Lessons from the Current Crisis

by Jagdish Bhagwati

Introduction

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Intertwined Crises

The current crisis—or perhaps two crises, one financial or Wall Street, the other macroeconomic or Main Street, both are intertwined—has caused not only panic, but also much anguished thought about its implications for capitalism and globalization. Clear thinking is necessary to prevent both of these principles being undermined in the populist reaction that seems to have emerged.

Market Fundamentalism

The financier George Soros and the economist Joseph Stiglitz, in particular, have gone around saying that the crisis has put an end to "market fundamentalism," and that it represents for capitalism and globalization what the collapse of the Berlin Wall did for communism. Both arguments must be rejected.

The post-war shift to more reliance on markets, greater integration of national economies into the world economy (which we call globalization), and the shift away from knee-jerk expansion of public-sector enterprises into activities beyond utilities that are "natural monopolies" was a shift from "anti-market fundamentalism" towards a more pragmatic center. It was not, as these critics claim, a shift from pragmatism to "market fundamentalism."

Besides, the analogy with the collapse of the Berlin Wall is laughable. The Wall's collapse signified the epitaph of a failed communism, which had landed its supporters in authoritarianism and economic wilderness. The current crisis follows instead decades of post-war prosperity, ushered in by the shift to the pragmatic center and away from anti-market fundamentalism. It also follows a steady shift of more of the world's nations to democracy, with economic and political liberalization often reinforcing each other.

Globalization and Financial Innovation

Again, we must avoid the fallacy of aggregation. Globalization, in the shape of freer trade and multinational investments, has been generally a force for good and economic prosperity. But it has also advanced, rather than harmed, social agendas such as gender equality and reduction of child labor, as demonstrated in my 2004 book, *In Defense of Globalization*. But, as every sophisticated economist knows, the financial sector offers asymmetries *vis-à-vis* international trade and, while it provides credit, which is the lifeblood of capitalist (or indeed any) systems, it can also lead to huge downsides and requires monitoring and informed regulation.

In relation to freeing capital flows and capital account convertibility that led to the East Asian financial crisis in the 1980s, I illustrate this asymmetry by using a couple of analogies.

Regarding trade, if I exchanged some of my toothbrushes for some of your toothpaste, and we both remembered to brush our teeth, we would both have white teeth and the probability of our teeth being knocked out in the process would be pretty slim.

However, the analogy for free capital flows is different. It is like fire, which enables me to turn veal into delicious "wiener schnitzel," but it can also burn down my house. The downside is huge, as we discovered at the time of the East Asian crisis.

This insight applies to financial innovation, which underlies recent crises, including the one we are in right now, perfectly. The long-term capital management crisis was precipitated by the financial innovation of derivatives which few understood. The innovation, and its downside when things got rough, had gone beyond comprehension by most, including the regulators. Currently, we have had similarly dangerous financial innovations like the credit default swaps and securitized mortgages. I am afraid few people realized the downside potential of these instruments. Yes, there were some warning voices. But they did not belong to what I have called the Wall Street–Treasury Complex: players who go back and forth, like Treasury Secretary Robert Rubin, between the Treasury and Wall Street (in his case, he went from Goldman Sachs to the Treasury and back to Citigroup). This Complex shared the euphoria about the financial innovations. So, they took us right into what turned into the bonfire.

The point we need to learn is that nonfinancial and financial innovations have important differences. Nonfinancial innovations (such as the innovation of the personal computer) raise the issue of what Schumpeter called “creative destruction” (i.e. smoothing into obsolescence the typewriter). With financial innovations, the problem is that there is a potential downside which can turn it into a “destructive creation.” Therefore, we need a high-level “Standing Committee of Experts” whose job would be to look hard at the potential downside of whatever is the latest innovation being created by Wall Street.

