Cutbacks must be made to the financial welfare state

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These are happy times for anti-globalists and other critics of the free market economy. Since the fall of the Berlin Wall the triumphal procession of Capitalism seemed for a long time to be unstoppable. However, during the last two years all over the world banks have been nationalised. State interventions in the economy are no longer taboo.

Trade protectionism is rearing its ugly head. It would seem that economic liberalism is dead and buried.

However, anyone who studies the root causes of the credit crisis knows that it started in a sector – the banking sector – which is uniquely protected by the public sector. The conscious or unconscious knowledge that responsibility for any losses or damage can be shifted on to the government has encouraged the taking of irresponsible risks.

In the end, tax payers have to pick up a colossal bill for the damage. The costs of the rescue operations and the consequences of the recession have seriously disrupted government finances. America and the United Kingdom have budget deficits which exceed 10% GBP. Monetary financing of the national debt – read: print new money – is no longer taboo in the English-speaking world. These are practices which, at the West's behest, most developing countries have actually abandoned during the past ten years! The badly needed and unavoidable reduction in public and private debt positions in large sections of the world economy will put long-term pressure on economic growth. It is not out of the question that the West, like Japan in the Nineties, will experience a 'lost decade' of very moderate economic growth. The financial and economic consequences of the crisis will be with us for a very long time.

A factor which is at least as serious as the direct economic damage is the harmful effect on public confidence in the market economy. In particular, the fact that ordinary tax payers have to pay a large portion of the bill for the excesses of the financial sector is leading to widespread indignation. Dutch bankers often maintain that this unpleasant situation has been primarily an

American and British affair. Although it is true that the most extreme forms of bonuses were awarded in the English-speaking world, very considerable bonuses have been paid in the Netherlands as well, only for the banks in question to end up in an anemic state. The detrimental effect on people's sense of justice is huge and may have very damaging consequences.

There is a real risk that the understandable feelings of unease among the population will turn into a general abhorrence of the market economy. Given that the banking sector is regarded as the bastion of capitalism, it is tempting to view the 'free market' as the main culprit. In my opinion this would be both dangerous and also undeserved. I am convinced that a general distrust of the market economy would not only take us further off track but would also be based on an incorrect analysis of the causes of the credit crisis. My view is that serious shortcomings in public policy have played a greater role than the failure of the free market in a general sense.

First of all, most economists agree that monetary policy during the past decade has been too accommodating. Keeping interest worldwide artificially low for too long has led to the creation of one *bubble* after the other, for example in the shares and housing market. In addition, abundant monetary growth encouraged banks to provide too many and too risky loans. Although the Basel ratios (the international capital adequacy standards) continued to look promising, the equity capital of many European and American banks dropped to between just 2 and 3% of the assets. A small decrease in the value of the assets was therefore all that was needed to cause a bank's equity capital to evaporate. Low interest rates also encouraged investors to turn to non-transparent, risky products in order to still achieve a reasonable return.

On top of this, a lot of countries pursued imprudent budget policies. America started lowering taxes despite being engaged in a hugely expensive war in Iraq. A lot of European countries ignored the Stability Pact. They failed to build up reserves during the good times. A large part of the world had used up all its Keynesian ammunition before the credit crisis had even started.

The consequence of the lack of prudence as regards macro-economic policy was that, in large areas of the industrialised world, the private and public sector jointly started to accumulate untenable debt positions. America's total burden of debt grew to 350% GBP, a level which was historically unprecedented. This house of cards was bound to collapse sooner or later. In hindsight it is unbelievable that so few economists saw it coming. Relatively simple indications of indebtedness of economy and the financial sector showed very clear signs of huge imbalances.

Thirdly, we should realise that the epicentre of the crisis - the financial sector - has not been a truly free market since the Great Depression of the Thirties. Governments and central banks are always on hand to support the financial sector in order to limit the systematic risk of collapsing banks as much as possible. The implicit guarantee of such a large safety net under the financial sector is to a great extent unavoidable but it does affect the way the free market's sense of discipline. In effect, therefore, the banking sector is a kind of welfare state within the market economy.

The problem is that protection can lead to abuse. We know from our experience with social security that a welfare state needs to be strictly supervised to prevent abuse. The more effectively unemployment is protected by high benefits, the greater the danger of people not finding new jobs quickly enough. It is therefore essential to supervise strictly that the unemployed are looking actively for a new job.

Protection of the financial sector can also encourage undesirable behaviour. The knowledge that, in emergencies, the central banks are willing - in the words of Fed chairman Bernanke - to fly around in helicopters dropping money has undoubtedly encouraged bankers to take greater risks.

Unfortunately, the prevailing supervision doctrine, particularly in the United States, was that the financial market had to be treated like a normal market wherever possible. A deliberate decision was taken not to supervise the American mortgage market and risky products like credit derivatives. Where supervision did take place, the criteria were insufficiently strict to prevent banks becoming undercapitalised. In addition to ideological blindness, supervision competition also played a role. Policymakers and supervisors often felt obliged to relax rules because they were afraid that financial institutions would relocate to a different country. Competition between financial markets degenerated into a *race to the bottom*.

Without wanting to detract from the responsibility of the market participants themselves, it is therefore clear that public policy shortcomings exacerbated the credit crisis. As Adair Turner - the chair of the British regulator the FSA Financial Services Authority - bluntly admitted:

"(…) Financial authorities in total –finance ministries, central banks and regulators, including the FSA itself, must have made what in retrospect were serious mistakes." This frank acknowledgement of errors made is, incidentally, a lot more convincing than the many half-baked 'sorries' that we have heard in recent times. This observation leads irrevocably to the conclusion that changes in public policy are needed in order to come out of the financial crisis in a healthy state. Confidence needs to be restored in macro-economic policy. The risk of the banking sector again being able to shift responsibility for losses on to general taxpayers has to be limited wherever possible, not only to avoid a new credit crisis but also to restore people's sense of justice.

