The triumph of the market system over the planned economy was probably the defining economic event of our lifetime, its symbol the collapse of the Berlin Wall in 1989. In the advanced economies of the West, increased government intervention in the economy, more or less unchecked through the twentieth century, was halted in 1980 by the ideologically conservative governments of Reagan and Thatcher, with policy innovations that were widely if often reluctantly imitated elsewhere. In Asia, China and India followed some of their smaller neighbours into the market economy and the global trading system.

These developments provoked the hubris famously framed as *The End of History* by Francis Fukuyama, who argued that a combination of liberal democracy and lightly regulated capitalism was now an inevitable form of political and economic organisation. If one country was the standard bearer for that new vision of the twenty-first century, it was the United States: if one industry was
the standard bearer for that new view, it was the financial services industry.

Today, that assertion lacks conviction. If there were defining events in that revisionism, analogous to the breaching of the Berlin Wall, they would be – for politics – the collapse of the Twin Towers and its bungled consequences, and for economics the bankruptcy of Lehman seven years later. There is, evidently, no end of history – as, indeed, Fukuyama today readily acknowledges.

What I want to do tonight is to provide a more nuanced view of the nature of markets and the merits of the market economy. The critique of the market economy today is, as it has been since the end of socialism, largely incoherent – an incoherence nicely captured in the demonstrator’s slogan ‘capitalism should be replaced by something nicer’.

But the defence of the market economy is often little more coherent. Supporters often do no more than point of the wealth of countries that have adopted the market economy – and to their own personal wealth. That isn’t necessarily a bad argument. But it looks tarnished today. When the people who are the largest beneficiaries in terms of their own personal wealth have done substantial damage of the wealth of other people, such an argument becomes more difficult to sustain.

I am going to argue that there are three elements to the triumph of the market economy. The first I will describe under the
heading of ‘prices as signals’: the price mechanism is generally a better guide to resource allocation than central planning. The second element is ‘markets as a process of discovery’: a chaotic process of experimentation is the means through which a market economy adapts to change. The third heading is ‘diffusion of political and economic power’. The economic point here is that prosperity and growth require that entrepreneurial energy should be focussed on the creation of wealth, rather than the appropriation of the wealth of other people.

In what we teach, in what we say, in our economic research and most importantly in the policies we adopt – we put too much emphasis on the first of these elements – prices as signals to guide resource allocation – at the expense of the, possibly more important, second and third elements – markets as process of discovery, markets as mechanism for the diffusion of political and economic power.

The result is that both supporters and critics of the market economy have often confused policies that are pro-business with policies that are pro-market. That confusion has both undermined the social and political legitimacy of the market economy, and led to serious policy errors that follow from a mistaken, or at least incomplete, understanding of how a market economy works. I will illustrate that proposition by reference to three areas of policy – financial services, inevitably; digital media, and competition policy.
These sectors are only a topical selection from what could be a much longer list.

There is one central theme that runs through all three strands in the success of the market economy, a theme which I have called disciplined pluralism. When prices act as signals decentralised enterprises and decentralised information are brought together to create a coherent result. Markets as a process of discovery are based on freedom to experiment, combined with discipline: unsuccessful experiment is acknowledged and terminated. Markets as a means of decentralising power are the determinant of the areas where politics and economics meet.

If the essence of markets is their pluralist character, then there is an inevitable association between the successful market economy and other components of an open society – freedom of expression, and democratic institutions. While it is evident that authoritarian regimes have operated market economies, at least for a bit, the combination is probably not sustainable in the long run. There is an important corollary: political freedom is jeopardised by excessive concentrations of economic power. Even if Fukuyama was wrong in his assertion of inevitability, the identification of an elective affinity between liberal democracy and lightly regulated capitalism was entirely appropriate.

The model of ‘prices as signals’ describes how self-interested agents – individuals or firms – might, through independent
decisions, make consistent and efficient choices about how to organise production and distribution and the allocation of capital, labour and other resources. In a loose formulation, this idea has been around since the beginnings of economics. Many people interpret Adam Smith’s famous remark about ‘the invisible hand’, and his observation that it was not the benevolence of the baker, but his self-love, that furnished our table in this way. In an astonishing demonstration of the power of spontaneous order, decentralised markets manage the process of coordinating complex production systems better than centralised direction.

