Regulation, liberalisation and interventionism

Some thoughts on the relation between economic ideas and the crisis

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The purpose of this article is to share some thoughts on the relation between economic thought and the present crisis, and to do so in two ways – from the perspective of the influence ideas have had in creating the crisis and the impact this crisis may have on dominant thought in the next decades.

The creation of the crisis

There is ample reference on the economic cycle describing multiple mechanisms through which situations of strong and weak economic activity of different length and intensity originate, propagate and endure time.

As occurs with avalanches and many other natural and social phenomena, economic imbalance tends to accumulate without changing significantly the trend until it becomes irresistible, and then this trend abruptly changes. This is why economic cycles trigger crises, understood as situations in which after a relatively long period of fluid activity it declines suddenly and dramatically.

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Consequently, the gravity of an economic crisis depends on the size of forces lying at its origin and on the lack of flexibility of structures needing to adapt to it. My thesis is that dominant economic ideas play a crucial role in both factors.

For instance, it is well known that the world of ideas that suffered the crisis in the 1930s was dominated by liberalism and faith in the market self-regulating capacity. The best founded thesis on the cause of the depth and length of that depression pointed towards the US economic policy after the 1929 crash, characterised by fiscal balance and *laissez-faire* as the banking crisis was spreading all over. This policy was based on the belief that stakeholders having taken wrong decisions (bankers who had invested carelessly and savers who had placed their savings in wrong institutions) needed to be punished and if they were allowed to act freely, the market would recover its balance in the quickest and less costly way possible. In this respect, it was also important that the public sector adjusted its expenditure to revenue in order not to divert resources from savings to private investment. That is, the depth and length of the crisis in the 1930s was under the strong influence of the dominant paradigm being based on the neo-classical dogma of self-regulated market.

However, that crisis changed this paradigm deeply, so from then on economy scholars had to familiarise with two inconsistent models. In the first – microeconomic – one, stakeholders are rational, virtue is rewarded, irresponsibility punished and the market tends to balance on its own, and resource allocation is optimal. In the second – macroeconomic – one, stakeholders are still rational but virtue is not always rewarded, the market tends to imbalance and balance requires persistent, benevolent and discerning action by a knowledgeable authority that permanently adjusts public revenue and expenditure and the monetary mass.

The 2008 crisis

To understand the present crisis, I think it is important to distinguish between two different phenomena that have come together in time: the financial and the industrial crisis.

The financial crisis

Subprime mortgages as one of the main triggers of the financial crisis have already been massively referred to. There is no doubt that the Western financial system took a set of risks in recent years that seemed acceptable then but now appear as being excessive, and there is barely any doubt that it is this a sudden change of mind what has triggered the crisis. I will try to argue that this development has been under strong influence of economic consensus that was prevailing so far.

Nothing is more frequent than hype and depression in the financial system, and this is due to the ease with which speculative bubbles form: once the price of a given asset rises significantly for any reason, it goes on rising because stakeholders expect it to do so, and this expectation is self-fulfilling till it becomes impossible to keep the trend, and then the price plummets suddenly while stakeholders try to get rid of the asset as quickly as possible. This occurred with the tulip bulbs in 17th century Holland, it just has happened with housing in Spain and it occurred in between with many durables, among which internet company stock, and there is no reason to believe that this will not go on with other assets as long as humans have the opportunity of buying and selling them in free markets.

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In the case we are dealing with, greed and short-sightedness of financial business managers has logically been largely blamed for it, but in my opinion there has not been enough emphasis on the responsibility of regulators. Let us be plain: only the most extremist liberals believe in the self-regulating capacity of financial markets, i.e. in their ability to prevent greed and short-sightedness of finance managers from driving their institutions – and hence the whole economy – towards collapse. The rest of economists believed and still believe that financial markets need regulation, which has to consist of two things: protecting profitability of each financial institution and controlling inflation. These are two very different tasks but they share one point in common that can be summarised in that famous and fitting sentence said by one regulator: «Withdraw the alcohol when the party is getting fun.»

