In the Eye of the Storm – The Myth and Paradox of the Deregulated Free Market and The Moral Hazard of Government Intervention

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The recent crises and their rippling nuclear effects are far from over. If anything, the global governmental bailouts of the banking and insurance industries, the overnight mergers and acquisitions, the unprecedented governmental financial guarantees, etc., so far have only acted like tourniquets, momentarily slowed the haemorrhaging. Once revered and indestructible financial and industrial titans are teetering on the verge of collapse.

Over the last eighteen months in particular, the cracks and tremors started proliferating rapidly on both sides of the Atlantic, followed by elsewhere around the world. Like dominoes, investment banks, commercial banks and financial institutions folded and fell one after the other. With the globalization and interconnection of the various national economies, the problem quickly spread like a virus (viralization) and contaminated banks and financial institutions worldwide. The once unimaginable had suddenly become reality. Wall Street has gone from bullish to sheepish, and a number of its giants are falling like autumn leaves. Companies, that were once considered too big to fail collapsed, overnight, and the list reads like an extensive and impressive obituary. Panic infested Wall Street, spread throughout Main Street, gripped Sweat Street, and metastasized around the world. Locally, nationally and internationally, the pandemic wiped out trust and confidence between institutions and their clients.

Before the mayhem started to unfold, there were numerous indicators that things were going bad, but governments, afraid of dramatizing the situation, delusionally avoided and refused to admit that the skeletal structure of the global economy was under attack and being infected - "Osteoporosis" if not "recession", had struck. There was no shortage of denial, explanation and spin.

In the heyday of financial glory when firms were aggressively competing to outvalue each other, and shareholders reaped huge profits, investors complained that the setbacks they faced in increasing their capital gains were due to the "excessive regulation" in the economy. Government was conveniently seen as the problem, blamed for obstructing the system, and lobbyists touted little or no regulation, and no governmental control as the perfect solution. Supported by numerous success stories, they hyped the virtues of the high performing low-regulated sectors, and urged governments to quickly "free up" the more regulated ones. They argued that a free-for-all and "laissez-faire" approach was best, would lead to the highest market returns, and should be the cornerstone of all aspects of the economy.

Many investors, and governments to some extent, share the belief that the free market is really free, and that its 'invisible hand' is the perfect ortho-regulator of all ills in the economy. Governments were thus logically prudent if not hesitant, in responding to the crisis. As the situation spiralled into extensive dismay and disarray, and the meltdown accelerated, governments and their intervention suddenly became the solution. Private capital, having suffered colossal losses when their market value dissipated, was no longer rushing in to maintain the system, but praying for a miracle recovery, and hoping that government would step up to the plate. Ironically, it was these very markets that were now clamouring that the long 'resented and despised' governments are the only ones who could provide the much needed bailout and effectively inject new liquidity into the blocked-up system to get it working again.

The investment community is not the only one to be blamed for the crisis, and few would disagree that Reaganonmics helped paved the way for the current financial landscape with its abundant deregulation policies. By succumbing to the pressure of lobbies to not enact legislation and regulation on the one hand, and by encouraging firms and individuals to accept more debt as a means of boosting homeownership on the other, governments have also contributed to the situation. Market self-regulation was very limited, did not work in this context, and the trust and confidence that are so vital to ensure the functioning of the system vanished into extinction. As governments scramble to come up with a fix, the Europeans are primarily pushing for major new legislation. So far, governments worldwide have responded with a combination of desperate measures that ranged from coordinated cuts in trans-Atlantic interest rates, lending and savings guarantees, capital infusion, cancellation and blocking of CEOs' golden parachutes, etc., but have yet to tackle the root causes of the disaster.

However, resolving the crisis, turning the global economies around and getting it back on sound footing, requires more than just regulation. It requires a plan for containing and resolving the current bad debt, and for anticipating and preventing future crises, while allowing the market economy to exist and flourish in a globalized world of business. What is needed is not just a cocktail of a new injection of cash and liquidity and some new appropriate and articulated (integrated) regulation, but also more control and enforcement, and a new set of societal and market values. Ultimately, this may mean that everyone will have to contribute to the restoration effort, and some more than others. Those who have always been victims of the system will oppose any attempt to aggravate their situation.

Governments' challenge therefore is to come up with a suitable fix and appropriate regulation that will foster but not impede the market, knowing fully well that some individuals will always figure out and invent ways to circumvent and beat the system. Their dilemma, as witnessed in the recent G20 meeting, is multi-dimensional:- they need to use regulation as the only effective mechanism for re-establishing trust and confidence among actors, while at the same time providing the necessary safeguards for the economy and citizens; they need to implement new regulation to close the loopholes and control the excesses in the system, but they also need to be wary of the effects of over regulating, while ensuring that the new regulation must not be too complex that it would facilitate the creation of new and more sophisticated deviations and derivations. Governments need to find the right dose and combination of regulation without overdosing it.

"Ignoring A and hoping for B only to be forced to respond to A"

Ironically, governments are now being forced to do what they previously refused to do, in order to prevent a repeat performance.

In the future, they will not hesitate to scuttle (abandon) and supersede their free market principles and respond more promptly to early warnings in order to prevent a cascade and widespread economic devastation.

Paradoxically, having adopted a "laissez-faire" approach to free market financial capitalism, governments are today being forced into an "interventionist" nationalized market environment where financial capitalism risks becoming state dependent. This would only result in a new predicament for free market economy governments.

Intervening in this crisis, governments now find themselves on a slippery slope back to the past as lobbyists, once again, have naturally started extensive campaigning for a 'no-strings attached' bailout, which would, in effect, result not in a bailout, but rather a government 'buyout' of corporate bad debt, and tax payers and future generations will end up picking up the tab.

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"Damned if I do, and damned if I don't"

Like everything a government does or does not do, there will always be ramifications. Measures that may be considered as corrective today, can be engineered or manipulated so as to aggravate the situation, and may ultimately prove to be the source of more problems in the future…

As companies that are heavily indebted watch governments rush to rescue their banking counterparts and the investors on Wall Street, they too, like the Big 3 auto makers, will come calling for their handouts and helpouts, and so would other financial, industrial and economic actors in Main Street and Sweat Street. After all, the crisis is also an opportunity for them to take advantage of the context and new measures, to restructure their operations, inject new liquidity into their accounts and eliminate most, if not all of their bad debts – all on the governments' dime.

The crisis and the attempts to resolve it tell a tall tale of spectacular and dumbfounding paradoxes, and mesmerisation where what was previously unthinkable has unpredictably rung true. There is a great sense of economic, financial and political urgency. Overnight, governments are being forced to adopt a very visible ‘hands on’ approach to issues where they have long practiced a ‘hands off’ attitude. They are being compelled, much against their will and ideological stances, to intervene extensively in the once sacred marketplace and deal with issues they have long chosen to ignore. They are at the moral hazard crossroads.

As personal and institutional credit allowances continue to shrink into the no-credit zone, and unemployment continue to rise, we can expect more delinquencies and a new shakeout as credit conditions and terms tighten, and rates and fees increase. This will only lead to an intensified velocity in the downward spiral and a new round of rippling. Unfortunately, more fallout and global economic chaos are underway, and the end result may eventually be not just localized recession, but degenerate into a globalized depression.

Unfortunately for governments, this new crisis has once again demonstrated that markets and competition are anything but perfect. It has also served as a timely reminder that when the economy fails, everyone turns to government for a solution because ultimately, governments have the responsibility for the economic well-being of their citizens, economies and countries. Unless governments learn the lessons and take the necessary responsible and courageous corrective steps, we can be sure that history and 2008 will repeat themselves.

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