What Happened to "Efficient Markets"?

PETER J. BOETTKE

The financial crisis of 2008 has challenged the reputation of the free-market economy in the public imagination in a way that it has not been challenged since the Great Depression. The intellectual consensus after World War II 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 in detailed regulation and heavy government involvement in economic life.

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

With the stock market losing 50 percent of its value over the past 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 situation arises from previous intellectual failings in the discourse concerning the nature of the

Peter J. Boettke is a professor of economics at George Mason University.

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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 policies, which in turn produce bad economic outcomes. The economist's role must be to counter the first step and defeat the promulgation of bad economic ideas. Doing so is no easy task given the counterintuitive 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, market corrections may be transformed into economic crises by the implementation of ill-fated government policies, and economic crisis may 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, persuade the public to trade their liberties for the promise of security.

In a time of extreme economic adjustment, it is important to remind everyone how markets in fact work. Falling asset prices, business failures, and reallocations of resources (including workers) evince efficient-market adjustments to changing circumstances as much as the exploitation of profit opportunities and the exhaustion of mutual gains from exchange do. 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, and 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 every day 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 in attempts 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 from the proposition that individuals will discover what they have an interest in discovering. As Adam Smith put it, the necessary adjustments are not accomplished by "accurate measure, but by the higgling and bargaining of the market," and although the result is not exact, it is "sufficient for carrying on the business of common life" ([1776] 1976, book I, chap. V, 36). Ludwig von Mises makes a similar point about economic calculation's not being "perfect," yet nevertheless necessary and sufficient for the practical demands of commercial life. The deficiencies of monetary calculation that critics of economics often highlight are real, but their criticism is misplaced because within the specified limits (and Mises argues that 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" ([1922] 1981, 100).

The classical economists' market theory did not provide a point prediction of exchange ratios except in the simplest of examples (for example, Smith's deer-and-beaver model). Instead, the theory traced out tendencies and the direction of change in response 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 did not maintain that producers and consumers never make errors in judgment, but that persistent errors are weeded out as producers confront resource constraints and consumers are presented with alternatives. Consumers' buying and abstaining from buying as they seek greater satisfaction ultimately direct resource use, and the striving for profit ensures that producers employ least-cost methods in their attempts to meet consumer demand. Any position short of this end point will mean that both consumers and producers can become better off by changing their behavior and realizing the mutual gains. The classical theory of the market economy is a theory of economic activity, not of a state of affairs, and it relies not only on the individuals currently populating the market to correct previous errors, but also on perceptive entrepreneurs who may enter the market to eradicate error. Property, prices, and profit or loss cajole and discipline market participants to act so as to realize gains from trade and create wealth.

The depiction of *economic activity* is less analytically precise than the depiction 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 nineteenth century, the analytical focus centered on the settled state of affairs rather than on the economic activity. This state of affairs was previously described using simple examples and was intended only to highlight the central tendencies of the market-exchange process. The classical economists' value theory and cost theory could not explain several paradoxes that demanded resolution for scientific refinement. It must be stressed, however, that although in a fundamental sense the classical economists of the eighteenth and nineteenth centuries were correct in their understanding of market theory and the price system—the big picture—they were wrong about the particulars of value and cost. In their turn, the emerging neoclassical economics, in resolving the paradoxes in value theory and cost theory, at times unfortunately lost sight of the big-picture understanding of the market system as the active process of "higgling and bargaining" that was evident in the work of Hume, Smith, Say, Ricardo, and Mill.

This is not to say that classical economics needed no adjustment—it certainly did. But 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 market's self-regulation needed not so much repair as refinement in explanation.

