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Reforms signal end of 'free market' era in U.S. and around the world

By Patriot-News Op-Ed
July 04, 2009, 4:47PM

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The U.S. stock market the summer of 2007 during the "boom times."

The 1980s marked the golden era of free markets.

Under President Ronald Reagan and Britain's Prime Minister Margaret Thatcher, the gospel of deregulation, limited government and the primacy of the private sector took firm root in the United States and U.K., before spreading inexorably worldwide.

Developing countries threw off decades of shackles of government intervention and some, such as China and India, were rewarded by years of sustained economic growth. The Clinton era did nothing to stop the juggernaut.

The Washington consensus of the 1990s became the unofficial doctrine of the International Monetary Fund and the World Bank, leading to waves of privatization of state-owned industries and liberalization of trade and capital flows around the developing world.

Governments were asked to become more prudent. Budget deficits, which required governments to borrow, were frowned upon, as was rapid money growth, which tended to fuel inflation.

But the Washington consensus was not universally loved. Referred to derisively as neo-liberalism in some quarters, the doctrine was seen as being inimical to the interests of the poor and welfare of workers, both in developed and developing countries.

A motley group of labor unions, environmentalists and student activists, bound by a deep distrust of the consensus and globalization (both were regarded as philosophically equivalent), began picketing meetings of the World Bank, the IMF and World Trade Organization, and, in fact, almost any meeting of developed countries (such as the G8). Occasionally these protests turned violent, and in almost all cases, engendered vast publicity for their cause.

The free-market citadel might have survived this onslaught, but for a few events that underscored the perils of excessive reliance on the private sector.

The Asian financial crisis of 1997, the Russian debt default in 1998, Argentina's implosion in the early 2000s -- all caused governments worldwide to rethink the virtues of unbridled capitalism.

In the U.S., the crash of the dot-com bubble and the accounting scandals involving Enron and WorldCom also had a similarly sobering effect.

And now, with the decimation of the housing market, the collapse of the titans of finance and the emergence of a global recession, doubts about the efficacy of the capitalist enterprise have become markedly more pronounced. Insufficient financial regulation, we see now, played a significant role in the rise of the subprime lending market and the accretion of excessive risk by commercial banks, investment banks and insurance companies. The rise in housing prices that followed proved to be unsustainable, and with the collapse of the housing bubble, the economy has gone into a recession.

The recession began in December 2007. For the last several months, the news has been increasingly grim: rising unemployment, layoffs by the tens of thousands by large companies, falling output and incomes. Other countries are in the same boat. The European Union and Japan are suffering greatly, and though China and India are still growing at a decent clip, their growth rates have come down.

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And the policy response to these economic trials and tribulations? A heavy dose of government spending -- and increased oversight of financial markets.

Governments worldwide, including the U.S. and U.K., have crafted policy packages that include increased expenditure on infrastructure (roads, highways, the Amtrak station in Elizabethtown) and bigger outlays on social spending (unemployment benefits, welfare payments).

In the short run this will lead to larger budget deficits -- the U.S. deficit is expected to be more than 13 percent of GDP in 2009, an astonishing figure.

But in the absence of such government measures, the recession is likely to become far worse, as consumers and firms, anxious about prospects in the near term, will reduce spending on goods and services.

The increased regulation of financial institutions also marks a departure from the free-wheeling era that began in earnest in the 1980s.

A well-functioning financial sector is critical to the operation of a modern capitalist economy, matching savers with investors and allocating credit to finance innovation, entrepreneurship and economic activity.

But, as recent experience has shown us, this industry cannot be left entirely to the mercy of the private sector.

While government supervision might impose costs, a lack of regulation can lead to traumatic outcomes.