The economic crisis between liberalization and government intervention

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Abstract: *The aim of this article is to provide a brief analysis of the current financial crisis, event that represents a major economic challenge and which reinforces the eternal dispute between the two economic thoughts: economic liberalization and government intervention. The analysis focuses on clarifying how these two concepts are represented, and the ways in which they have affected (or not) the recent events. Although the main variable in the crisis equation was supposed to be liberalization, this article finds out that it is the inadequate regulation that played an important role. In order to prevent such events, it is vital to properly understand the causes of the crisis and to identify the valuable lessons that can be learned.*

Keywords: financial crisis, economic liberalization, government intervention, regulation.
JEL classification: B0, G01, K20.

INTRODUCTION

Economics is the social science that analyzes the way in which limited resources are used in order to satisfy the unlimited human needs. Traditionaly, the factors of production are land, labour and capital. Furthermore, nowadays, the capital has become the axis around which the other resources revolve, thus becoming a final purpose itself. The economy is seen as a special branch of social sciences, as it considers the main characteristics of a nation`s welfare and the ways throughout it is obtain.

The gross domestic product per capita has a high influence in all statistical studies because the opportunities for personal progress mostly depend on the development level of a country (living standard, access to education, etc.). By its nature, the economic segment is more liable to failure, and this is why the market intervention is a sensitive and controversial decision.

This article will provide a briefly analysis of the actual global financial crisis, event that represents a major economic challenge and reinforces the eternal dispute between two mainly

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opposite economic thoughts: liberalization and intervention. The discussion focuses on clarifying how these two concepts are represented, and the ways in which they have affected or not the recent events. It also includes theoretical insights to examine ineffective regulations and law enforcements connected to market failures. It addresses especifically the role of the regulatory system.

This fascinating subject, regulation versus liberalization, that generated a whole literature, was called into question along with the onset of economic crisis from 2007. Over time, many authors especially from the economic field have tried to unravel the "magic formula" between these two concepts, which will ultimately ensure a high and growing living standard for all citizens.

1. LIBERALIZATION AND INTERVENTION: HOW MUCH OPPOSITE ARE THEY?

Regardless of the form that economic freedom and government intervention took over the history, disciples that promoted their "interests" always existed. Brilliant voices argued in both directions, and their number was not small.

Over the time, ***economic liberalism*** has been a subject of theoretical and doctrinal dispute. The word traces its history from the Latin noun *Libertas*, which means "freedom". Its foundations have emerged since the time of the physiocrats. Then, philosophers like Spinoza, Locke, Kant, Hume and Montesquieu promoted ideas concerning the priority of personal before collective and social interest, about the private property as the basis for the human personality affirmation, or about the rationality of the individual behaviour. Classical and neoclassical economists transposed these values in an original manner, from ethics, sociology and politics to economics. Since then, economic liberalism had a sinuous evolution, adapting and taking new forms imposed by reality. However, all the advocates off liberalism (including Smith, Laffer, Gidler, Backer, Menger, Webber, Popper, Mises, Hayek, Friedman et.al.) defend the core values which define it, namely individualism, private property, competition, free initiative and free enterprise (Pohoaţă, 2000, pp. 45-64).

On the opposite side, the doctrine of ***interventionism*** has emerged especially when the great depression hit the economy. Here, a distinction between mixed economy (promoted by interventionism) and centralized economy has to be made. The first form suggests a dirigisme towards the transformation of the state from a "night watchman state" in a direct and effective agent of economic life serving the private initiative in the last instance, while the second form is an extreme one of economic subjugation. Although early forms of interventionism were placed during World War I, the world economic crisis of 1929-1933 is considered to be the moment of its appearance, the moment when the state abandoned some of the liberal theses about economic and social life and engaged more deeply in the redistribution, the allocation and the use of resources. The father of interventionism is considered to be John Maynard Keynes, who promoted the role of an active state and advocated for a mixed economy in which the government and the public sector is called to help the private sector (Pohoață, 1993, pp. 11-27).

