Return to Common Sense Is Needed *

By
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1. Economic freedom is not synonymous with non-regulation

I have written these words at a time of a deepening financial crisis which is ricocheting worldwide and causing tremendous anguish and tremors, a spreading economic downturn. It is also not a long while after the European Parliament passed a report which I worked out together with a Dutch colleague, Ieke van de Burg, in which we argue in favour of an overhaul of the regulatory and supervision frameworks of financial markets in the EU[1]. I should underline that the paradigmatic underpinnings of our report were not dawned upon us by a growing financial mess engulfing western economies; for a longer period of time both of us, though belonging to two different political groups in the European Parliament, had harboured similar views on what has been wrong with the dynamics of world finance.

Economic freedom and entrepreneurship, which lie at the root of innovation and economic advance, rely on and feed on free markets; this is indisputable and explains why communist economies collapsed, eventually, during the last century. In this regard Ludwig von Mises, Friedrich von Hayek, Joseph Schumpeter and others[2] were quite right. But it is misleading to argue that free markets are synonymous with non-regulated markets, with the practical extinction of public sectors and public policies. Modern economies and societies do need regulations and public policies so that public goods be in adequate supply and negative externalities be prevented or constrained; this implies the functioning of public sectors against the backdrop of a free allocation of resources (at market prices) and vibrant economic competition. That one needs to streamline public sectors and make them run efficiently so that public resources be not wasted goes without saying. And there is also need of a moral compass, without which everything else gets bogged down, sooner or later.

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1 Ieke van den Burg and Daniel Dăianu, “Report with recommendations to the Commission on Lamfalussy follow up: future structure of supervision”, Rule 39 of the Rules of Procedures, European Parliament, 2008.

2 Especially economists who belong to the Austrian School.

I was chief economist of Romania's central bank when I was asked by some IMF officials whether I would support the opening of its capital account; that dialogue happened in 1996, about one year before the eruption of the Asian financial crisis. I responded that such a move would be highly risky in the Romanian environment, a dangerous course of action, which I would not recommend to my country's political leaders. Fortunately, Romanian policy-makers took the right course of action during those years. As many accept nowadays the Asian crisis was caused, not least, by a premature opening of the capital account in the economies of that region. I always felt that the rush to privatise public utilities is not warranted. As Joseph Stiglitz[3] and others have highlighted institutional contexts are essential for companies which are turned private to perform well. In addition, there are public utilities which should rather stay in public hands. One has to add here that institutional change is time consuming and time cannot be compressed at will.

The oversimplification of "good practices" in governance and, not least, the hypocrisy which has, in not a few instances, accompanied their propounding, by major industrialized countries, around the world is more than obvious nowadays[4]. The deep financial crisis, the failed Doha trade round (with the controversy between free and fair trade), the lack of results where-ever development policies have been simplistically encapsulated in the ideological mantra of neo-liberalism are quite telling. Having said that, I do not overlook the corruption, lack of clarity of property rights, waste and stealth of public resources in many poor countries, a terrible misallocation of resources, all of which impede economic growth[5]. But such structural weaknesses do not make up a convincing argument in favour of accepting, without qualifications, policy remedies which are too general and, sometimes, in divorce of concrete local conditions. Market-oriented reforms have unfettered entrepreneurship and have stimulated economic growth in China after 1978, and in India during the last decade, but those reforms have been implemented in a pragmatic way, with a close attention paid to social issues and rural development problems, while financial markets have not been liberalised recklessly. In these two very complex cases big policy trade-offs and dilemmas remain,

3 Joseph Stiglitz, "Making Globalization Work", New York, Allen Lane, 2006. See also Narcis Serra and Joseph Stiglitz (ed.), "The Washington Consensus Reconsidered", New York, Oxford University Press, 2008.

4 The World Bank has been concerned with "good practices" (good governance) for a long time and disseminates information on this topic around the world regularly. I wonder why hasn't this institution paid attention to malpractice in the financial industry in wealthy economies, which are not of recent vintage, as well.

