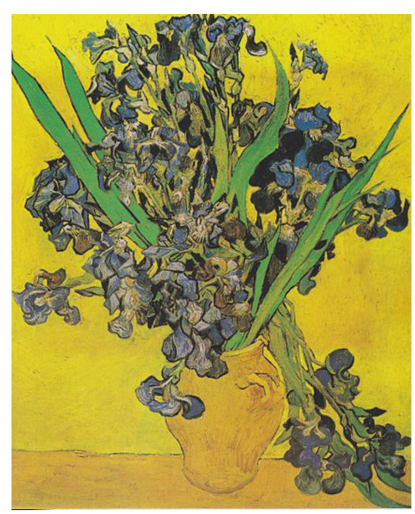
What about architecture? Who should pay for an architect to reach for the sublime?

Can art as a public good be reconciled with capitalism and its harsh demands for customer satisfaction?

Markets, as a rule, do not perform at their best where public goods are needed. Individual buyers and sellers who drive markets with their decisions to buy or sell are best at pricing that which is immediately before them, immediately gratifying, tangible and of obvious utility. They are less willing, in the normal case, to price with assurance that which is distant, not easily used, intangible and of no immediate emotional attraction. Private goods fall into the first category of what can be priced and public goods into the second. Because it is more difficult to price public goods, markets don't allocate them well. Buyers and sellers don't show up for transactions in public goods. Intervention by society – mostly by government – is necessary to promote the supply of public goods.

Some non-market form of financing – subsidy or the imposition of regulatory burdens on public "bads" – is most often turned to when the public interest is to be enhanced.

Where art partakes of a public good, therefore, it moves beyond markets towards alternative venues for production. Those interested in the production of such public goods for their inherent aesthetic or cultural impacts and advantages must set up non-market criteria for subsidy and patronage. This is a cultural/political process of compromising different tastes and points of view



Left to right: Pablo Picasso, Guernica, 1937; Vincent van Gogh, Vase with Iris against a yellow background, 1890

Left to upper right: Venus de Milo, Greece, 130-100 B.C.E.; Choral performance in Notre Dame, Paris, France, 2011; Pokrovsky Cathedral/St. Basil's Cathedral, Moscow, Russia, 1561; Martha Graham, Letter to the World, 1940, photograph by Barbara Morgan

where price is only part of the decision to finance what markets will not.

Public goods have a claim on corporate social responsibilities ("CSR"). Corporate social responsibility is the business function which negotiates the relationships between business, society and government. It presides over the arena of goods, which are hard to price. It is the decision-making metric which values for business externalities to market prices, intangibles and stakeholder relationships.

Business should, therefore, as a matter of best CSR practices, place a value on highbrow art which can't sustain itself through normal market dynamics, but which elevates our souls, brings beauty to our lives and promotes goodness in our sensibilities.

IT'S THE **LACK OF ETHICS**, STUPID

BY **STEPHEN B. YOUNG**
GLOBAL EXECUTIVE DIRECTOR
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The recent breakdown in civic leadership in Washington, D.C., when compromise fell victim to self-righteousness and the seduction of wanting to hold the upper hand, teaches many lessons about the dynamics of poor governance.

One important lesson is that ethics, more than rights, make for the common good.

Individual rights, to be sure, are the conceptual, as well as the practical foundation for constitutional democracies. They prevent abuses of power by diffusing it widely. They promote human dignity and minimize discrimination by empowering individuals to live as they see fit for themselves. Without rights, culture, society and politics would be quite oppressive as outcomes would be driven by those with money and power and by those who are most extreme in their views.

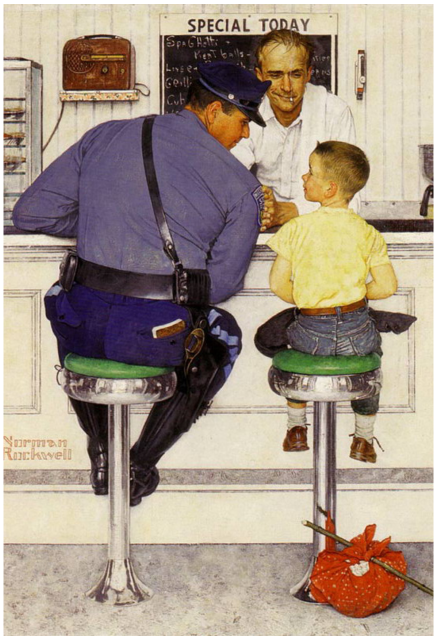
Rights provide checks and balances against the freedom of others to use their rights. By necessity and by definition, rights are limited. No one can have rights that deny or trespass upon the rights of others. To abuse the rights of others is not to act of right, but only to oppress them with power.

