The triumph of the invisible hand

"By virtue of exchange, one man's prosperity is beneficial to all others."

- Frédéric Bastiat.

It remains one of the most powerful metaphors in economics. In 1850 Frédéric Bastiat gave the world the story of the broken window. The son of a shopkeeper accidentally breaks a pane of glass in the shop. A crowd gathers at the scene. Pretty soon, the onlookers jump to the conclusion that it's an ill wind that blows nobody any good. Admittedly, the shopkeeper is out of pocket by the cost of a window. But the glazier just summoned will reap the benefit. Where would poor glaziers be in a world without broken windows ? Imagine all the good uses to which the glazier can put his new-found windfall from repairing the damage. Think what he could buy. All that new money circulating through the economy. Perhaps we might all be better off if more windows got broken on a regular basis ?

"Stop there !" cries Bastiat, addressing the crowd directly.

"Your theory is confined to that ***which is seen***; it takes no account of that ***which is not seen***."

Hence the title of Bastiat's essay: 'That which is seen, and that which is not seen'.

The six francs paid to the glazier for effecting his repairs are what is seen. The crowd can speculate to its heart's content to what luxurious end those francs might be expended. But what is not seen is what the shopkeeper might have done with those six francs if he had not had to pay them to the glazier in the first instance. He would, perhaps, have bought some new shoes, or a book for his library.

"To break, to spoil, to waste, is not to encourage national labour; or, more briefly, destruction is not profit."

Government projects may seem to create work for some, but there is also a someone who must pay for them, and that someone is normally the taxpayer. And if the capital is raised from the bond market, it doesn't come directly from today's taxpayer – it is extracted from tomorrow's. Such projects may also divert spending from a more deserving group. Some government spending might even involve the outright destruction of wealth. There are, after all, only three ways in which money can be spent. You can spend your own money on yourself. You can spend your own money on other people. Or you can spend other people's money on other people. The last is the spending prerogative of government. And government is not the best allocator of capital. Milton Friedman wryly suggested in 1980 that if you put the federal government in charge of the Sahara Desert, within five years there'd be a shortage of sand.

As the world economy gets more and more financialised, and as more and more capital starts flowing in ways that are less than wholly transparent, Bastiat's metaphor only becomes more powerful over time.

And more misunderstood. The economist Paul Krugman, for some reason allowed a regular forum in The New York Times, wrote in the aftermath of the Japanese earthquake and tsunami of 2011, that “the nuclear catastrophe could end up being expansionary.. remember, World War II ended the Great Depression”. Krugman would also claim that the threat of an invasion by space aliens could bring the US economy out of recession within eighteen months. Not to be outdone, the economist Larry Summers, formerly senior economic adviser to President Obama, told CNBC that Japan’s earthquake and tsunami “may lead to some temporary increments, ironically, to GDP as a process of rebuilding takes place. In the wake of the earlier Kobe earthquake, Japan actually gained some economic strength.” As Bloomberg’s Caroline Baum somewhat tartly responded, “Too bad Japan had to wait sixteen years for another opportunity.”

UK politicians are currently scrambling over each other to point fingers of blame for the collapse of prospects in what remains of the British steel industry – which has been in slow but terminal decline for decades. Government is not the best creator of jobs, either; its best economic efforts should normally be devoted to keeping out of the way and letting a free market do its job. Saving Tata Steel’s interests in the UK is, sadly, a lost cause. As we pointed out on March 7th, China’s surplus capacity in steelmaking is now bigger than the entire steel production of Japan, America and Germany ***combined***. The Economist notes that in 2015, British steelmakers contributed less than 1% of world supply. Helping steel workers retrain is the right thing to do. Throwing taxpayers’ money at keeping doomed steel mills alive is not.

Peter Tasker, writing for the Nikkei Asian Review, highlights the purchase of Japan’s Sharp by Hon Hai Precision Industry, better known as Foxconn. The deal marks the end of Sharp’s 104-year history as an independent business. Tasker also cites Renault’s 1999 acquisition of Nissan Motor as the “model for a successful foreign takeover”. The company’s newly drafted CEO, Carlos Ghosn, introduced a rigorous rationalization programme, slashed surplus capacity, and dramatically cut the number of the company’s suppliers. Today Nissan is one of the world’s most successful car companies. But there is no shortage of Japanese companies with a legacy of operational resilience going back centuries. Tasker cites by way of example the Sumitomo Group (founded a century before the United States), Sudo Honke, Japan’s oldest sake brewer (formed in 1141) and Hoshi Ryokan, a hot springs hotel established in 718. “Such businesses have survived for so long because they have provided what customers wanted through centuries of upheaval.”

But foreign investors seem to have given up on Japan, and have resorted to their old habits of treating its stock market like some kind of ATM machine. John Seagrim of CLSA points out that for the week ending 11th March, foreign investors sold ¥1.58 trillion of Japanese stocks, the biggest weekly sale of Japanese equities since records began. The magic of markets, however, is that for every seller, there must be a buyer. Trust Banks and pension funds have been net ***buyers*** of Japanese stocks for 13 of the last 18 weeks. And not everybody regards foreign players in Japan as particularly sophisticated. Interviewed on Bloomberg, Brian Heywood of Taiyo Pacific Partners says that he welcomes the selling by overseas investors, because it largely represents dumb money:

“When the market punctures, there are companies that we want to add to. The market overreacts. We know the company. We’re at 3 percent and we’d like to be at 6 percent. We use it as an opportunity.. Over the last several years, Japan’s market grew more than almost any other equity market, and it's still one of the cheapest markets in the world. It had margin expansion but it had valuation compression."

Japan's ¥137 trillion Government Pension Investment Fund – the largest pension fund in the world – has more than doubled its domestic equity allocation, from 12% to 25%. Now that Japanese interest rates have gone negative, and Japanese bond yields look distinctly unattractive, being also mostly negative, it seems increasingly likely that Trust Banks and other Japanese pension funds will follow the GPIF's lead and raise their equity holdings. A secular shift towards greater institutional ownership of the market, allied to compelling valuations, accounts for Japan remaining the single largest country allocation in our global value fund.

When it comes to capital allocation, you can go with the dead hand of the State, or you can follow the market's invisible hand. We favour the latter.

Tim Price is Director of Investment at PFP Wealth Management and co-manager of the VT Price Value Portfolio.