In striving to provide a formally rigorous explanation of self-regulation, neoclassical models have tended to focus not on the adjustments to changing conditions, but on the settled state of affairs that results when all changes have ceased. The equilibrium condition occupies center stage, and the idea of an "efficient market" has come to mean something entirely different. It took decades for this transformation to take hold of the imagination of economists fully, but the analytical roots are found in the effort to depict the economic system as a set of simultaneous equations with unique price and quantity vectors that will clear the market. For mathematical tractability, the model relies on a pre-reconciliation of economic plans prior to the posting of bids and asks. Because no "false trades" are allowed in the market, the precision of the mathematical solution to a system of simultaneous equations means that the "higgling and bargaining" process that Smith described as the core of the market economy is formally suppressed in the neoclassical model of the market: the current market price not only clears the market, but also fully reflects opportunity costs. Firms produce the quantities of outputs that minimize average costs of production; in other words, they employ in production the least-cost technology. With proof of the existence of unique price and quantity vectors, not only will quantities supplied and demanded be equated and the market clear, but such a state of economic affairs will also possess simultaneously the desirable welfare properties of achieving exchange efficiency, production efficiency, and product-mix efficiency. In other words, such a world cannot be improved because all gains from trade are being realized—and realized in the most efficient way.

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

1. H_1 (neoclassical perfect-competition perspective): Markets are efficient, and there are no unexploited opportunities for mutual gain.
2. H_2 (neo-Keynesian synthesis, market-failure perspective): Markets are imperfect and inefficient, and government intervention is a necessary corrective.
3. H_3 (classical and new institutional market-process perspective): Markets at any point in time have many unexploited opportunities for mutual gain, but this fact drives the market system to mobilize individual initiative effectively and to utilize the dispersed knowledge in the system to realize gains from trade and gains from innovation and in so doing to make systemic adjustments that promote wealth creation and produce generalized prosperity.

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 therefore scientific debate, not to speak of public debate, tends to focus on the clash of H_1 and H_2, often leaving unexamined the proposition that government can serve effectively as a corrective agency.[1] As a result, we simultaneously fail to understand how markets actually work to coordinate economic life and underestimate the costs of

1. It is for this reason that I have argued (e.g., Boettke 1997) that economics during the twentieth century for the most part engaged in an intellectual detour where economists became increasingly precise about irrelevant points—precisely irrelevant. This was the fate of the discipline that Kenneth Boulding (1948) predicted in his review of Paul Samuelson's *Foundations of Economic Analysis* (1947). 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.

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 fallacies, and therefore public policies that undermine long-term wealth creation (and in the extreme limit the nation's economic viability) are more likely to be adopted.[2]

This situation obviously has relevance for current policy debates over the role of the market economy in generating long-term prosperity. In the scientific and public imagination, efficient markets came to mean that at any point in time the current market arrangement is the best of all possible worlds. Even the most ardent defenders of the efficient-market hypothesis were usually more subtle in their verbal presentations, but this nuance was glossed over owing to the primacy placed on the formal model for assessment. In *Foundations of Finance,* Eugene Fama argues: "An efficient capital market is a market that is efficient in processing information. . . . In an efficient market, prices 'fully reflect' available information" (1976, 132). In *The Theory of Finance,* Fama and coauthor Merton Miller explain: "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' 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" (1972, 335).

As noted 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 is no need for government action beyond establishment of the framework—law and order, a monetary system, and international peace. In the public imagination, this depiction is the modern rendition of Adam Smith's "invisible hand" and thus provides the technical argument for laissez-faire economic policy.

The market economy would truly be self-correcting in this scenario because no errors would be made. No $20 bills would be left lying on the sidewalk except when the cost of picking them up exceeded $20. The only change to the system would be exogenous changes in tastes or technology, but the market would adapt to those changes instantaneously, and the prices in the economy would fully reflect the relevant information.

In contrast to Fama and Miller (and others), theorists such as Joseph Stiglitz (developing earlier ideas of market failure found in the writings of Samuelson, Bator, and Arrow) set out to offer an alternative to the efficient-market hypothesis. Stiglitz built his career on demonstrating the fragility of the neoclassical model of market efficiency, given slight deviations from its restrictive assumptions. Stiglitz stresses

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

imperfections in the information that actors possess and deviations from perfectly competitive market conditions. Given asymmetric information and a monopolistically competitive environment, Stiglitz argues, market perversities rather than market perfection are likely to result. Summarizing his contribution to the literature on market efficiency in *Whither Socialism?* he 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. (1994, 43–44)