Liberty does not mean the total absence of coercion. The man itself is a creature governed by rules. The individuals ritualize their behavioural manifestations because of the multiplicity of conditions under which they operate. None of the participants in this great social game will know the ultimate effects and reactions of their action on others (Mursa, 2005, pp. 192-197). It is easy to see that simple rules, for example "not stealing", limit the sphere of human behaviour manifestation, but respected by everyone gives security, for example for the property owners, both in terms of current and future possession. From here to an excessive regulation the road seems not to be that long, as the history of facts has demonstrated it (in the socialist systems, for example).

John Stuart Mill was the first to argue that it is a difference between "liberty as the freedom to act and liberty as the absence of coercion" (Westbrooks, 2008, p. 134).

Furthermore, Friedrich August von Hayek believes that for a nation to exist and operate there must appear, through a selection process, certain rules that compel people to behave in a manner that makes social life possible (von Hayek, 1980, p. 44).

Another notable liberal theorist, Ludwig von Mises, in his work *The Anticapitalistic Mentality,* states that "as human nature is, society cannot exist if there is no provision for preventing unruly people from actions incompatible with community life. (…) Society cannot do without a social apparatus of coercion and compulsion, i.e., without state and government". The author continues saying that in this situation an additional problem arises: how to keep under control those people who are in central governmental positions which could excess their control and authority and "convert all other people into virtual slaves" (von Mises, 2011, p. 88). In his opinion, this problem can be solved if the individual freedom is respected. Furthermore, the author argues that the modern concept of freedom means that every adult is free to "arrange" his life according to his own plans and he is not forced to live according to the plan of an authority. In the author words, freedom means "not to depend more on other people's discretion than these others depend on one's own" (von Mises, 2011, p. 97).

1.1 Why Regulate?

"A central function, of any democratic government is to promote the economic and social well-being of its people" (OECD, 1997, p. 5). Any government that wants to accomplish this objective needs a central tool, and that is regulation. Generally, regulation refers to the various instruments by which states (through their governments) establish “requirements on their citizens and enterprises” (OECD, 1997, p. 5). There are three categories of regulations: *economic regulations* (that are directly involved in the market processes), *social regulations* (that defend public services such as health care, environmental protection, water supply network, or social services), and *administrative regulations* (paperwork and legal procedures).

In the ***economic literature***, regulation usually refers to government intervention in markets, such as pricing, innovation, competition, market entry, or market exit. Here, the purpose is to increase productivity by decreasing the obstacles to competition and innovation, justified by reasons of economic welfare.

The theoretical ***argument for economic regulation*** depends on the notions of market failure or market imperfection, and sometimes even market absence (there are contexts in which there is no effective market such as the situations when, for example, households cannot buy clean air or peace in their areas) (Baldwin, Cave and Lodge, 2012, p. 15). The arguments in favour of regulation are deeply related to market failure and are connected with the concepts of ideal markets or perfect competition that might appear from the existence of monopoly or oligopoly aspects, the existence of externalities, the lack of information in general or the existence of moral hazard (a particular case of asymmetric information) in special; there are also others arguments like windfall profits, anti-competitive and predatory pricing behaviour, scarcity and, along with it, the need to rationalize resources, and even human rights and social protection etc. Furthermore, the regulation of financial market in its various forms and levels is justified by the political sensitivity of the financial products and services (the political level often interfere with the economic level) together with the existence of market failure.

However, there are some ***arguments against regulation***, because it: produces *moral hazard* (it determines individuals to comport in a counter-productive way), results in *agency capture* (the regulatory process dominates producers because they are in a relatively small number compared with the number of consumers), determines *compliance costs for producers* (the costs of respecting the regulations), and the obligations imposed by respecting the regulations *enlarge the costs of entry and exit markets* (this favours the creation and conservation of monopoly positions and constitutes a source of stability for cartels) (Howells and Bain, 2004, pp. 361-364).

An appropriate regulation involves looking and facing to the economic reality objectively, beyond ideology, before deciding what to do, in order to maximize benefits. But the regulatory quality is a sensitive subject because their inadequacy can block the concerned sector.

Without any doubt, the regulation has a major influence on economic activity. The effects of regulation depend on a diversity of elements (Joskow and Rose, 1989, p. 1451), such as: the factors that motivate the regulation; the nature of the instruments and framework of the regulatory process; the economic characteristics of the concerned industry; and the legal and political structure in which regulation occurs.