However, it is quite clear that Western financial regulators did not withdraw the alcohol when they had to. To describe the situation of financial markets over a decade ago, the then main regulator, Alan Greenspan, made the expression «irrational exuberance» famous. However, from the point he said this till his retirement as president of the Federal Reserve, the policy of this body did not halt market liquidity. In the meanwhile, in Spain and other real estate markets suffering from acute inflation, less knowledgeable observers were wondering how such prices could be maintained over a long period if they made it impossible for the middle class to buy any housing.

Why did regulators not intervene and «withdraw the alcohol» when the need to do so was as clear to them as to the layman? More specifically, why did financial regulators allow excess liquidity to stay in the market after the internet bubble burst?

The «deregulation» process made in the West in the 1980s and 1990s has sometimes been accused of being a cause of the lack of response of finance authorities. According to this view, regulators have been left without any tool to act while the bubble was growing. I think this argument is wrong as basic instruments of monetary policy were in place.

It is true that accounting legislation allowed banks to take some too risky assets from their balance sheet, and it is also true that they were able to securitise («package», as Anglo-Saxons say) and sell them to any third party as rating agencies assessed these assets in such an unprofessional way as so-called single-line insurance companies stood surety shortly after. It seems hard to challenge that at least in the US, banks, building societies, insurance companies and rating agencies acted with unheard carelessness, endangering their own assets and those of their customers (apart from the fact that affected assets were eventually those of the taxpayer). It is also true that the new accounting legislation, specifically the mark-to-market principle of asset assessment deepens imbalance and forces to sell assets when their price is falling, thus turning the decline of the market more acute.

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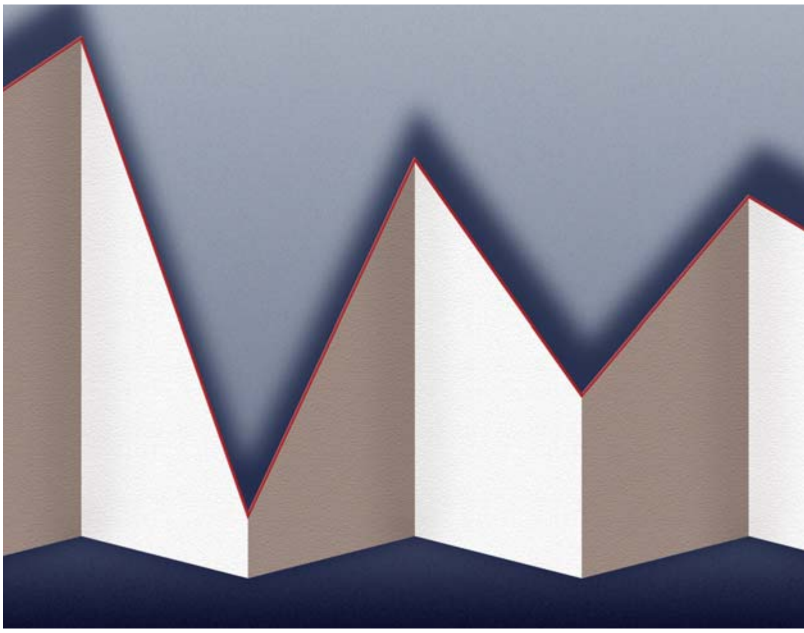
So in recent years, financial markets have been provided with accounting rules as well as agents and practices that eventually turned out to be lethal. However, the Spanish regulator, as seems commonly accepted, had no problems with asking for additional allocations to protect the assets of Spanish banks. Why did other regulators not do this? Why is it only now that the Securities and Exchange Commission (SEC) is acting against what has been called «market stalls» here, financial institutions managing pyramids, though it seems that reports challenging them were piling in their offices for years?

We will leave the answer to these questions for later. Let us talk about the second mission of a financial regulator.