Although it appears to be an empirical fact that markets achieve this, economists did not offer a comprehensive explanation of why until the 1950s. That explanation proved both that a competitive equilibrium might exist, and that, if it did exist, it could be efficient. That general equilibrium model (concisely ‘the model’) proved largely influential, both in shaping the research agenda of the economic profession and in providing an intellectual basis for economic policy among people who may know nothing of the underlying arguments.

The implication is that profitable transactions are socially beneficial: indeed that their social benefit is demonstrated by their profitability. A corollary is of the ‘market failure doctrine’, which is central today in economic policy in Britain and Brussels: intervention in markets is justifiable only in the light of a narrowly
defined list of market failures, which is generated by deviations between the world and the assumptions of the model.

The model also provides a rationale for a certain kind of market fundamentalism. Not only is interference with market forces usually inappropriate, but market outcomes are efficient, even morally justifiable, simply by virtue of being market outcomes. Not only are markets good, but more markets are better than fewer markets. The emergence of new markets for financial products, for example, is presumptively beneficial.

Among economists, the popularity of this approach is in large part the result of physics envy: the model provides a universal explanation of economic affairs which resembles in many ways the equilibrium models that have proved so powerful in the natural sciences. Rigour has become the measure of the quality of a theoretical economic argument, where rigour means the logical consistency which readily finds mathematical expression.

Among practical people, the simple message that government should go away and leave business alone has wide appeal to business: and the simple message that greed can serve a constructive social role also has wide appeal to greedy people. The claim that profitability demonstrates, is even the measure of, public benefit relieves people of any worries they might have harboured about the utility of their profitable activities. These worries are not common, but one does encounter them from time to time.
These messages, however, resistible to intellectuals who are not economists who are indifferent to the theoretical arguments. They are also resistible to the population at large, which does not run business, benefits only indirectly from the activities of business, and is not necessarily enamoured of greed. The political world today is one in which both parties and voters acknowledge the empirical success of the market, but dislike almost every aspect of it. ‘The market’ and ‘market forces’ are the source of our prosperity, but are also terms of abuse. We have succeeded in providing a description of how markets work that is at once repulsive and substantially false.

The model probably contributes something to our understanding of how markets work. But that contribution is largely misunderstood and grossly over-emphasised. One problem is that there is no real acknowledgement of uncertainty in the model, or, to be more precise, uncertainty is acknowledged only in essentially formal ways. This omission is of fundamental importance when the model is used to describe financial markets, in which trading in risk is the essence of the transaction. In such markets, the means of incorporating uncertainty into the model requires, in effect, that there is some true underlying value of an asset, which is independent of beliefs about that value, and that market transactions involve a process of convergence towards the true
value. Experience has demonstrated clearly that this claim is a hopelessly inadequate account of market behaviour.

A larger problem is that the model fails to recognise the extent to which a functioning market economy is embedded in the society of which it forms part. Property rights are not a fact, but a social construction: and there are many alternative ways in which these rights could be constructed. In a modern economy characterised by complex products, sellers generally know more about what they are selling than buyers about what they are buying. Trust relationships and supplier reputation are the market’s mechanisms for handling this problem.

These are not theoretical quibbles: they are problems at the centre of recent events. There were always two broad accounts of the reasons for the explosion of trade in complex structured products in the financial sector over the last decade. In one, these developments represented a more sophisticated form of risk sharing and risk transfer, an exemplification of the benefit of the creation of new markets. In another, the trade was mainly driven by information asymmetry: the products were bought by people who overestimated their value.

The consequences of these different explanations are very different. When structured products bring about more efficient risk allocation, the private profitability is mirrored by public benefits in the form of lower costs of risk. When they are bought by people
who do not understand them, private profitability overall is illusory and disappears when asset prices ultimately revert to the underlying value of the asset.

In retrospect, it is evident that this latter explanation is closer to the truth. Trade was driven by differences of information and interpretation and the profits from it evaporated when these errors were revealed. That is why Adair Turner is right when he invites us to query the social value of current trading values, and when he suggests that its extent goes far beyond what is needed to serve its economic function. But that is not the issue I want to pursue tonight. I simply want to cite it as example of the doubtful value of endless promotion of markets, are also the potential fruitfulness of examining the correspondence between the model and the world.

There is a good deal more to the power of markets than ‘the model’. The world is uncertain: not just risky, but uncertain, in the sense used by Keynes and Knight. Not only do we not know which future outcomes will happen: we are unable to specify at all fully what these possible outcomes will be. If we could predict or anticipate the invention of the wheel, we would have already invented it. Market economies do not predict the future, they explore it. That is a fundamental – perhaps the fundamental – difference between a planned and a market economy.

