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What is a Fair Trade?

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Tonight I will explore with you the ways in which economists, accountants, lawyers and business people try to arrive at a fair price of things, a price that is somehow the "correct price". To illustrate how difficult that is, I begin with three controversial examples, two of which will be familiar to you.

My first example is taken from a book of short stories by the brilliant Jamaican satirist Anthony Winkler. The story I will quote from at some length is entitled "The man who knew the price of all fish". Here is how that story opens:

Baba was a black man with no past. He had nothing ahead of him; he had nothing behind him. He had dropped out of oblivion one day, grew up in Montego Bay on the island of Jamaica, growing into manhood with a tremendous lower jaw burgeoning above his windpipe, a jawbone as large as the top jaw of any mastiff, a jaw that jutted out under his face disjointed, un-proportioned, stiff, mysteriously heavy, capped with a lower level of green teeth. He was a black man with no past and no future, with a forehead rounded and indented like a goat's with two thick and hirsute arms that dropped below his waist when he walked.

His eyes, which people would squint to look into, were sunk deep inside his black face, sheltered by two fat lids that dropped thick as cream, squiggled down deep into the mystery blackness of his skin, and black themselves, so that except for their shine in the sunlight, they were hidden in the camouflage of his face.

And, on top of this, he had no past. He had no future; he had no wife; he had no children; he had nothing, except a small black hulled canoe, and some wire fishpots and mangrove-stained lines he used to catch fish with.

Every night he rowed out in his canoe and set his fishpots and threw down his lines, and every morning he rowed into Giddy Beach with a canoeful of dead fish and sold the dead fish to women as poor as himself, who would higgle him furiously, insult his fish, call him a jinal, meaning that he was intent on robbing them, paw over the corpses of the fish, hold him up to cynical comparison with more

> *successful fishermen, accuse him of having a white mother, call him a Rastafarian, then walk away clutching contemptuously at the dead fish wrapped in newspaper, for which they had paid Baba's price. For it was impossible to higgle him down, because he had no past and could not be either insulted or deprecated.*
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> *It did not matter what they called his mother, because he had no mother. He had no wife they could say cuckolded him; he had no children who got poor marks at school; he had no grandfather who bubbled over his senility on street corners; he had no cousins who were cat-o'nined for stealing; he had no aunts who painted their faces for tourist men at nights; he had no attachments which made him vulnerable to abuse; he had no one to be called into shame over.*
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> *And so no one had ever higgled him down on the price of his fish. If he said that the green-skinned, beak-teeth parrot-fish were a shilling each, it was impossible to shake him. The woman could call the fish gangrened, she could say it had slimy skin, she could say it was not a fish, she could say anything, it would not matter. She could higgle until her black face was greener than the parrot-fish, it would not matter. For once Baba had decided that a fish was worth a shilling, God could not alter its price. The fish was always sold for a shilling.*

My second example is familiar to you: it is the Emera purchase of Barbados Light and Power (BL&P) shares a couple of years ago. You will recall many people argued that the price being offered was too low, and

that based on the company's earnings or some other criteria, the shares were worth much more. Those who made such arguments were wrong. There is only one correct price known to economics, and that is the price at which a trade takes place, provided there is no coercion of seller or buyer, and no misinformation as to the quantity or quality of the good or service exchanged. The price offered by Emera for the shares of BL&P was a fair price, simply because many of us were happy to sell at that price.

My third case study has become a *cause celebre* in the new international game of bashing the banks. I refer to the London inter-bank borrowing rate (Libor) scandal. I am sure you believe you know what happened: banks borrowed at one interest rate, but reported a different rate to the Bankers' Association which compiled the averages, and that is why they have been prosecuted by the New York Attorney General. I have to tell you that that story bears no resemblance to the facts. Much of my understanding of these events is based on my correspondence on this matter with Professor Avinash Persaud.

In fact, the problem with Libor emerged in 2007 when the major banks in the London market stopped borrowing from each other at short term. It puzzles me greatly that no-one thinks to ask why a problem arose with Libor only as recently as 2007. The answer is that up until then banks did borrow from each other when they were temporarily short of cash. Every day each bank reported to the Bankers' Association the rate at which it

had borrowed, the Association computed the average, and the whole world used that as their reference rate.

