

Economic Freedom: The Best Way to Confront the Crisis

Just a few days ago on the 9th November we celebrated "Freedom Day" the 19th anniversary of the 1989 Revolution and the fall of the Berlin Wall. This year we are celebrating the anniversary at a special moment in time: we are suffering the consequences of an international financial crisis which started in the United States, then spread to Europe and in the last few weeks to the rest of the world, due to its impact on the true economy.

The critics of freedom have tried to show that this crisis first started in "the heart of capitalism", signifies "the fall of the capitalist wall North American style". Therefore, those of us who believe in and promote a free society, have to react over the profound impact of this crisis in relation to freedom, especially in the economic sense.

On the same date last year we produced a document called "Freedom: the best recipe for cohesion and social opportunity"¹ on the occasion of the XVII Iberoamerican Summit that took place in Chile. There we showed how those countries with the greatest economic freedom are precisely those that achieve the biggest opportunities and social integration for their people.

This year 38 institutions² from 18 countries signed and issued a document that we

have called "Economic Freedom: the best way to confront the crisis."

Economic cycles have existed since the origin of humanity. If we look at the period from 1881 up to the year 2000 and consider the recessions and recoveries for 16 industrial nations, we can appreciate that approximately 27% of the period between 1881 and 1938 were recession years.

Faced with the financial crisis that the world is experiencing, we believe that mistakes in public policy can occur in countries with more or less economic freedom. Notwithstanding, the more liberal countries, with democratic Governments, a free press and market economies have a reduced probability of this type of economic cycle, and are in a better position to confront them when they do happen.

Similarly, between 1950 and 2000 about 9.3% of the years were in recession. Likewise, the evidence shows that over the length of time the recessions have reduced in intensity and duration (Table N° 1).

The debates over the causes of the economic cycle are diverse. In the case of the current crisis each day there is more and more evidence that points not to a "failure of the market" but more towards a "failure of the State".

In reality, the crisis started in the mortgage market of the United States. If we look carefully at what was behind the so called sub prime mortgages, there was a government policy to promote borrowing to buy homes in sectors that did not have sufficient savings, through the two financial entities Fannie Mae y Freddie Mac, with implicit government guarantees. There were many regulatory drivers from the Government and the North American Congress to encourage this irresponsible conduct.

**Table N°1:
Recessions and Expansions 1881 – 2000**

	1881-1913	1919-1938	1950-1972	1973-2000
Recesiones				
Promedio caída de producto	-4,3	-8,1	-2,1	-2,5
Proporción años en recesión	24,7	29,4	5,2	13,4
Expansiones				
Promedio: crecimiento del Producto	19,8	34,6	102,9	26,9
Proporción años de expansión	75,3	70,6	94,8	86,6

Source: FMI

It is worth mentioning, with respect to legislation, the “Community Reinvestment Act” of 1977 and many others. As mentioned in the prestigious weekly “The Economist” the politicians encouraged the banks to give risky loans. The other failure of the State was in the monetary policy promoted by the Federal Reserve Bank of the United States, which was especially expansive during periods of reduced economic activity and without prudence in the boom years. This allowed interest rates which were artificially low which in turn stimulated personal and company borrowing.

As shown by the science of economics, an excess of easy credit has as a counterpart an excess in demand for financial shares which artificially raises their values, creating a bubble especially in the most rigid sales markets such as real estate. When they had to reverse this policy they raised the interest rates which made it more difficult for the people with debts to honor their financial commitments and there-

Empirical evidence shows us that one of the most serious mistakes after the 30’s crisis was to restrict commercial freedom, therefore making the recovery from the crisis more difficult.

three fundamental requirements: ensure that there its transparency so that the economic agents make decisions with the best possible information; have a system of signals that shows the situation relating to liquidity and insolvency that can occur in this market, and to have rules such that the economic agents have to assume responsibility for the costs of their bad decisions.

