

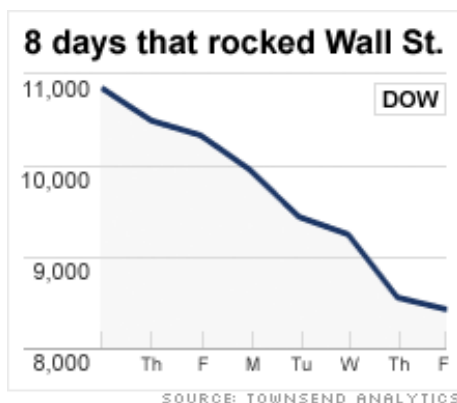
## **Dealing with financial turmoil: Market self-correction or more Government intervention? <sup>1</sup>**

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### **I. Introduction**

This paper will not attempt nor pretend to be a financial analysis of the on-going financial turmoil in the United States and other major markets around the world. This is because the writer is not a “finance whiz” guy; rather, an advocate of “shrink the State” (not “abolish” government) philosophy and apply said framework in analyzing the financial turmoil. And so, the role, or non-role, of governments, in the present problem, if people – investors and borrowers, bankers and depositors, rich and poor – are to get out of the current financial difficulties that they currently experience.

Development in Wall Street in the last two weeks was among the most difficult in recent global financial history. By Friday last week, the eight-session selloff saw the blue-chip index fall 2,400 points or 22 percent, and wiped out about \$2.4 trillion in shareholder wealth. The 22 percent decline in the Dow index was roughly equal to the October 1987 crash.



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After a weekend of meeting by heads of Central Banks and Finance Ministers or Treasury Secretaries, stock markets around the world made double-digit recoveries increases on the first day of this week. The recovery was not sustained though on the next day.

So an important question can be asked: was the double-digit percentage increase in Dow and other world markets a case of market self-correction, or government inspiration as a result of coordinated actions and intervention by rich country governments?

Market self-correction would mean, people say, "Hey, those companies' shares are too cheap, time to buy now!" While government inspiration would mean, "Hey, the State's multi-billion dollar bail-out (or rescue package) is under way, we are 'insured', time to resume the party!"

It seemed that it was a mixture of both. But with or without market self-correction, the US government will go ahead with its planned bail-out or rescue package. The first installment is \$250 billion direct injection and part-ownership of some banks.

## **II. US government intervention in housing credit**

While it is the US government – the Treasury Department, the Federal Reserve, White House and Capitol Hill especially – that postures itself as the “savior” of the current turmoil, it was also the US government policy that forced banks to give out bad loans, and more bad loans indeed were given away. Eamonn Buttler in his article, “[\*Blame bad rules, not capitalism\*](#)”, wrote “(On) 12 October 1977, US President Jimmy Carter signed the ‘anti-redlining’ law. Before then, lenders generally denied loans to people in poor neighborhoods. But the politicians – with good intent – wanted to make home ownership available to all Americans. So lenders were forced into giving out risky mortgages: what we now call ‘sub-prime’ loans.”

David Littman in his article “*The government’s plan to fix Wall Street will do more harm*”, also cited the “anti-redlining” law, Community Reinvestment Act (CRA, 1977 during the Carter Administration). He said that the law “compelled banks and other lenders to loan money and grant mortgages in areas where they’d have never dreamed of making such loans, due to exceptional risks of default. Banks were denied charters for growth and geographical expansion if found by regulators to be out of compliance with these politically-correct regulations.”

Then there were Government enterprises Fannie Mae and Freddie Mac, that receive taxpayer subsidies and had the privilege of keeping thin capital reserves as buffers against losses that result from defaulting or delinquent mortgages.

These were major State interventions that helped produce major abuses and corruption of personal and corporate discipline. Making a bad public policy even bigger. Freddie and Fannie state enterprises made investors believe that the bad mortgages they made

were guaranteed by government, creating a “moral hazards” problem wherein complacency can be rewarded with bailout, not penalized with bankruptcy.

### III. When the supposed savior is itself highly indebted

The US government, well all governments of G7 member-countries, is among the most indebted countries in the world. Being trapped in budget deficit (expenditures larger than revenues) annually is the norm for them. Below are some figures.

**Table 1. General Government Gross Debt, % of GDP**

G7 Countries	1980	1990	2007
Japan	52.1	69.3	195.4
Italy	56.9	94.7	104.0
Canada	45.6	75.2	64.2
France	20.4	35.2	63.9
Germany	31.3	42.3	63.2
<b>United States</b>	<b>43.6</b>	<b>61.2</b>	<b>60.7</b>
United Kingdom	46.1	32.6	44.1

Source: IMF, World Economic Outlook, October 2008, Database,  
<http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/>

The “debt culture” largely explains for the current financial mess. In a paper, “*Debt is whittling away US economic power*”, David Leonhardt observed, “Debt built up, and then laid low, modern Wall Street, where some firms borrowed \$30 for every \$1 they owned. And in the coming years, debt will constrain the U.S. government, as it copes with the combined deficits created by the policies of the administration of President George W. Bush, the ever-more-expensive financial rescue and the biggest item of all, Medicare for the baby boomers.”