5 See for instance William Easterly, "The Elusive Quest for Growth, Cambridge, MIT press, 2001.

though economic progress has been extraordinary. Dani Rodrik[6], Paul Krugman[7] and other clairvoyant economists have constantly asked for open-mindedness in examining the major problems afflicting poor countries; they have rejected oversimplifications and asked for policy variety depending on local circumstances. Although their intellectual credentials are exceptional their voices were not sufficiently listened to.

I lived for a substantial part of my life under communism and I value economic and political freedom in ways which those who were fortunate to live in liberal democracies (to use Fareed Zakaria's concept) may not understand fully. But I am not blind to the bads which can plague market economies, especially those that are not adequately regulated and do not offer a decent amount of public goods to their citizens. I consider myself an economist of a liberal persuasion, though I am not a libertarian. For me, liberal values (in the European sense) under-gird, essentially, liberal democracies; in a democracy liberal creeds, arguably, underlie various political inclinations – be they more social-democratic, or of the "people´s party" brand, along the European political spectrum. I espouse a type of liberalism which owes o lot to Karl Popper and his concept of an "open society"[8]. For me individual liberties coexist with concepts of social solidarity, social equity[9], public goods and moral values (trust, honesty, trustworthiness, sense of accountability, etc). The German notion of "social market economy" (*soziale Marktwirtschaft*)[10] illustrates pretty well my way of thinking in this regard. I mention moral values because, frequently, I hear people (in the European Parliament, too) who claim that morality is meaningless in business. I would argue that it is so for those who choose to disregard moral values and for whom society is quite meaningless. I also think that ruthless competition in the global economy does strain European societies and their social model. But measures which focus on boosting competitiveness, while ignoring social cohesion and the social contract between state and citizens, can be equally damaging to society as it is a policy status quo. In the European Union the experience of Scandinavian countries with undertaking reforms

6 Dani Rodrik, "One Economics, Many Recipes", Princeton, Princeton University Press, 2007. See also his "'The New Global Economy and Developing Economies. Making Openness Work", Washington DEC, Overseas Development Council, 1998.
7 Paul Krugman got his Nobel Prize for having shown the effects of economies scale on trade patterns and on the location of economic activity. He was prescient in foreboding the pitfalls of the new financial system; see his, "The Return of Depression Economics", New York, Norton, 1999.
8 Karl Popper, "The Open Society and Its Enemies", London, Routledge, 1945.
9 See John Rawls, "A Theory of Justice", Cambridge, Harvard University Press, 1971.
10 A main theorist of the social market economy was Wilhelm Roepke and a leading practioner in Germany was chancellor Ludwig Erhard.

that enhance competitiveness without disregarding the social fabric of society is quite relevant in this regard.

2. A shift of paradigm

The financial crisis which has struck the core of the world financial industry is, in my opinion, a decisive refutation of the paradigm that glorifies total deregulation in economies, be they wealthy or poor[11]. The repeal in 1999 of the Glass-Steagall Act that limited ownership of financial companies operating in other market segments, like the decision in 2004 to exempt the brokerage operations of Wall Street investment banks from limits on the amount of debt they could take on, have proved to be historic blunders[12]. The root cause of this crisis is an inadequately and under-regulated financial system. The waves of deregulation in the financial industry brought to the market a plethora of fancy products whose risks were poorly understood. Mortgages are not toxic per se; badly constructed securities based on them are toxic. The packaging and repackaging of financial products are toxic, making their valuations increasingly unclear and reducing their tradability. Reward schemes that shape the decisions of managers and agents in markets and that make their behaviour irresponsible - that is toxic. Misleading quantitative models are toxic. The trigger for this financial crisis may have been in the housing industry, but housing is not the structural cause of the crisis.

What this crisis should make plain to everyone is that not all financial innovation is benign. It is baffling to hear the argument that fresh regulation is bad because it would stifle financial innovation. Fresh regulation is necessary because there has been a lack of proper regulation and supervision. The enormous mistakes that have been made by allowing finance to develop its own, highly risky “raisons d'être” must be undone. But are we capable of learning that lesson? Why is it that we fail to learn from previous crises? Alexander Lamfalussy issued warnings almost a decade ago; the

