

A Failure of Governance, Not Markets

By Philip Bowring

THE GLOBAL ECONOMIC CRISIS is not the consequence of the failure of market-based economics. But it is proof that any system requires a stable framework and set of rules. Indeed, Adam Smith, the prophet of the market system and coiner of the term “invisible hand,” was very clear about this. The market place can only deliver its benefits if laws and institutions provide an atmosphere of trust between economic actors and protection against monopolistic practices. Only then can free, competitive commerce thrive.

What we have been witnessing is not the collapse of free trade and the free flow of investment capital between nations but the breakdown of the financial framework caused by governance failures at both a national and international level.

At the national level, led by the United States, there was the development of a new range of financial instruments — stemming from derivatives — that undercut the institutions, primarily central banks, whose job it was to police the financial framework needed for day-to-day commerce. Derivative instruments are not themselves new. They have been a particularly useful part of commodity markets for 150 years. But their very recent introduction to credit markets magnified the impact of another development — the end of direct links between borrowers and lenders through the packaging of individual loans, particularly home mortgages, into asset-backed securities. This enabled banks to offer mortgages, and then offload the lending risk onto the buyers of the securities.

The failure was of the regulatory institutions in the US, notably the Federal Reserve, to appreciate how far these developments undercut their role in regulating the supply and cost of credit and the danger of transferring credit risk from the loan originator to many unconnected third parties. Some other countries, especially in Europe, followed the Fed’s bad lead. Worse still was that these instruments contravened the principles on

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which free markets are supposed to operate — transparency and open information. The result was that when credit defaults began to escalate, financial institutions were unsure of the solvency of counter-parties. The trust needed to operate a financial system was no long there.

Behind this explosion of credit and derivatives was a longer-term international factor: the breakdown of the post-World War II Bretton Woods system in 1971, when the US ended the convertibility of the dollar into gold and the associated system of generally fixed exchange rates between major currencies. The floating-rate regime operated tolerably well for many years, generally supported by responsible US monetary policies. The past decade or so, and particularly after the 2000 stock market slump, the US pursued very lax monetary policies with real interest rates at or close to zero.

As a result, US housing prices and consumption boomed and so did the US trade deficit. Other countries were, unwisely, willing to accept this situation because the dollar was the main reserve currency. Exporting nations were happy to sell anything to the profligate US consumer and accumulate dollars in return. Asia was the main destination for dollar reserves as China's manufacturing sector boomed, and other countries sought to build big foreign exchange reserves to prevent a repeat of the 1997-98 Asian financial crisis. Almost everyone knew this was unsustainable, but governments

were unwilling to accept short-term pain to restore balance, and the architecture of the financial system lacked a self-correcting mechanism.

The national and international imbalances were inextricably linked. Debt in the US, and some other countries, was allowed to swell dramatically, while dollar assets in the reserves of Asian and oil-exporting central banks grew enormously. Opaque new credit instruments facilitated the flow.

The consumption and credit boom in the US had its counterpart in the investment boom in China, enabling absurdly high rates of investment relative to gross domestic product, some of it flowing into wasteful projects and some into excess capacity in a wide range of industries such as metals and autos. It is thus no surprise now that China's economy is facing huge difficulties as US and other consumers belatedly reduce spending and begin to save while Chinese consumers have yet to acquire the buying power necessary to purchase many of the goods the new factories produce. Wages now account for only about 43 percent of China's GDP.

What we are seeing here is an economic cycle that has been taken to very dangerous extremes by an out-of-control financial framework. It may look as though open markets are at least partly to blame for exacerbating the crisis. Thus, for example, Asian currencies as diverse as the Korean won and Indonesian rupiah have fallen probably far

more than reality justifies because of panicky but ill-informed market players on the other side of the globe. These falls, in turn, unsettle both households and governments, stifling consumption and making governments unwilling to stimulate domestic demand in case low interest rates or rising current account deficits simply add to instability.

There is a theoretical case for short-term capital controls to limit de-stabilizing movements and focus capital on longer-term investment in enterprises. But controls themselves can create more fears than they relieve and are difficult to apply in the Internet age. The real problem is not open markets but the amount of footloose capital created by Wall Street with the connivance of the Fed.

Few or none of today's problems can be laid at the door of the increasingly free trade that the world has enjoyed over forty years, or at the movements of direct — and to a lesser extent, portfolio — investment that have been so important in industrializing Asia over this period. The level of commitment to market freedom may have varied from country to country, but in overall terms the merits of such freedom is accepted and should continue to be — unless Asia wants its development to stall, as has happened in much of Latin America, or to decline to the levels seen in the non-oil producing Middle East and Africa.

There is now a serious danger that the wrong lessons will be learned from the crisis and that protectionism or retreat from sound principles of free trade could result.

The right lessons are: 1) For central banks, especially in the major countries, to get a grip on monetary and credit policies and prevent the recurrence of instability created by excess liquidity; 2) For the international reserve system to be revised not just to reduce the role of the dollar — which will probably happen anyway as the US external deficit shrinks dramatically — but to engage more countries in it, perhaps through issues of special

drawing rights, or SDRs, by the International Monetary Fund; and 3) For smaller countries to set exchange-rate targets linked to major trading partners or informal regional arrangements.

In the short run there are of course other things that can and need to be done to mitigate a financial hangover caused by past excesses. One is to boost wages in countries that have had excess investment. Another is to increase currency-swap arrangements, and make longer-term loans to vulnerable middle-income countries with the potential to boost domestic demand. These are not anti-market measures, nor are they illustrations of market failure. They reflect the fact that the public sector is part of the market in all economies, and that extra efforts are now needed by governments to offset the damage caused by past failures to create a stable and sustainable monetary environment.

Like the Asian financial crisis, this is primarily a crisis of monetary mismanagement and credit bingeing. And just as Asia used trade as a means out of its crisis a decade ago, so the world needs to focus on keeping trade and capital flows open as it moves to stimulate demand.

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