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The Price Is Not Right

By THOMAS L. FRIEDMAN

I don’t expect much from the G-20 meeting this week, but if I had my wish, the leaders of the world’s 20 top economies would commit themselves to a new standard of accounting — call it “Market to Mother Nature” accounting. Why? Because it’s now obvious that the reason we’re experiencing a simultaneous meltdown in the financial system and the climate system is because we have been mispricing risk in both arenas — producing a huge excess of both toxic assets and toxic air that now threatens the stability of the whole planet.

Just as A.I.G. sold insurance derivatives at prices that did not reflect the real costs and the real risks of massive defaults (for which we the taxpayers ended up paying the difference), oil companies, coal companies and electric utilities today are selling energy products at prices that do not reflect the real costs to the environment and real risks of disruptive climate change (so future taxpayers will end up paying the difference).

Whenever products are mispriced and do not reflect the real costs and risks associated with their usage, people go to excess. And that is exactly what happened in the financial marketplace and in the energy/environmental marketplace during the credit bubble.

Our biggest financial-services companies, some of which came to be seen as too big to fail, engaged in complex financial trading schemes that did not adequately price in the costs and risks of a market reversal. A.I.G., for instance, was selling insurance for all kinds of financial instruments and did not have anywhere near adequate reserves to cover claims if things went badly wrong, as they did. And our biggest energy companies, utilities and auto companies became dependent on cheap hydrocarbons that spin off climate-changing greenhouse gases, and we clearly have not forced them, through a carbon tax, to price in the true risks and costs to society from these climate-changing fuels.

“When the balance sheet of a company does not capture the true costs and risks of its business activities,” and when that company is too big to fail, “you end up with them privatizing their gains and socializing their losses,” Nandan Nilekani, the co-chairman of the Indian technology company Infosys, remarked to me. That is, everyone gets to rack up their private profits today and pay them out in current bonuses and dividends. But any catastrophic losses — if the company is too big to fail — “get socialized and paid off by taxpayers.”

This is why we need new banking regulation that reins in the leverage and speculative trading that big banks and insurance companies can undertake so they never again become simultaneously too reckless to regulate but too big fail and taxpayers are forced to pay off the toxic assets they accumulate. And this is also why we need a tax on carbon — so we and our power utilities don’t become permanently addicted to cheap coal that makes for lower electricity prices today but spits out toxic greenhouse gases that have to be paid for by future generations tomorrow.

That's what "Market to Mother Nature" accounting is all about. It begins with the premise that the distinction between the G-20 and the Copenhagen climate change negotiations is totally artificial. They are just flip sides of the same global problem — how we as a world keep raising standards of living for more and more people in ways that will not, as a byproduct, have both the Market and Mother Nature producing huge amounts of toxic assets.

The old system, which has reached its financial and environmental limits, worked like this: We built more and more stores in America to sell more and more stuff, which was made in more and more Chinese factories powered by more and more coal that earned more and more dollars to buy more and more U.S. T-bills that got recycled back to America in the form of cheap credit to build more and more stores and more and more houses that gave rise to more and more Chinese factories. ...

This system was a powerful engine of wealth creation and lifted millions out of poverty, but it relied upon the risks to the Market and to Mother Nature being underpriced and to profits being privatized in good times and losses socialized in bad times. This capitalist engine doesn't need to be discarded; it needs some fixes. For starters, we need to get back to basics — accountable lending, prudent saving, reasonable leverage and, most important, more engineering of goods than just financial products.

Some of our biggest financial firms got away from their original purpose — to fund innovation and to finance the process of "creative destruction," whereby new technologies that improve people's lives replace old ones, said the Columbia University economist Jagdish Bhagwati, in an interview in The American Interest. Instead, he added, too many banks got involved in exotic and incomprehensible financial innovations — to simply make money out of money — which ended up as "destructive creation."

"Destructive creation" has wounded both the Market and Mother Nature. Smart regulation and carbon taxation can heal both.