11 In a letter published by the leading French daily Le Monde, 22 May 2008 one can read: “Some are tempted to see the ongoing financial crisis as a recurrent accident, albeit more severe, along an economic cycle and following worldwide very cheap credit for years in a row. But a careful reading would go at its structural roots. Globalisation of markets and financial engineering, with precarious and, frequently, missing regulations, highly skewed incentive schemes, and numerous conflicts of interest, have created the milieu for the current crisis”. The letter was signed by Helmut Schmidt, Otto Graf Lambsdorff, Lionel Jospin, Jacques Delors, Michel Rocard, Romano Prodi, Jacques Santer, Göran Persson, Pär Nuder, Massimo d’Alema, Hans Eichel, Poul Nyrup Rasmussen, Daniel Dăianu, Paavo Lipponen, Ruairi Quinn,Laurent Fabius, Anneli Jaatteenmaki.

12 Alan Greenspan, the long-serving president of the Fed is quoted by the International Herald Tribune to have acknowledged that something has been wrong with the free market theory he has upheld (Brian Knowltoon and Michael Greenbaum, “Greenspan makes rare admission of fallibility”, 24 October, 2008, p.1). Greenspan is well known for having been a staunch opponent of regulating derivatives, the “new banking sector”.

financier Warren Buffett and the former Federal Reserve chairman Paul Volcker are among those important figures who fired off warnings years ago. Nouriel Roubini did the same, including at Davos Forum meetings. How is it that their predictions of a crisis have not been listened to?

As traffic needs rules and lights in order to protect people's lives, so market economies need regulations to limit collateral damage and enhance the production of public goods. A lax monetary policy can lead to higher inflation and, ultimately, to a recession, but cannot, by itself, cause the meltdown of a financial system. This is the crux of the matter: the features of the financial system that have brought the threat of collapse are structural features of the "new" financial system, including a breakdown of due diligence.

Vested interests can have a long arm and try to influence regulations and supervision. But vested interests must be strongly resisted, using all means available. Regulators and supervisors should know that financial markets are volatile and prone to instability, and that the efficient-markets hypothesis – that prices reflect all known information – is a fantasy.

3. If "they are too big to die", then split them up!

The fall of Lehman Brothers, a leading Wall Street investment bank, is seen by most analysts as the event that brought the confidence crisis to a climax in world financial markets. While the financial crisis irrupted almost a year before the Lehman Brothers's fall it seems to have been a tipping point –into a spreading economic recession worldwide. Here I wish to focus on an issue that has under-lied much of the debate on government bailouts in mature economies. The bottom line in this debate is whether/why the entities which are supported, or rescued, via public money, pose any significant systemic risk. When AIG was bailed out through a staggering amount of American taxpayer's money the argument was quite clear: the scope and depth of its operations, its intricate linkages with a very large number of financial clients around the world, made such a rescue operation a must; non-intervention was judged to, potentially, had been quite fatal to the financial system as a whole. In a way, the action to rescue AIG replicated, on a much grander scale, what the FED did in 1998 when it helped, indirectly, the LTCM by summoning five investment banks to participate into a joint aid demarche.

I wrote several articles in the European Voice on the causes of the current financial crisis, but there is one aspect which needs more emphasis when the argument "too big to fail" comes to the fore. If the size of financial groups can become an overwhelming problem and policy issue, in the sense that enormous risks to the financial system emerge when their network of linkages cripple it, then "size" has to be dealt with. A long time ago anti-trust legislation was enacted by governments, in the US and in Europe, in order to combat monopolistic behaviour that undermined competition and extracted undue rents. Remember the splitting of Standard Oil in the early 20tieth century; later on AT&T suffered a similar fate. There were also waves of divestiture, in certain industries, when it became clear that conglomerates and oversized groups do not bring about better performance necessarily; just remember Textron.

In finance, waves of deregulation in recent decades (I would point out the repeal of the Glass Steagall act in 1998, in particular) increased the scope for the formation of very large groups, with operations covering the whole gamut of financial services. Citigroup comes easily as an example in this respect. The globalization of markets and the new information and communication technologies (which enhanced global trading in real time) gave a very powerful stimulus to the emergence of genuinely global players. By the way, AIG was one of them. Some of these groups have cornered the markets –which can be easily evidenced by the manifold rise in the share of the financial industry's profits in the world GDP in last couple of decades. But a fundamental challenge is that the reckless behaviour of not a few financial giants and their fantastic interconnectedness have become synonymous with and have epitomized systemic risks. Such systemic risk-producing trans-frontier groups are an obvious nuisance for and a flaw of the financial system to the extent governments are forced to step in when there is need to avoid a financial meltdown.

