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Needed: a contingency plan

The sub-prime hurricane is wreaking havoc on the global financial system. After a series of relatively small, firm-specific rescue missions, the US government has now cast all its dice on a $700 billion bail-out package. Opinion is divided on whether this will work, and there is widespread scepticism. Meanwhile, all governments should be giving serious thought to their own economic contingency planning. What kinds of threats does India face in today's context, and what mechanisms does it have in place to deal with them? The question assumes urgency when the Sensex has dipped to its lowest point in the year, and when net sales by overseas investors in the secondary market have already topped $18 billion this year. If as much more were to flow out again in the next six months (and the FIIs still hold $150 billion worth of stocks), bears could be in command on Dalal Street.

One risk here is the robustness of the clearing and settlement systems. Fortunately, India's trading systems have held up quite well; even in the bloodbath of May 2004, by far the worst one-day fall, they did not let traders down. A second area of concern is liquidity. As large amounts of money are withdrawn and repatriated, domestic liquidity is compressed and this disrupts the normal course of business. Credit costs significantly more already, and could become more difficult to access. This may render an otherwise viable business activity infeasible. Over the past several weeks, the attention of central banks around the world has been focused on maintaining appropriate levels of liquidity, though no one is quite sure how much is needed. The Reserve Bank of India (RBI) did its bit on September 8, but the situation appears to have tightened again, suggesting the need for further measures, including some unwinding of the Market Stabilisation Scheme holdings, built up earlier.

A third pressure point is the downward thrust on the exchange rate because of escalating outflows, which add to the pressure that oil companies are exerting on the forex market by virtue of their buying up dollars to pay for imports. Taking the latter out of the market, by resuming the dollars-for-oil bonds swap that was tried in June, will help stabilise the exchange rate, but cannot guarantee it. Meanwhile, managed depreciation of the rupee could aggravate capital outflows as foreign investors act to minimise their losses in dollar terms. However, it is probably better than risking a free fall in the currency. The RBI needs to decide where it stands on the issue — resist depreciation by drawing down on reserves, or let the rupee fall where it may. If it chooses the former, how far down is it willing to let reserves go? Fourth, for both exporters and financial institutions, there is a very real risk of exposure to bankrupt counter-parties. ICICI Bank has already been impacted by its investment in Lehman Brothers' securities. Others may be hurt as more institutions go under — and one seems to be going down every day now. For exporters, payment schedules may be thrown out of gear if banks that had extended credit to importers fail.

The only thing that is clear is that a contingency plan needs to be put in place, if it hasn't already been. At the very least, this is going to require effective co-ordination between the ministry of finance and the two main financial regulators, RBI and the Securities and Exchange Board of India.

Extreme step

For matters to have reached a stage where the three defence chiefs should collectively decide not to implement a government pay order is surely serious. Fortunately, if the country's defence capability is not to be impaired. Therefore, through a combination of incentives, status recognition and generous hardship allowances, some way should

Illustration by BINAY SINHA

Libertarian paternalism

The Nanny State must not be allowed to replace the Planned Economy, says DEEPAK LAL

With the ending of political debates about the plan versus the market, Western politicians, particularly on the Left, have been searching for new areas to rouse the political interest of their electorates. Increasingly they have turned to interventions in the previously protected private domain. It began with the attempts by Clinton's New Democrats and Blair's New Labour to find a Third Way between collectivism and liberalism. Since this ended in a blind alley, British and US politicians (Obama and Cameron) are embracing a new ruse — "nudging" — to justify their interventionist instincts. This moral paternalism is the subject of this column.

Moral paternalism has a long lineage in social democratic thought, which makes its adoption by the UK's Tory leader surprising. A clear exposition was provided by the distinguished Oxford legal theorist and philosopher Herbert Hart in a debate with Lord Devlin in the 1960s (*Law, Liberty and Legislation*, 1963) about the legalisation of homosexuality. Hart upheld Mill's principle of liberty that an individual is at liberty to undertake feasible actions if they do not harm others, in advocating the legalisation of every consensual private sexual activity. But, he abjured the classical liberal case against moral paternalism, on the specious grounds that individuals are not really free to choose. So while sexual permissiveness is legitimate, all forms of paternalistic supervision or coercion are needed to ensure that all other individual choices are in fact freely made. As these choices are psychologically determined, it becomes imperative to exercise thought control: to make "windows into men's souls". This is not classical liberalism but the route to *1984* and Big Brother, which classical liberals would eschew.