Current debt and future, unfunded welfare programs will be very huge. One estimate puts the Federal government is facing an estimated \$56 trillion debt. In a commentary, “*America's \$53 trillion debt problem*,” David Walker wrote: “The nation's real tab amounted to \$53 trillion as of the end of the last fiscal year (September 30, 2007). That was the sum of our public debt; accrued civilian and military retirement benefits; unfunded, promised Social Security and Medicare benefits; and other financial obligations... The rescue package and other bailout efforts for Fannie Mae, Freddie Mac, AIG and the auto industry, escalating operating deficits, compounding interest and other factors are likely to boost the tab to \$56 trillion or more by the end of this calendar year.”

The US' gross domestic output (GDP) last year was \$13.8 trillion. The cumulative debt of the federal government alone will be about 4x of GDP! GDP is the combined production of goods and services by the federal, local and state governments, private

corporations and households. So, can an institution that can irresponsibly accumulate various debts amounting to 4x of GDP, be expected to provide leadership in disciplining all corporations, earning or misbehaving, private corporations? This does not look good.

#### **IV. Market self-correction: always suspected but never tried**

The author of the book, “In Defense of Global Capitalism”, Mr. Johan Norberg, has some good arguments why the “more government financial regulations please” mantra is wrong. In his paper, “[\*Regulators cannot avert next crisis\*](#)”, he wrote: “Every crisis has led to thousands of new pages of regulation. Why is it that regulation doesn't stop crises from happening again? Look no further than the US federal institutions in Washington, DC, and we find 12,113 individuals working full time to regulate the financial markets. What did they do with the powers they had? So we get new rules that target the mistakes that everybody already knows they must avoid. The next possible crisis and its causes are so far unknown, and our regulations may have no effect or even make them worse...”

Melik Kaylan in his article, “The socialism of bankers”, posed a number of witty but no-nonsense questions He asked for instance, “If the bailouts are ultimately paid by the taxpayer, where will the taxpayer get the money from as the economy collapses? From the bailouts? This would involve the government taking our money in order to give it back. What do you call this system?”

Yes, indeed. The circular and bureaucratic process of government taking the people’s money through various taxes and fees, to supposedly give them back various subsidies, creates some leakage and wastes somewhere. Letting individuals, households and private enterprises to decide and spend on things that they deem are important for them, is often minimized if not blocked, by various government regulations in the name of social equity.

On a philosophical note, an Indian intellectual, Desai, wrote in “*The Marx-Hayek solution to the crisis*”:

“Hayek took the stark view that cycles were natural to capitalism and arose from a tendency to resort to cheap money which, in turn, led to mal-investments and then a crisis which had to ‘detox’ the system . He was against any rescue and any premature reflation.... Reagan and Thatcher and Kohl took control and shook up the system and made it profitable again. Marx saw that crises, far from being a problem, were the way capitalism cured its problems. In this he was very similar to Hayek; they both saw capitalism as a system prone to cycles but capable of self-regeneration... If you seriously believe in free markets, then you let it take its course and rely on the system to correct itself. Don’t feed the fever; starve it. Don’t insulate the system from shocks; expose it so it will become more robust.”

This author has argued in another paper, “*Capitalism without failure is like religion without sin*”. Or like Christianity without hell. If capitalism and the market economy are capable of expanding and creating more wealth, they are also capable of making mistakes and failures. Either way does not need big government intervention. Such intervention is needed in controlling and neutralizing killers, robbers, embezzlers and other criminals that violate the rule of law and the citizens’ right to life, right to private property, and right to liberty.

## V. The Philippine connection

How will the Philippine economy be adversely affected by the current global financial turmoil?

There are various transition mechanisms by which the credit tightening will reach its final destination: more unemployment, more poverty. Two tables below will show some avenues by which income and investments in the Philippines can be affected.