It appears to me that a major component of the current efforts to overhaul the regulatory and supervision systems of financial industry in industrial economies needs to address the size issue of financial groups. For if they are too big to be left to die, one has to find an effective response to two ensuing problems: the moral hazard (not to encourage bad practices by eliminating failure); and reduce, as much as possible, the burden on public money in case government action does involve it. Simply by increasing transparency, capping leverage, improving capital adequacy ratios and avoiding pro-cyclical behaviour, new remuneration schemes, trying to regulate conflicts of interest, improving quantitative methods in order to capture complexity and "Minsky moments", etc., is arguably, not sufficient when the size of some players keeps the system hostage. I would say that splitting large financial groups does make sense under such circumstances! Anti-trust legislation needs to be reexamined/completed in this regard. I would also consider a resuscitation of a sort of Glass-Steagall Act. It goes without saying that such measures would need to be considered from a global perspective.

The irony is that the current crisis has induced a spate of takeovers (some of them prodded by governments --like Bank of America's takeover of Merril Lynch), which goes counter to the policy venue advocated herein, though deleveraging and a dramatically reduced securitization will very likely reduce the share of financial services industry in overall economic activity. In addition, in Europe, the burden-sharing of rescue packages for trans-frontier groups is more than murky (what Charles Goodhart has highlighted quite a while ago) while the supervision and regulation of banking sectors is fragmented along national lines. This state of affairs may relent many banks' drive to continue to expand internationally; they may even retreat and turn more parochial. But, overall, this crisis is likely to lead to a consolidation in finance, the perpetuation of the "too big to fail" syndrome (be it on a local/international scale), that might recreate the systemic risks we are trying to diminish via regulatory and supervision reforms. This situation is a further reason to resort to anti-trust law, or very strict regulation of finance (should banking be deemed a special industry, of a "public utility" nature).

Some might ask: can the US and Europe afford to split up "too large to die" financial groups at a time when Asian financial entities appear to gain a competitive edge in the wake of the current crisis? This motivation has to be seen in relation with the regulatory arbitrage argument. Both these issues need to be taken into account. But it would be wrong to jeopardize the functioning of whole economies for a corporate benefit which is uncertain, in the end. In addition, why would Asians themselves ignore the lessons of the current financial crisis, which has worldwide implications? Why shouldn't G 20 and the Financial Stability Board help major countries see eye to eye in this regard?

4. The financial crisis and tectonic shifts in the global economy

The huge bail outs underway (in the financial sectors) are going to introduce, or reinforce, elements of state capitalism in numerous industrialized countries, including the US. The impact on national budgets would by burdensome for years to come. In order to mitigate the pains and reduce dependency on external borrowings saving ratios would have to go up in all economies where bank recapitalization will be very serious. A legitimate question arises: can rich societies become, almost all of a sudden, much more economizing and forward looking. This very much hinges on social cohesion (solidarity) and the capacity of politicians to lead in times of distress. If one adds here the implications of aging and strained welfare states, climate change, as well as the competitiveness challenges posed by emerging global powers, the contours of very complicated public policy agenda in the decades to come are not hard to delineate.

The effects of the current financial crisis have hit the western world at a time when tectonic shifts in the global economy had been taking place for more then a decade. The rise of China, India, Brazil, the resuscitation of a capitalist Russia (that benefits on huge natural resources) are ushering in an increasingly multi-polar world, with growing reverberations economically and geopolitically. The struggle for the control of exhaustible resources (oil and gas in particular) epitomises this phenomenon. The financial crisis has given more salience to the inherent weaknesses of policies which are not pragmatic and which succumb to fundamentalist tenets.

