



The World Economic Crisis

**An essay on its origins,
characteristics and possible outcomes
from a liberal perspective**

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I. Introduction

The economic crisis that has roiled the world over the past nine months gives a new meaning to a phrase, so beloved of philosophers and sociologists, “a world historical event.”

As a “world” event, these months have revealed, with shocking ferocity, the interconnectedness not only of national economies and economic domains, but also of the political and moral beliefs that surround capitalism. Sub-prime loans in certain American states set off a chain reaction that spread across the economic spectrum—from the insurance industry and the automobile industry to commercial and investment banking—and across continents, as countries as distant as Ireland and Iceland, Spain and China experienced economic upheaval and crisis. This global event has triggered a profound meditation on the perils of a global economy.

As a “historical” event—the economic crisis raises a number of pertinent questions from a liberal perspective. In what sense is this crisis historical? Is it a repetition of earlier bubbles—from the South Sea bubble of 1720 to the Great Depression of the 1930s—or is it something radically new? Moreover, how should liberals interpret these moments of economic collapse? Are they ruptures exposing fundamental structural weakness in capitalism? Are they events in

which the system recalibrates itself and expands its interests? Or are they events in which the system simply demands to be recalibrated?

Some have traced the crisis to the climate of easy borrowing created in the United States by Alan Greenspan, the chairman of the board of governors of the Federal Reserve, in response to the collapse of the hedge fund Long Term Capital Management in the late 1990s and the bursting of the dot.com bubble that inflated the housing market bubble. Others (again tracing the origin of the crisis to the United States) suggest that the repeal of the 1933 Glass-Steagall Act, which was designed to limit speculation by separating commercial from investment banking, created an environment that allowed reckless lending. Others regard the crisis as symptomatic of a fundamental instability in the type of finance capitalism that has developed in America, Britain and some other Western countries. These accounts are neither mutually exclusive nor exhaustive. But economics alone may not provide a satisfactory understanding of the events of the past year, for they include shifts in geopolitics that go beyond economic performance. Market economies are not controlled solely or even chiefly by economic theories; they rely on ideas about right and wrong, fairness in society, and orderliness in the world. For that reason, a liberal analysis that is at once systemic and historical, particular and global, must also emphasize the extent to which political ideologies and economics shadow one another.

II. Political and Economic Underpinnings of Liberalism

Obviously, we can find historical parallels to the current situation that are relevant. Such parallels can still trigger debate. For example, the first European bankers were Italians from Genoa, Venice, Pisa, Florence and Lombardy, who began their activity in the twelfth century, establishing offices all over the continent. They lent huge sums of money to the kings of England and France, even to the point of financing the Hundred-Years War. The sovereigns, however, never repaid their debts and the banks went bankrupt. In those days there were no governments willing to cover their liabilities. When Lehman Brothers also went bankrupt there were those who considered it a mistake not to have saved it. But many liberals no longer favor the idea of dedicating vast quantities of money to save banks that did business like unscrupulous gamblers. However, I believe that it is important as liberals not to lose sight of our foundational principles in the course of debating our response. Ours is a tradition that holds values that must not be forgotten in the urgent climate of crisis.

For classical greek philosophers, and to a certain extent for thinkers like Jean-Jacques Rousseau, liberty primarily meant the right to have a voice in the collective process of decision-taking. Livius, Tacitus and Cicero are Roman thinkers and orators that built concepts around more advanced ideas of individual liberty. In modern times, however,

liberty has come to be understood as a protected sphere of non-interference with personal freedoms in which independence can be regulated by the law. Hobbes and Spinoza were the first modern apostles of liberty in the form of individualism. Their formulation of human liberty, power, and self-interest expanded the limiting boundaries imposed by previous concepts of politics.

Generally, the conception that free individuals could form the foundation for a stable society is dated from the work of John Locke, whose *Two Treatises on Government* established two fundamental liberal ideas: economic liberty, meaning the right to have and use property, and intellectual liberty, including freedom of conscience. Locke saw the earlier idea of natural rights as "life, liberty and property." To him, property was more important than the right to participate in government and public decision-making and he feared that giving power to the people would erode the sanctity of private property. He conceived of a society of human beings equal under the law, gathered without a common purpose, who still shared respect for the rights of other human beings, but he was perceptive in recognizing the while human liberty and independence presupposes private property safely protected by the rule of law, the desire to expand property required certain restraints. Liberty, in other words, did not guarantee abusive privileges to any individual. This fundamental point has been obscured in recent bailout procedures although underscored in the public outcry against funds expended on corporate luxuries,

bonuses, and lobbying efforts.

The British contribution to the development of liberal ideas was seminal. Political liberties gained during the “Glorious Revolution” in the United Kingdom influenced French thinkers such as Montesquieu and helped Benjamin Constant and Alexis de Tocqueville reformulate an understanding of political and economic liberty. Both Constant and Tocqueville worried about the future of liberty—Constant on the basis of his reading of the French Terror after the revolution and Tocqueville preoccupied by the limits on individualism that the tyranny of the majority could impose in a government by the masses.

