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Economic Viewpoint

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Changing Economic Paradigms: How Far to Go?

There seems to be an unanimous call for dramatic policy changes following on from the financial crisis, including calls for re-examination of the role of markets and the state, the reliance of national economies on international trade and finance, and the bearing of risk between economic agents and government as well as among taxpayers when things go wrong. Before we throw out the system that has served the world economy pretty well for many decades, it might be useful to separate out the arguments and examine exactly what has failed and why.

The fact that financial markets were under-regulated and that faulty risk assessments were to blame is commonly accepted. The notion that financial agents were either blissfully unaware of their risk exposures or simply willing to ride the wave because the profits were too appealing is reason enough to allow financial bankruptcies. The problem seems to be not only that the bailouts are of indeterminate size (viz., recent estimates indicate that the total assets at risk may be more than twice the approximately $3 trillion that the FED, FDIC, Treasury and others have put up), but also that the contamination is so pervasive that the recovery may well be stalled despite a large fiscal stimulus. The idea of good bank-bad bank separation a la Sweden sounds good, but the nature of the assets that were segregated at that time was quite different from today's complex structures.

All this leads to question whether the system—one that relies on markets to make risk-related decisions—can survive, especially since the taxpayers are picking up the tab. The costs of this crisis, adding in the eventual safety net and employment generation costs following the output and income losses, makes some wary that the status quo ante is a viable model. And what then is our advice for emerging market and poorer countries? With supposedly weaker institutions and governance that are considered less responsive to welfare needs, developing countries as a group have shown themselves to be more not less responsible in their economic management. Still, can markets be trusted is the question, and of course, what is the alternative? It should certainly not be state capitalism, despite some European pronouncements to that effect.

So where does this leave us? We need better regulation without a doubt. We need bailouts that preserve the upside potential for the taxpayer. We need greater internal equity so that the burden of adjustment doesn't fall so heavily on the lower and middle classes. We need penalties for the wrong-doers. But what we do not need is a reversal of the relatively open system of international trade and neither do we want controls on capital or other spanners to be thrust into the globalization framework that will rekindle economic nationalism. This is a tall order indeed.

Some speak of the need for a less triumphalist view of globalization. The issue up and until now was the inability of government to successfully tax some of the benefits of globalization in order to protect those who were negatively affected. Governments, such as the US, had the means to do so but chose to penalize the middle class—see the data showing that 95% of the American public lost real income since 2000, while the economy was booming. This can be remedied without abandoning the principles of open trade. This tenet needs an early re-affirmation so that developing countries don't get derailed in their export-oriented growth strategies.

Open capital accounts have always been controversial. As one who was always sympathetic to the additional reserve requirements imposed by Chile on short-term inflows (a tax that aimed to dissuade hot money and helped protect the country during the financial crises of 1994 and 1998), I can see merit in a smart policy, but not in a closed capital account. We do need more effective supervision and regulation with a feedback loop other than rating agencies into share prices. How else will equity-holders understand how much risk is really being taken? Now is a perfect time, in fact, for sovereign wealth funds and other surplus countries to invest heavily in the third world. The returns are there, but only if we can reassure markets that trade and finance will remain open. Strengthening regulation does not mean changing the paradigm, and the sooner that is clarified the better for all.

*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.*