Efficiency X Robustness and Other Tradeoffs

Efficiency X Robustness

- Outsourcing, leverage, specialization and trade, low interest rates, these are the symbols of efficiency. A long period of efficiency over robustness appears to have come to a turning point, if a rather protracted one.
- Specialization and trade, globalization, led to increased efficiency and disinflationary forces, for a long time. For several reasons, this dynamic is coming to an end. Re-shoring, friend-shoring, self-sufficiency, tariffs and embargoes, lead to lower efficiency and possibly more robustness.
- Leverage is capital efficiency but leads to precarious balance sheets less able to withstand shocks. Since the financial crisis in 2008, the financial system has pursued an agenda of reducing leverage in the banking system. Generally, leverage has been shifted from the private sector, i.e. banks, corporates and households, to the public sector, where insolvency is less well defined and the ability to absorb losses is greater.
- Low interest rates mean greater propensity to experiment and fail, and invest. Low interest rates aid and abet leverage in the quest for capital efficiency. Low interest rates lead to more fragile capital structures as it supports more leverage with higher debt service convexity. Higher interest rates present a higher hurdle for investment encouraging capital discipline and more robust capital structures and lower debt service convexity.

Focus X Diversification

- Index ETFs (exchange traded funds) provide low cost, diversified access to markets. Ironically, as more capital is funnelled into index ETFs, they reduce market diversification by directing more capital to stocks that are rising and less to stocks that are falling. As equity valuations are the inverse of cost of equity financing, this momentum loop acts as a tax on small companies and a subsidy to large ones.
- Robust systems require diversity (or entropy) for stability. Diversity means a large number of independent participants and resource allocation decision makers. Pooling vehicles, of which index ETFs are but one, reduce the number of independent participants and increase the size of the remaining ones. This can reduce the informational efficiency and robustness of a system or market.
- Norms and conventions can also cause pooling of behaviour. Value at Risk systems can lead to coincident de-risking and re-risking leading to heightened market volatility.
- AI adoption has been slow thus far but when adoption accelerates, will AI guide large numbers of humans into common behaviour and with what effects? Will it lower the entropy of social and commercial systems?

Autocracy V Democracy

- Central planning is best when there is perfect information. In a subset with perfect information, central planning and hierarchical organization work best.
- Free markets are best when there is imperfect information. Subsets of perfect information and hierarchical organization transacting with one another under uncertainty result in the best outcomes.

- Autocracy suffers from informational inefficiency. Feedback is an important factor in effective policy. Autocratic regimes have poor feedback mechanisms making policy calibration difficult.
- Liberal democracies benefit from a safety valve. Failures are ascribed to individuals instead of their offices. This sustains the system while individuals who fail are replaced. In autocracies, failure tends to result in system change which can be disruptive.
- The USA is becoming less democratic as the organs of state are controlled by one party, and the party is heavily influenced by one individual. China is by construction a one party country and the concentration of power with one individual further affects the efficiency and efficacy of the state. India remains democratic especially as the current government has lost its simple majority in the lower house. European political dispersion remains alive and well despite a lurch to the political right.