The first modern liberal state, the United States of America, was founded on the principle that "all men are created equal; that they are endowed by their creator with certain unalienable rights; that among these are life, liberty and the pursuit of happiness; that to insure these rights, governments are instituted among men, deriving their just powers from the consent of the governed." It is a commonly known fact that Thomas Jefferson substituted the famous phrase “life, liberty, and the pursuit of *happiness*” for the words “life, liberty and *property*” contained in an earlier draft. The Federalist papers offer a contrast with French liberal writings in their understanding of human imperfections that permeates their concept of liberalism. Again, we find recognition of the potential for abuse within the exercise of individual freedoms. Thus, an interesting tension between the

ownership of property and the pursuit of happiness lies at heart of liberal politics. A tension, I might add, that this economic crisis brings into higher relief.

We find in David Hume's *Treatise of Human Nature* (1739) a link between political and economic liberalism: he notes the restricted benevolence of human beings, as well as the permanent scarcity of resources sufficient to satisfy human needs, and from these two postulates he infers the causes for the appearance of the basic principles of justice. He acknowledges three fundamental laws of nature: stability in possessions, their transference by consent, and the keeping of promises. "I shall therefore venture to acknowledge," he declared, "that not only as a man, but as a British subject I pray for the flourishing commerce of Germany, Spain, Italy and even France itself." This acknowledgement of a need for global progress rather than protectionist exclusions prefigures the current liberal stance.

In *The Wealth of Nations* (1776), Adam Smith gave shape to the central ideas that govern a market economy. His observation of people, institutions, firms, and households, convinced him that economic growth was best served by the free operation of markets, in contrast to the regulations of internal and external trade that had favored the mercantilists, and he postulated that the epochs of human history would culminate in a free market economy. At the same time, he recognized that government should assume tasks that could not be

entrusted to the profit motive, such as preventing individuals from using force or fraud to disrupt competition, trade, or production. Smith articulates the liberal idea that changes in the economic system are parallel to changes in the political structure and that a free market system goes hand in hand with a political system that guarantees civil and political liberties. In a systematic and universal way, he formulated a theory of methodological individualism which implied that individual human agents determined any social outcome. For Smith, the wealth of nations originated in the productivity of labor. But the division of labor on which productivity depended was in its turn based on the extent of the market and capital accumulation.

At the end of the Napoleonic Wars, the reign of liberalism was relatively unchallenged. Classical liberalism evolved in the hands of liberal thinkers such as Jeremy Bentham, who gave it a new twist. In many respects, Bentham was a classical liberal, but he advanced the idea that social institutions could be the object of rational redesign, an innovation that led later thinkers to elaborate illiberal and interventionist prescriptions that moved far beyond his original, merely utilitarian, concepts. His disciple James Mill worked on a rigid rationalist defense of democracy in his *Essay on Government*. His son, John Stuart Mill, was in a sense closer to classic liberalism than either his father or Bentham, but in the field of economics, he flirted with some socialist schemes and helped justify British interventionist and statist policies of the end of the nineteenth century. However,

Mill articulated fundamental principles of what might be called cultural liberalism that are directly relevant to the current crisis. In 1859, in his essay “On Liberty,” he claimed that neither physical nor moral good would justify interfering with the liberty of another person. The only rightful exercise of power against a person’s will, therefore, would be to prevent harm to others. In other words, a desire for profit or the acquisition of property must be pursued within defined ethical limits.

David Ricardo strengthened the case for liberal laissez-faire economics. In his theory of comparative advantage, he demonstrated that international trade benefits all trading economies and increases world output. Using Ricardo’s theory of international trade, Mill was able to analyse the division of gains among trading partners and came close to developing the concept of price elasticity of demand. While rejecting the socialist condemnation of private property and competition, at times he advocated strong intervention of the state in the economy. Thus, while he defended the classical tenets of liberalism, he justified intervention by the state in order to counter the injustices he observed in the capitalist system. For Mill—and this is perhaps his most critical insight for addressing contemporary issues—individual improvement and self-fulfillment were as much a basis for his philosophy as liberalism was a basis for his economic beliefs.

Alfred Marshall is probably one of the most influential neoclassical economists. He acknowledged different strains of methodological approach to economics. Going beyond a purely mathematical, historical, or politically oriented method, he recognized the complementarity in all of these approaches. He avoided controversy over whether prices resulted from supply or from demand alone to apply marginal analysis to the complex issues of price determination. With Smith and John Stuart Mill, he analysed the behavior at the level of the household and the firm. Conceiving of free markets as a mode of working out economic conflicts, he set up the framework for today's partial equilibrium microeconomic theory although modern microeconomics has moved away from Marshallian economics through the work of John Hick and Paul Samuelson, with later contributions by Arrow and Debreu. The Chicago School of economic analysis continued to be based on Marshall's work but with a much more pronounced pro-market approach.