You immediately see the problem: if nobody is borrowing, there is nothing to report, and the rate on which international finance is anchored disappears. That is what has been the case since 2007, when commercial banks began to withdraw from the short term market for funds. Round about 2005 British banks were sourcing as much as 1/3 of their funding by borrowing on financial markets at short term, rather than through customers' deposits. Confidence in the value of the short term instruments used in the financial markets began to evaporate in 2005, with the large-scale failure of sub-prime mortgages in the US. By 2007 short-term international funding had all but dried up, including the sourcing of funds on the London interbank market. Libor had ceased to exist, and the most important reference rate for international financial transactions had disappeared. The market had no solution to this problem; in market economics there is no price if there is no transaction. Since 2007 there have been no transactions of substance between the major banks in the London market, and therefore no short term London interbank interest rate.

It is strange that economists and bankers the world over fail to acknowledge this fact. Notice I did not say that Libor had ceased to exist. The crucial word is "offer"; the banks continued to make token offers to buy and sell liquid funds, but those offers were deliberately set at

unrealistic levels, for reasons that are obvious, if you think about it. I like old cars, and I own a version of the original Mini, built by the British Leyland Company. I have no intention of selling it, so if you were to offer to buy, I might quote you an outlandish price, rather than saying an outright no. In similar fashion, banks on the London market had a motive to quote unrealistic rates, since they did not wish to borrow on the interbank market.

A difficulty arises because the calculation was based on *offer* rates, rather than actual realised rates. I presume that, up until 2007 when the market dried up, the rate that was published by the British Bankers' Association was in fact the average rate at which borrowings had actually been realised on the day. It may have been called an offer rate, but it was actually the realised rate, and should have been called the London inter-bank realised rate (LIBRR). This was the rate that disappeared in 2007. Offer rates remained, as many of them as there were banks, and none of them realistic, because nobody wanted to lend or borrow. The LIBRR, the only rate that mattered, because it is the only rate at which transactions actually took place, no longer exists.

These three examples - the price of fish, the Emera transaction, and the disappearance of the London Interbank Realised rate - illustrate some of the conundrums economists face in their search for an objective way to determine what is a fair trade. Can a trade be fair if the seller adopts a take it or leave it attitude? Can we say that a trade is unfair if both buyers

and sellers are happy with the price, even though others not party to the trade say it is unfair, whether or not they had an opportunity to participate? What is the fair price, in circumstances where no transaction actually takes place? Let me say a little about how economics has tried to address these questions.

One approach adopted by economics is to imagine that everything in the world is traded by open auction, and that the final auction price is the fair price. That is the model underlying the famous demand and supply cross which everyone who has done an elementary economics course will have encountered. The seller hopes for top dollar, the buyer is looking for a bargain, and the auctioneer achieves a price that is within an acceptable range for both parties. Except when he doesn't. As you know, it often happens that an auction item fails to reach the reserve price, so this is not a complete answer to the question of the fair value. The auction is also not objective. The result depends on who attends, where and when it is held, the skill of the auctioneer, and many other factors. Similar items may fetch widely different prices at different auctions.

An alternative economic approach to determining fair value is to establish the cost of the item to be traded, and a fair profit for the trader. This approach is of limited applicability in practice, because the cost of bringing items to market is information which is seldom available to all parties at the time of the trade, and the notion of a "normal" profit is completely arbitrary. As the hearings on public utility prices which the

FTC and its predecessor has conducted in the past four decades would by now have demonstrated, there are so many discretionary factors which go into the pricing decision that there is no single unambiguous cost of producing anything. The problem is especially intractable when we're talking about services, such as airline transportation, hotel accommodation, legal services, banking and educational services, to cite just a few random examples.

Economics has made many attempts to make either of these two basic approaches – cost plus and the equilibrium of demand and supply - a better match with our everyday transactions in the real world. This is not the occasion to go into detail, but it is fair to summarise by saying that no convincing model has emerged that would adequately provide a fair value in the circumstances of the examples with which we began, or in many other instances that might be cited.

The most important element in determining values in practice is what actually obtains elsewhere in the market, for all goods and services and in all markets. Whatever it is you may be selling or buying, your benchmark for determining what is a fair price is the price of comparable products or services. If you are buying or selling a 3 bedroom, 2 bathroom house, you feel satisfied with your settlement price if the value is roughly what similar homes have sold for in the neighbourhood in recent times. If you are opening a hairdressing business, you will price your services on the basis of what others in the profession are charging.