**Table 2. Net Foreign Equity Investments \* in the Philippines, \$ Million**

<b>Rank in 2008</b>	<b>2000</b>	<b>2007</b>	<b>Jan-July 2008</b>
<b>Total Net Equity</b>	<b>1,333.0</b>	<b>2,000.0</b>	<b>716.00</b>
1. United States	155.43	664.65	214.79
2. Japan	107.35	827.07	106.92
3. Singapore	48.55	-5.39	91.88
4. S. Korea	0	14.46	22.86
5. Malaysia	15.16	5.96	14.82
6. Hong Kong	45.34	3.29	8.46
7. Taiwan	3.36	0.09	6.52
8. European Union	578.70	69.86	3.42
Others			

Source: Bangko Sentral ng Pilipinas, [www.bsp.gov.ph/statistics/spei/](http://www.bsp.gov.ph/statistics/spei/)

\* Computed as: Placements less withdrawals by non-residents

The first seven months of the year already showed drastic decline in net foreign equity investments in the country. If current trends will continue, it is possible that full year equity investments will be one-half or a little over one-half of 2007 level. Investors from the US, Japan and the European Union showed huge decline in their investments this year. If not for the investors from Singapore and S. Korea, the equity investment numbers would have been worse.

Remittances from some 8 million Filipinos working abroad are a significant source of income and financial resources in the country. If the current credit tightening and lack

of confidence in the global investment climate will continue for long, it is possible that many of those Overseas Filipino Workers (OFWs) will be packing back home as the employment situation in their host countries will deteriorate.

But the remittances for the first seven months of the year did not look bad. From an average of \$1.2 billion per month in 2007, this year it is \$1.37 billion per month on average.

**Table 3. OFW Remittances, in \$ Million**

Rank in 2008	2000	2007	Jan-July 2008
<b>Total Remittances</b>	<b>6,050</b>	<b>14,450</b>	<b>9,608</b>
1. United States	3,945	7,565	4,729
2. Saudi Arabia	494	1,141	787
3. Canada	47	595	668
4. United Kingdom	91	684	465
5. Italy	161	636	438
6. United Arab Emirates	28	530	354
7. Singapore	105	386	290
8. Japan	370	402	276
9. Hong Kong	147	383	242
10. Germany	101	208	174
11. Norway	14	159	124
12. Bahrain	13	142	103
13. Taiwan	142	183	97
14. Kuwait.	36	165	80
15. Australia	16	92	74
16. Greece	54	99	67
17. S. Korea	42	95	50
Others			

Source: Bangko Sentral ng Pilipinas, [www.bsp.gov.ph/statistics/spei/](http://www.bsp.gov.ph/statistics/spei/)

## VI. New global dynamics: Asian economies continue rising fast

One hopeful note in the global economy is that many Asian economies are growing rather fast. Based on the most recent calculations by the International Monetary Fund (IMF) in their “World Economic Outlook” released early this month, this table is constructed. Check the Asian economies in red color. PPP valuation is used by economists to account for relative prices of similar goods and services across countries.

**Table 4. Gross Domestic Product based on Purchasing Power Parity (PPP) valuation of country GDP, in \$ Billion**

Rank 2007	Economy	1980	2007	Multiple increase
1	United States	2,789.5	13,807.6	4.9
<b>2</b>	<b>China</b>	<b>249.1</b>	<b>7,034.8</b>	<b>28.2</b>
<b>3</b>	<b>Japan</b>	<b>1,039.4</b>	<b>4,292.2</b>	<b>4.1</b>
<b>4</b>	<b>India</b>	<b>271.2</b>	<b>2,996.6</b>	<b>11.0</b>
5	Germany	752.6	2,812.3	3.7
6	United Kingdom	486.6	2,167.8	4.5
7	Russia	n/a	2,089.6	
8	France	536.7	2,067.7	3.9
9	Brazil	444.0	1,837.1	4.1
10	Italy	507.6	1,787.9	3.5
11	Mexico	333.1	1,486.3	4.5
12	Spain	272.5	1,351.5	5.0
13	Canada	272.1	1,269.7	4.7
<b>14</b>	<b>Korea</b>	<b>94.8</b>	<b>1,201.9</b>	<b>12.7</b>
15	Turkey	116.3	885.9	7.6
<b>16</b>	<b>Indonesia</b>	<b>107.7</b>	<b>838.5</b>	<b>7.8</b>
<b>19</b>	<b>Taiwan</b>	<b>60.0</b>	<b>696.1</b>	<b>11.6</b>
<b>24</b>	<b>Thailand</b>	<b>50.7</b>	<b>519.8</b>	<b>10.3</b>
<b>26</b>	<b>Pakistan</b>	<b>49.1</b>	<b>410.3</b>	<b>8.4</b>
<b>30</b>	<b>Malaysia</b>	<b>32.4</b>	<b>359.3</b>	<b>11.1</b>
<b>37</b>	<b>Philippines</b>	<b>60.3</b>	<b>299.7</b>	<b>5.0</b>
<b>38</b>	<b>Hong Kong</b>	<b>36.9</b>	<b>293.3</b>	<b>7.9</b>
<b>45</b>	<b>Singapore</b>	<b>16.8</b>	<b>228.3</b>	<b>13.6</b>
<b>47</b>	<b>Vietnam</b>	<b>16.2</b>	<b>221.6</b>	<b>13.7</b>

Source: IMF, World Economic Report, October 2008, Database;  
<http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/>

The above figures show the following interesting facts:

**One**, based on PPP valuation of country GDP, three of the five biggest economies in the world as of 2007 are Asians – China, Japan and India. In 1980, the combined size of their economies are almost one-half that of the United States. After 27 years last year, their combined size of economy is larger than that of the US at more than \$14 trillion.