Between Fama and Stiglitz, Stiglitz would seem to have the upper hand in the debate in our current context. The reason for this verdict is simple: the informational burden of the investment market during the 2000s obviously seemed to be greater than what the efficient-market hypothesis can bear. But this conclusion is only an artifact of the model fetishism of twentieth-century economics. First, even the strictest model of competitive equilibrium does not contend that government policy cannot derail the market economy. To use an analogy, if Michael Phelps were 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 simply would be prevented from swimming. The problem is not swimmer failure, but the rope and shackle with weighted ball that prevent him from making the very movements required to swim effectively. If government interventions distort information and provide perverse incentives, and in this situation economic actors make mistakes, the market is not leading them astray; the government interventions have discouraged the market's participants from weeding out error. Second, the market-failure criticism fails to appreciate how, from Adam Smith to F. A. Hayek, the historical argument in favor of markets does not focus on the equilibrium properties of the market, but on its adjustment properties. Today's inefficiency represents tomorrow's profit for the entrepreneur who recognizes and grasps the opportunity. The market economy's strength 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 spurs entrepreneurs to realize the gains from innovation through the introduction of new products or the discovery of better ways to produce or deliver existing products.

In the 1940s, Hayek warned his fellow economists of the misleading standards of perfect competition and static efficiency in assessing the market economy. As he wrote in *Individualism and Economic Order*, "[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" (1948, 87).

The efficient-market hypothesis theoretically represents a misplaced concreteness as the formal model becomes confused with the reality of the market process. The price system's "true function" is to guide entrepreneurial discovery and adjustment. Hayek also recognized the market's robustness in the face of numerous interventions. In *The Constitution of Liberty,* he points out: "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" (1960, 228).

Making a similar point almost two centuries earlier, Adam Smith argued: "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" ([1776] 1976, book IV, chap. V, 49–50). To use my earlier analogy, Michael Phelps certainly might still swim with hands tied and feet shackled (he did win the gold medal in the butterfly, so he could do some sort of kick to get across the pool), but if a weighted ball were added to drag him down, the restraint of his movement and the burden of the weight would probably prove to be insuperable. Government policies can likewise reach a point at which they obstruct the market from working effectively to make the necessary adjustments. This situation does not evince the inefficiency of the market economy, but only the destructive power of sufficiently burdensome government intervention.[3]

The critical question we must ask is, What government policies represent the tipping point at which market forces cannot overcome the obstruction? I suggest

3. 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, the trend will be reversed, and economic performance will not improve through time. In other words, we can, economically speaking, put up with a great deal of government stupidity provided freedom of price fluctuations remains so that arbitrage opportunities can be pursued and also provided freedom of entry remains so that entrepreneurial discovery and innovation can continue.

three: inflation, price controls, and regime (or rule) uncertainty. Each of these government policies undermines the market economy's basic functions. Inflation threatens to destroy the meaningfulness of the capital and cost accounting that provides the basis for commercial decisions. Price controls block the market's ability to adjust to changing conditions of supply and demand. And regime uncertainty (not a policy itself, but a condition that results from the kind of policies adopted and the frequency with which they are altered), by shifting the ground on which economic actors make decisions about saving, investment, and consumption, clouds an already murky economic landscape and thus distorts choices and shortens time horizons. All three conditions curtail the market's ability to muddle through the trials and tribulations of ordinary politics.

The case for laissez-faire is often difficult to communicate when, if the government obstructions are overcome, the economy muddles through, and the society materially progresses because the case ultimately relies on a counterfactual claim: economy X had a ten-year period of growth with government interventions *a, b, c,* and *d,* but had no such interventions occurred, more rapid growth would have occurred. How much greater growth there would have been nobody knows because the counterfactual world was not experienced. This problem is, of course, not new to economic reasoning. Frédéric Bastiat described it as a comparison between "what is seen" and "what is unseen," and he warned that bad economic reasoning results from focusing only on "what is seen." Hayek similarly argued that owing to the intellectual prejudices of scientism, expediency always defeats principle in public policy because the benefits for specific parties are identifiable, whereas when principle guides the government's actions, the 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 leads policy intellectuals to conclude that the government interventions *caused* the good economic performance (rather than *hindering* them) simply because the growth was experienced after the interventions were instituted—post hoc ergo propter hoc, a logical fallacy that rears its ugly head all too often in economic policy discussions.

