Merrill Lynch, Lehman Brothers, AIG – What might it all mean?

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Markets are unforgiving; they expose truth and drive out chaff. As the Tao Te Ching says of Heaven itself, markets “treat all things as straw dogs”. They have no emotions, shedding no tears for losers and taking no pride in winners, for today’s winner may be tomorrow’s loser. And, markets refuse to subsidize idealisms.

Over time, free markets reject fraud, abandon products that have no sound purpose or accommodating price, and undermine false or misleading valuations.

That Bear Sterns with balance sheet assets worth $80 pre share was sold for $2 and then for $10 per share, that Lehman Brothers with billions in assets nonetheless went bankrupt, wiping out owner’s equity, and that Enron as an enterprise was gone within months of revelation regarding its true debt obligations and real income flows, testify to the cruel discipline of markets at work.

True, markets create liquidity and asset bubbles; but then they turn and destroy them if they are bubbles. Bubbles can’t last forever. Only well-supported valuations are sustainable.

It is better, I think, to say that market makers create bubbles and also that market makers break bubbles. Perhaps market makers are more irresponsible in making than in breaking bubbles for the breaking can only occur if bubbles have been created. And, the breaking gets us back closer to the reality of sustainable values, a salutary step towards truth.

But, in the breaking of bubbles, people get hurt as we see happen all around us in the continued destruction of wealth and value flowing from the subprime mortgage/CDO/credit default swap bubble and bust of the past 5 years.

The teaching of market makers when they lose faith in valuations and so refuse to buy more at that price, or sell to unload risk, or suddenly refuse to extend credit or guarantee an obligation, is that the valuations at play in the market have become unreliable. Prices will thereafter drop until valuations become more acceptable.

The bubble stretches credulity about valuations (“irrational exuberance” some call it) until confidence is lost and the search for “quality” and security begins.

So, in some sense the current crisis of American financial institutions is necessary and just. It is correcting a past injustice. Only, the pain of correction does not fall fairly on those who made the mistakes in the first place. They have most likely taken the money and run.

Prices go down, wealth is un-created, and the economy contracts. People lose jobs; families suffer.

The lesson of this current financial retraction is perhaps keener still. It may be telling us that the share of global cash flows appropriated by the financial services industry in general was excessive and unsustainable.

The value of the mortgage brokers, the investment banks, insurance companies like AIG, depended on their making hay while the cash was flowing. High fees, charges for all kinds of intermediation, huge bonuses, were converted into capital values. But such substantial and systematic extraction of commissions from the economy could not last if the financial intermediaries collectively were not providing real value-added to investors and players in the real economy.

And, perhaps the failed Wall Street intermediaries were not contributing enough to justify their returns. So, losing them – in the long run – is just treating them like "straw dogs" - useless playthings that will burn and disappear.

Some coldness is required to let companies and their fortunes decline and fade away as casualties of poor risk management and imprudent forethought.

Over time, market makers turn to second thoughts about values, then to third thoughts, and then to an endless series of different thoughts. It takes real worth to survive all these market-maker changes of attitude and desire more or less intact as Goldman Sachs and Morgan Stanley seemed to have done. Though they too were shopping themselves to avoid liquidation and loss of equity for their owners.

But the un-creation of value is not what we want from free markets and capitalism. We should hold the system and its leaders to the powerful capitalist standard of wealth creation on a grand scale so that the positive synergies of investment and production will flow throughout the economy improving lives for all.

The first Principle of the Caux Round Table Principles for Business sets this standard: the purpose of a business is to create wealth, not destroy it. Other CRT Principles and stakeholder considerations add ethical obligations to the manner in which such wealth is to be created and its benefits distributed.

I would assert that the titans of financial intermediation which took the lead in building the investment bubble in subprime mortgages and subordinate contracts did not live up to this CRT ethical principle. Had they done so, the bubble would have been smaller and so its bursting would have caused less harm to society and far fewer financial losses to investors and owners.

If the CRT Principles for Business are to be assiduously implemented, there should be no bubbles at all – not ever - just a sustainable rise in valuations as a rising tide floats all boats. Such a sustainable rise would rest on sound, real value-adding, business activities of tangible, non-illusory benefit to stakeholders.