In the United States the Great Depression shook public faith in "laissez-faire capitalism" and "the profit motive," leading many to conclude that the unregulated markets could not produce prosperity and prevent poverty. Troubled by the political instability and restrictions on liberty that they believed were caused by the growing relative inequality of wealth, many liberals argued for the creation of a more elaborate state apparatus to serve as the bulwark of individual liberty, permitting the continuation of capitalism while protecting the

citizens against its perceived excesses. Key liberal thinkers of this persuasion—John Maynard Keynes, in particular—had a significant impact on liberal thought throughout the world. Liberal International was heavily influenced by Keynes, as were the Liberal Party in Britain, particularly since Lloyd George's People's Budget, and the Oxford Liberal Manifesto of 1947 of the world organization of liberal parties. In the United States and in Canada, Keynesianism influenced Franklin D. Roosevelt's New Deal and led social liberalism to be identified with American liberalism and Canadian liberalism. But the liberal position on economics was not a unified one, as evidenced by the positions adopted by the Austrian School in contrast to those favored by American liberal economists and these differences persist in liberal thought in the United States and in Europe.

One of the central questions of the twentieth century—one that interested economists everywhere—was whether socialism or capitalism could better allocate resources. Keynes was not a socialist, but he was criticized from both sides of the political spectrum, some thinking he wanted to dismantle capitalism, those to the left believing that he was its apologist. In his formulations of economic policy, he defended individualism and the use of self-interest to achieve efficiency and innovation. “But above all, individualism,” he wrote, “if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice. It is also the best

safeguard of the variety of life, which emerges precisely from this extended field of personal choice, and the loss of which is the greatest of all losses of the homogeneous or totalitarian state.”

Keynes' General Theory changed the existing focus on microeconomics of resource allocation to macroeconomic business fluctuations. Recognizing instabilities inherent in capitalism, he concluded that the automatic working of the market produced equilibrium at less than full employment, and advocated investment spending to determine the level of economic activity. Monetary and fiscal policies advanced by Keynesians required little direct government intervention in the economy and they were put to use in the United States, but Keynesian policies were contested by monetarists, who countered that he did not account for the role of money. A new macroeconomic model emerged and later new literature on the microfoundations of macroeconomics was produced to reconcile micro- and macro- theories.

Friedrich von Hayek believed that Keynesian analysis conferred a causal power on statistical measures that they do not have in the real world. He elaborated on the negative response of his compatriot Ludwig von Mises to the question of socialism's allocation of resources, but he also argued that socialism was incompatible with economic and political freedom. Dismissing any objective theory of value, Hayek maintained that economic value is conferred by the preferences and evaluation given by individuals. His subjectivist lens

refused to acknowledge the theory of general equilibrium and questioned the validity of systems of global economics. The Austrian School of economic thought regained momentum in the recession of the seventies, when it postulated that inflationist monetary policies would fail because they modified the expectations of the governing class. Monetary expansion, the Austrians argued, could not stimulate the economy unless its results were to be unexpected. Therefore, once inflationist policies became a given, they could not have an expansionist effect on the economy. In the end, the Austrian school came to recommend the classical economists' solution to economic depression and collapse: government should pull away from the economy and restrictive practices at the border should be diminished.

The arguments of the Austrian School contradicted those of the Chicago School, as well as Keynesian economists. Milton Friedman, for example, proposed monetary control as the way to achieve stable growth. He argued that the Great Depression was not a result of "laissez-faire" capitalism but of too much government intervention and regulation upon the market. For him, the government regulation that occurred before the Great Depression (including heavy regulations upon banks that prevented them from reacting to the markets' demand for money and the creation of a fixed currency pegged to the value of gold) prevented the country from reacting to currency demand, thereby creating a run on the banks that the banks were unable to handle. Fixed exchange rates between the dollar and gold

also created deflationary pressures. To address the crisis, the government inflicted pain upon the American public first by raising taxes and then by printing money to pay debts (thus causing inflation). The combination helped to wipe out the savings of the middle class.

Significantly, modern macroeconomics has focused primarily on business-cycle theory as well as on monetary and growth theory. One of the first economists to focus on business cycle theory was the French physician and economist Clement Juglar. In 1889 he wrote: "The periods of prosperity, crisis, liquidation, although affected by the fortunate or unfortunate accidents in the life of peoples, are not the result of chance events, but arise out of the behaviour, the activities, and above all out of the saving habits of the population, and the way they employ the capital and credit available." These factors, of course are all implicated in the current crisis. But Joseph Schumpeter also addressed the role of business and human endeavor in his theory that the principal agents of economic growth are non-economic. They are found, he argued, in the institutional structure of society and the activities of entrepreneurs who are able to grasp the potential of a new invention and exploit it for personal gain. As long as government institutions stress laissez-faire markets, an innovative entrepreneur can thrive and the economy can grow. But Schumpeter feared that successful firms would become more risk-averse as they grew in size and instead of rewarding innovative entrepreneurs would be run

bureaucratically. Ownership would be removed from the concerns of the company. In this evolution, which is one of the contextual elements of the current crisis (with its attendant emphasis on CEO bonuses, creative accounting practices, and insider trading to manipulate stock values), he foresaw the removal of a large part of support for capitalism. Schumpeter's perception is based fundamentally on the idea that losing the value of stewardship also stifles innovation.

