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HEADLINE: THE IDEAS EXCHANGE: ECONOMIC VIEW - HOW AMERICA LOST ITS BALANCE

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In the Roaring Nineties it seemed that capitalism, American style, would take over the world. Unemployment fell to levels not seen for more than a quarter of a century and many even thought the "new economy" heralded an end to the business cycle.

But that was not to be the case. The boom ended, the stock market fell. Under George W Bush, more jobs have been destroyed than during any presidency since Herbert Hoover presided over the beginning of the Great Depression. We now recognise that the seeds of destruction were sown during the boom and that we were let down by the US Federal Reserve, which had been hailed as one of the architects of the boom. The Fed should have at least tried to let the air out of the bubble gradually by slowly raising interest rates and margin requirements - the amount of money that investors have to put down when they buy a stock (rather than borrowing from the broker). Instead it joined the cheerleaders, talking of unprecedented increases in productivity that further excited the market.

If the Fed failed, so too did others. As the bubble took off, capital gains taxes were cut, feeding the frenzy. At the centre of the bubble economy was deregulation - in electricity, financial markets and telecommunications. Big companies in these sectors pushed for deregulation, saying it would bring a new era of competition. But their actions showed they didn't really believe that. In fact, they thought that if they could be first into the market, they would come to dominate it. The race to be first meant there was huge over-investment.

Meanwhile, bad accounting meant that prices did not reflect underlying realities. The problem with American capitalism was not a few bad apples; it was systemic, involving, for instance, most of the United States' iconic banks and accounting firms.

Europe recognised some of these problems and was slow to push deregulation to American extremes. In its ideal form, the continental version of capitalism paid more attention to workers' rights and less to the corporation's bottom line. But the success of the US seemed so great that its example was hard to resist. Many European firms adopted US-style managerial practices, and a few even tried to get away with US-style accounting practices. More recently, in the WTO negotiations that ended so tumultuously in Cancun, Europe followed America in pushing developing countries to liberalise their capital markets quickly - to open themselves up to the sort of speculative money that had caused such devastation in East Asia and Latin America.

Apparently, European officials have for- gotten that the region's highest growth came when most countries had capital mar- ket restrictions; today, even the IMF recog- nises that such extreme liberalisation leads to greater instability, not greater growth.

It is important we learn the right lessons from these recent events. At the start of the last decade, the Clinton administration was seemingly succeeding in doing what conservatives had been trying to do for 70 years - to kill the Keynesian idea that countries ought to cut taxes or increase spending in the face of a recession. But President Clinton's deficit reduction programme was carefully designed, involving tax rises for the very rich, with most of the deficit reduction occurring later, after the economy was hopefully on the way to recovery. And there were some special circumstances: banks loaded up with long-term government bonds, so that a fall in the long-term interest rate recapitalised them.

The Bush administration has shown the flipside of this: poorly designed deficits don't necessarily do much to stimulate the economy when the tax cuts go to upper-income individuals or corporations that do not spend the money. Many in Europe have been following President Bush's lead in touting the virtues of deficit spending, but if they follow his lead in poorly designed tax cuts, it will have similar effects.

Today, Europe suffers not only from a stability pact that ties its fiscal hands, but an independent Central Bank focusing on inflation, which has done less than it could to ameliorate Europe's downturn. There is a myth that central banking can be left to technocrats, that doing so will lead to better economic performance, and that independent central banks are non-partisan. America's experience shows the contrary. No central banker has been more praised than the Fed's Alan Greenspan, and yet the recent history of the US casts doubt on these views and shows the limits of what the banks can do.

The Fed failed to forestall the recessions either of 1990-91 or 2001, failed to tame the Nineties boom, and has continued to fail to restore the economy to full employment. The Fed supported Mr Bush's profligate tax cut for the rich in 2001, a reduction that turned the unprecedented surpluses into deficits reminiscent of the Reagan era. In the early Nineties, there was the belief that were unemployment to fall below 6.0 per cent, inflation would increase. Fortunately, the Fed did not raise interest rates even as unemployment crashed through the magic 6.0 per cent barrier. Eventually it fell to 3.8 per cent, and still inflation remained tame. It was the most important real part of our growth strategy, and also the most important part of our social policy, for as the unemployment rate fell, so did poverty and even crime.

In the Nineties, we placed too much faith in the wisdom of finance, in unfettered markets, in simplistic versions of capitalism. Most importantly, the lesson to emerge is this: there needs to be a balance between government and the market. In the Roaring Nineties, we lost that balance.

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