We find ourselves in this situation today. The debate over the merits of the market intellectually misses the main merit of the price system and the market economy—their dynamic adjustment ability as prices, profits, and losses continuously signal, adapt to, and accommodate the ceaseless changes that occur in tastes and technology. 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 only on the details. The cost of government intervention is either unexamined or understated throughout the debate.[4] In short, the current intellectual consensus

4. A classic example 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 nationalization's cost. No serious effort to account for the vested interests that will form around the nationalized entity is made. It is as if public policy were made in a vacuum and the actors were all economic eunuchs.

on economic policy fails to understand how markets work and why they are the source of prosperity and social harmony, and it underestimates how political control of economic life distorts incentives and information and gives rise to social conflict.

The public-policy reality is that laissez-faire economics was *not* the policy norm in the United States over the past twenty-five years. Keynesian economics might have been intellectually defeated in the 1970s among academic economists, but in practice Keynesianism was the core intellectual framework for public policy and the guiding light for macroeconomic 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, whereas Obama's fiscal stimulus is "liberal" Keynesianism. Both, however, are fundamentally Keynesian policies and therefore suffer from the same fundamental problems that plague all Keynesian policies, as pointed out more than fifty 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 them reasons for caution concerning our current path, it would comprise Hayek's *A Tiger by the Tail: The Keynesian Legacy of Inflation* (1979) and Buchanan and Richard 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 have been removed, the natural policy outcomes of democratic governments are government budget deficits, public debt, and monetary debasement.

Hayek argues that attempting to control inflation in our current monetary system is analogous to holding a tiger by the tail: if we let it go, it will eat us; if instead the tiger runs faster and faster, and yet we attempt desperately to hold on, we are still going to be eaten in the end (1979, 110). Buchanan and Wagner 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" ([1977] 2000, 57).

Democratic government's natural proclivity is to concentrate benefits on the well-organized and well-informed interest groups in the short run and to disperse the costs across the ill-organized and ill-informed mass of voters and consumers in the long run. Fiscal responsibility is relaxed not only during a war or a economic crisis, but permanently as part of ordinary politics. Budgetary deficits finance the concentration of government benefits and steadily enlarge the public debt, which, in turn, is paid down through monetization. Thus, 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 through the introduction of binding restrictions on the natural proclivities of electoral politics will fiscal responsibility and monetary stability have a chance of being established.[5] But we are not heading in this policy direction.

As I am writing (in March 2009), the Obama administration is simultaneously continuing the Bush administration's activist agenda and distancing itself from that administration—quite a political balancing act. We are told that only bold and decisive government action can stave off catastrophe. When pushed during a House Ways and Means Committee hearing (U.S. Congress 2009), Secretary of the Treasury Timothy Geithner claimed that the government's drastic actions during the fall of 2008 were essential to stop a complete collapse of all financial institutions in the United States and that the aggressive steps now being taken are fiscally responsible given the magnitude of the economic challenges the administration faces. He defended not only the fiscal stimulus, but the Troubled Asset Relief Program and the various bailouts—indeed, the entire set of policies implemented since September. He clearly blamed the policymakers of the previous eight years, whom he claimed had engaged in reckless fiscal policy and gutted regulations, thereby letting loose Wall Street greed. And he repeated the standard line that all of the income growth over the past eight years was experienced by the top 2 percent of the income recipients, whereas the middle class enjoyed little to no income growth. Such rhetoric fosters class warfare, 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 certainly may be faulted, but the roots of our current crisis go much deeper in U.S. history. The housing bubble, for example, owes much to policy initiatives introduced in the 1990s. The 1977 Community Reinvestment Act effectively lowered banks' lending standards so as to encourage home ownership, and in 1996 regulations issued under this act were extended from small to large banks. At the same time, the Clinton administration put pressure on the government-sponsored agencies Fannie Mae and Freddie Mac to expand mortgage lending to low-income borrowers. These policies perverted incentives and distorted the economic signals that individuals faced in making choices.