A close look at what has happened in the North American and European financial markets allows us to conclude that none of these three prerequisites was in place. As a result, there was inadequate information, the corresponding preventative signals were not given, and there were no adequate incentives so that those responsible for the bad decisions

fore precipitating the crisis.

The State made a third mistake, precisely connected with the role that it has in the financial market. In effect, it has to be regulated to conform to the liquidity of the economy. An adequate regulatory system has to have

**Table N°2:
Cost and Duration of the Recessions**

	Pérdidas de Producto Acumulado %	Duración (Años)	Libertad Económica *
Latinoamérica (Crisis 8-1-82)	24,6	6,6	5,3
Sudeste Asiático (Crisis 97-98)	9,4	3,3	7,2

Source: J. De Gregorio y L. Felipe Céspedes. Central Bank of Chile. 2005

**Table N°3:
Evolution of GDP Per Capita in Anglo-Saxon and European Capitalism
(1990 dollars)**

	1820	1913	1950	2001
Países de Europa Occidental	1.204	3.458	4.579	19.256
Estados Unidos, Canadá, Nva.Zelandia y Australia	1.202	5.233	9.268	26.943

Source: Angus Maddison "Growth and Interaction in the World Economy". AEI

should pay the corresponding costs. To summarize, substantially the State did not do its job and the crisis was born and grew because of these failures.

We have shown that the economic cycles have been present throughout human history. Given this reality it is relevant that we should ask: how has economic freedom helped to overcome these cycles?

The empirical evidence is very clear about this. Those countries with the most liberal and flexible economies have recovered faster from the crises. Economies with more freedom in their financial and labor markets, with more flexibility in prices, with a rule of law that governs with integrity and economies more integrated with world commerce, overcome the recessions more easily.

A good example can be seen in Table No

We reiterate what history shows us: those countries that have achieved progress are precisely those where a free economy is the pillar of their policies and public institutions.

2, which analyzes the two most relevant recessions in the last three decades in the emerging nations. As can be appreciated, the crisis of the 80's in Latin America lasted nearly twice as long in comparison with the 90's crisis of south East Asia, and in addition the economic cost was substantially higher. Similarly the Index of Economic Freedom in the countries of south East Asia was 36% higher than that of the Latin American countries under consideration.

It is also appropriate to inquire: what type of country has definitively overcome these economic cycles, and achieved higher levels of economic growth in the long term? In this respect the history of growth can shed a lot of light on the subject, especially for the current economic debate. In effect, in the last few weeks voices have arisen suggesting that "self regulation is over", insinuating as such the advantages of a form of capitalism with greater participation of the State as in Europe, in contrast to the form

**Table N°4:
Evolution of GDP per capita in the United States, Canada and Latin America (dollars 1990)**

	1700	1820	2001
Estados Unidos y Canadá	511	1.231	27.384
Latinoamérica	527	692	5.811

Source: Angus Maddison "Growth and Interaction in the World Economy". AEI

found in Anglo-Saxon countries.

In this respect, it is useful to look at what happened during the last two centuries as is shown in Table N° 3. In 1820 the average income per capita of the eastern European countries was practically identical to countries like the United States, Canada, Australia and New Zealand. At the start of the present century (2001) these latter countries have overtaken the income per capita of Eastern Europe by 40%. Therefore, notwithstanding the economic cycles, the capitalist countries with limited State involvement have achieved greater growth.

It is also useful to compare what happened in Latin America, where there was “oligarchic mercantile capitalism”³ with a high state presence compared with the United States. In 1700, the income per capita of the Continent (US\$527) was very similar to that of Canada and the United States (US\$511). As is shown in Table N° 4 in 2001 the income of these later countries was higher by 371% than the income in Latin America.

In the face of the financial crisis with which the world is living we believe that mistakes in public policy can happen in countries with greater or lesser economic freedom. Notwithstanding, the countries with greater freedom and with a democratic Government, freedom of the press and a market economy have a reduced probability of economic cycles and are in a better position to confront them should they occur.