The fall of communism, which was equated by some with the "End of History"[13], has favoured immensely the advance of neo-liberal ideas. In the western world this advance has fuelled the ascendancy of the so called Anglo-Saxon type of capitalism – with its "Third Way"[14] reflex on the left side of the political spectrum. Needless to say that the overwhelming superiority of the US on all fronts (economic, military, technological), offered a sort of a sui generis *Pax Americana* and created prerequisites for an *international regime*. The latter was supposed to order the world by providing international public goods and resolving/preventing possibly major conflicts. Neo-liberalism (market fundamentalism) has revealed its serious flaws over time and is, currently, willy-nilly, put on the shelf for the sake of salvaging the functioning of market economies. Because, what is happening now is not a dismissal of market forces as an essential mechanism for resource allocation and stimulating entrepreneurship, but an invalidation of a grossly misinterpretation of what it takes for a modern economy to perform economically and socially over the long run.

13 Francis Fukuyama, 'The End of History", New York, Free Press, 1990.
14 Anthony Giddens, "The Third Way", Cambridge (UK), Polity Press, 1998.

Fragments of state capitalism are being put in place and we will see what will remain out of them over time. Probably, substantial chunks of the new state sectors in the making will turn private at one point in time. Monetary policies are geared now toward achieving financial stability and have acquired a sort of flexibility that is reminiscent of the injunctions of John Maynard Keynes, the great British advocate of the value of government intervention, regarding ways of avoiding bad equilibria (the Great Depression was a terribly bad “equilibrium”). The very concern of governments and central banks with radically overhauling the regulation and supervision of financial markets, so that “Minsky moments” – moments at which, according to the now deceased economist Hyman Minsky, financiers lay waste to the economy[15] – are averted is a strong validation of Keynes' intellectual legacy and of his sense of realism in understanding the functioning of markets in general.

The crux of the matter is that the reshaped mixed economies have to function in such a way that extravagant policies be avoided for the benefit of democracy and the welfare of most citizens. Cycles cannot be eliminated, and crises will pop up again. But a financial meltdown, with its very dire effects on the real economy, can be prevented by adopting proper policies and regulations; and very severe crises can also be averted.

The EU and US will come out of this crisis with reshaped economies (with larger public sectors) and will, very likely, continue to be, fundamentally, liberal democracies. But the financial crisis has already weakened them whereas the ascendancy of the new global powers is hard to stop, although an economic slowdown will be felt worldwide. I see the future as being driven by a competition between liberal democracy and authoritarian forms of capitalisms – the latter being represented by China and the Russian federation, principally.

For the European Union the aims of the Lisbon Agenda are not diminished by this financial crisis. But they have to be pursued while momentous changes are occurring in the *Zeitgeist* and the frame of policy-making.

Liberal democracies will have to come to grips with their weakened relative status in the world economy and shed much of their hubris in dealing with the rest of the world, for their own sake[16]. This would apply to the reform of the International Financial Institutions and a new architecture for tackling global governance issues,

15 Hyman Minsky, "Stabilizing an Unstable Economy” (first edition, 1986), New York, Mc Graw Hill, 2008.

16 To see how “others” view the US and the EU in the 21st century read Kishore Mahbubani, “The New Asian Hemisphere”, New York, Public Affairs, 2008.

which would have to involve the emerging global powers. As some say, a new Bretton Woods is needed.

This period, the years to come, mark the prominent return of Keynes and the idea of government intervention. We need common sense and pragmatism in economic policy-making, not fundamentalism. As some aptly observe "History proves the importance of policies for preserving the social fabric".[17]

5. Limits of openness

In the midst of the deepest financial crisis after the Great Depression, the instability of the world's financial system is all too evident. But that is not a momentary instability: there have been several crises in industrialised countries in the past couple of decades, numerous financial and currency crises in emerging markets, trade liberalisation has left many poor countries in the dust, the myth of the "new economy" has dissipated, corporate scandals have shown that cronyism and bad governance are more complex and widespread than thought, wealth is more unequally distributed than it was and social fragmentation and exclusion have risen in rich and poor countries alike.

And yet this disorder has co-existed with a 'consensus' on the principles and practice of economics, translated into policies that have unbridled markets, privatised the economy and downsized the public sector to the maximum. This 'rational economics' is perhaps of a piece with what Max Weber referred to the "rationalisation of life", our tendency to ascribe primacy to knowledge and theory and the search for the ultimate piece of wisdom.