Even if so-called «deregulation» had stopped the regulator from acting upon the practice of financial institutions, its second purpose would still be fully valid: preventing inflation.

Inflation measured in terms of consumer price or industrial price index has been moderate in the last decade, basically thanks to the new industrialised countries – particularly China regarding goods and India regarding services – that have provided products at a low price and immobilised an enormous mass of Western currency, especially US dollars. However,



▲ Accounting legislation allowed banks to take some too risky assets from their balance sheet and sell them to any third party by securitising them.

inflation measured in terms of asset value – stock, real estate, privatised infrastructure and similar – has been astronomical.

From a formal point of view, the mission of the regulator is to keep inflation measured in terms of consumer price index under control. However, common sense tells that inflation of the asset value also needs to be controlled. It is also known that when the monetary policy sets an indicator to measure its effects, the market immediately deactivates it. In my opinion, the consumer price index has been the latest manifestation of this principle.

From a monetarist perspective, we know that any inflation has a monetary origin. Hence the regulator had to know that behind asset price explosion was a lax monetary policy.

The biggest bubble was the real estate one, but the rest of assets have also followed this explosive development. Looking at the prices easiest to measure, i.e. stock, we will see that the Eurostoxx index doubled in value between early 2003 and late 2006, while the intervention rate of the European Central Bank (ECB) went from 3% to 2% and again up to 4%. In the same period, the Dow Jones index kept its level achieved after the 2003 rally (at a 25% increase), starting later another one that led to an additional 30% rise. In this period, the intervention rate went down from 5% to 4%.

As a consequence, even if the regulator had been unable to intervene in every financial institution's risk quality due to deregulation in the 1980s and 1990s, it always could have «withdrawn the alcohol» by simply applying a restrictive monetary policy in order to halt the inflation spiral in assets. It had the tools to do so but it did not act. Why?

Political imposition is to be disregarded. It is true that governments are barely inclined to cool down the economy when it is time to do so, but Western regulators are protected by strong statutes. Incompetence is also to be disregarded, as regulators have been generally selected from within people with a high intellectual reputation.

The only explanation left is that regulators knew that they had to take action but they were not self-confident enough to do so. The task of a regulator is ungrateful: when they intervene to halt a spiral they are cooling down the economy and frustrating a period of which many people, if not all, seemingly benefit, particularly very influential institutions – financial institutions in general and their colleagues in particular. In this case, as in any other, this consideration may have had its stake. But I think we would be ignoring an important item of the present crisis if we forgot that economic regulation has been under heavy fire over the last decades, and this must also have played a role.

Until the crisis in the 1970s, consensus in managing the economic cycle was so-called Keynesianism. According to this, the market tends towards imbalance, and monetary and taxation policy could – and thus has to – reduce depression and keep a permanently high employment level. In my opinion, Keynes' contribution is not this but the fact that under exceptional circumstances, financial markets can suffer a blockade as expectations are too pessimistic and need to be unblocked by means of strong and determined action: expansive monetary policy and public deficit. In any case, Keynesian doctrine was usurped by technocrats and trade unionists to discredit inflation control and fiscal balance in a situation that had nothing to do with the 1930s. The result was the inflation spiral of the 1960s and, particularly in Europe, survival of obsolete industrial structures under the protection of a public sector obsessed with controlling unemployment. The process ended with the perception that the West was on its way to a social and economic disaster that threatened to destroy the foundations not only of its welfare but even of its global preeminence. This view might seem exaggerated, but let us not forget that the depression of the 1970s coincided with defeat in Vietnam and the emergence of an OPEC hostile to the West, at least in part, and of Japan as a fearful industrial competitor.

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Ideological reaction came with an economic doctrine that is as ideologically neutral per se as Keynes' ideas had been: monetarism, which simply established that inflation always has a monetary origin. However, its ideological interpretation – among others by Milton Friedman himself – went beyond that: the free market is the best regulator of activity and the mission of monetary policy has to be exclusively the struggle against inflation (and thus non-neutralisation of the economic cycle).