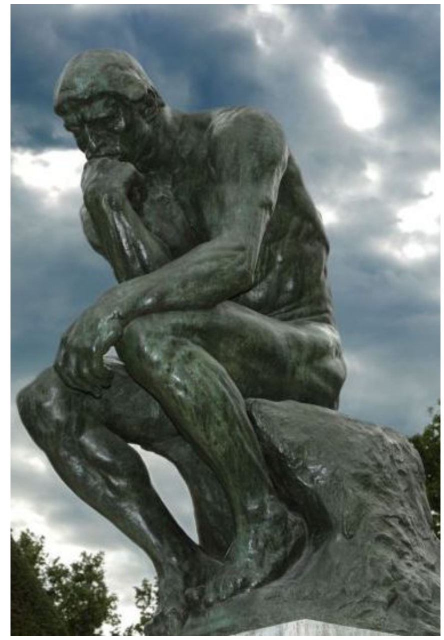
The continuing question for free societies is: where do my rights end and yours begin? When should I yield to your right and when should you yield to mine?

In theory, all these questions should be answered by the law, which exists to define both rights and their limits. But what would happen if my sense of entitlement goes beyond current law to seek future conditions that are more favorable to me than to you? If I frame my demands as an extension of my rights, I would give myself a trump card in politics over you, which can now be portrayed as unjustly standing in my way.

As seen in the recent confrontation in Washington, D.C., rights, when exercised with vigor, lead to conflict and stalemate. Worse, advocacy of rights can lead to violence when others do not provide sufficient regard and respect for those with differing approaches. Law is designed to limit rights out of concern for the whole and out of respect for the rights of others. But extreme rights consciousness will challenge the law itself for bias and corruption in favor of others, leading to lack of compromise, civil disobedience and worse.

From an individual's perspective, the limits of his or her personal and communal rights are set by selfish understandings, which can be very expansive and intolerant of others. Rights are shaped by identity politics. We demand as a right what makes us feel more self-confident, secure and powerful.



Left to right: Norman Rockwell, The Runaway, 1958; Marco Cianfanelli, Release (sculptural portrait of Nelson Mandela), 2012; Auguste Rodin, The Thinker, 1903

When rights are taken to their fullest extent, they always run the risk of trespassing on the rights of others who don't think the way we do about ourselves and our claims on the world. The common good melts away under pressure from factions and from individuals demanding special treatment. I push and you push back. Sometimes, push comes to shove. Then, shove comes to shooting. The pendulum of public authority begins to swing towards anarchy and rough justice, where force and guile tend to prevail.

Such is the critique of brute, free markets, where the struggle for market power among individuals asserting personal rights to property and profit does not guarantee the greatest good for the greatest number. Rights logic in free market conditions seeks to impose costs on others, while obtaining benefits for the self alone. Raw, self-interest conceptualized as personal rights does not provide an invisible hand promoting the common weal.

If it is "my way or the highway," usually, we end up on the highway looking for a ride.

Self-restraint, then, is more likely to produce the common good than aggressive self-seeking and exploitation of claims of right. Self-restraint is ethics applied in action. With ethics, compromise becomes possible and overreaching brinkmanship avoided. Ethics, or the capacity to act with virtue, opens the door to higher levels of prosperity, civil order and happiness for a community.

Simply put, ethics arises out of concern for the consequences of our actions on others. Ethics places restraint on selfishness; it keeps us from going to the extreme.

Aristotle famously described ethics as moderation – keeping to the middle, avoiding extremes.

Buddhism teaches us the wisdom of following the middle path.

Taoism and the Confucian text, *The Doctrine of the Mean*, find justice in keeping to the Mean or the Tao, which never flow too far away from accommodation with reality.

Alvin Ailey (choreographer), Revelations, premiered 1960, photograph of Alvin Ailey American Dance Theater by Paul Kolnik, 2010

When imposing ethics on rights, it is the power given by the right which must yield to the restraint of ethics. Compromise, then, is the path of ethics. In politics, one is not justified in demanding unconditional surrender from the other side. That would be war.

According to Clausewitz, war is an extension of politics that uses force and violence to break one's will. Might makes right and victors get to write the laws.

War may vindicate principle if we stand our ground and refuse to compromise, but we may lose the war, while it unleashes misery, death, destruction and economic retrogression. War is not conducive to human flourishing and is generally avoided by thoughtful people. It is to be the exception, not the rule, resorted to by those who are forced by evil intent to defend themselves and their rights.

No constitutional republic can be successful if it turns to civil war.

If we are to refrain from politics as war, ethics must constrain demands of rights.

How is this to be done?

In the first place, compromise with the understanding that compromise is not surrender of our rights or our values. It is a tactical measure to get our way through evolution. Politics is a series of compromises. Over time, large changes can be made peacefully with majority support as others come to respect our positions.

Second, the use of discourse. Ethics applied to politics implies that I try to convince you that I am "right." I don't stand on my rights, but rather, engage you in persuasive discourse, opening myself up to the possibility that you may convince me that you are "right." Discourse implies give and take; I take and I give, leading to mutuality, not enmity.

Third, office is a trust. Being our President or Majority Leader of our House of Representatives only gives power in trust to use for the common good. Ethics is infused into the job description. The job is not to impose one's views, but to advance the common good with reference to one's views; not to dictate, but to find agreement.

Those who become intransigent remove themselves from doing their duty as a public official. Making excessive demands should be rewarded with marginalization, as the political center is usually where the public trust can best be protected. That is why failed states have no center, only extremes.

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