This crisis should deals another coup to the belief that economics is a hard science. It has certainly revealed the serious weaknesses of market fundamentalism. There have, of course, been significant market-driven transformations – but they too appear a little different under close inspection. Liberalisation and privatisation transformed post-communist societies – but their unique geography, cultural and political consciousness combined with considerable support from the US and western Europe made these countries exceptional. Market-oriented reforms have spurred China and India forward – but their reforms have been pragmatic, with close attention paid to

17 Robert Shiller, "The Subprime Solution", Princeton, Princeton University Press, 2008, p.2.

social issues and rural development problems, while financial and trade markets have not been liberalised recklessly.

Globalisation (and liberalisation) does not, though, need to be an ideological mantra; it could be an open-ended concept that purports to define the 'opening up' of societies, under the impetus of technological change and the manifold quest for economic progress. Such an interpretation would encourage pragmatic and flexible policies, and would rid globalisation of its perceived Western-centred origin.

Such a nuanced interpretation of globalisation would have major repercussions for national public policies and international politics. Thus, national public policies could become fairly pragmatic, varied and geared towards the traditional goals of economic growth, price stability and social justice. Some might say that too much variety in institutional and policy design would damage a level playing-field and prevent markets from functioning effectively. There is truth in this argument, but it underplays the importance of working out policies that keep in mind the extreme diversity of conditions in the world economy and the fact that market forces do not automatically bring convergence.

We may already be seeing the start of a significant change in financial policy-making. One of Keynes' intellectual legacies – namely that highly volatile capital flows are inimical to trade and prosperity – has demonstrated its relevance in this crisis. For decades now a mantra has been heard worldwide: that not much can be done in national policy-making because global markets would punish a government. This crisis encourages fundamental questions (such as: is the complexion of global markets God-given?) and questions that raise the prospect of policy changes (are not global markets, aside from their technological drivers, also the product of human beings' decisions to set rules for finance, trade and investment?). The claim that nothing can be done about financial flows, when they bring about misery, is unconvincing. There are plenty of specific regulations that can be imposed and restraints that can be exercised.

Similarly, free trade is likely to be re-examined as states' concerns grow about its impact on security. One concern – shared by leading and developing economies alike – is the cost of adjustment to competitive pressures. Another set of concerns relate to 'hard security'. How much 'trading with the rival' is likely before restrictions are imposed? Will the US, or major EU member states, accept big chunks of their most sensitive manufacturing and IT sectors being acquired by China's and Russia's companies and sovereign-wealth funds? Food security and climate change will concentrate minds on preventing over-reliance on overseas suppliers. We may think globally, but risks may force us to limit ourselves to ‘safer' patterns of trade and production.

In other words, we may well see a partial domestication of market forces in national governments' quest to cope with systemic risks and social strain. This would involve a greater state presence in the economy (state capitalism) and broader regulations; elements of ‘war economy'-style conduct in public policy will also be quite visible, even in liberal democracies. Perceived needs will trump ideological propensities.

Such concerns could stimulate the formation of alliances among groups of countries that share common interests. The EU is one such a bloc. A transatlantic trade area could also emerge. We could see a replica of it in Asia. Rivalry and experience – no monetary union emerged after the Asian crisis of 1997 despite speculation – suggest this might not happen; however, if the yuan turns into a reserve currency, the rationale for creating an Asian monetary area would grow.

Several sub-global clusters might, then, emerge to mitigate the potentially devastating effects of a completely open world system. They would operate in a multi-polar world of major global state powers – and the presence of poles that are alternatives to US power could itself create barriers to unrestrained free world trade, investment and finance.

How might the EU evolve in such a context? The logic of single markets might remain dominant, but policy-making would be quite nuanced at national level. In the absence of a common foreign and security policy and faced with greater security risks, national governments would be more active in the economy. The EU would therefore continue to have a fairly complicated policy-making structure.

So, who would formulate and enforce a suitable international regime for the 21st century? The US will not have the capacity do so any longer. In its current shape, the EU could not take over such a role. And an overhaul of the international architecture of financial institutions hinges on what the main international actors wish to do and on how they relate to each other. If the US, the EU, and the emerging global powers can strike a deal on reform, other significant players would eventually come along. Their challenge would be to make openness work for the world as a whole. That implies shedding a blind belief in the self-healing and self-regulatory virtues of markets. That may be happening.