Unfortunately, as occurred with the previous doctrine, this one has also been usurped by spurious interests – to be more precise, by those advocating tax reduction for the highest incomes and weakening regulation of speculative activities. Usurpation took place out of the «invisible hand» that took the market (once again) to the position of the best possible mechanism to allocate resources at both microeconomic and macroeconomic level. This sanctification of the market has been to the detriment of regulation: let us remember the success of Ronald Reagan's sentence: «The state is the problem, not the solution». Well, the state is, above all, regulation.

Where does legitimate defence of an economic management model – either Keynesian or liberal – end and where starts its illegitimate distortion? In my opinion, one of the cornerstones is tax deficit: the predatory character of such usurpation becomes apparent in that both cases coincide in ransacking collective property. Interested exploitation of Keynesianism had led to advocate tax deficit by expanding public expenditure, arguing that it would later lead to increase activity and thus tax revenue. Starting with Reagan, exploitation of monetarism has led to advocate tax deficit with the same argument as long as there is tax reduction at its origin.

In our case, the first symptoms of how bad management was did not take long to appear in the shape of general tax deficit in the West that went hand in hand with tax reductions (not in the case of Spain) and fraudulent practice (of which Enron was the first case and Bernard Madoff one of the last), taking place in a setting of discredited regulation.

Finally, due to the lack of formal alerts – inflation or exchange rate pressure – regulators were not feeling legitimated to take action because of discredit of interventionism and because dominant consensus stated that the market would finally be self-regulating. According to this analysis, the root of inactivity of the regulator and thus of the gravity of the crisis has not been instrumental but ideological.

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The party finished as all bubbles do: bad. But the fact that the regulator allowed it to last so long drove correction to an extreme that placed financial markets in a blockade as the one Keynes described in the 1930s: mistrust of financial institutions, pessimism about economic development and asset prices, «liquidity trap» and credit crunch for companies. The result is a decline in economic activity and pessimism as it had not been seen since the 1930s.

From an ideological point of view, the crisis will most likely do away with the reputation of liberalism in general and «neoliberalism» in particular. Western governments are now nationalising financial institutions and are trusted to save the economy from disaster by intervening in the financial system, entering the shareholder structure of financial institutions and spearheading their credit policy. Public deficit does not seem to be penalised in the European Union anymore – all this amidst applause of business leaders. One of them, based in Spain, summarised this change of attitude talking of the need of a «market moratorium». To entrepreneurs, the state is not the problem but the solution now.

The institutional crisis

Let us turn to the industrial crisis that broke out at the same time as the financial one.

The extraordinary industrialisation process in the East developed according to a system based on low saving and trade deficit in the

West compensated by high saving and specialisation on exports in the East. Specifically China has been the financial hinge of it. Meanwhile, the lax monetary policy and the subsequent inflation spiral of asset prices led some Western countries to specialise in building, a branch protected from international competition and turned an exceptionally lucrative activity. This specialisation was particularly strong in Spain.

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The burst of the financial bubble set an end to Spanish deficit financing and caused an abrupt fall in expectations on housing prices. This in turn caused demand to disappear and a building standstill. The price decline will become even stronger when delinquency of transactions done with speculative purposes and possible return of migrants provide the market with additional stock in vacant housing.

Even in countries not specialising in building, readjustment of the leveraging capacity of owners and pessimism, both as a consequence of the financial crisis, have led demand of durables to plummet, which affects production in both the West and especially the East.

To summarise, the industrial crisis has a lot to do with the financial bubble and its burst: the low-interest policy has exaggerated the leveraging capacity of property owners everywhere and led certain countries to unsustainable productive specialisation. Although durables markets will recover within reasonable time, it is clear that it will take years to absorb the excess of housing built in recent years and the scarce number being made during this period. In the short term, it will become impossible to prevent generalised high unemployment and declining living standard, which will be the stronger the more wrong productive specialisation is.

