VIEWPOINT

Redrawing

Rethinking the role of the state and markets

Roger Bootle

ECONOMISTS should be used to shocks. When the Berlin Wall fell, there was little on the stocks about how to make the transition from a totalitarian state with a centrally planned economy to a democratic society with a market economy. In the years that followed, a whole new aspect of the subject was developed—and many brilliant careers were forged.

A similar act of reinvention is needed now, in light of the current financial market turmoil. It is not that many people in the West—and, let's hope, not that many economists—will want a shift to central planning and extensive public ownership of businesses, but the boundaries between government and the markets are now back in the melting pot.

In a sense, we have been here before. But that makes this all the more disturbing. The events of the 1930s brought a revolution in economics—but not before they had ushered in a period of political revolution that led to untold human misery.

Lessons learned

It is impossible to give a summary of the lessons of the 1930s that will please everybody. But this is my attempt at a distillation. First, ***economies can get stuck in a state of depression*** from which individual actors, whether people or companies, can find no escape. The state is the only agent in society capable of working for the collective interest on a sufficient scale. Moreover, this is its duty—first to try to prevent a depression and then, if it occurs, to get us out of it.

Second, ***the financial markets are different***. Huge uncertainty and long time horizons make the markets subject to wild swings of sentiment and herd behavior. Because of the importance of the financial markets for real economic activity, they cannot be left to their own devices. They require intervention, management, regulation, and restriction.

Revolution and counterrevolution

This Keynesian view of the macrorelationships between markets and government broadly held sway in most Western countries throughout the postwar years until the 1980s. But then a counterrevolution overturned it. In the intellectual world, the driving force was Milton Friedman, who argued fervently that markets were rational and effective. Governments, by contrast, were inefficient and often irrational. What's more, they weren't even always acting in the public interest, as they could fall prey to corruption or be captured by group interests.

Perhaps the clearest expression of this change of view was Friedman's overturning of the Keynesian explanation for the Great Depression. The Keynesian view was that the Great Depression revealed a flaw in capitalism. The Depression derived from a collapse of the confidence of investors, interacting with the peculiarities of a monetary economy.

Friedman's explanation? Policy failure. The Federal Reserve made umpteen mistakes—most important, allowing the money supply to contract. Without this, there would have been only an ordinary slowdown, but not a depression, let alone the Great Depression.

Friedman's philosophy found practical implementation in the policies of U.S. President Ronald Reagan and British Prime Minister Margaret Thatcher, who seemed to reject just about all of the postwar settlement. Appropriate control of money, which was admitted as belonging to the public realm (although some free market vigilantes even questioned that), would provide macrostability; competition, deregulation, privatization, and low taxes would provide microefficiency.

From the perspective of the financial collapse of 2007–09, so many of the simple certainties of the free market fundamentalists now seem naive to the point of absurdity. Keynes may have been overplayed and subsequently revealed as a plaster saint. But it is surely now evident that the same was true of Friedman.

Getting Keynes right

What do recent events tell us about markets and the role of government? I believe they reaffirm the lessons drawn from the 1930s by the early Keynesians. Most important, they confirm that financial markets are different. They can be left alone only at our peril. Government policy needs to be directed toward preventing extremes in both directions and stabilizing the financial system and the economy.

the Boundaries

There is also a serious problem for capitalism in the behavior of corporate executives—something that has been well-known almost since the beginning of the capitalist system. The theory of capitalism is all about self-interested behavior delivering the common good. Yet, on the whole, companies are not run by their owners, but by employed managers, who have enormous day-to-day power. This is known in the literature as "the agency problem." In banking, although pay is not the root cause of the crisis, extraordinary levels and structures of remuneration have played a key supporting role—encouraging risk taking that destabilized the system.

Not bigger, but better, government

But this crisis has not been only a failure of the market system. Government failure has played a large part as well. After all, if you accept that government should have the responsibility of supporting the economic system to fend off depression, including by the use of massive fiscal expansion, then you would expect government to foster and preserve the power to do so.

Yet this means having access to massive fiscal resources. It is unsettling to see so many Western governments reluctant to provide such support on a massive scale because they are wary of reaching a point at which the markets fear a sovereign default. But the reason for this is governments' own past profligacy in borrowing so much and letting the debt-to-GDP ratio reach such high levels. Ironically, being prepared to exercise the state's vital role as the protector from depression requires that the state ordinarily minimize its need for money from the market and keep the debt-to-GDP ratio low. In nearly all Western countries, it has signally failed to do so.

Also, amid the demand for more regulation, let us acknowledge that the markets were in fact quite heavily regulated. It is just that they were badly regulated. The answer to the crisis is not more regulation, but better regulation.

What's more, it has been less a matter of microregulation and more a matter of macrosupervision. What went wrong was not the misregulation of a particular market but rather the mismanagement of the whole economy—the excessive reliance on credit; the tolerance for, and even embracing of, the housing bubble; and, in the case of several countries, including the United States, the United Kingdom, Spain, and much of Eastern Europe, excessive reliance on foreign funds that enabled those countries to run huge current account deficits.

But who should be responsible for such macromanagement? Not the private sector, surely. This is a failure of government—of treasuries and central banks—who deceived themselves, as well as others, and basked in the glory of an illusory prosperity, which was built on sand.

Don't fix what ain't broken

The supreme danger in all this now is that we will throw the baby out with the bathwater. Outside the world of finance, this crisis has not revealed any widespread failure of capitalism—although capitalism is in crisis as a result of it. For the most part, in Western economies, the ordinary business of producing goods and services and distributing them has proceeded well. The only lesson for that part of the economy from these events is the importance of the agency problem. Taming greedy executives and getting companies to behave in accordance with the interests of their shareholders, never mind society at large, is a serious challenge. Now that whole swaths of executives have been shown to be not just greedy but also incompetent, recent events will imperil popular support for capitalism itself.

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The great danger I fear is that feelings of disgust and disillusion after the events of 2007–09 will bring widespread disenchantment with markets in general, just when we need more of them to do what they are good at—incentivizing, signaling, and encouraging the best use of scarce resources, especially now in the fields of environmental protection, climate change, and road usage.

We do need to fix the financial markets, and that means, in a variety of ways, a bigger role for government. But we do not need bigger government. Nor, except in relation to the powers of corporate executives, do we need to fix the market economy in general. ■

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