Perhaps the greatest tension now within the context of Liberal International is between those who argue for "creative destruction," in Schumpeter's phrase, and those who argue for "Keynesian" stimulus of demand. Although they are not mutually exclusive ideas, some parties, particularly those that rely on a general national vote, are likely to emphasize creative destruction while others, whose representation is more locally based, are likely to emphasize the need to protect particular industries and regions through stimulus packages and the protection of local industry. This is one of the essential debates we must pursue and one of the greatest challenges facing international collaboration.

The 1970s were prolific in the rebirth of liberal ideas in political philosophy. John Rawls in his *A Theory of Justice* (1971) developed a liberal concept of social organization very much linked to the classical liberal concern for individual liberty in a constitutional order governed

by the rule of law. Robert Nozick underlined the necessary connection between economic freedom and personal non-economic freedoms, such as freedom of expression and way of life. His postulates directly contradict the rightist use of the free market by conservatives in the United States. However, the 1980s were characterized by a strange dichotomy between economic and political liberalism. Conservative political leaders coopted the ideas of the new classical theorists of the economy, such as Hayek and Friedman, and free market policies came to be associated with conservatism. However, the application of classical liberal policies became associated with non-liberal policies in the field of civil and personal liberties.

John Gray notes that liberalism is the political theory of modernity; a political theory of modern individuals concerned with liberty and privacy, and with the growth of wealth and of invention and innovation; which conceives a machinery of government indispensable for civil life but sometimes posing a threat to the civil life it aims to safeguard. It has been attacked by conservatives as well as by socialists, who seem to converge, he believes, in certain aspects of their criticism of liberalism. Both socialism and conservatism have in their own way tried to reject the liberal concepts of a civil society in favor of their respective understandings of a moral community. At one point in their ideological development, they both conceived of liberalism as only a phase in social development. However, apart from vague references, neither conservatism nor socialism have been able

to forecast a satisfactory theory of what state of affairs they would prefer in a post-liberal world. In certain countries, the breakdown of liberalism after World War I created grotesque and in the end tragic totalitarian states and led to major disasters and genocides. Some kind of idealized return to communitarian value systems like those of the middle ages, whether in a socialist perspective or in a conservative one, does not relate to the individualism assumed by many to be the basis for economic and political freedom in our modern world. The current economic crisis must be viewed in this perspective: a crisis of growth, of stewardship and of classical liberal ideals gone awry. Many of its origins and consequences have been tackled by economists in the past, and this suggests that the present crisis can be understood and countered with remedies found in the evolution of economic ideas.

III. The Question of Property

One of the basic ideas of the early liberal thinkers was contractual: *individuals* made agreements and owned property. Gradually, the liberal tradition introduced the idea that voluntary consent and voluntary agreement were the basis for legitimate government and law. Thus traditionally, economic liberalism has supported the individual rights of property and freedom of contract, without which, it argues, the exercise of other liberties is impossible. And as long as no coercion is used, economic liberalism accepts the economic inequality

that arises from unequal bargaining positions as being the natural result of competition. Twentieth-century economic liberals stressed the importance of a free market and free trade and sought to limit government intervention in both the domestic economy and foreign trade. Social liberal movements often agree in principle with the idea of free trade, but maintain some skepticism, seeing unrestricted trade as leading to the growth of multi-national corporations and the concentration of wealth and power in the hands of the few.

Although the events of the past year have returned Keynesian economics to favor, and the policy of reducing the cost of borrowing to near zero while expanding debt-financed government spending on a large scale resembles the proposals Keynes advanced in the 1930s, it is not clear whether he would approve of their application today. Their goal is to encourage people to spend and borrow more, a strategy that attempts to return to debt-financed consumption. One challenge to realizing this goal is that developed world economies and many in the fast developing world—the U.S. is a significant exception—will rely on older people to provide the demand-pull and the labour supply to draw economies out of recession. Yet during recessions, older people leave the labour force in disproportionate numbers and they do not return, creating problems of long-term depressed demand and a lack of key skills and general labour supply. Critics also point out that the strategy of a return to debt-financed consumption cannot work without sparking inflation at some point in

the future. Large sections of the population, whose wealth has already been depleted by the decline of the housing and stock markets, could find it shrinking further as the value of money is reduced. And large sections of the population already occupy an economic position of impoverishment or need in extreme contrast to the situation of the most wealthy. The social contract—the liberal link between regard for the rights of property and regard for ethical limits—has in many ways been broken.

In one sense, the shift from preservation of property rights to the pursuit of happiness has entangled the definition of happiness with ownership of things and economic status, turning the liberal individual into a consumer indifferent to limitations of prudence or concern for others. Often the basic values of a capitalistic economy are negative: become rich at all costs, gain wealth to obtain power, selfishness, prevarication over the weakest and over those unable to produce, such as the elderly and the unemployed. These un-values were the engine of a market without rules and of un-braked financial anarchy, severing all ties with the productive system, with the State, with laws, and morality. The pursuit of happiness has become the pursuit of material accumulation, whether in terms of bonus rewards, corporate jets, plastic decorations, or luxury brands.