The prices of Banks beer, Carib and Heineken are not identical, but they are comparable.

The ruling prices that we observe in daily commerce cannot be explained by established economic theory, even though theory may be employed to rationalize them after the fact. That becomes clear whenever there are abrupt changes in the prices at which trades take place, in circumstances where nothing fundamental has been altered. The markets for property and financial assets provide the most striking examples. With no extraordinary change in demand or supply, and with little increase in cost, market prices from time to time spiral upwards, only to come crashing down eventually. That was the case with the housing boom in the US and Europe in the mid-2000s. The rapid upward spiral in prices from around 2003 cannot be explained with reference to changes in the demand and supply of housing; prices developed a momentum of their own. Naturally, the price spiral did come to have an effect on demand and supply; more and more property developers vied to construct new homes, which in turn spurred frenetic activity in building supplies, furnishings, transport and related services. At the same time, as the price of housing soared beyond the reach of ordinary folk, many over-reached themselves, and many more were pushed out of the home buyers' market. With supply going up and demand falling, the twain could never meet, and the famous intersection point with which is the enduring symbol of market economics became unattainable. In these circumstances, the market can never find the fair price.

Another circumstance in which the inadequacy of economists' pretensions about determining fair value may be seen, is in the market for entirely new products and services. If I am not mistaken, Amazon.com, the internet retailer, made losses for most of the first decade of its existence. Yet its share price kept on rising throughout. For all of this time Amazon was funding its deficit with additional capital. As it turned out, Amazon's business model was successful and the investors who waited out the company's long incubation period have benefitted from an appreciation in the value of their holdings, but the majority of similar ventures went belly up, resulting in the collapse of the Dotcom Bubble.

A third illustration of the difference between economic theory and how prices are in fact determined, comes from the world of automobiles. The world's leading manufacturers, Toyota, General Motors, Volkswagen , all sell some models that are virtually identical in markets all around the world. But the landed price of a Corrolla of a certain specification always varies from country to country, even when all else is identical: the factory where it was made, the shipping costs, etc. There is evidently not a single global market for Corrollas which clears at the fair value of a Corolla. Nor is there a determinate fair value at which all the currencies of the countries in which Corrollas are sold exchange with each other.

The evidence is all around us of our failure to understand what drives prices, and our inability to determine when a transaction is fairly valued. The increase in the demand for gold from wealthy Asians, and from others seeking a safe haven for their investments, is admittedly large, but it is nowhere near enough to explain the enormous spiral in gold prices. Violence and political instability has clearly been an element driving an upward spiral in oil prices, but actual supplies and new sources and technologies have not produced the expected correction. The relative values of the dollar, the yen and the euro owe much to traders' guesses about what markets will do next, and little to the fundamental weaknesses or strengths in policy or economic performance of the countries concerned. Airline pricing is a complicated mystery to us all, involving so many factors that have to be projected years into the future, that an objective measure of operating cost, which takes replacement costs fully into account, is beyond practical reach.

Together with my colleague Dr. Winston Moore, and our late friend and colleague Prof Roland Craigwell, I recently edited an e-book which recorded how frequently and by how much prices actually change in the Caribbean. The book, which may be freely downloaded from the website of the publisher, the Caribbean Centre for Money and Finance, analyses price changes in Barbados, Curacao, St Lucia and Trinidad and Tobago, using data from the consumer price surveys conducted every month for the compilation of the Consumer Price Index. We found that in Barbados between 50 and 80 percent of consumer prices were changed every

month, by as little as 3 percent for some items, and by as much as 29 percent for others. Moreover, very few prices moved in tandem with the prices of substitutes or similar items, and prices jumped around, rising rapidly one month and barely increasing or even falling in the following month, a phenomenon economists refer to as "low inflation persistence". These features are not at all what might have been expected from either of the two approaches economists use to determine value. The demand for consumer items hardly fluctuates from month to month, nor does the supply, which, in the short term, will be taken from inventories which have already been priced.

Economists are understandably reluctant to accept the fact that their fundamental contributions to determining fair values have limited practical application. Most economists still believe that supply prices and demand by informed customers do conflate to produce a fair price, in spite of all the evidence to the contrary. This is not the place to discuss the very many studies that purport to find support for the conventional view and why there is such dissonance with everyday experience, nor is this the audience for such intricacies. Whatever may be their merit, it is clear that we need a way of arriving at fair values in trade that may be applied to our everyday transactions.

