



Markets in crisis

Balancing markets and government regulation

COMM 5

The heads of financial institutions didn't even know what toxic assets were on their own books let alone anyone else's. At the same time a lack of checks on financial markets had been allowed to develop by a laissez-faire culture that had become dominant since the 1980s – a culture that had little time for Adam Smith's view that markets could not be free-standing. The post-Second World War consensus on the need for a balance between markets and government regulation had broken down.

SEN

Reagan started that, very much it has continued in the Clinton era. Some of the major deregulations of particularly insurance industry occurred in the modification that the Clinton era legislation provided. All these became deregulated. There was no need for that. The economies with the mixture of government regulation and the market were doing much better than they're doing now. So I think the crisis was generated by a kind of confusion about what is it that provides a stable progress using the market but at the same time relying on many other institutions. It was a very costly mistake.

BRONWYN CURTIS

What we saw was this huge credit crunch. And some banks got into trouble quite quickly. Bear Stearns was allowed to go bust by the US government. Then and even more worrying was that Lehman Brothers was allowed to go bust. Now the problem with that was they were actually too big to fail and they were central among all the banking community; they weren't the only one but they were so big that lots of people had contracts with Lehman Brothers. You let them go bust, what happens to those contracts?

So what happened? Well, you found that some of the intermediaries start to get into trouble and you suddenly saw the fear. I think this is important. It's that once it starts to unravel the fear picks up in the market. Everyone heads for the door at the same time.

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Economists were reminded of something that those who remembered the 1930s depression had all known: markets are unstable, and can be driven by contagious fear as well as unfounded optimism. Economists were also reminded, as governments refinanced and part-nationalised the financial sector, of the need for government itself.

It was not only the crisis in the banking sector that was raising questions about the limitations of markets. Since the 1980s and 1990s, both the ex-communist countries of the Soviet block and China had enthusiastically embraced unfettered markets as they moved away from an economic system based on central planning.

SEN

Somehow the lesson learned was that, for the people who were making the decision, that the market can do fine thank you very much we don't need any other support. The total copybook case of that with what not to do is China. Up to '79 they ignored markets altogether. The industries were in a bit of a mess, agriculture in a total mess, and the communes there has been never a system devised which are less productive on agriculture than communal agriculture. Now they abandoned them all in 1979 and that worked brilliantly well for agriculture, pretty well for industry with slightly mixed record but pretty well generally, but in health care – disaster. You see the Chinese thought, so the market is so good it works very well in health care too. So they abolished universal social insurance provided either by the

communes in agriculture, within the rural economy or by the state in other parts of the country. The Chinese abolished that and suddenly from after '79 you had to buy your own insurance with your own earned money and, except for a small group of people for whom, high civil servants and some business firms, everybody else had to do it, and the result was it precipitated slowing down of China's progress in health care. Earlier on they will have none of the market, and after that they will have nothing other than the market and I think what was missed out is the basic Smithian notion that you need a mixture. You need many institutions, market is an extremely important institution for god's sake don't neglect it, but it needs the support of other institutions and it definitely needs supplementation.