In addition, although the practice of central banking seemed to have become "perfected" during the post–World War II era and settled on a Milton Friedman–inspired "inflation-targeting" policy rule, Friedman's explanation of the Great Depression as the result of a series of policy errors, most notably monetary contraction and deflation, seemed to have been taken to heart by the central bankers. In 2002, at a celebration of Milton Friedman's ninetieth birthday, Ben Bernanke said: "Let me end my talk by abusing slightly my status as an official representative of the Federal

5. Hayek argued for the denationalization of money to keep countries from feeding their governmental habit through inflation; Buchanan has argued in favor of a constitutional amendment to require 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.

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 describing as the greatest challenge to the U.S. economy since the Great Depression. Bernanke has definitely not allowed a "great contraction" during this period. Instead, he has done everything in his power to respond to the credit crunch with expansionary monetary policy.

To my mind, this situation illustrates Hayek's "tiger by the tail." Because of Friedman's concern with deflation, postwar monetary policy fought inflation in theory, but feared deflation in practice. The result was that Volker, Greenspan, and now Bernanke have spoken about controlling inflation, but their monetary policy has been highly expansionary whenever economic times turn bad. The monetary base expanded tremendously under Greenspan in response to the dot.com, Y2K, and 9/11 scares, and again during the housing bubble. Market corrections take the form of price reductions, businesses failures, and resource (including labor) reallocations to higher-valued uses. But if each time a market correction takes place, the monetary authorities ease credit in an attempt to minimize the market correction's pain, they further distort the pattern of economic activity and delay the needed market adjustments.

Let us sum up the current U.S. policy situation. A future of microeconomic distortions awaits us owing to the bank nationalizations, proposed restrictions on compensation, talk of financial re-regulation, and changes in the tax structure. Ill-designed and ill-thought-out macroeconomic policies are being implemented, justified by the analogy that policymakers are throwing water to stop a burning fire, when, to stay within the analogy, they are actually throwing gasoline on the fire. Expansionary monetary policy to deal with the credit crunch is inflationary, and expansionary fiscal policy is not facing up to the microeconomic reality of the necessary market corrections to the previous resource misallocations. A fundamental semantic issue also clouds current policymaking because many of the proposed policies confuse credit with capital. Capital formation requires savings, not credit expansion. Recapitalization of the banks cannot be accomplished through easy credit, but only through increased saving. Credit expansion distorts rather than aids the relationship between saving and investment. If fiscal stimulus further distorts the process of market correction to the previous misallocation of resources, then the public spending will likewise be counterproductive. To repeat, policies that unleash the governmental habit, rather than constraining it, do not foster the creation of wealth. Deficits, debts, and debasement do not promote long-term economic prosperity. Yet the policy choices under the Bush administration and now under the Obama administration have moved us farther in this ill-fated direction.

To return to my opening question—What happened to efficient markets?—I conclude that they are alive and kicking to survive. The "bad news" we often hear actually evinces market participants' working to correct for previous errors in the pattern of exchange, production, and distribution. However, if whenever the market attempts to adapt to changing circumstances and correct for previous errors, the government implements policies to stop the adjustments and corrections, the unfortunate outcome signifies not a failure of "efficient markets," but rather a government failure. Some of the propositions that follow from this perspective are difficult to swallow. Unemployment, for example, attests that the market is working to reallocate scarce labor resources to more productive uses. Idle resources may very well be idle because they are no longer of sufficient value in their previous uses. Resources must be reallocated in the process of economic-value creation. Wage rigidities, unemployment compensation, and so forth prevent labor from being reallocated as quickly as normal market pressures would bring about its reallocation.

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, the workings of an efficient market are evident throughout the economy. Markets work through a process of entrepreneurial discovery and competitive selection. If, however, an "efficient market" entails that no errors are ever made and that adjustments occur instantaneously so that a Pareto optimal pattern of resource allocation exists at any point in time, then we have to reject this standard. This conception of market efficiency is not what thinkers from Smith to Hayek ever embraced in arguing for the market economy's superiority to alternative economic systems. Instead, their claim for the market was more dynamic in nature and humble in policy prescription. They argued that the advocates of government intervention displayed a "pretense of knowledge" and an "arrogance of power." Perhaps the most timely passage on this point in classical political economy belongs to Adam Smith, and it is fitting that I conclude this article by quoting 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, chap. II, 478)

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