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The 2008 Financial Crisis – A Failure of the Free Market System

The triumph of America in the Cold War is usually perceived as the triumph of the free market system over communism. The supporters of the free market system have a tendency to take extreme positions in favor of the free market system which involves opposing any kind of government role in the economy beyond basic regulatory framework. The latest example of this comes in the form of intense opposition to Obamacare, as well as additional financial regulations by some who argue that markets can function perfectly well without government intervention and are capable of self-regulation, too. Even though the free market system may be the best of all economic systems, it cannot function properly without active government participation in the economy, and the financial crisis of 2007-2008 is one such example.

The development of complex financial products by the free market system is often seen as one of the major contributing factors behind the 2008 financial crisis. These innovative financial products, such as mortgage-backed securities, were so complex that the market participants who traded these securities had little understanding of the underlying risk. As a result, even high-risk securities were rated AAA by credit rating agencies (Jickling 6). It is apparent that the free market system severely underestimated the risk borne by the sellers and buyers of these products. If the free market system can function well on its own and is capable of self-regulation, it should have been able to understand the financial products it itself helped create. In fact, even leading players such as Bear Stearns and Lehman Brothers had no idea of the risk they would encounter which ultimately led to their collapse. The recent financial crisis is an example of how government participation in the economy is essential to the market's functioning, because without government intervention, there was real danger of the collapse of the entire U.S. financial system.

The 2008 financial crisis also demonstrated the importance of government's monitoring of the free market system because markets are unable to perform self-monitoring competently, often due to conflict of interests. The credit rating agencies have traditionally been paid by the same companies whose products they rate, thus, there is reasonable probability of generous rating to attract more business from clients. Market participants often rely on ratings given by credit rating agencies for buy and sell decisions because these ratings determine the price and return of the underlying assets. In the years leading up to the financial crisis, credit rating agencies often gave their top-notch rating AAA to numerous subprime mortgage-backed securities that should have been rated junk instead (Jickling 6). As a result, many investors ended up paying higher prices for these financial products and took on more risk than they could manage. It is clear that the free market system is not fully capable of effective self-monitoring.

One of the arguments made in favor of the free market system is that incentives are properly aligned with performance and risk, which could not have been further from the truth. The 2008 financial crisis is proof that those who embrace the free market system often have a short investment time horizon and their compensation doesn't always reflect their real performance. One of the reasons is that it takes some time before the consequences of actions taken by individuals are fully realized and understood, but often compensation policies have a much shorter time frame. Prior to the 2008 financial crisis, financial market players were usually compensated on year-to-year performance (Jickling 9), as has been the historical norm on Wall Street. In order to boost their personal interests, many participants took excessive risk. This short-term approach to performance has the danger of ignoring long-term consequences, so it didn't come as a surprise that Wall Street focused on short-term gains. It is believed that Wall Street generated total revenues of $27 billion through transactions involving asset-backed securities. Frequent trading contributed towards layers being added to the securities by different players, with no one possessing all the information to understand the risk behind the asset-backed securities (Lim 4). Naturally, a poor understanding led to inaccurate pricing and portfolios ridden with excessive risk.

Without government monitoring and regulation, the free market system is vulnerable to multiple problems, and while some greed is good, too much greed may lead to unethical behaviors. Prior to the collapse of the market, some banks had engaged in unethical conduct such as off-balance sheet accounting which made it difficult for investors to understand the sources of risk in the underlying bank's operations. Banks even created off-the-books special purpose entities to pursue speculative investments (Jickling 7). When the economic bubble burst, banks were left with greater liabilities than capital and many had to turn to government for bailout.

On top of that, financial markets are not efficient because their players do not always act in a rational manner and often do not weigh the prospects of things going wrong. The computer models developed by the financial companies underestimated the risk, too, while many models were insufficiently designed, relying on only few years worth of data (Jickling 8). Similarly, market participants are often influenced by group thinking because they reason the majority could not be wrong.

The supporters of the free market system like to claim that markets can correct themselves but the 2008 financial crisis proves otherwise. Even companies that earned billions under capitalism, such as Goldman Sachs, Bank of America, and Morgan Stanley, etc., were forced to seek government financial assistance. Had those companies really believed that the market would be able to correct itself without government intervention, they would not have sought assistance from the government.

The free market system might be the best economic model there is, but to function properly it requires some government support. This is because market participants often have short time horizons, do not always behave in an ethical manner, do not always correctly interpret the information available to make informed decisions, and may follow the crowd without objectively evaluating its behavior.

References

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