The ethos underlying earlier property ownership also involved a sense of stewardship that is foreign to present-day consumption of

resources. The level of consumption achieved in recent decades has run up a large debt to the planet. Our natural capital is reaching a state of global crisis equivalent to the turmoil in the financial markets. In 1929, when the run on the banks tilted the American economy toward the Great Depression, Keynes wrote, "It will take 100 years before the economy reorganizes itself on more positive values, such as solidarity and understanding towards the most unfortunate and the needy, placing human beings at the top of every economic activity and establishing ethical finance to be at the service of human and social progress." Today, we recognize that the economic reorganization he envisioned has failed to occur.

IV. Economic Self-Interest

Contemporary liberalism has come to represent different things to Americans and to Europeans: in the United States it is associated with the welfare-state policies of the New Deal program of Democratic President Franklin D. Roosevelt, while in Europe liberals more often adopt a conservative political and economic outlook. American liberals endorse regulation for business and a limited social welfare state. In Europe liberalism is characterized by beliefs in free trade and limited government. The global nature of the current crisis tests all these assumptions.

In the wake of the economic crisis of the 1990s, American economist Lawrence Summers asserted that well-capitalized and supervised banks and reliable, transparent corporate accounting had protected the United States. But in reality, deregulatory zeal had empowered bankers to develop highly sophisticated financial markets. The temporary paralysis of the world credit markets when the Long-Term Capital Management hedge fund collapsed in 1998 should have indicated that this deregulated system, with its highly leveraged players and global capital flows, was becoming dangerously fragile, yet ironically the close escape from calamity made investors more complacent. It is now clear that by making ever-larger gambles, elite American financiers, with implicit government backing, played a central role in creating the current crisis and are using their influence to prevent rapid reforms needed to pull the economy out of its collapse.

Like the failure of the Iraqi war, the economic crisis is costing America some of its credibility, and with it some of its ability to lead, but the United States was not the only nation in which banks ran wild. Stronger social safety nets mean that Europeans may experience less human suffering than their American counterparts, but economic and financial troubles have afflicted countries that only a few years ago were being praised as “economic tigers” or “economic miracles.” In these countries, an inrush of capital created an illusion of wealth, just as it did for American homeowners.

And damage spreads. In America, for example, the housing bubble mainly took place along the coasts, but when the bubble burst, demand for manufactured goods collapsed—and that has taken a toll on the country's industrial heartland. Europe's bubbles also mainly occurred around the continent's periphery. Spain, for example, has been called the continental Florida and the situations are similar: the huge speculative housing boom that buoyed up its economy is over and new sources of income and employment must be found to replace lost jobs in construction. Meanwhile, thanks to a plunge in exports, industrial production in Germany—which never experienced a financial bubble but is Europe's manufacturing core—is falling rapidly.

Moreover, in this globalized financial system, a crisis that began with a bubble in Florida condos has caused monetary catastrophe in Iceland, and countries linked by the euro are tied to the inflationary or deflationary health of the European economy as a whole. Thus Spain, unable to improve competitiveness by devaluing its currency, is being forced into the painful process of cutting wages. China is experiencing another type of linked monetary problem. Having chosen to keep the value of the yuan more or less fixed in terms of the dollar, its trade surpluses resulted in inflows of foreign capital, much of it invested in safe but low-interest U.S. Treasury bills. Now China's exports have fallen and selling dollars would drive the dollar down and

trigger a big loss of capital. The world in which China could save more than it invested and dispose of its excess savings in America is gone. Wrenching changes will be needed to deal with this global crisis and those changes will affect us all.

V. What the Crisis Means for Liberalism

With hindsight, we can tally up the causes of the crisis (see the discussion in Appendix I). They include unparalleled expansion, unbridled optimism, lack of perspective in the economic profession, blind belief in the unbreakable strength of large financial and economic institutions, the failure of regulatory supervision, unwillingness to assess real risks, and accumulation of debt (both public and private) in an environment of expanding optimism. Failures, in other words, of stewardship.

In this context, the core liberal belief in the benefit of open markets requires examination into the extent to which the culture of always wanting more contributed to this crisis, for stewardship is incompatible with sacrificing the environment either for the sake of exceptional profits in industries that depend on the aggressive consumption of natural resources or to feed the desire to preserve (or emulate) increasingly affluent lifestyles. That is not the same as

saying that the concept of markets is outdated or that protectionism offers a magic solution to our problems. In fact, competition stimulates the innovation that can lead out of the crisis. On the other hand, it seems inevitable that banks must deleverage and be subject to stricter governance and compensation arrangements in the future. Some may object to the idea of more regulation, but perhaps the essential question is whether governments possess the political will to collaborate in order to achieve a solution.

