How Governments Influence Markets

By Andrew Beattie

In the 1920s, very few people would have identified the government as *the* major player in the markets. Today, very few people would doubt that statement. In this article, we will look at how the government affects the markets and influences business in ways that often have unexpected consequences.
TUTORIAL: The Federal Reserve

Monetary Policy: The Printing Press
Of all the weapons in the government's arsenal, monetary policy is by far the most powerful. Unfortunately, it is also the most imprecise. True, the government can do some fine control with tax policy to move capital between investments by granting favorable tax status (municipal government bonds have benefited from this). On the whole, however, governments tend to go for large, sweeping changes by altering the monetary landscape.

Currency Inflation
Governments are the only entities that can legally create their respective currencies. When they can get away with it, governments always want to inflate the currency. Why? Because it provides a short-term economic boost as companies charge more for their products and it also reduces the value of the government bonds issued in the inflated currency and owned by investors.

Inflated money feels good for awhile, especially for investors who see corporate profits and share prices shooting up, but the long-term impact is an erosion of value across the board. Savings are worth less, punishing savers and bond buyers. For debtors, this is good news because they now have to pay less value to retire their debts - again, hurting the people who bought bank bonds based off those debts. This makes borrowing more attractive, but interest rates soon shoot up to take away that attraction. (Learn about the tools the Fed uses to influence interest rates and general economic conditions *How The U.S. Government Formulates Monetary Policy*.)

Fiscal Policy: Interest Rates
Interest rates are another popular weapon, even though they are often used to counteract inflation. This is because they can spur the economy separately from inflation. Dropping interest rates via the Federal Reserve - as opposed the raising them - encourages companies and individuals to borrow more and buy more. Unfortunately, this leads to asset bubbles where, unlike the gradual erosion of inflation, huge amounts of capital are destroyed, which brings us neatly to the next way the government can influence the market. (For more on how interest rates affect economics see *How Interest Rates Affect The U.S. Market*.)

Bailouts
After the financial crisis from 2008-2010, it is no secret that the U.S. government is willing to bailout industries that have gotten themselves into problems. Truth be told, this fact was known even before the crisis. The savings and loan crisis of 1989 was eerily similar to the bank bailout of 2008, but the government even has a history of saving non-financial companies like Chrysler (1980), Penn Central Railroad (1970) and Lockheed (1971). Unlike the direct investment under Troubled Asset Relief Program (TARP), these bailouts came in the form of loan guarantees.

Bailouts can skew the market by changing the rules to allow poorly run companies to survive. Often, these bailouts can hurt shareholders of the rescued company and/or the company's lenders. In normal market conditions, these firms would go out of business and see their assets sold to more efficient firms in order to pay creditors and - if possible - shareholders. Fortunately, the government only uses its ability to protect the most systemically important industries like banks, insurers, airlines and car manufacturers. (Learn more about the bailouts in *Liquidity And Toxicity: Will TARP Fix The Financial System?*)

Subsidies and Tariffs
Subsidies and tariffs are essentially the same thing from the perspective of the taxpayer. In the case of a subsidy, the government taxes the general public and gives the money to a chosen industry to make it more profitable. In the case of a tariff, the government applies taxes to foreign products to make them more expensive, allowing the domestic suppliers to charge more for

their product. Both of these actions have a direct impact on the market.

Government support of an industry is a powerful incentive for banks and other financial institution to give those industries favorable terms. This preferential treatment from government and financing means that more capital and resources will be spent in that industry, even if the only comparative advantage it has is government support. This resource drain affects other, more globally competitive industries that now have to work harder to gain access to capital. This effect can be more pronounced when the government acts as the main client for certain industries, leading to the well-known examples of over-charging contractors and chronically delayed projects. (Everything you need to know - from the different types of tariffs to their effects on the local economy, check out *The Basics Of Tariffs And Trade Barriers*.)

Regulations and Corporate Tax
The business world rarely complains about bailouts and preferential treatment to certain industries, perhaps because they all harbor a secret hope of getting some. When it comes to regulations and tax, however, they howl - and not unjustly. What subsidies and tariffs can give to an industry in the form of a comparative advantage, regulation and tax can take away from many more.

Lee Iacocca was the CEO of Chrysler during its original bailout. In his book, "Iacocca: An Autobiography," Iacocca points at the higher costs of ever-increasing safety regulations as one of the main reasons Chrysler needed the bailout. This trend can be seen in many industries. As the regulations increaser, smaller providers get squeezed out by the economies of scale the larger companies enjoy. The end result is highly-regulated industry with a few large companies that are necessarily intertwined with the government.

High taxes on corporate profits have a different effect in that they discourage companies from coming into the country. Just as states with low taxes can lure away companies from their neighbors, countries that tax less will tend to attract any corporations that are mobile. Worse yet, the companies that can't move end up paying the higher tax and are at a competitive disadvantage in business as well as for attracting investor capital.

The Bottom Line
Governments may be the most terrifying figures in the financial world. With a single regulation, subsidy or switch of the printing press, they can send shockwaves around the world and destroy companies and whole industries. For this reason, Fisher, Price and many other famous investors considered legislative risk as a huge factor when evaluating stocks. A great investment can turn out to be not that great when the government it operates under is taken into consideration. (Though the U.S. government can help its citizens by subsidizing risky loans, the costs always come back to the taxpayers *The Government And Risk: A Love-Hate Relationship*.)
