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Economic Viewpoint

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Rebalancing Government and Market or the End of Capitalism As We Know It?

Many prominent commentators have been signing the capitalist Doomsday Book of date. This gloom is understandable since we have seen the worst financial meltdown since the Great Depression and as a consequence are entering the most coordinated recession in the post war period. What has shaken the financial pundits is the paradigm shift away from the primacy of the market in the U.S. as well as the inability of governments to halt the freefall in the global economy. But are we in such a profound course reversal that the system is irreparable? I think not, but there is a long list of things to do.

The fact that governments are paying the price for a lack of effective regulation with massive infusions of public monies is clear. For some, like the U.S. and the U.K., this reverses decades of deregulation and competition that provided globalization with much of its openness, creativity, and growth. After all, had all OECD followed the no growth policy of Japan, the low risk strategy of Germany or the statelist policies of France, the BRICs wouldn't be a term of discourse today. In many economies as diverse as China, Finland, or Spain, the interconnections between government and business have been tight. The alternative Anglo-American model proved superior for decades until extensive risk taking, either undetected or simply ignored, reached intolerable limits. Fee hungry deal- makers and credit agencies deserve particular scorn, but perhaps not as much as the set of ineffective regulators.

The socialization of risk model as practiced in varying forms in Japan, Korea and China can be contrasted to the crisis lifeline model of the U.S., for example, where once in a decade or so massive intervention occurs—for Chrysler, for banks via Brady Bonds, and for the Savings and Loans. Which model is preferable can be left to economic historians. What cannot wait, however, is a way out of the current morass.

The following steps would help turn the crisis into a manageable downturn and allow for future paradigm adjustments.

1.Get trade moving again. Excess reserve countries (who are losing value daily) need to provide trade credit finance through a consortium of central banks with government oversight to prevent liquidity hoarding or nonpayment. A special regulatory team, empowered to vote government shares in bank ownership and oust recalcitrants, is required to substitute for the lack of trust among economic agents.

2. A coordinated large fiscal package needs to be announced by those whose consumers matter and where debt levels are not yet excessive. Yes, global financial regulatory reform is needed, but the name of the game for 2009 is fiscal expansion.

3. A commitment is required from countries with massive trade surpluses that they will not keep undervalued exchange rates and should benefit from the relatively open world trading system. Without this, protectionism will become a likely reality, and Martin Wolf is right.

4. Governments that have rescued the private sector need to get their pound of flesh in the recovery. Given dramatically higher debt levels in the U.S., U.K and elsewhere, governments on behalf of tax payers need to recoup profits from their investment. This means a different mindset by the public sector and the rules of this recapture of public monies need to be determined now – in the depth of the crisis.

The rebalancing of markets and governments has been dramatic, but it is not necessarily irreversible. On smaller scales Chile owned its banks in the early 1980s, Korea owned major car companies like Kia that have since thrived, and the list goes on. Governments—particularly the U.S.—were too lax (to shut the party down) and markets too greedy (because the risks were underestimated). The net result is large, temporary government ownership in the U.S.—a massive one time socialization of liabilities. If this is to be reversed, the U.S. needs a radical reform of supervision, corporate governance, and a strong piece of the corporate recovery. The world economy needs to move away from the talk of Armageddon and get on with rebuilding confidence (beginning with trade flows), consumer demand, and contribution to global recovery from all those who have benefitted from the past decades of growth.

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