Joseph Stiglitz: Why we have to change capitalism

In an exclusive extract from his new book, Freefall, the former World Bank chief economist, reveals why banks should be split up and why the West must cut consumption.

Published: 9:04PM GMT 23 Jan 2010

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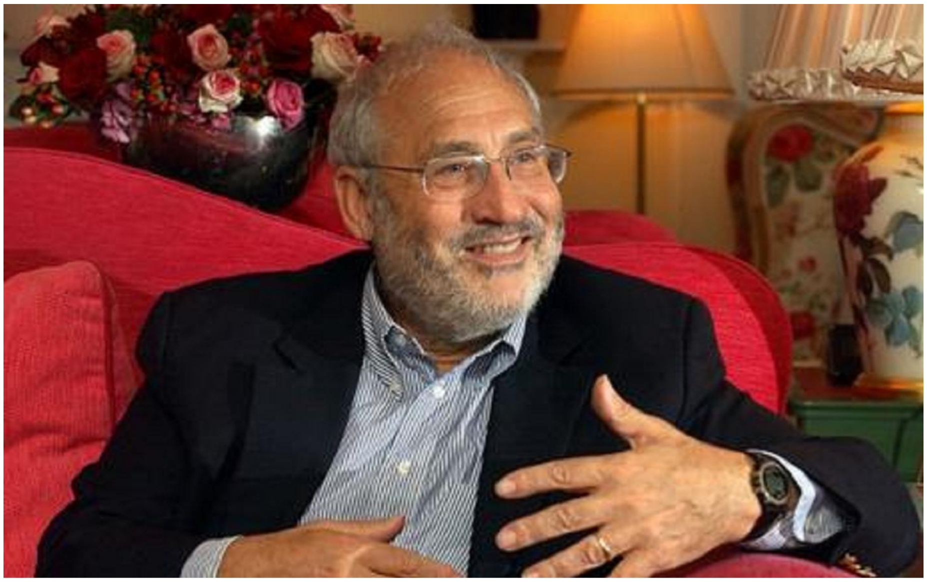
In the Great Recession that began in 2008, millions of people in America and all over the world lost their homes and jobs. Many more suffered the anxiety and fear of doing so, and almost anyone who put away money for retirement or a child's education saw those investments dwindle to a fraction of their value.


Joseph Stiglitz Photo: Justin Thomas

A crisis that began in America soon turned global, as tens of millions lost their jobs worldwide – 20m in China alone – and tens of millions fell into poverty.

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This is not the way things were supposed to be. Modern economics, with its faith in free markets and globalisation, had promised prosperity for all. The much-touted New Economy – the amazing innovations that marked the latter half of the 20th century, including deregulation and financial engineering – was supposed to enable better risk management, bringing with it the end of the business cycle. If the combination of the New Economy and modern economics had not eliminated economic fluctuations, at least it was taming them. Or so we were told.

The Great Recession – clearly the worst downturn since the Great Depression 75 years earlier – has shattered these illusions. It is forcing us to rethink long-cherished views.

For a quarter century, certain free-market doctrines have prevailed: free and unfettered markets are efficient; if they make mistakes, they quickly correct them. The best government is a small government, and regulation only impedes innovation.

Central banks should be independent and only focus on keeping inflation low.

Today, even the high priest of that ideology, Alan Greenspan, the chairman of the Federal Reserve Board during the period in which these views prevailed, has admitted that there was a flaw in this reasoning – but his confession came too late for the many who have suffered as a consequence.

In time, every crisis ends. But no crisis, especially one of this severity, passes without leaving a legacy. The legacy of 2008 will include new perspectives on the long-standing conflict over the kind of economic system most likely to deliver the greatest benefit.

I believe that markets lie at the heart of every successful economy but that markets do not work well on their own. In this sense, I'm in the tradition of the celebrated British economist John Maynard Keynes, whose influence towers over the study of modern economics.

Government needs to play a role, and not just in rescuing the economy when markets fail and in regulating markets to prevent the kinds of failures we have just experienced. Economies need a balance between the role of markets and the role of government – with important contributions by non-market and non-governmental institutions. In the last 25 years, America lost that balance, and it pushed its unbalanced perspective on countries around the world.

The current crisis has uncovered fundamental flaws in the capitalist system, or at least the peculiar version of capitalism that emerged in the latter part of the 20th century in the US (sometimes called American-style capitalism). It is not just a matter of flawed individuals or specific mistakes, nor is it a matter of fixing a few minor problems or tweaking a few policies.

