News and Views from the Dismal Science

Dr. Econ's commentary on global economic and other affairs

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Financial Storms

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A good bit of Wall Street crashed this year, especially this month, and more turmoil may yet come our way. Politicians are scrambling to get a piece of the action — and therein lies the rub. First they, and their voters!, ushered in a prolonged period of market liberalization, and now they, and their voters!, cry for market regulation. The pendulum swings back.

When economists — who are not known for clarity of speech — speak of free markets, what they really mean to say is well-regulated markets rather than unregulated, or unfettered, markets. Every game needs rules. Rules determine the permissible strategies and hence the behavior players engage in. Strategy and behavior in turn determine the outcome for those who play. But the looser the rules, the wilder the game, and people can get hurt. Before long, a game can disintegrate into a free-for-all brawl, and what was to be a game disintegrates into a fight.

People will need to decide just what sort of game they want. Too few rules, or rules too unclear, and the game becomes anything but. Too many rules, or rules too strict, and the game becomes stifled. Similarly for the market. It's just a question of whether they are more or less regulated, not whether they are "free" or "unfettered."

The next question then is, just what amount and degree of regulation is appropriate? The answer depends on the particular market being examined. The market for chewing gum needs less overt regulation than the market for real food stuffs. An example is given by the current mess in China surrounding the production of (tainted) milk. Another example is given by transportation such as private motor vehicles, public transport, and airplanes. When health and safety are directly at stake, regulations — and monitoring and enforcement — ought to be fairly strong. Likewise, when people's major assets are at stake, as in the case of real estate and retirement markets, regulation ought to be fairly strong. When highly integrated world markets are at stake, so that failure in one country's market can spill over and drastically affect people in other countries, it is obvious that the world as a whole needs to regulate markets such that contagion effects can quickly be isolated and contained.

One needs to permit markets' upside of course but guard on the downside, especially the more systemic the risk potential is. Systemic means that if a single individual is affected, that's bad enough, but when millions or hundreds of millions of people are affected, and the risk can bring down an entire economic system, failsafe guards need to be build into the system, whatever the loss on the upside. When the economy sputters, so usually does the political system as well, and the entire engine of the way we govern ourselves seizes up. The engine can be awfully hard to fix and to restart. Meanwhile, much unnecessary damage has been caused.

I inserted an important couple of words in the preceding text: monitoring and enforcement. Even when the rules are perfectly adequate, but no one is watching, or if someone is watching but not enforcing, the game again can fail to please. Along with *The Economist* magazine, I argued some years ago that the U.S. Federal Reserve Bank under Mr. Greenspan's leadership failed to watch out properly. Too much of a bet was placed on ever rising markets, first the U.S. stock market and then, after it burst in the early 2000s, the real-estate market which has bursted just now. Mr. Greenspan has argued that the Fed has no special knowledge to permit it to "prick" asset bubbles as they develop. He argued that the Fed should simply assess the risk and prepare accordingly to intervene if and when and as necessary.

That is a good traditional argument. Economists have learned that no one is smart enough to outsmart the markets. On the other hand, what if — as has happened now — the risk builds up to such a degree that virtually no known intervention can stave off disaster? It's like a hurricane: let the markets build up to category 3, and we know that if they crash on shore, we can still handle the mess. But if they build up to category 4 or 5, we know that we really can't deal with the aftermath. The solution is either to build higher dikes or to slow down the financial hurricane as it builds up beyond what we know we can handle. Building higher dikes is the equivalent of having more sophisticated economic knowledge than economists currently possess. Over time, we might learn to deal with ever greater systemic risks — build ever higher dikes — but meanwhile the only responsible thing to do is to slow down the financial hurricanes which, unlike real hurricanes, we actually do know how to do. That this was not done in time, I see as the failure of the regulators, particularly the Fed under Mr. Greenspan.

Unfortunately, politicians are not going to make things any better at all. They are merely liable to slow down the hurricane to a leisurely evening breeze, that is, to overly regulate the markets. Markets do need a bit of turbulence. Slowing them down to a crawl also will bring the economy — people's livelihoods — to its knees.

In a word, no pleasant choices are ahead. Here's hoping that a deal will be struck sooner rather than later in Washington, D.C., and that the Treasury and Fed win the battle. And also that, after the boat rights itself from the gale forces, future hurricanes will not be permitted to build themselves up so dramatically.

Jurgen Brauer's latest book, co-authored with Hubert van Tuyll is *Castles, Battles & Bombs: How Economics Explains Military History* (Chicago, IL: The University of Chicago Press, 2008).

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