Let us look first at the strength of political will in the United States. In effect, the US administration appears ready to shower benefits on everyone who made the mistake of buying the banks' so-called "toxic assets." It's true that some benefits would trickle down to shore up the balance sheets of key financial institutions. But most would go to people who don't need or deserve to be rescued. Not only is the plan to unfreeze the credit markets vague and potentially inadequate, laying out trillions of dollars to bring the financial system back to health adds to already serious concerns about the deficit. Officials appear to have seized on this solution because it's very hard to rescue an insolvent bank without taking it over, and politically, even temporary nationalization appears unthinkable. Another danger is that once the economy begins to recover, the urgency for financial reform will be lost and those making easy money again will lobby against anything that interferes with their interests. Nor were politicians and economic officials approving the stimulus plan able to transcend the

conventional prejudices against deficit spending and making significant changes. Stimulus packages with short-term benefits in stimulating demand and can be put into effect immediately (the "shovel-ready" initiatives, for example, built into the US stimulus package) also need to project a long-term effect on improving infrastructure and the environment. The EU's Enterprise Directorate is looking to identify types of innovation in which short-term investment has a long-term benefit. Extending IT network capability would be one example. In Britain, the London School of Economics and the Treasury have been working on green aspects of stimulus packages with long-term benefits in improving the environment and tackling climate change. In the US, stimulus plans including infrastructure and "green jobs" acknowledge this necessity for long-term investment.

Most economists agree the plan that emerged from Congressional compromise was weaker and contained more tax cuts than it should have (and even so failed to gain broad bipartisan support). On the other hand, President Obama's proposed budget would set America on a fundamentally new course in terms of stewardship. It represents a huge break with policy trends over the past 30 years by allocating \$634 billion over the next decade for health reform (paid for in part by halting the privatization of Medicare and eliminating overpayments to insurance companies) and it projects \$645 billion in revenues from the sale of emission allowances (signaling that after years of delay and

denial, this administration is ready to address the problem of climate change).

Although Europe's problems are equally grave, the political will is equally fragile and the focus of debate is somewhat different. For example, politicians will not admit to protectionist policies. Instead they present them under better colours, for example, as the need to use national money to protect national jobs. Strong leadership is essential to avoid the temptation to offer "buy European" or "buy Dutch" as a solution. The liberal position would hold to the principle that despite radically different market conditions, the single market must be guarded like the jewel of the EU family. That implies a refusal to bail out structurally inefficient companies and thus place a massive tax burden on future generations. Here is evidence for the contrast between American and European liberalism.

European governments have begun to improve interbank lending with bank guarantees and recapitalisation. The need for a consistent and coordinated approach among the EU countries is non-negotiable, but member states must be resolute to reduce uncertainty. Otherwise the risk is the perpetuation of failed business models, ruin of public finances, entrenchment of competitive distortions, an imperilled single market, and the loss of a viable banking market after the crisis is resolved. Although implementation involves difficult questions, for actions must be timely, targeted, and transparent as well as

sustainable from a budgetary perspective, the demand for transparency and a willingness to restructure seems more evident in Europe than in the United States.

If American economists argue that the Obama administration's stimulus plan was too small to address the depth of the crisis, European actions have been proportionately smaller, in part because officials remain complacent. Paul Krugman, with typical candor, excoriates this lack of fiscal action, blaming structural weaknesses inherent in the absence of any government in a position to take responsibility for the European economy as a whole or take political risks for the benefit of another country and the lack of unitary support for the European Central Bank, which owes allegiance to sixteen countries that disagree among themselves.

The International Monetary Fund, which has a leadership mandate, near universal membership, and a blend of macroeconomic and financial expertise, is instituting steps to increase global coordination. A new warning exercise, for example, will bring together scattered macro-financial expertise, piecing together macroeconomic and financial sector developments into a big picture that takes into account cross-country spillover effects and can drill down on key threats. It is also reviewing its lending framework to make sure it is well-suited to members' needs. However, the bureaucratic ways and rigid power structures that characterize the IMF have shifted the policy debate towards smaller, more flexible groups, including to the

G-20 and the FSF. Yet these smaller groups have their own problems of legitimacy and capacity for follow-up. Making decision-making more accurately reflect today's global economic landscape would require a further rebalancing of voice and representation among IMF members.

The extent to which financial regulation can be made both international and binding remains in question. Clearly, a common currency requires stronger common rules than a looser association, but while recognizing the need for international cooperation the desirability (or even the possibility) of over-riding national control of regulation with pan-national structures undoubtedly is an issue that will cause debate. Such structures may be more efficacious when combined with national and, particularly in the EU case, trading bloc regulation.

The world will not be the same at the end of the current crisis. Important changes will reflect new attitudes toward stewardship, including a new industrial revolution impelled by ecologically sustainable development. In many countries, research for new production systems, conservation, and the thrifty use of energy are already expected to be a means for creating new jobs. As one example, the world's fifth exporter of petroleum, the United Arab Emirates, has commenced a multi-billion dollar project to make their capital, Abu Dhabi, the international center for renewable energies.

The fundamental stages of human economic development have always coincided with the ability to capture new sources of energy: fire, wind, water, sun, natural gas, petroleum. Acceleration of development in the last two centuries was made possible through a parallel acceleration of energy production, using new sources and applying more advanced technologies. But solutions cannot rest on technology alone; in many ways heightened financial technologies abetted the current monetary crisis and a variety of biological innovations have the potential to alter the world's commodity markets. And a rapid return to the rate of economic growth of the past decades—the aim of many policy makers around the globe—would increase the emissions of greenhouse gases that are altering the climate. Moreover, in this urgent crisis, political pressures run the danger of restarting economic growth by any available means. But returning to the levels of consumption that characterized the recent past will run up an environmental bill that the planet will surely collect.