Hayek continues to be the most eloquent exposition of the concept of the market as a process of discovery. His argument was
a priori, but vindicated by the failures of the eastern bloc in the post-war era. These planned economies failed in the development, not just of consumer products, but of business methods. Their technological development was disappointing in almost all not related to military hardware. Centralised systems experiment too little. They find reasons why new proposals will fail – and mostly they are right in finding reasons why they will fail because most experiments do fail. Market economies thrive on a continued supply of unreasonable optimism. And when, occasionally, the experiments of entrepreneurs succeed, they are quickly imitated. It is a sad fact of the market economy that even for innovations that are commercially successful, few are commercially successful for the innovator.

If market economies are better than planned societies at the origination and diffusion of new ideas, they are also better at disposing of failed ideas. Honest feedback is not welcome in large bureaucracies. In authoritarian regimes, such feedback can be fatal to the person who delivers it. In less draconian contexts, unwanted messages can be fatal to careers. And when I talk about large bureaucracies here, I am talking just as much about large private bureaucracies as large public ones. Disruptive innovations most often come to market through new entrants – from Google, EasyJet, Amazon. Incumbents have good reasons to be suspicious of novelty and protective of their established markets and activities.
The health of the market economy depends, therefore, on constant replenishment of the business sector by new entry. If, as planner or sponsoring department, you had been planning the future of the computer industry in the 1970s, would you have asked Bill Gates and Paul Allen? If, as planner or sponsoring department, you had been planning the future of aviation in the 1980s, would you have asked Stelios Haji-Ioannou? If, as planner or sponsoring department, you had been planning the future of retailing in the 1990s would you have asked Jeff Bezos? Of course not: whether you were the politburo or permanent secretary you would have asked men in suits like yourself.

Watching the impact of electronics and the internet on children and grandchildren, makers of business and public policy have at least understood these issues. Committees of the middle-aged Twitter about technology like embarrassing adults trying to have fun at the teenagers’ disco. But, like those adults at the party, we are not really serious. Whether planners or governments of a market economy, we see industries through the eyes of established firms in the industry. And in doing so, miss the pluralism that is the market economy’s central dynamic.

That leads directly to the third group of reasons for the superior performance of market economies. If I were to offer a one sentence description of why some countries are poor and others rich, it would be that the politics and economics of poor countries
are dominated by rent-seeking and the politics and economics of rich countries are not. Rent seeking is the process by which the ambitious find it more rewarding to batten on the wealth created by other people than to create it themselves.

Rent seeking takes, and has taken, many forms – castles on the Rhine, the Wars of the Roses; ten per cent on arms sales, or seven per cent on new issues: awarding yourself control over former state assets, stealing the revenues from your country’s resources deposits, seeking protection from foreign competition, blocking market access by new entrants; winning sinecures or overpaid positions by ingratiating oneself with public servants or corporate employees. The mechanisms of rent-seeking range from the application of armed force to victory in democratic election; the methods pursued range from lobbying on Capitol Hill and in the restaurants of Brussels, through access to the King or the Chief Executive.

But while rent seeking is ineradicable, we can have more of it, or less. Politics everywhere used to be dominated by rent seeking; factions would battle for control of the state and when they won such control would use it to steal as much as they could get their hands on. In much of the world, it is like that still. ‘It’s Our Turn to Eat’ is the stomach churning title of one fascinating recent book about the corrupt – and moderately - democratic politics of modern Kenya. We have come to recognise the resource curse – wealth
from national resources does more harm than good in many countries because of the rent-seeking it attracts – and foreign aid may have some of the same characteristics. But in Western Europe, at least, corrupt politics has ceased to be an avenue for rent-seeking.

The ability of a political/economic system to resist rent seeking depends on the degree of economic decentralisation. If there are concentrations of economic power. Individuals will try to get their hands on the rents concentrations of power attract whether they are found in the public sector, in private businesses, or in groups of private business. The wider the extent of the opportunities this created, the greater the tendency for individuals to gain wealth and influence for themselves by attaching themselves to power rather than exploiting their own individual talents and by developing distinctive capabilities in their own economic activities.