The most recent manifestation has been labelled "libertarian paternalism" by its progenitors, the behavioural economists Richard H Thaler and Cass R Sustein (in *Nudge*, 2008). Based on the findings of psychology, behavioural economists have found many anomalies in the standard economic model of an individual's maximising utility subject to the usual budget constraints. The centrepiece of these findings is the problem of self-control, or *akrasia*, as the Greeks called it. A divided self is postulated with the short-term myopic self being tempted not to act in the interests of its longer-term rational self. Just as Ulysses tied himself to the mast to prevent his destruction by the voices of the Sirens, it is suggested that "nudges" can help the far-sighted Planner self "to promote your long-term welfare … [which] must cope with the feelings, mischief, and strong will of the Doer [self], who is exposed to the temptations of arousal" (p. 42).

Paternalism is advocated because "of the false assumption that almost all people, almost all of the time, make choices that are in their best interest or at the least better than the choices that would be made by someone else" (p. 9). They are libertarian because instead of coercing people to serve the long-term Planner self, the public and private "choice architects" would merely use "nudges" to point people in the right direction as in the male urinals at Schiphol airport in Amsterdam. These bear etchings of a black housefly, and an economist's "fly-in-urinal trials found that etchings reduced spillage by 80 per cent" (p.4). But as the economic journalist Tim Harford rightly remarked: "I am no more in favour of spillage than the man standing at the urinal beside me, but how is this libertarian paternalism? 'We recognise your right to wet your shoes, but in case that is not your objective we will structure your choice environment to help you'" (*FT*, 22 August, 2008).

But if the 'nudges' fail, as in the case of smoking, the State has moved towards coercion.

This is justified by moral paternalists by basing themselves on Mill's correct argument against a person's freedom to sell himself into slavery, namely that "the principle of freedom cannot require that the person be free not to be free. It is not freedom to be allowed to alienate his freedom" (*On Liberty*, Everyman edition, p. 158). Amartya Sen (*FT*, 11 Feb, 2007) has claimed the smoking ban in the UK is based on Mill's principles of liberty: "as habit-forming behaviour today restricts the freedom of the same person in the future". But as I and others pointed out, this is a complete travesty of Mill's argument against slavery (*FT*, 15 Feb 2007, and especially S Simpson, *FT*, 2 March 2007). Mill's robust arguments against bans on addictive substances like alcohol and opium do not mention his argument against slavery as being relevant in any way.

The argument for prohibiting addictive substances, based on assuming a divided self, postulates a negative inter-temporal consumption externality facing potential addicts. Current consumption depends on past consumption but not future consumption. This omission is repaired in the rational addiction models of Becker and Murphy (*Journal of Political Economy*, 1988). They show how even with inter-temporally inconsistent preferences, consumers maximise utility over their life cycle taking account of the future consequences of their actions in consuming addictive substances.

More seriously, as the economic theorist Dew Fudenberg's (*Journal of Economic Literature*, 2006) critical review of behavioral economics rightly notes: "Even if we believe people do make systematic errors in evaluating how various choices will influence the appropriately defined measure of their 'welfare', we might not trust that the government or policy analysts would make better evaluations. For this reason, it is consistent to believe both that people make mistakes and that government policy should be based on the assumption people's actions and ex-ante predictions are the best guide to what is in their own interests" (p.707). Quite!

But, this does not mean that in teaching our children "how to live", they should not be encouraged to exercise self-control and think of long-term consequences. But this is the domain of preachers. There is nothing libertarian about "libertarian paternalism". It *is* paternalism which should on Mill's principle of liberty play no part in the public policy of the good society. The Nanny State must not be allowed to replace the Planned Economy.