It has been hard to see these flaws because we Americans wanted so much to believe in our economic system. "Our team" had done so much better than our arch enemy, the Soviet bloc.

Numbers reinforced our self-deception. After all, our economy was growing so much faster than almost everyone's, other than China's – and given the problems we thought we saw in the Chinese banking system, it was only a matter of time before it collapsed too.

Even now, many deny the magnitude of the problems facing our market economy. Once we are over our current travails – and every recession does come to an end – they look forward to a resumption of robust growth. But a closer look at the US economy suggests that there are some deeper problems: a society where even those in the middle have seen incomes stagnate for a decade, a society marked by increasing inequality; a country where, though there are dramatic exceptions, the statistical chances of a poor American making it to the top are lower than in "Old Europe".

It is said that a near-death experience forces one to re-evaluate priorities and values. The global economy has just had a near-death experience. The crisis exposed not only flaws in the prevailing economic model but also flaws in our society. Too many people had taken advantage of others. Almost every day has brought stories of bad behaviour by those in the financial sector – Ponzi schemes, insider trading, predatory lending, and a host of credit card schemes to extract as much from the hapless user as possible.

My book, *Freefall*, is focused, though, not on those who broke the law, but the legions of those who, within the law, had originated, packaged and repackaged, and sold toxic products and engaged in such reckless behavior that they threatened to bring down the entire financial and economic system. The system was saved, but at a cost that is still hard to believe.

We should take this moment as one of reckoning and reflection, of thinking about what kind of society we would like to have, and ask ourselves: are we creating an economy that is helping us achieve those aspirations?

We have gone far down an alternative path – creating a society in which materialism dominates moral commitment, in which the rapid growth that we have achieved is not sustainable environmentally or socially, in which we do not act together as a community to address our common needs, partly because rugged individualism and market fundamentalism have eroded any sense of community and have led to rampant exploitation of unwary and unprotected individuals and to an increasing social divide.

Economics, unintentionally, provided sustenance to this lack of moral responsibility. A naive reading of Adam Smith might have suggested that he had relieved market participants from having to think about issues of morality. After all, if the pursuit of self-interest leads, as if by an invisible hand, to societal well-being, all that one has to do is be sure to follow one's self-interest. And those in the financial sector seemingly did that. But clearly, the pursuit of self-interest – greed – did not lead to societal well-being.

The model of rugged individualism combined with market fundamentalism has altered not just how individuals think of themselves and their preferences but how they relate to each other. In a world of rugged individualism, there is little need for community and no need for trust. Government is a hindrance; it is the problem, not the solution.

But if externalities and market failures are pervasive, there is a need for collective action, and voluntary arrangements will typically not suffice (simply because there is no "enforcement").

But worse, rugged individualism combined with rampant materialism has led to an undermining of trust. Even in a market economy, trust is the grease that makes society function. Society can sometimes get by without trust – through resort to legal enforcement, say, of contracts – but it is a very second-best alternative.

In the current crisis, bankers lost our trust, and lost trust in each other. Economic historians have emphasized the role that trust played in the development of trade and banking. The reason why certain communities developed as global merchants and financiers was that the members of the community trusted each other. The big lesson of this crisis is that despite all the changes in the last few centuries, our complex financial sector was still dependent on trust. When trust broke down, our financial system froze.

It's easy to curtail excessive risk-taking: restrict it and incentivise banks against it. Not allowing banks to use incentive structures that encourage excessive
risk-taking, and forcing more transparency will go a long way. So too will requiring banks that engage in high-risk activities to put up much more capital and to pay high deposit insurance fees. But further reforms are needed: leverage needs to be much more limited and restrictions need to be placed on particularly risky products.

Given what the economy has been through, it is clear that the federal government should reinstitute some revised version of the Glass-Steagall Act. There is no choice: any institution that has the benefits of a commercial bank – including the government's safety nets – has to be severely restricted in its ability to take on risk.

There are simply too many conflicts of interest and too many problems to allow commingling of the activities of commercial and investment banks. The promised benefits of the repeal of Glass-Steagall proved illusory and the costs proved greater than even critics of the repeal imagined. The problems are especially acute with the too-big-to-fail banks.

The imperative of reinstating the Glass-Steagall Act quickly is suggested by recent behaviour of some investment banks, for whom trading has once again proved to be a major source of profits.

The alacrity with which all the major investment banks decided to become "commercial banks" in the fall of 2008 was alarming – they saw the gifts coming from the federal government, and evidently, they believed that their risk-taking behaviour would not be much circumscribed. They now had access to the Fed window, so they could borrow at almost a zero interest rate; they knew that they were protected by a new safety net; but they could continue their high-stakes trading unabated. This should be viewed as totally unacceptable.

