

Clashing ideologies behind the global financial crisis

Ross Gittins

March 16, 2009 - 12:01AM

Let me let you into a little secret that will help you make more sense of the never-ending debate over the global financial crisis, what caused it and what should be done about it.

As all the professional participants in these debates well understand but rarely, if ever, acknowledge, whatever theory or empirical evidence they quote, the position they take gets back to their "priors" - their previously formed beliefs and values.

On the face of it, what's being argued over is people's beliefs about markets - whether the market can be trusted to get things right, to allocate resources efficiently and to manage itself, or whether the market will always get things wrong, having been manipulated and exploited by the rich and powerful.

At the intellectual level it's an argument about whether "market failure" - failure to act in the self-correcting way described in neo-classical economics textbooks - is, in practice, a big problem or a fairly minor one. At one extreme you have people with quite naive faith in markets; at the other you have people who seem utterly unaware that markets have any dynamism about them, that when problems arise markets respond to them.

But it's probably more enlightening to see the dispute as being not about the properties of markets so much as about the proper role of government.

The popular interpretation of the global financial crisis is that, in a situation where financial markets in the United States and elsewhere were

largely unregulated, a lot of Wall Street bankers and other fat cats got carried away by their own greed and eventually brought the whole system down on their heads, causing great pain to millions of innocent bystanders.

The obvious answer, it follows, is for governments to leap in and start regulating everything so the fat cats are kept on a leash and ordinary people get a fair shake.

But if you listen to people such as Professor John Taylor, of Stanford University, you find they have a radically different interpretation of the causes of the crisis. The problem lay not with the unregulated financial markets, but with misguided government intervention in those markets.

Alan Greenspan, for instance, held interest rates too low for too long, thus distorting the prices to which the market responded. The US Government was actually encouraging banks to lend to sub-prime borrowers, not to mention spending far more than it raised in taxes and thus running protracted budget deficits.

We could debate the merits of those particular arguments - there's merit in many of them - but that would miss the point. Like many on the right of politics, Taylor is interpreting whatever happens in a way that fits his priors: his deeply held conviction that markets never get it wrong, but governments always do.

I think it was Ronald Reagan who said "government is always the problem, never the solution".

Some people who think that way have grave doubts about whether governments should be stepping into the market to rescue failing banks, let alone - God forbid - nationalising them.

And people with an anti-government view have doubts about whether governments should use their budgets to attempt to stimulate economic activity during recessions. They believe government attempts to "manage" the macro economy are futile at best (because of fancy theories such as "rational expectations" and "Ricardian equivalence") and counterproductive at worst.

(Of course, they're also mindful of the fact that the US already has a net public sector debt far exceeding 40 per cent of GDP, a constraint that doesn't apply to us.)

People who think governments almost always get it wrong also tend to believe governments do far too much already and make us pay far more tax than we should.

One of the things governments do is redistribute income from the better-off to the less well-off by making higher income-earners pay higher rates of income tax and by using means tests to exclude the better-off from receiving government benefits.

All this, I suspect, helps explain why we inherited from the US a debate about the stimulatory effectiveness of one-off cash bonuses versus a "permanent" tax cut, complete with an appeal to Milton Friedman's "permanent income hypothesis".

The anti-government types' attitude would be, if you must do something, then cut my taxes. They'd see this as returning to them money they shouldn't have had to pay in the first place, and returning a sum proportionate to what they'd had to pay. The trouble with cash bonuses is that they're redistributive - low income-earners get back proportionately more than they paid, whereas high income-earners get back proportionately less.

I don't want to imply that Taylor shares the more extreme beliefs I've described. He is respected among economists as the inventor of the Taylor Rule - a formula central banks may use to decide when to raise or lower interest rates.

But this reminds us of a long-running dispute among economists that rests as much on priors as on evidence: whether central banks should be allowed to exercise their discretion in setting interest rates or whether they should be bound to follow a pre-determined rule (such as a target for the growth of the money supply).

See the connection? Those who distrust governments want to tie their hands to rules.

Where do I stand in this debate? Somewhere in the uncomfortable, no-simple-certainties middle.

I have great respect for the power of market forces and the constraints they impose on the rich and powerful, not just ordinary punters. But I also believe markets are perfectly capable of getting it wrong, with or without bum steers from regulators.

I'm happy to blame regulators for the global financial crisis, not because their interventions let the market astray, but because they should have had the experience and good sense to protect the market from its own folly. The proof that sensible regulation could have kept the banking system out of serious trouble is right here in Australia. We kept our banks under a tight rein; they hated it, but now they're laughing.

I believe governments can and should manage their macro economies. In doing so they need to exercise discretion, not blindly follow mechanical rules.

I believe governments can and do achieve more good than harm with their activities. I'd like to see them do more redistribution of income, not less.

There's little doubt we're entering a new era of reregulation and government activism. But I share the anti-government types' fear that we could overreact and go too far in the opposite direction. Intervention is a tricky business.

Ross Gittins is the Herald's Economics Editor.

This story was found at: <http://business.smh.com.au/business/clashing-ideologies-behind-the-global-financial-crisis-20090315-8ywj.html>