

The harsh lessons of 2009

Written by 3K Admin

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The best that can be said for 2009 is that it could have been worse, that we pulled back from the precipice on which we seemed to be perched in late 2008, and that 2010 will almost surely be better for most countries around the world. The world has also learned some valuable lessons, though at great cost to both current and future prosperity ♦ costs that were unnecessarily high given that we should already have learned them.

The first lesson is that markets are not self-correcting. Indeed, without adequate regulation, they are prone to excess. In 2009, we again see why Adam Smith's invisible hand often appears invisible: it is not there. The bankers' pursuit of self-interest (greed) did not lead to the well-being of society; it did not even serve their shareholders and bondholders well. It certainly did not serve homeowners who are losing their homes, workers who have lost their jobs, retirees who have seen their retirement funds vanish, or taxpayers who paid hundreds of billions to bail out the banks.

Under the threat of a collapse of the entire system, the safety net intended to help unfortunate individuals meet the exigencies of life was generously extended to commercial banks, then to investment banks, insurance firms, auto companies, even car-loan companies. Never has so much money been transferred from so many to so few.

We are accustomed to thinking of government transferring money from the well off to the poor. Here it was the poor and average transferring money to the rich. Already heavily burdened taxpayers saw their money intended to help banks lend so that the economy could be revived go to pay outsized bonuses and dividends. Dividends are supposed to be a share of profits; here it was simply a share of government largesse.

The justification was that bailing out the banks, however messily, would enable a resumption of lending. That has not happened. All that happened was that average taxpayers gave money to the very institutions that had been gouging them for years ♦ through predatory lending, usurious credit-card interest rates, and non-transparent fees.

The second important lesson involves understanding why markets often do not work the way they are meant to work. There are many reasons for market failures. In this case, too-big-to-fail financial institutions had perverse incentives: if they gambled and succeeded, they walked off with the profits; if they lost, the taxpayer would pay. Moreover, when information is imperfect, markets often do not work well and information imperfections are central in finance. Externalities are pervasive: the failure of one bank imposed costs on others, and failures in the financial system imposed costs on taxpayers and workers all over the world.

Keynesian policies are kaput

The third lesson is that Keynesian policies do work. Those countries, like Australia, that implemented large, well-designed stimulus programmes early emerged from the crisis faster. Other countries succumbed to the old orthodoxy pushed by the financial wizards who got us into this mess.

Whenever an economy goes into recession, deficits appear, as tax revenues fall faster than expenditures. The old orthodoxy held that one had to cut the deficit raise taxes or cut expenditures to "restore confidence." But those policies almost always reduced aggregate demand, pushed the economy into a deeper slump, and further undermined confidence most recently when the International Monetary Fund insisted on them in East Asia in the 1990s.

The fourth lesson is that there is more to monetary policy than just fighting inflation. Excessive focus on inflation meant that some central banks ignored what was happening to their financial markets. The costs of mild inflation are miniscule compared to the costs imposed on economies when central banks allow asset bubbles to grow unchecked.

The fifth lesson is that not all

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innovation leads to a more efficient and productive economy let alone a better society. Private incentives matter, and if they are not well aligned with social returns, the result can be excessive risk taking, excessively short-sighted behaviour, and distorted innovation. For example, while the benefits of many of the financial-engineering innovations of recent years are hard to prove, let alone quantify, the costs associated with them both economic and social are apparent and enormous. </p>Indeed, financial engineering did not create products that would help ordinary citizens manage the simple risk of home ownership with the consequence that millions have lost their homes, and millions more are likely to do so. Instead, innovation was directed at perfecting the exploitation of those who are less educated, and at circumventing the regulations and accounting standards that were designed to make markets more efficient and stable. As a result, financial markets, which are supposed to manage risk and allocate capital efficiently, created risk and misallocated wildly. <p align="justify">We will soon find out whether we have learned the lessons of this crisis any better than we should have learned the same lessons from previous crises. Regrettably, unless the United States and other advanced industrial countries make much greater progress on financial-sector reforms in 2010, we may find ourselves faced with another opportunity to learn them.</p><p align="justify">◆ Project Syndicate, 2009</p><p align="justify">Joseph E. Stiglitz is University Professor at Columbia University and winner of the 2001 Nobel Memorial Prize in Economics.</p><p align="justify">Source: http://gulfnews.com/opinions/columnists/the-harsh-lessons-of-2009-1.558254</p>