Spanish banks in their turn are doing their best to save their balance sheets, where mortgages to individuals and any sort of financing of real estate developers play a significant role. The most reasonable way for a bank to act is devoting its financial capacity to refinancing these assets in order to avoid delinquency and thus deterioration of their own balance sheet. Their very survival is at stake. However, this will only delay price adjustment and thus prolong the crisis. At the same time, this justifies the claim of the public for governmental action to stream credit into productive activity.

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Also, the crisis has exacerbated protectionist pressure against international competition all over, especially in the United States.

From an ideological point of view, the crisis is thus likely to do away with reluctance to government intervention in allocating resources among economic sectors: economic state control. It will take time to forget the picture of the Big Three bosses (the most important United States car makers) humbly asking Congress for funding and Barack Obama – an outstanding politician but after all a lawyer with no industrial experience – making statements on strategic lines these companies have to invest in.

The ideological consequences of the crisis

If the crisis blew up the intellectual reputation of liberalism regarding both macroeconomic balance and industrial management, the question is now which consensus will dominate post-crisis economic thought.

A reason for optimism is provided by our seeming ability to learn from our mistakes when their consequences are catastrophic:

- After the 1930s it was accepted that the neoclassical self-regulated market model worked very well in theory and could even be applied to the light industry but it could not afford default of a medium-sized financial institution, no matter how irresponsibly their managers may have acted and how bad its balance sheet may be. After seventy years and much talk about market omniscience, this lesson seemed forgotten to the point that Lehman Brothers was allowed to go bankrupt. However, as soon as it became clear that the consequence could be a default cascade, the attitude changed and all Western governments quickly made clear that they would not allow any more bankruptcy in finance.

- While the Western world collectively yielded to inflationary numbness during the 1960s, Germany kept inflation at bay because it had not forgotten the catastrophic effects of hyperinflation in the 1920s. After depression in the seventies, Western European monetary policy was based on the German model.

What lesson will we learn from this crisis? Certainly two: interest rates cannot be kept very low during a bullish phase even if inflation seems under control, and public authorities must not stop protecting financial institutions from incompetence and carelessness of their managers, even if supervisors are necessarily civil servants.

In an ideal world we might learn more things. Out of the mistakes made in the 1930s, in the 1960s and in the turn of the century, a wise balance between Keynesianism and monetarism (or social-democratic interventionism and liberalism, if you prefer political terminology) could emerge: market and fiscal balance in times of normality, restrictive monetary policy when asset prices rise, control over risk quality of financial institutions and Keynesian intervention only in case of market blockade – and keeping foreign markets always open.

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However, I have few doubts in human capacity to repeat the same mistakes. Even if every past crisis taught its lesson, it is also true that it led to create a paradigm that resulted fatal in the long term. It is difficult to think that inflation will be tolerated again, but once liberalism – or mistrust of intervention – has ideologically been blown up, the danger is now that Western governments surrender to corporative pressure of any kind. Such action would mean a higher public deficit than that justified to leave the crisis behind as well as protection of economic areas against foreign competition. This is unfortunately what happens when the state takes over economy.

The author had the occasion of practising industrial interventionism when it had not many intellectual advocates but was quite necessary (in the late 1980s and early 1990s). However, now that scruples have disappeared everywhere, I think it is important to say that economic progress is intimately linked to market freedom, interventionism has to be exceptional in its timely and physical scope and protection creates slow but steady weakness of what is supposed to be protected.

Hence I think that the intellectual economic community, apart from being humble, has now the duty to keep enough calm and warn of excess caused by the current economic intervention wave. The market is not omniscient and particularly the financial system needs to be controlled, but lack of competition leads to incompetence. The public sector needs to provide – either directly or indirectly – a set of commodities for welfare and for economic strength, and these commodities need to be funded with taxes. Finally, markets need to be open to international trade, even if emerging countries have different regulations and practices from ours.

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