**Two**, in terms of how many times the size of GDP has increased over the last 27 years, Asian economies’ growth were spectacular. China’s economy has increased by 28x, while those of Korea, Singapore and Vietnam have increased by 13x; and those by India, Malaysia and Taiwan have increased by 11x. Compare that with the increase of G7 member-countries’ economies of only 4 to 5x.

One can argue that it is always easier to grow fast coming from a lower base than one coming from an already high base. This is true, but other countries from other regions, like South America or Southern Europe and Africa did not exhibit the same trend. And many Asian economies have come from a deep financial turmoil 10 years ago, and have recovered rather quick.

With this development, the bulk of Philippine economic integration has shifted from US and Europe to its Asian neighbors, as shown in the country’s international trade. The figures 10 years ago are shown for a brief comparative analysis.

**Table 5. Philippine Exports by Country Destination, in \$ Billion except %**

<b>Rank in 2008</b>	<b>1998</b>		<b>2007</b>	<b>Jan-Aug 2008</b>	
1. United States	10.10	<b>34.2%</b>	8.59	5.52	<b>16.0%</b>
2. Japan	4.23	14.3%	7.29	5.39	15.6%
3. China			5.72	3.98	<b>11.6%</b>
4. Hong Kong	1.32	4.5%	5.80	3.44	<b>10.0%</b>
5. Netherlands	2.32	7.9%	4.15	2.59	7.5%
6. Singapore	1.83	6.2%	3.13	1.94	5.6%
7. S. Korea			1.78	1.83	<b>5.3%</b>
8. Malaysia	1.14	3.9%	0.64	1.42	4.1%
9. Taiwan	1.76	6.0%		1.28	3.7%
10. Thailand	0.63	2.2%	1.41	1.03	3.0%
Germany	1.03	3.5%	2.14		
<b>T O T A L</b>	<b>29.9</b>	<b>100 %</b>	<b>50.28</b>	<b>34.42</b>	<b>100 %</b>

Source: National Statistics Office, [www.census.gov.ph](http://www.census.gov.ph)

The emergence of China and Korea as among the Philippines’ largest exports market in recent years up to the present is consistent with the earlier data that showed these two countries’ dramatic expansion of their economies.



## VII. Concluding Notes

As people regain composure and try to figure out how bad were the past and recent mistakes and problems, the natural instinct is to avoid those past mistakes. And one such big mistake is the “debt culture”.

It is notable therefore to hear and read more often these days subjects like “frugality”, “living within one’s means”, “hard work” and “more personal responsibility”.

Market failures always create opportunities for market solutions and market self-correcting mechanisms. The “more government regulation and taxation” mantra is an anomaly that creates not only moral hazards problem, it also corrupts the self-correcting mechanisms of the market.

The market is composed not only of big stockholders and investors, big banks and traders. It is also composed of small and ordinary buyers and sellers, average consumers and suppliers. Thus, when people say “free market”, they are effectively referring to “free individuals”, explicitly or implicitly.

When there is sustained rise in the price of houses or any other commodity and service, the good-old-theory of supply and demand says that suppliers of such commodities will produce more to capitalize on high consumer confidence. Then the “supply curve” shifts to the right, resulting in decline in prices in the future as more suppliers and players enter the market, and more houses or any other commodity are produced.

So when people assumed that housing prices will rise “forever”, they were trying to believe that there is an exception to the law of gravity in this planet; and hence, they were courting a financial disaster. The disaster has come, and it is still taking its time counting more victims.

Although the Philippines was not as badly affected as the US and other rich countries, there is still a long way for the country and its citizens to reach the material level of even the current “bad business environment” of the US. The necessity of freeing up markets and reducing government regulations and interventions – what people call “laissez faire capitalism” – remains an important philosophical and policy alternative.

The call for responsible entrepreneurship will be the “guiding light” for many private enterprises to make this country and its citizens a better place to live in. Where more personal and parental responsibility, not more “government responsibility”, will ensure social order amidst occasional financial turmoil that is inherent in a society where the market, where the individuals, are free.

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