There is an obvious solution to the too-big-to-fail banks: break them up. If they are too big to fail, they are too big to exist. The only justification for allowing these huge institutions to continue is if there were significant economies of scale or scope that otherwise would be lost. I have seen no evidence to that effect. Indeed, the evidence is to the contrary, that these too-big-to-fail, too-big-to-be-financially-resolved institutions are also too big to be managed. Their competitive advantage arises from their monopoly power and their implicit government subsidies.

This crisis has exposed fissures in our society, between Wall Street and Main Street, between America's rich and the rest of our society. While the top has been doing very well over the last three decades, incomes of most Americans have stagnated or fallen.

The consequences were papered over; those at the bottom – or even the middle – were told to continue to consume as if their incomes were rising; they were encouraged to live beyond their means, by borrowing; and the bubble made it possible. The consequences of being brought back to reality are simple – standards of living are going to have to fall.

Someone will have to pick up the tab for the bank bail-outs. Even a proportionate sharing would be disastrous for most Americans. With median household income already down some 4pc from 2000, there is no choice: if we are to preserve any sense of fairness, the brunt of the adjustment must come from those at the top who have garnered for themselves so much over the past three decades, and from the financial sector, which has imposed such high costs on the rest of society.

But the politics of this will not be easy. The financial sector is reluctant to own up to its failings. Part of moral behaviour and individual responsibility is to accept blame when it is due; all humans are fallible – including bankers. But as we have seen, they have repeatedly worked hard to shift blame to others – including to those they victimised.

America is not alone in facing hard adjustments ahead. The UK financial system was even more overblown than that of the US. The Royal Bank of Scotland, before it collapsed, was the largest bank in Europe and suffered the most losses of any bank in the world in 2008.

Like the United States, the United Kingdom had a real estate bubble that has now burst. Adjusting to the new reality may require a decrease in consumption by as much as 10pc.

I have argued that the problems our nation and the world face entail more than a small adjustment to the financial system. Some have argued that we had a minor problem in our plumbing. Our pipes got clogged. We called in the same plumbers who installed the plumbing – having created the mess, presumably only they knew how to straighten it out. Never mind if they overcharged us for the installation; never mind that they overcharged us for the repair. We should be grateful that the plumbing is working again, quietly pay the bills, and pray that they do a better job this time than the last.

But it is more than just a matter of "plumbing": the failures in our financial system are emblematic of broader failures in our economic system, and the failures of our economic system reflect deeper problems in our society. We began the bail-outs without a clear sense of what kind of financial system we wanted at the end, and the result has been shaped by the same political forces that got us into the mess. And yet, there was hope that change was possible. Not only possible, but necessary.

That there will be changes as a result of the crisis is certain. There is no going back to the world before the crisis. But the questions are, how deep and fundamental will the changes be? Will they even be in the right direction? In several critical areas, in the midst of the crisis, matters have already become worse. We have altered not only our institutions – encouraging ever increased concentration in finance – but the very rules of capitalism. We have announced that for favoured institutions there is to be little, or no, market discipline. We have created an ersatz capitalism with unclear rules – but with a predictable outcome: future crises; undue risk-taking at the public expense, no matter what the promise of a new regulatory regime; and greater inefficiency.

We have lectured about the importance of transparency, but we have given the banks greater scope for manipulating their books. In earlier crises, there was worry about moral hazard, the adverse incentives provided by bail-outs; but the magnitude of this crisis has given new meaning to the concept.

It has become a cliché to observe that the Chinese characters for crisis reflect "danger" and "opportunity". We have seen the danger. The question is, will we seize the opportunity to restore our sense of balance between the market and the state, between individualism and the community, between man and nature, between means and ends?

We now have the opportunity to create a new financial system that will do what human beings need a financial system to do; to create a new economic system that will create meaningful jobs, decent work for all those who want it, one in which the divide between the 'haves' and 'have-nots' is narrowing, rather than widening; and, most importantly of all, to create a new society in which each individual is able to fulfill his aspirations and live up to his potential, in which we have created citizens who live up to shared ideals and values, in which we have created a community that treats our planet with the respect that in the long run it will surely demand. These are the opportunities. The real danger now is that we will not seize them.

Extracted from FREEFALL: Free Markets and the Sinking of the Global Economy
by Joseph Stiglitz, published by
Allen Lane on January 28 at £25. Copyright © Joseph Stiglitz 2010.

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