First of all, a change of tack is required as soon as possible in the direction of a stable macro-economic policy. If the crisis has been exacerbated by a policy which was too expansionist, it is obvious that the purse strings need to be tightened as soon as is it is prudent to do so. During the past two years, numerous emergency measures have been taken in response to the crisis. That was understandable given the dramatic collapse of private demand and the danger of a deflatory spiral. However, the risks are considerable. The danger associated with continuing to pursue an expansionist policy is that *bubbles* or inflation will reappear. The first signs of such are already visible In China.

It is also clear that supervision of the financial sector has to be become a lot more stringent. Cutbacks must be made to the financial welfare state so that, wherever possible, banks take responsibility themselves for any mistakes they make. A lot is already being done in this field. The Basel Committee recently tightened up the capital adequacy standards for the banking sector.

Besides the supervision of individual banks, there is also going to be more stringent supervision of systematic risks. Large portions of the obscure over-the-counter derivatives market will be made transparent. Credit derivatives will be standardised as much as possible and made subject to an adequate processing infrastructure. Complex financial products will have to fulfil stricter transparency requirements. Credit rating agencies are also going to be supervised. In a lot of countries principles are being developed to which the banks' bonuses policies will have to comply in order to bring an end to unacceptable bonus practices. Progress is being made, therefore.

At the same time the road to economic recovery is strewn with obstacles. For example, there is currently no clear global economic leadership. At the moment, Asia is the only part of the world which exhibits any considerable degree of resilience.

Following the Asia crisis of 1997, a lot of Asian countries reorganised their banking sectors and state finances and are now reaping the fruits of the measures they took. (However, it is a shame that the West itself did not learn anything itself from the lessons the IMF taught Asian countries at that time). However Asia is a politically fragmented continent and it is only slowly becoming more assertive in international economic fora.

The image of America as the economic guru has been seriously damaged. In China the American finance minister recently had to explain repeatedly why America is still a safe country to invest in, despite the phenomenal budget deficit. For the time being the dollar will continue to be the most important reserve currency, but its role will become less prominent.

Neither is President Obama's plan to tackle the structure of supervision in the US oozing with ambition. There are not going to be any major changes to the overpopulated - but inadequate - American supervisory landscape. Congress – which is strongly influenced by the financial sector - is more likely to water down the plans rather than make them more rigorous. The question is, therefore, whether President Obama will get sufficient support for improved protection of financial consumers through the setting up of a separate consumer financial protection agency. The United States cannot be expected to come up with any daring plans to reinforce the international financial architecture (a new Bretton Woods).

Many in Europe appear to be taking some satisfaction out of America having to assume a more modest role. However, as far as I am concerned, there is no time for gloating, certainly not while Europe still has its hands full trying to cope with its own problems. According to the IMF, Europe is still lagging behind the Americans as regards reorganising its banking sector. It is also true that the American economy is still a lot more flexible than the European economy and will probably come out of this economic downturn sooner. Whatever happens, good cooperation with the United States will be essential in order to survive this global crisis.

The European Union will have to demonstrate greater leadership. First and foremost, Europe will have to arm itself more explicitly against a new wave of supervision competition. In the past, the European Union has often given in to the tendency to relax regulations in the English-speaking world for reasons of competition. Once again, banks have started claiming that they can only tighten the rules if the same is done on a global scale. One promising sign is that the British regulator is now openly questioning whether the United Kingdom can still join in with this rat race. It is also true that countries such as Canada and a number of Asian countries which continued to impose stringent capital demands on their banks are now in better shape. Thanks to the experience with the credit crisis, investors and consumer can be expected to make doubly sure that proper protection measures are in place. Therefore, strict supervision can in fact reinforce the competitive position of a financial sector in the long term, even if the rest of the world is engaged in a race to the bottom!

Europe ought, therefore, to opt to become a bastion of financial stability which properly protects the interests of investors and financial consumers. A region in which governments have their finances in order, a stable monetary policy is pursued and the financial sector is subject to strict supervision.

The European Union has a fantastic basis for making this financial stability objective a success. Firstly, the European Central Bank is the most independent central bank in the world which, during its short life, has already built up a sound reputation. Secondly, the stability pact provides excellent rules for pursuing a stable budget policy. Thirdly, the European Commission recently issued a number of excellent proposals for initiating European supervision of the financial sector. If we tackle this in the right way, we can end supervision competition in Europe.

At the same time it is clear that the road to regaining confidence is littered with all kinds of obstacles. In a period of moderate economic growth and a disillusioned population, a lot of political persuasion will be required before painful measures can be implemented. Due consideration will have to be given to the damage done to peoples' sense of justice without lapsing into economic populism.

It would be tragic if we were to sink into a climate in which the free market system was labelled the root of all evil. After all, the problem with this crisis was not the free market in itself, but the fact that naive free-market thinking was applied to a sector in which market discipline was severely lacking. In the months and years ahead, the dynamism of the free market system will, in fact has to play a vital role. Although almost all economists appear to have reconverted to Keynes, the end of macro-economic spending policy again seems to be in sight. In the next few years, governments will scarcely have any resources with which to boost the economy. The aim, therefore, must be to make optimal use of the entrepreneurial spirit and innovation which the free market system can generate.

At the same time, politicians, policymakers and supervisory bodies will have to set clear rules for those parts of the market economy that rely on public guarantees. We must allow the market to function optimally, but the financial welfare state cannot be anything else than a strictly regulated market. The financial welfare state has been far too generous and it needs to be cut back to size as soon as possible