This is why liberalism, in the sense not only of economics but of the classical regard for economic and social progress for all, will become a crucial force in the process of solving the crisis. To rebuild a new economic system, it will not be enough to control the banks, make balance sheets more transparent, regulate speculative funds, and refurbish the economy through public spending. We must remind ourselves that the market is not a dogma; it is merely an instrument in the service of economic progress. Liberals put liberty in first place

as a creative force that multiplies opportunities for everyone. A return to those classical principles—principles that call for responsible stewardship of both human and natural resources—must become part of our future.

(This essay is the result of an on-going conversation with a number of liberal thinkers and politicians, especially Beatrice Rangoni Machiavelli, Frits Bolkestein, Ricardo Lopez Murphy, Vince Cable, Josep Soler, Steingrímur Hermannsson, Carles Gasòliba, Cecilia Malmström, Harald Klein, Gordon Lishman, Graham Watson, Neelie Kroes, among others, who have made available their thoughts, information, speeches and publications on this matter. Thanks also to Nikola Spatafora, senior economist at the IMF for his valuable contribution. My thanks and acknowledgement to all of them, and to the members of the LI secretariat, under Emil Kirjas, for their help. A particular acknowledgement to Lord John Alderdice, President of Liberal International, whose trust and friendship has guided my steps in LI these past four years and who is primarily responsible for my attempt to write this essay. Of course, the conclusions and opinions expressed in this document are those of the author and they do not reflect the position of LI or any of the above mentioned thinkers. This essay just pretends to be food for thought at the 182nd Executive Committee of Liberal International)

Appendix I

Origins of the crisis

- **Unparalleled expansion and unbridled optimism.**

In the 30 years prior to 2008, the global GDP grew 5.5 times and trade was multiplied by 10 (Lopez Murphy). The IMF characterizes this as the highest global growth in recorded history. This longest expansion span since World War II gave rise to unbridled optimism, leading to an ever less cautious way of handling the economy. The effects of opening up China and the emerging economies of Asia, the East of Europe, and, to a lesser extent, the rest of the developing world, to the world economy compounded with outstanding technological advancements in production—in the fields of telecommunications, IT, and biogenetics particularly—led experts, politicians and the general public to rely on a sense of ever-lasting prosperity, justified by what appeared to be a never-ending economic expansion.

- **Lack of perspective of the economic profession.**

Professionals in the fields of economics and finance forgot the lessons of the Great Depression of the thirties. The historical cut created by World War II made all events prior to that event appear somewhat alien to modern economic analysis. The joint and simultaneous occurrence of a sharp drop in the value of assets and in capital inflow, as occurred in the 1930s, seemed impossible. Explanations for the enormous increase in the value of assets were derived from the idea that the potential for growth was extraordinary and, based on experience from the 1940s, that the economic system would automatically compensate for any correction that might occur (Lopez Murphy). It is sobering to realize that most economic analysts and commentators failed to consider the risk of a profound and durable crisis such as the one that has occurred.

- **Blind belief in the strength of large financial and economic institutions.**

The sheer size and reach of many highly well-appraised financial institutions, such as Lehman Brothers, convinced many specialists of their invulnerability.

Consequently financial markets and regulators disregarded the dangerous risk-taking activities practiced by these firms. As events have demonstrated, regulatory norms did not prevent these mammoth financial institutions from assuming unsustainable levels of risk.

- **Failure of statal regulatory supervision.**

The quality of practical supervision of the risk-taking activities of most financial firms by the structures of most states has been proved dismally insufficient. In some cases, these structures were almost ineffectual.

- **Incapacity of management, boards, and investors to assess real risk.**

The value of assets and credits being traded, in structured products, being assigned by financial institutions was biased by expectations of short-term gain and general optimism in the economic outlook. Little attention was given to actually understanding the composition and real value of many acquired products. The Spanish banker Emilio Botin coined the phrase “If you don’t understand it, do not buy it,” but this was not the dominant way of

thinking for most decision-makers and investors in the financial world.

- **Accumulation of public and private debt.**

In an environment of expanding optimism, debt-accumulation exercised a destabilizing effect on the economy. In the US, subprime loans allowed people without the usual financial qualifications to buy houses and investors bought securities backed by these loans. Investors also snapped up high-yield corporate debt, “junk bonds,” driving the spread between junk bond yields and US Treasuries down to record lows. During the subprime melt-down, the difference between the yield on B-rated corporate bonds increased from 2.45% to 4% in just two months.

- **Contagion effect.**

The globalization of markets as well as economic and technological interconnections increased the scope and reach of the crisis.

- **Lack of preparation among monetary authorities.**

Monetary authorities reacted to early symptoms of the crisis in a surprisingly sluggish manner. The fall in the value of assets, and the corollary effects on consumption and investment, happened long before they took any coordinated action against deflation.

- **Low interest rates and high world growth.**

For seven years, low interest rates had prompted investors around the world to search for yields further down the credit quality curve. A combination of high growth and low volatility led them to over-optimistic assessments about the risks they were taking. Partly in response to demand, the financial system also developed new structures and instruments that seemed to offer higher risk-adjusted yields, but were in fact more risky than they appeared (IMF).