Accountants, lawyers and others have attempted to fill the vacuum left by the economists. However, their definitions all come back to use of the market mechanism. Their guidelines are tantamount to saying that any

trade that is accepted by agents on both sides of the market may be said to be a fair trade. That is a tautology. We want to know which market price is fair value: is it the price I paid for my house just days before the bottom fell out of the market? I should think not. But neither is it the upset price at which the auctioneer disposes of my former property after the lender has repossessed. Somewhere in between the fair value lies, but the market cannot tell us what it is.

Is there no way of determining what is a fair trade? The answer to that question is nuanced.

In cases where today's offer price is not much different from the price I paid the last time I bought a similar item, the markets work perfectly well. Everyone accepts that the price is fair if it accords with their expectations, and our expectations are formed on the basis of previous experience. The market does work, for known products with which everyone is familiar, and for modest price variation.

The market cannot provide a fair estimate of value when the product is unknown, and when prices vary sharply over time. For new or unfamiliar products there is no reference price to use as a point of departure. Typically such a price appears in due course, after a small number of dominant firms arrive at an understanding among themselves on the range of values at which the product will be offered.

The problematic cases occur when there is an abrupt change in the value at which the market makes a trade, and in circumstances when a fair value is needed, but there is no trade. The value may be needed for accounting and reporting purposes, as for example when assets have to be booked at market value, or it may be needed as a reference price for other transactions, as was the case with Libor.

Unless there is official intervention at this point, or unless a market leader emerges with sufficient power to impose their will, no settled price may emerge. In the latter case, when a price is imposed through market dominance, traded values may not be considered fair.

So, is it not possible to determine what is a fair trade, if the product price fluctuates a great deal? It is possible to arrive at a fair price, but only with official intervention. Left to its own devices, the market will continue to flounder, and agents on the buying or selling side will object that the price at which they are obliged to trade is unfair.

These circumstances warrant aggressive and credible official intervention, sufficient to establish a benchmark for values, determined on a basis which is fully explained, and which is consistent with market understanding of the fundamentals that drive that particular market, as well as being sensitive to production costs and market demand for the product.

Official intervention has gotten a bad rap in recent policy discussion, often because the policy has not been fully understood, is not in line with market sentiment, or is based on economic assumptions that are unrealistic. However, official intervention which is in line with economic fundamentals, which is fully explained, and which takes full account of the intentions, motives and resources of market participants, may be the only way of attaining a fair value in trade, in circumstances where there is no established norm for prices, or where there has been a large departure from the norm.

I will conclude by applying this approach to some of the examples I have cited in this essay.

In the case of Libor, my view is that the Bank of England needs to set a benchmark rate, on the basis of a full analysis and documentation of the underlying market liquidity situation used to justify that rate, and invite banks to use that as their reference rate for international transactions, should they choose to do so. No unofficial financial institution in London has the wealth of data and analytical resources to take an informed view of the real costs of liquidity, comparable to what the Bank of England may deploy. The Bankers' Association would be free to circulate offer rates, and should be encouraged to do so, but the only rate that may logically be averaged for the guidance of the market should be the Interbank Realised Rate, the rate at which money was actually borrowed and lent.

In contrast, I believe the Barbados authorities were correct to have stayed out of the determination of the settlement price for the BL&P shares. In this case, the market achieved a price which was accepted as a fair price by a majority of shareholders, and the transaction was executed in a clear and transparent manner. Not everyone agreed with the pricing, but it is the nature of markets that not everyone agrees.

The management of asset price bubbles, including surges in property prices, also justifies aggressive intervention by official institutions. The nature of the intervention will be determined by individual circumstance, but it must be large enough and must be pursued with determination and persistence, until the steam goes out of the inflationary surge. Sound data, convincing analysis and effective communication are the key to success.

Finally, what about the man who knew the price of all fish? For me, that is a true example of a market that functions as well as any market can, in the real world. As we all know, there are so many things having nothing at all to do with economics which influence whether we think a transaction is fair: whether the counterparty is someone we trust, whether the parties to the transaction have comparable bargaining power, whether the circumstances of the trade facilitate bargaining, whether the parties meet face to face, and many other factors. Small traders and informal markets often work to the satisfaction of all, if the

price at which items are traded is left to the parties undertaking the transaction.

Thank you.