Nonetheless, once the cycle has happened, greater levels of economic freedom allow faster recoveries, allowing the private players to agree on changes that are neces-

sary based on superior information, avoiding policies that only end up deepening the problem and loading the weight onto those that have done things well.

Finally, it is a fact that, in the longer term notwithstanding the economic cycles, those countries with greater levels of economic freedom are those that allow more welfare to their people in a sustainable manner.

Empirical evidence shows that one of the most serious errors of humanity after the crisis of the 30's was to suppress free commerce and that made it more difficult to recover from the crisis.

A good example of what not to do is shown in the case of Argentina. In 1928 the countries exports, in relation to their Gross Domestic Product (GDP) reached almost 30%. Mistaken policies put the lid on that economy and reduced the proportion of exports to no more than 10% of GDP.

Those and other policies that constrained the free economy, brought one of the most prosperous nations at the start of the last century, with standards of living comparable to the first world, once again to underdeveloped status.

Today, once again with around about 30% of its population living in a state of poverty, the Argentinean Government is repeating its mistake by intending to expropriate employees savings currently deposited in their pension funds.

The “signed up” Latin American institutions have called out to those responsible for the economic stewardship of our countries, so that they will have this evidence to hand, and so that it is not left for speeches and ideological debates that ignore the signaled reality.

We repeat what history has shown: Those countries that have achieved progress are precisely those that where economic freedom is the pillar of their policies and public institutions.

Considering all this, the signed up Latin American institutions have called out to those responsible for the economic stewardship of our countries, so that they will have this evidence available and so that it is not left for speeches and ideological proposals which ignore the signaled reality.

In this we agree with the intellectual and ex President of the Czechoslovakian republic, Vaclav Havel: "*... I have always known that the only economic system that works is that of the market. This is the only "natural" economy, the only one that really makes sense, the only one that can bring prosperity; because it is the only one that reflects the true nature of life*".

¹ Text available in www.lyd.org, http://www.lyd.com/LYD/Controls/Neochannels/Neo_CH3756/deploy/CUMBRE.pdf

² NOTORIA: Agenda para una Sociedad Libre (Bolivia), Instituto Político para la Libertad IPL (Perú), Centro de Investigaciones Económicas Nacionales (Cien) (Guatemala), Instituto Ecuatoriano de Economía Política IEPP (Ecuador), Instituto Ecuatoriano de Economía Política IEPP(Ecuador), Movimiento Libertario (Ecuador), AIPE (Estados Unidos), Freemarket (España), Hispanic American Center for Economic Research HACER (Estados Unidos), Fundación Libertad (Argentina), Instituto Libertad (Chile), Centro de Estudios Públicos (Perú), Instituto de Estudios y Capacitación Cívica (Guatemala), Andes Libre (Perú), Centro de Estudios en Educación y Economía Academia de Investigación Humanística (México), Asociación Consumidores Libres (Costa Rica), Fundación Jaime Guzmán (Chile), Centro de Información y Documentación de Estudios Cubanos (España), CITE (Perú), Instituto Libertad y Progreso (ILPRO) (Costa Rica), Centro de Divulgación del Conocimiento Económico CEDICE (Venezuela), Fundación FAES (España), FULIDE (Bolivia), ESEADE (Argentina), Fundación Libertad (Panamá), Libertad y Desarrollo (Chile), Fundación Atlas 1857 (Argentina), Internacional Liberal (Cuba), CITE (Ecuador), Instituto de Estudios de la Acción Humana (Perú), Instituto de Ciencia Política (ICP) (Colombia), Instituto Veritas (Honduras), Círculo Liberal (Uruguay), Instituto Democracia y Mercado (Chile), Instituto para la Libertad y el Análisis de Políticas (Costa Rica), Instituto de Libre Empresa (ILE) (Perú), Instituto Liberdade (Brasil), Fundación Libertad (Paraguay).

³ Good Capitalism, Bad Capitalism "W. Baumol, R.E. Liton and C. Schramm. Yale University Press