- **Failure of market discipline.**

While optimism prevailed, due diligence was outsourced to credit rating agencies, and the compensation system in the financial systems was based on short-term profits, which reinforced the momentum for risk-taking (IMF). Counterparties and collateral in credits that were later

sold in structured financial products were not assessed in depth. Probes of the nature of assets being traded, and specifically the default risk, were grossly insufficient.

- **Lack of checks and balances.**

Checks and balances were not invoked at the right time and the right location. Loan brokers did not screen risk appropriately; end-investors and their analysts did not apply due diligence in checking the soundness of what they were buying. At the same time, because regulation and supervision were centered too much on individual firms, the risks within the whole system were not assessed correctly from a global perspective.

- **Size and centrality of the shadow banking system.**

As a site of innovation beyond the stricter controls applied to the deposit-taking institutions, and as a way for banks to evade capital requirements and proper assessments of risk, the shadow banking system became a major risk in itself. Its failure could provoke an economic melt-down that could only be avoided by shoring it up with public funds. The concentration and interrelation of firms (be they banks or shadow banking institutions) that have

been “too-big-to-fail,” to use the currently accepted expression, has masked the underlying risk and the toxic assets in the complexity of both the structured financial products and of the firms themselves. Size is an issue in this crisis.

- **Rating agencies.**

The rating agency practice of giving advice on how to structure products they must rate in order to get a better rating has rightly been called into question as improper and an obvious conflict of interest. Practices including over-optimism, too-big-to-fail firms, under-appreciation of firms, advice sold on how to structure products to maximize ratings, and inadequate assessment of default risk, resulted in inaccurate credit ratings. Investors too intent on realizing ever-growing short-term profits did not question these ratings and took them at face value.

- **Compensation schemes.**

Firms provided incentives to maximize profit in a short amount of time, encouraging managers to become more tolerant of risk. Bonuses and other compensations do not account for unassumable risks transformed into losses

down the line. A hit-and-run culture developed in which the firm's overall sustainability became less important than short-term growth and profits.

- **Procyclical regulatory practices and regulations.**

Procyclical regulations magnified the crisis. Specifically, most loan loss provisioning rules are based on incurred rather than expected portfolio impairment. They recognize risk too late and allow excessive risk in the upswing.

- **Accounting practices.**

Most economists consider the transparency required by Fair Value Accounting practices to be a good thing. But it raises the net worth of a firm during upswing cycles, allowing it to take on additional debt and leverage. On the other hand, it devalues net worth in illiquid times, such as this crisis, compounding the problems.

- **Macroeconomic settings.**

Macroeconomic settings in place prior to the crisis help to explain its magnitude. An extremely stable and growth-

oriented economy existed in most of the world (high productivity, stable inflation, low long-term interest rates, high saving rates for Asia and oil-producers, net capital inflows in the United States and in Europe), and it fed the search for high-yielding risky assets. Benefiting from the low interest rates and the limited volatility, stock and housing prices went up. The central banks failed to assess the growing risk while they concentrated on managing inflation and aggregate activity. They believed that the rules and regulations already in place were sufficient to give warning and prevent the build-up of risk. They also thought that low interest rates would take care of any drop in activity if the price of assets were reversed. Furthermore, in many states, the inability to reduce budget deficits in times of growth to prepare for a fiscal stimulus in times of crisis has not helped to address the crisis.

- **Global imbalances.**

The US has accumulated a large account deficit, while China, the rest of Asia, and oil-exporting nations have account surpluses. Large capital inflows towards the US, and to a lesser extent towards Europe, have caused concern. Should they be subject to a sharp reversal, it

would cause headaches for the host economies and undermine the dollar, which continues to be the currency of reference. Although the concern has not been realized, imbalances have kept interest rates low with a subsequent effect on the appearance of the crisis.

- **Poor forecasting ability on the part of international financial organizations and governments.**

The difficulties encountered in coordinating a response during the first months after the start of the crisis speak unfavorably about the capacity of the global financial architecture to predict, prevent, and respond rapidly to crises. International financial institutions have done a *mea culpa* for failing to assess and adequately give warnings about the form and shape of the current situation. One of the problems in financial surveillance is the fragmentation of data, data analysis, and sharing information between international financial institutions and within institutions. Also, efforts on the part of multilateral organizations to shape action towards early signs of the crisis have been curtailed by the inability of participant states to take policy action quickly and in a coordinated fashion. In many cases, they preferred to

focus on home markets at the expense of a coordinated response that might have been more effective. This difficulty shows the lack of leadership afforded by the international community to some of the Bretton Woods institutions.

- **Cross border resolution and burden sharing among national regulators.**

Once the crisis started, regulators experienced difficulty sharing burdens across borders that impeded resolutions. This problem illustrates the lack of a coherent cooperation and information-sharing system among supervisors in times of crisis.

- **Access to adequate liquidity and financing.**

For many countries, large and small, the problem of adequate liquidity and financing surfaced at the onset of the crisis. The IMF and other international financial institutions have faced a situation in which broad liquidity insurance has been insufficient.