National Post

Dangerous ideas; Canadian authorities should shun ideas at both ends of the ideological spectrum and remain pragmatic

Saturday, October 18, 2008
Page: FP15
Section: FP Comment
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Source: Financial Post
Illustrations: Black & White Photo: Canwest News Service / Nicolas Sarkozy is in Quebec City for the 12th Francophone Summit.

Some very dangerous ideas are beginning to circulate: Namely, that financial markets not only need immediate government help to get going again, but continuous supervision thereafter. U. K. Prime Minister Gordon Brown has called for a revamped International Monetary Fund that will provide early warnings of impending crises so that they can be prevented, and France's President Nicolas Sarkozy is proposing an international conference to set such changes in motion, while leaving little doubt that he believes the key to crisis prevention lies in a large dose of dirigisme.

The IMF was founded to oversee an international monetary system based on pegged exchange rates -- which broke down in the 1960s and vanished in the 1970s -- not to be the centre of expertise on financial system regulation. Indeed, we already have the Bank for International Settlements (BIS) for that. The BIS gave ample early warnings about the current crisis for anyone who would listen -- and is no doubt learning lessons from what has happened because it was ignored.

Economic policy, however, is the responsibility of elected politicians. Warnings and advice from international organizations, old or new, will be useless so long as politicians ignore them. Those same politicians, moreover, have a long record of turning to international agreements -- the Smithsonian, the Louvre and the Plaza agreements, for example -- as a way of evading their responsibilities for repairing the sources of instability already under their jurisdiction. If and when European politicians have succeeded in putting a coordinated regulatory framework in place for EU financial markets, or even for the smaller Euro Zone, and when they, the Japanese and the U. S. among others, have brought the potentially destabilizing long-term growth of their government debt under control, then it might make sense for them to try to reorganize the whole world's financial system -- but only then.

Perhaps the most dangerous of today's ideas is that it is possible to design a financial system that will promote economic efficiency but never again generate a crisis like the current one. The first modern financial bubble started in Paris in around 1719 and spread to London before bursting in 1721. There have been many since, and it seems unlikely that the current example will turn out to be the last. And even if it was, how could we ever be sure of that? As discussions of financial system reforms proceed over the next few years, therefore, they should pay more attention to improving mechanisms for dealing with the effects of crises than to vainly pursuing allegedly surefire methods of preventing them.

This is not to argue for letting nature take its course during the current crisis. That markets always function, an idea assiduously taught in many business schools for decades, is also dangerous and all too influential. It tempted U. S. Treasury Secretary Paulson into allowing Lehman Brothers to go bankrupt a month ago and misled 200 economists into opposing the rescue legislation that followed. The very market mechanisms that permit the economy to function are precisely what the financial sector provides, and while it can stand occasional individual failures, when the whole industry seizes up because of shared errors among its managers, then so does everything else.

In a financial crisis, each institution tries to look after itself by piling up stocks of safe marketable assets -- liquidity -- and if that requires a stop to lending, so be it. But when such a response becomes system-wide, there is no market cure for what ensues. Only the authorities can provide the liquidity needed to get lending started again.

Meanwhile, worries about inflationary consequences are misplaced. These fears arise from over-generalizing lessons relevant only when markets are functioning. At such times liquidity injections, not being needed, are spent, but in a crisis, they satisfy a desire to hoard, and hence relieve deflationary pressure. When misplaced inflation fears slow down the application of this remedy -- as they seem to have done recently -- institutions that start out lacking liquidity end up needing more capital as losses from declining business pile up.

Likewise, when things have gotten so far out of hand that the only reliable source of new capital is the government, fears of the onset of "socialism" must not inhibit policy. Capitalism is fine when it is working, but to do so it needs a functioning financial system. To do whatever is needed to ensure that system's continued existence is a matter of good government, not the first stage of the Revolution.

In the current circumstances, the Canadian authorities should shun dangerous ideas at both ends of the ideological spectrum and remain pragmatic. The Bank of Canada should provide the liquidity the financial system needs and if output and inflation are now set to fall, it should also ease monetary policy by all feasible means to keep inflation on its 2% track.

As to the federal government, if enabling the financial system to work requires more mortgages to be bought or interbank deposits to be guaranteed, it should do so; and if the budget slips into deficit, this should be tolerated. As to the international financial system, Canada is a small player and should be defensive, supporting changes that might help markets to function and opposing grand designs calculated to paper over those deeper seated threats to stability located in the houses of bigger players.

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