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The Global Financial Crisis: Does the State Matter?

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As evident from the current global financial crisis, state intervention in market dynamics is desirable, though not as inevitable as it is in hard security issues. A free-market system is not as free as it is commonly perceived. When markets fail, the state must step in to restore confidence and order.

IN THE past few weeks, the financial landscape of the world has changed dramatically. Mortgage-finance companies Fannie Mae and Freddie Mac were put under conservatorship. This is a legal status giving the government the option and time to restructure and revive the companies. Lehman Brothers, the fourth largest US investment bank, went bankrupt. Merrill Lynch was bought out by Bank of America.

The core of the debate

The government secured American International Group, the world's biggest private insurer, with an $85 billion loan. Goldman Sachs and Morgan Stanley, two big independent investment banks were allowed to transform themselves into bank holding companies in an effort to minimize risks of exposure to the ongoing credit crunch. The crisis, as explained by most financial analysts, was a consequence of the uncontrolled home-lending and an investment banking industry overwhelmed by "toxic" loans.

The bailout by the government, no doubt, is very good news for the market. The failure of the private sector has the potential to disrupt and devastate financial markets worldwide. For the time being, the crisis appears to have been contained. Nonetheless, critics perceive this as an attempt by "undemocratic" elements of liberal capitalist institutions to socialize costs and risks and privatize profits, rather than to secure public interests. According to this view, profit-oriented private sectors should not be allowed to free-ride on taxpayers' money.

Drawing experience from the Asian financial crisis during 1997-1998, former Malaysian Prime Minister Mahathir Mohamad accused the Western capitalist governments of double-standard. Then, many countries were forced by the International Monetary Fund (IMF) and the World Bank to

privatize their economies as a condition to secure structural adjustment loans to weather the financial crisis. Others wonder whether this is not a case of expropriation, a lurch towards socialism and the end of the free-market economy.

At the core of the debate, however, is the issue as to whether the state matters and what the latitude is of state intervention in a liberalized and globalized world.

The "new" state?

In his article *The End of History and the Last Man* published in 1989, Francis Fukuyama argued that the end of the Cold War reflected the triumph of liberal democracy and capitalism over communism. Fukuyama predicted that capitalist economic culture and a free-market system, as opposed to regulated and planned economies, would be the order of the day. The state should, therefore, be kept "out" from the financial marketplace, "permitting a substantial degree of economic competition and letting prices be determined by market mechanism". This coincided with the economic crisis in the early 1990s, affecting a number of developing countries struggling with the balance of payments issues. The proponents of what came to be known as the "Washington Consensus" argued that poor market performance was due to dysfunctional public policies and therefore the state must reduce its role in economic activities and let the market be free to allocate resources.

About the same time, the advocates of the human security discourse argued that the state is not a good or sufficient provider of "public goods" such as human security encompassing human rights, freedom from hunger, disease and violence and the security of the environment. It was suggested that the state should withdraw from these areas and should allow private initiative to take over. The state was expected to function as a facilitator to ensure a level-playing field, by enforcing the rules of the game.

The 9/11 incidents exposed the limits of private initiative. The state came firmly back to deal with security concerns involving terrorism. State intervention has also been found to be inevitable in dealing with non-traditional security issues, especially pandemics such as the SARS epidemic in 2004, bird flu, natural disasters, global warming and climate change. Private initiatives in these areas are either non-existent or woefully lacking. And the state has intervened to bail out the market system.

Is state intervention needed?

The US government has proposed a $700 billion bail-out package to forestall a further meltdown of the financial system, which has catastrophic and cascading economic consequences -- recession, unemployment and high market prices at home and abroad. However, this does not necessarily guarantee that the market can be bailed out completely from the mess that it has created for itself in a deregulated market environment.

Nevertheless, as evident from the present crisis, state intervention in market dynamics is desirable, though not as inevitable as it is in hard security issues. The present crisis is largely a negative effect of a system where economic activities heavily relied on the markets and virtually excluded the government. "And," as Tony Benn, British Labor politician, said, "the markets failed". Moreover, a free market system is not as free as it is commonly perceived. This is more so in developing and transitional economies. Countries that are still holding up reasonably well – China, India and much of Southeast Asia and Latin America -- are the ones where markets are not as "free" as they should be in an ideal capitalist system.

Much of the financial capital market in India continues to be in government control and thus claimed to be insulated against global financial shocks. Singapore expects that its well-diversified economy will help it through. Indonesia asserts that its economy is "well managed," and its domestic fundamentals are good enough to withstand the crisis.

Impact on Asia

Arguably, the impact of the US financial turmoil has not been felt uniformly world-wide. The Japanese stock market has been hit hard and others may follow suit. China and India believe that their economies may not hold out for long. As the Bank of Thailand chief Tarisa Watanagasethat acknowledged, the crisis today is much more complex because it is unfolding in the world's biggest economy and the most sophisticated capital market. It is feared that the financial crisis may lead to a decline in US consumerism, affecting Asian products in the US markets. This will inevitably lead to an imbalance in trade and threaten Asian economies, already reeling under a food crisis and rising inflation.

Whether the tools at hand for policymakers are adequate in ensuring economic stability is critical, especially in the Asian context. In September 2008, Asian Development Bank (ADB) urged greater regional financial integration. It proposed an "Asian Financial Stability Dialogue" involving the region's finance ministry officials, financial regulators and supervisors and other market participants. However, the extent to which this can secure regional economies against market vulnerabilities remains debatable.

Attempts to bail out the market by the state address the symptoms, not the root causes – the limitations of the free market. The vicissitudes and the volatility of the market are part of the game and may be difficult to wish away. In such cases, it is but inevitable for the state to step in to restore confidence and order.

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