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Remembering Adam Smith before it's too late

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Adam Smith in his *Inquiry into the Nature and Causes of the Wealth of Nations*, published in 1776, marvelled at the way the factory system made vast improvements in productivity due to its division of labour.

In his pin-making factory example, he estimated that this allowed 4,000 pins a day per worker to be manufactured, while one man working alone would probably only make one such pin. A modern manufacturing plant, like a car factory, assembles in pre-arranged formats tens of thousands of 'pins'. Many, like semiconductor chips, are manufactured in climate-controlled facilities largely by robots.

Smith attributed the success of the nascent capitalism he was living through to the development of secure property rights, frugal government spending, an absence of government monopolies (and trade unions), and an ability to trade across and within borders. These he linked with his famous ‘invisible hand’ whereby workers, financiers, and entrepreneurs pursue their own self-interest in maximising their personal incomes and in the process increase the wealth of those around them.

This outcome has shown repeated confirmation over the past quarter of a millennium. It has seen prosperity spread from Britain and its European colonies, through western Europe and the far East, latterly encompassing China and India. Wherever secure property rights were absent or government restraints inhibited trade and enterprise – as in the Soviet bloc, China, and India until the past three decades – only modest growth took place.

That process is now under serious threat from a number of directions largely associated with the Environmental, Social, and Governance (ESG) movement. This movement is mainly focused on attacking mining and use of coal and other hydrocarbons.

An important part of the threat is the leveraging of ESG by lobbyists seeking favours for renewable energy, more recently reinforced by those (including the ubiquitous Twiggy Forest) seeking government funding for the latest fad, converting hydrogen to energy. But such lobbying has always been present and of itself has rarely derailed the march to greater economic efficiency.

Much more problematic are the actions of individuals, those managing their investable funds and the institutional guardians seeking to ensure the integrity of fund management.

For Adam Smith, a crucial outcome of what became known as *laissez-faire* capitalism was the reduced risk that lenders faced. This allowed interest rates to fall to 2 per cent in England compared to over 10 per cent in other places where government intervention was more significant.

Yesteryear’s financiers were wealthy merchants whose focus was on earnings. More important today are the accumulated savings of individuals rich and poor. And many individuals are willing to see potentially reduced returns in order to prove to themselves and others that they are not indifferent to what they see as the greater issues involved in financing commercial activities.

Individuals’ own preferences are reflected and amplified by those they have entrusted to invest their savings. In Australia, the union-controlled superannuation funds, which account for half the nation's investable resources, are major exponents of ESG. But many global private sector funds led by BlackRock, the world's largest, are equally fixated. 'Climate Action 100+' describes itself as an *'investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change.'* The members manage over $54 trillion in assets, which is equivalent to sixty per cent of the market capitalisation of all the world's stock market exchanges.

Added to these are activists opposing new resource developments through shareholder engagement, vilification of lending institutions, lobbying, and preventing activities commencing.

Although constraints on investment venues will mean the lender accepting lower average returns, this is not presently evident, possibly because increased demand for ESG shares is (temporarily) driving up their prices. Half of the best performing Australian funds feature ESG principles, and are taking decisions on that basis although, as Cliona O'Dowd shows, often less than rigorously.

These corporate funds are joined by charitable trusts bequeathed by self-made wealthy men like Rockefeller, Carnegie, and even our own Myer family, which have gradually been transformed into social actors increasingly with environmental agendas. They are joined by funds of living entrepreneurs like George Soros, Mark Zuckerberg, and Bill Gates.

Finally, we have institutional regulatory agencies, like the Bank of International Settlements and the Australian Securities and Investment Commission, seeking to force all businesses to identify and account for the risks they allegedly have in their exposure to climate concerns and enforce any backsliding and prevent message fabrications. The latest addition to these is President Biden's appointment of climate change activist Lael Brainard as the Federal Reserve Bank's vice chair.

Neither the recent apparent willingness of savers to accept lower returns for ideological reasons, nor less amplification of such deviations by the fund managers and institutional controllers were anticipated in Adam Smith's playbook prescribing the foundations of an enduring prosperity. The diversion of capital to less remunerative venues and the increased paperburden costs of regulatory oversight that these facets entail must surely have an impact on economic efficiency.

It remains to be seen if we will see a restoration of the ‘iron laws’ of markets that historically have forced firms and financial intermediaries to seek to maximise their profits or face business failure.