There is a strong tendency for private concentration of economic power to be self-reinforcing. This problem was widely recognised in America’s ‘gilded age’ at the end of the nineteenth century. The well-founded fear was that the new mega-rich – the Rockefellers, the Carnegies, the Vanderbilts – would use their wealth to enhance their political influence and hence enhance their economic power still further, subverting both the market economy and the democratic process. These concerns were the origin of
anti-trust legislation, a point today often forgotten. The process that concerned Americans then is the problem we see in Russia – and elsewhere in the world – today.

Parenthetically, it should be noted that this political economic nexus was not an issue of comparable importance in Britain at that time. Although there were many newly rich entrepreneurs and industrialists in the UK, their access to political power was limited by the persistence of aristocracy and class system. These social barriers are no longer relevant, and the implications are important.

The ability of a market economy to restrict rent-seeking, its capacity to channel the desire for acquisition into channels that create wealth rather than extract it, depends on measures both to prevent the concentration of economic power and to limit the terms of access to such concentration. These are constraints on the economic power of the state: constraint on the concentration of economic power in large businesses: constant vigilance at the boundaries between the state and business: and a mixture of external supervision and internal restraint which prevents individuals who pull levers of economic power from using these levers to direct renting to themselves.

Because the last decades have confused a pro-business stance with a pro-market stance, we have emphasised some of these conditions at the expense of others. Western – and especially Anglo-Saxon societies - have constrained the economic role of the
state. These measures have reduced the scope of one focus of rent-seeking, that by organised groups of public employees. A substantial element of such rent-seeking remains in areas that remain inescapably within the public sector. And, despite the furore over MPs’ expenses, we have continued to do well in maintaining the financial, if not necessarily the intellectual, integrity of our politics and politicians. Few people enter British, or west European, politics for the money. If the worst we have is the odd moat-clearing or duck-house, and the occasional sale of a peerage, we are not doing badly: although it is important we should continue to make a fuss about these issues. Corruption is a slippery slope, long and gentle.

There was a recent time, however, when similar restraint applied in large business: when people knew, as people in the UK Treasury do know but people in the Kenyan Treasury do not, that a lot of money may pass through your hands without any of it being yours. The senior managers of large British industrial companies before the 1980s did not pay themselves large salaries because they did not think it appropriate to do so. They would have been insulted by the idea of a bonus or success fee in much the same way as a doctor or teacher would still be insulted by a bonus or a success fee. They saw their jobs as a responsibility rather than a reward. These conventions have gone: and in the United States, the problem of the diversion of a substantial part of the rents
earned by large corporations into the hands of senior managers is now a serious issue.

This is, however, a side show. The larger issue is the concentration of power of large business, or groups of large businesses, and the use of the leverage that power gives to strengthen established positions and enhance the economic and political power still further. I’ll focus on two industries – two industries which have traditionally been key to the interface between business and politics – financial services and media. The issue which is common to both is the malign consequence of viewing the industry through the eyes of established firms.

The problems of the financial services sector are too familiar to require much elaboration. The governments of the world have pumped unbelievably large amounts of money into the system. Directly through recapitalisation and purchase or underwriting of so-called toxic assets: more substantially if indirectly through wide-ranging implicit and explicit guarantees of liabilities. Even if these explicit guarantees expire, a ‘too big to fail’ doctrine has been established which means that implicit guarantees persist indefinitely. The criteria needed to qualify for these guarantees are, essentially, that the firm is large, well established, and unsuccessful commercially. It is difficult to think of a policy more directly contradictory to the dynamic of the market economy.
Behind that lies the central fact of modern political life – that the financial services industry, and particularly its investment banking arm, has become the most powerful political force in Britain and the United States. The reasons are clear enough: the rents available in the financial sector have attracted much of the ablest talent in the two countries and created a generation of financiers who are both smart and wealthy.

We might note the story of the three Goldman Sachs bankers who set up Ocado to think of what might have been. I remember, however, the days in 1999 when my business school students spurned Goldman Sachs and McKinsey because they would all be dot.com millionaires within a few months. You saw the problem when you reviewed their business plans. The key milestones were first round funding, second round funding, IPO. The revenues came not from customers, but investors: the prospective millionaires were not entrepreneurs, but rent seekers.

Let’s return to media. I’m not going to talk about newspapers – although the political and economic issues raised by that industry are numerous and intriguing. Digitisation is transforming all media industries. The change was most immediate in music. You read regularly that the music industry is under pressure. The music industry is thriving. The demand for live performances is growing rapidly. As with so many leisure activities, people will pay much more for concerts than had traditionally been imagined. Recorded
music can be distributed much more cheaply and at higher quality than before. Overall expenditure on music has been increasing, and so has the share of revenue going to artists.