Again, an analogy helps. The United States, under the Cheney–Rumsfeld leadership, went to war against Iraq based on the assumption that the war would last six weeks. They did not have a scenario where it would last six years, which it has! They had not worked out the downside scenarios, and the cost of that omission, as with the current financial crisis, has turned out to be enormous. We may not be able to figure out the downside with prescience; after all, Keynes once said, with characteristically brilliant exaggeration: “The inevitable never happens. It is always the unexpected.” The task of the “Standing Committee of Experts” which I have proposed would be to reduce the unexpected whenever possible.

Financial Regulation

We therefore need to fix the financial sector and the problems that affect it. In this vein, let me also say that the US Congress was remiss in encouraging home ownership through its quasi-governmental agencies Freddie Mac and Fannie Mae, in effect regardless of adequate collateral, with many mortgages being given to people who could not possibly have qualified under normal commercial criteria. These agencies also “bribed” congressmen from both political parties with political contributions into effectively providing lax oversight. And again the big investment banks, such as Goldman Sachs, pressured the Securities and Exchange Commission into exempting them from the prudential reserve requirements, leading to gross over-leveraging. In turn, politicians like Senator Schumer of New York supported such irresponsible actions by arguing that, if New York imposed prudential requirements on the investment banks, the business would go to London, suggesting that the new financial architecture must seek some basic coordination of regulations so we do not get a dangerous “race to the bottom.”

Free Trade, Not Protectionism

The current crisis has also made the critics of free trade more confident. But trade did not cause the crisis, and protectionism will not cure it. The East Asians were smart enough to know that premature capital account convertibility (i.e. freeing of capital flows which is the “financial sector”) caused the crash from their remarkable growth for nearly three decades, which was attributable to outward orientation in trade. So, after the crisis, they refused to throw the trade baby out with the financial bath water. Surely, we are not going to be less smart than they were. So, the G20 has been right to urge that protectionism must be kept at bay.

On the other hand, the United States has failed to provide the lead in holding the line on protectionism, with the Congress working with the Buy America provisions in its Stimulus Bill. President Sarkozy, in keeping with the French skepticism over free trade, has even gone so far as to suggest that French firms should return to France from Eastern Europe. Apart from that, many leaders face demands to fire legal and illegal workers first, and to hire them last. So, the protectionism and anti-foreigner discrimination is showing incipient signs of breaking out, in trade, in foreign investment, in immigration, and labor markets. Only determined leadership will hold the line; and only time will tell whether it will be forthcoming in the way it should.

Morality in the Financial Sector

One final word is necessary. Many populists have concluded that the current crisis shows that markets are incompatible with morality. This is, of course, an old debate, ever since Adam Smith's time. Let me make just two observations.

First, markets affect our morality less than morality affects how we behave when we work in these markets. Our morality comes from our family, school, church, and even from literature, such as the great Russian novels which explore the ethical dilemmas of its characters. In turn, this affects how we conduct ourselves in the marketplace. Thus, we observe different types of capitalism: the Scandinavian version reflects egalitarianism, for example. In the same industry, again, we find some practicing corporate social responsibility, whereas others do not. It is therefore nothing short of vulgar quasi-Marxism to claim that where and how we work affects our morals.

Second, the corruption that we have seen in the financial sector should be put down not to greed (which suggests compulsive pursuit of self-interest to the exclusion of other virtues and vices) but often to the mere fact that the financial sector offers such enormous returns to skullduggery that, given the same propensity to cheat, the actual cheating is far greater than it would be without such returns. The greater the temptation, the greater the likelihood that you will succumb to it. So, you observe that, in agriculture, the display of "greed" is less than in the manufacturing sector, and it is the worst in the financial sector.

More Info

Book:

- Bhagwati, Jagdish. *In Defense of Globalization*. Revised paperback ed. New York: Oxford University Press, 2008.

See Also

Viewpoints

- Coping with the Crisis: Risks, Options, and Priorities for Developing Countries
- Forecasting the Credit Crunch and Future Market Prospects
- Globalization, Challenges and Threats—Where Will the WTO and Free Trade Go?
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