Foreword

Thirty years ago, in the otherwise miserable decade of the 1970s, the modern era of free-market economic revival began. The reigning Keynesian economists lacked an explanation, much less a policy answer, for the stagflation of that decade. Free-marketers of various stripes—Chicago-school monetarists, supply-siders, deregulators—stepped into the breach by offering a revival of classical economics. Their prescriptions set the stage for Reaganomics in the U.S. and Margaret Thatcher's success in the U.K., spreading eventually to China, India, and other once-socialist corners of the world. The result has been an astonishing era of innovation and prosperity, with literally hundreds of millions of people lifted out of poverty.

The daunting question as I write in late 2008 is whether that era is coming to a close. As an optimist by temperament, I like to think not. But there is no denying that the worst financial panic in 70 years has inspired fresh doubts about the utility of free markets and has led to serious policy setbacks. To prevent the collapse of the world banking system, governments have intervened in financial markets in ways not seen since the 1930s. In the U.S., the mortgage markets have essentially been nationalized. In Europe and the U.S., the government has injected public capital into the banking system.

As distasteful as it is, the need for public capital probably became inevitable once the panic become a global bank run and threatened a collapse of the entire financial system. However, the perils are obvious going forward. Politicians could seek to politicize the allocation of credit even more than they have through the likes of Fannie Mae and Freddie Mac. And with the election of a new Democratic Administration in Washington amid a recession, the political stage is set for even greater government intervention across the entire economy if policymakers ignore the lessons of recent decades.

Our private financial elites certainly made many mistakes, not least in their failure to assess risk adequately. But the irony of this panic is that its main causes lie in failures of government. The original sin was monetary, in the form of excessive money creation by the U.S. Federal Reserve from 2002 through 2005. This foreword has mentioned that mistake going back to 2004. The Fed created a subsidy for credit that produced asset bubbles in commodity prices and especially in housing. Facilitated by further government subsidies in housing through Fannie and Freddie and other policies, this credit boom produced a bubble in housing prices and mortgage-finance vehicles. When the bubble ultimately burst, the credit mania turned to panic and led to the events we have all been living through this year. Instead of anticipating problems at the most troubled institutions, Treasury and the Fed often moved in an ad hoc, arbitrary fashion that fed the panic.

Rather than admit its own mistakes, the political class in Europe and the U.S. wants to pin the blame on "deregulation." The reality is that the financial institutions that made mistakes are some of the most regulated in the world. The fault lies with bad or feckless regulation, not the lack of it. Adam Smith in his ruthless fashion has already punished the biggest mistakes, remaking Wall Street without Congress having passed a single reform. Thanks to revived market discipline, the world is already moving to a safer, more stable financial system. Governments are nonetheless set to rewrite their financial rules, and we have to hope they do so in ways that don't throttle innovation and the free flow of capital.

There are other policy dangers to watch. The Doha global trade round has stalled, and President-elect Barack Obama shows no signs of wanting to revive it. Taxes and spending in the U.S. are both likely to rise substantially, and the health care and energy industries are in for extensive new regulation or worse. Some European leaders want to use the excuse of the financial meltdown to impose a new global regulatory regime that could stifle competition and, ultimately, growth.

The good news, to the extent there is some, is that the benefits of economic liberty may have spread far enough in the past 30 years to prevent too much of a backlash. The financial panic has done great harm, but we have survived recessions in the past. If the U.S. makes policy mistakes, the rest of the world—especially in Asia—may choose not to follow. Already, the worldwide trend toward lower corporate tax rates means that even an Obama Administration may have no choice but to follow down that particular Laffer Curve. If the U.S. fails to lead on trade, the rest of the world will move to bilateral or regional pacts, as South Korea and Europe are already doing in the wake of Congress's failure to approve the U.S.–South Korean free-trade agreement.

The abiding lesson of the current panic is that the battle for liberty requires perpetual vigilance. Ostensibly free-market policymakers in the U.S. lost their monetary policy discipline, and we are now paying a terrible price. The *Index of Economic Freedom* exists to chronicle how steep that price will be and to point the way back to policy wisdom.

Paul A. Gigot
Editorial Page Editor
The Wall Street Journal
November 2008