As it has been observed, regulation, the establishment of legal relations in the economic field, is synonymous with the governmental supervision and control over economic activities. Ultimately, it represents the main form of interventionism, the way in which governments activate on market. Its main purpose is to help the economic activity and not to stifle it, as it happens many times.

1.2 Why Liberalize?

Economic liberalization usually refers to a reduced government implication in economy in exchange for greater participation of the private sector. It can be seen that liberalization does not mean the *total* absence of coercion, as sometimes it is interpreted especially by general public. Liberalization tries to minimize the government intervention on market, keeping only the basic laws of a good coordination of economic activity (for example to protect consumer rights), in order to increase competition and innovation.

Another term used to refer to fewer and simpler regulations is deregulation. The deregulation reasoning is a higher competitiveness, an increased level of productivity, more efficiency, lower prices and an improved variety and quality of goods and services (Cseres, 2008, p. 78). Even the terms liberalization and deregulation are not perfect synonyms, they are usually used to describe the same process of reducing the government role in the economic life. Both have the potential to increase competition and benefit consumers and, by this, to lead in last instance to economic growth.

Almost all of the notable liberal theorists allow a reasonable presence of the state, but only as a point of support and not as an influence factor of the phenomenon called market. For example, von Hayek states that the coercion exercised by state is essential to liberty, but the author advocates for maintain it to a minimum level. Moreover, the author argues that the more general concept of individual freedom is fundamental for the long-term growth of civilization and the progress of humanity (Miller, 2010, p. 49).

The theoretical ***argument for economic liberalization*** depends on the notions of greater efficiency and effectiveness of economic activity which will turn into economic welfare, because liberalization of international trade, investment and capital movements can enhance efficient allocation of resources and can give dynamism to an economy, thus leading eventually to economic growth. For example, as a result of international competition, the liberalization of trade, on one hand, can enhance innovation and productivity of national firms and, on the other hand, can help consumers to achieve from an extended option of goods and services and decreased prices. Moreover, the increased mobility of production factors - especially capital and, with it, technology - can help a country to exceed a static comparative advantage and to achieve an improvement in providing the required resources for a sustained economic growth and productivity gains. Furthermore, liberalization of capital movements means that domestic savings should flow elsewhere, to where they are requested (UNCTAD, 1996, pp. 9-12).

The common ***argument against liberalization and deregulation*** cites the benefits of regulation that implies the central argument which promotes governmental intervention, namely the market failure mentioned afore. However, market failure, the main argument for regulation, can also be the effect of inadequate regulation, for example an inefficient enforcement of competition law (Cseres, 2008, p. 77). This is why, the regulation authorities must pay a greater attention, not at the number of regulations, but at their quality to promote, in last instance, economic growth.

2. THE ORIGIN OF THE CURRENT CRISIS

According to some economic specialists, liberalization was the main cause of the actual financial crisis (an influent book on this subject, for example, is *This Time Is Different* by Reinhart and Rogoff, 2009). The outline of the origin and the trajectory of the current financial crisis, clearly the worst financial meltdown since the Great Depression, are set around the 1980s, when governments have restrainted their action in the market by reducing the regulation. Since then, in the last decades, liberalization has been an important attribute of economic policy all over the world.

The current global financial crisis started in August 2007. The effective moment was the suspension of three investment funds, with a value of 2 billion Euros, by the French bank BNP Paribas on the short-term credit market. BNP Paribas mentioned difficulties in the United States sub-prime mortgage sector; specifically it said that “the market had disappeared” (BBC News, 2008). In a very short time, the crisis was translated all over the world, mostly by the globalization channels, affecting almost all the economies even those without a sophisticated financial market or products. Furthermore, the globalization phenomenon is the consequence of liberalization process, and, in the same time, it has put in motion forces that work to stimulate liberalization. This situation with cirularity effect has strengthened the belief that liberalization is the main cause of this crisis.

