March 2009 | Number 10

Economic Viewpoint

Notes by
Danny Leipziger*

Global Challenges and Popular Misconceptions

The current debate on the roles of markets, government and regulation is a necessary cathartic step as we move through the morass of financial collapse and worldwide recession. What is not terribly helpful in confronting the dual problems of faulty confidence and weak global demand are misconceptions. What is worse perhaps are omissions. Let's take a look at what pundits are saying, much of it valid, but some not so persuasive.

I begin with Prof. de Grauwe's assertion (FT, February 23, 2009) that the current crisis validates the European approach of less flexible markets. De Grauwe, a good friend, is dead wrong to equate "circuit-breakers", such as the inability to fire workers with superior economic outcomes. Job creation has been a motor of US economic growth for two decades and US demand (admittedly excessive due to inadequate savings) has been the main global driver. Without US dynamism and, yes, market flexibility, China's growth would have been significantly delayed. The preferable combination for labor markets, for instance, is job flexibility and strong safety net for individuals. Even in Europe, one sees better results in Denmark than in Spain as a consequence of labor market flexibility.

A second curious line of argument is that only two countries - - US and China - - matter for recovery. Overall, the announced stimulus packages are inadequate, so two alone cannot revive global demand. More poignantly, it was major imbalances in the US and China that went unchecked for years, big deficits in the US fueled by excess spending and big surpluses in China based on excessive savings and perhaps a deliberately weak exchange rate. Relying only on the US will not do the trick as American households will need to save to rebuild damaged asset balances.

Relying only on China will not do the trick either since Chinese consumers cannot absorb sufficient imports and government spending is not sufficiently conducive to imports. That's why we need Germany, Korea and other high saving nations to join the global stimulus program in a concerted fashion.

Now let's turn to omissions. In his lead piece, Martin Wolf (FT, March 9, 2009) never mentions the two words - - corporate governance – in diagnosing why the Greenspan-induced market euphoria failed. Who should control the high discount rate of Wall Street managers? Who should keep an eye on the risk profile of the balance sheet rather than short-term profits? It is the role of the Boards of corporations. Unfortunately, there is complicity, laxity and lack of enforcement in most boards. Complicity in board selection. Laxity in corporate oversight. And lack of power except in extreme cases where share prices fall and CEOs follow. If Glass – Steagall is to remain repealed, this needs to change.

Second, as Charles Calomiris (2009) points out, we need to look at the incentives facing regulators. Regulatory failures due to "arbitrage" or globalization of risks are one concern. Lack of proper enforcement of existing and enforceable regulations is another. And where all benefit in the short-term by turning a blind eye, we should follow Singaporean precepts of penalties. How were Canada and Spain able to avoid the worst aspects of this crisis? The answer is both smarter regulations and their enforcement.

Let's not dwell on the future of capitalism and ignore some basic checks and balances that allow markets to function in a healthy way. There is much to be done, now that we hear from Chairman Greenspan that the expected self-regulation didn't materialize.

*The views expressed here are personal and do not represent necessarily the position of either the World Bank Group or its Board of Executive Directors. Comments can be sent to *Dannyleipziger@gmail.com.*