New technology isn’t a problem for the music industry, but an opportunity. New technology is a problem for some established firms in the music industry. Music publishers attempted to use legal restrictions to prevent internet distribution, to preserve their established business model, and failed. Piracy took off, not as an alternative to legal downloading, but as an alternative to no downloading. The result of this resistance to inevitable change was that these businesses marginalised themselves. They ceded market dominance to, bizarrely – Apple. But probably such marginalisation would have happened anyway. It is rare, as I’ve already described, for established firms to migrate successfully to new business models in the face of disruptive technological change.

We can already see the beginnings of the same problem in books. The idea of a universal digital library may be the most exciting development in the book business since printing. The issue is presented as a problem for authors. It isn’t. Not only will authors have expanded opportunities to make their work available, but the prospect of a digital library potentially solves the problem that has dogged authors and limited their economic opportunities for centuries: the absence of any recorded trail between author and reader. The problem is, as it is in music, what is the role for
existing publishers in the new era? Their ability to insist that policy makers must find one may delay the application of new technologies for decades.

If you read the recent government report on *Digital Britain* – and can comprehend the unattractive mixture of corporate report verbiage and technologese in which it’s written – you will see that one underlying economic theme runs through it. That theme is a policy of imposing restrictions on competition in order to create cross subsidy which will facilitate otherwise uneconomic investment. The purpose is to enable government to shape the development of the industry without explicit subsidy.

Once again, few policies are more potentially damaging to innovation. No-one, not even the worthy Lord Carter, knows what the shape of Digital Britain is going to be. Determining its future is a matter of perpetual small scale experiment, mostly unsuccessful, and we will all be surprised to discover which developments turn out to be seminal. It is almost axiomatic that committees of wise people from the industry, and consultations dominated by vested interests and their acolytes, will not include those who are likely to be the important players. There will be no Steve Jobs, Jeff Bezos, or Stelios. The job of government should not be to offer monopolies to encourage very large firms to invest. Government should not attempt to shape the industry, but give maximum opportunity for the industry to shape itself.
There are clear common elements in what is happening, and what should be happening, in both financial services and media. There is a need for policy, but a market policy, not an industry policy: But policy aimed at supporting the market, not supporting the industry: policy towards breaking up the industry, not promoting concentration: policy towards facilitating entry, not conferring artificial advantages on established firms: policy towards removing distortions of competition, not creating them.

Building on these arguments, I want to say a few final words about the role of competition policy. An industrial policy for markets is, above all, a policy for competition. But I think that competition policy has gone seriously wrong in the last two decades, and that economists bear a large share of responsibility. Let me develop that argument by reference to the underlying theory with which I began. The case for the market economy has three pillars – the role of prices, as signals, the role of markets as a process of discovery, and the need to restrict the rent-seeking which arises from the concentration of economic power.

The recent development of competition policy has focussed almost entirely on the first of these; and on the economic analysis which is derived from what I described as ‘the model’. The apparent, but I fear largely spurious, precision that this approach seems to offer has led to a naïve exaggeration of what economic can achieve: in particular, to a belief that it is possible to make
case by case assessments of the costs and benefits of alternative market structures.

I suspect I don’t have to spell out to this audience that this task cannot be done: or that the consequence of attempting to do it is a competition policy that, although quite intrusive, is also protracted and ineffectual. Competition cases today are arcane exercises in which experts exchange conflicting and inconclusive theoretical assertion and counter-assertion, often for years. Business can pay lawyers and economists sums which are although absolutely large are small in relation to overall turnover, to undertake this work. Anti-trust policy in Europe may be regarded as a modest tax on commercial activity. I shouldn’t knock it. I have benefited handsomely myself: but I don’t much want to do it any more, and, dog in the manger like, would prefer my colleagues didn’t either.

What these exercises miss, almost completely, is the wider dimensions of the power of markets. By focussing on the first pillar – prices as signals – competition policy underestimates the strength of markets as a process of discovery, and the vital political and economic role of markets in restraining concentrations of economic power. Markets are not a well oiled physical machine: they are a constantly changing, adaptive biological system. Pluralism is their motive force, their essence chaotic, their development inherently uncertain. If we could predict the evolution of markets, we would
not need markets in the first place. Perhaps that is an appropriate note on which a lecture on the future of markets should end.