However, the main cause of the crisis was represented by inadequate and outdated regulatory frameworks and that because, from time to time, regulation and supervision are outweighed by the markets, especially in a moral perspective. It was regulation and supervision failures that have determined the crisis, and not liberalization. In this respect, the affirmation in the *G20 London Summit Communiqué of 2 April, 2009*, according to which “Regulators and supervisors must (...) support competition and dynamism, and keep pace with innovation in the marketplace” is relevant as a recognition of the fact that the present financial crisis is not a result of market failure, but instead to the incapacity of regulatory and supervisory institutions to adjust to market realities (Isărescu, 2009, p. 2). The phrase can be also a guide on how to keep up with market innovations, because this process can be so dynamic and complex that regulators may fall behind. So, the inefficient regulation together with many other causes, such as the imbalance between the real economy and virtual economy and the increasing role of financial markets, contributed to the outcome of the crisis.

Furthermore, in their book *A crisis and five errors*, Braun and Rallo show that free markets and liberalism are not the main culprits of the current disastrous situation. In terms of doctrine, their message is that this “economic turbulence” originates from the interventionist government policies that have resulted in the massive intervention of central banks, the privileges offered by the fractional reserve banking system, and the unhealthy actions practiced by politicians to buy votes with popular policies financed with cheap money (Braun and Rallo, 2011).

A contemporary economist, promoter of liberalism, Hernando de Soto wrote in his book *The Other Path: The Invisible Revolution in the Third World* that in Lima, Peru, 289 days were needed for five people working full time to fill all the regulations required to legally open a tailor shop. Furthermore, in many cases, if the business was financed with foreign capital an additional layer of regulations and rules was needed to be added. Such policies only stifle economic competition, encourage political corruption, and even drive people towards the underground (informal) economy (Gwartney, Stroup and Lee, 2008, pp. 77-78). The situation described by the author, originates from 1989 and applies in many situations even today.

Also, there are situations when the level of bureaucracy is very high even in liberal countries. Not to mention that states often restrain and suffocate free trade when they replace the rule of law with discretionary authority in law. Many countries have made a habit in adopting frivolous and bombastic laws that can be interpreted.

Aristotle states that the man has a rational principle. The human being by its nature is endowed with consciousness, but it is complex and contradictory in the same time. Perhaps the dilemma of freedom can be reformulated under the auspices of a fundamental attribute: that of responsibility. Regarding this, von Hayek's remark is more than comprehensive: "Freedom means not just that the individual has both the opportunity and the burden of choice; it also means that each individual must bear the consequences of his actions, for which he will be praised or blamed. Freedom and responsibility cannot be separated" (von Hayek, 1998, p. 93). The author reveals that without responsibility people would not be capable to "learn from their own experiences and enjoy personal growth". It can be also added that responsibility can be a clue to avoid situation like this crisis.

CONCLUSIONS

The economy is a living organism because its existential core is the human being. As a whole, this paper finds out that, although the main variables of the crisis were decentralization and liberalization, the rules of the game were not set suitably. Before operating with any concept, it must be properly understood. The crisis was caused not by "*the absence*" of regulation (liberalization), but by the *inadequate and unsubstantial* regulation of financial markets. ***A minimum set of appropriate rules (of course, respected) could avoid the trigger of the biggest crisis since the Great Depression, without strait-lace or suffocate the market***.

The crisis was determined by many interconnected mobiles, and the fault cannot be placed into a single cell. The dazzling capital market evolution has determined that regulatory agencies cannot longer keep pace with new realities. Thus, the new financial products and their related risks were not perfectly understood. The creation of laws is usually a slow and rigid process and the technological development of recent decades, described by scientists as a "technological turbulence", puts serious difficulties in this direction. The great mobility of capital across national borders makes the role of regulatory authorities more difficult. Also not to forget that those who are at the helm of regulatory institutions are people: fallible, subjective and sometimes guided by feelings and instincts.

Freedom does not mean the total absence of the laws or anarchy. On the contrary, an effective framework is one with a minimum set of well developed principles. However, regulation is a sensitive process, because it implies risk elimination without restricting competition or stifling the market.

In order to prevent such episodes of market failure, it is vital to understand what caused the crisis and which lessons are to be learned. Furthermore, although the topic was intensely debated in the last years, there are still not completely comprehended aspects. Because the subject is a sensitive one, with a large spectrum of implication, it needs further investigations.

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