Rescuing Capitalism: The Lessons of Crisis 2008

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The collapse of Lehman Brothers on September 15, 2008 set in motion a global economic crisis the likes of which had not been seen since the Great Depression of 1929-1933. Now that a year of living dangerously is behind us, what lessons have we learned? Where are we headed?

The main lesson, surely, is that Keynesian economics has successfully rescued capitalism for the second time in sixty years. Keynes' economics was forged in the cauldron of the Great Depression, his singular mission the establishment of a policy framework that could protect capitalism from it's inherent tendencies of self- destruction. He recognized that the uncoordinated, atomistic decision making of millions of investors, the interaction of bullish and bearish market sentiments, would inevitably lead to periodic catastrophes of multiple market failures. Paradoxically, when things start to go wrong it is the state that has to be the rescuer of last resort for the market under capitalism. That recognition led him to design an architecture of fiscal and monetary policies that could pull economies out of such crises or, better, prevent them from getting into such crises in the first place. His policy prescriptions helped to pull the world out of the Great Depression in the 1930s, and they have worked again now in containing the depth of the current crisis.

The current crisis has been painful enough, but the recovery has started within a year. Also, it has not been anywhere as bad as in 1929-1933 when every fourth person in the workforce became unemployed. As Liaquat Ahamed writes in *Lords of Finance* , his justly acclaimed study of the Great Depression that was published at the height of the current crisis: 'No one struggled harder in the lead-up to the Great Depression and during it to make sense of the forces at work than Maynard Keynes…he declared that economists "are the trustees, not of civilization but of the possibility of civilization"….. There is no greater testament of his legacy to that trusteeship than that in the sixty-odd years since he spoke those words,

armed with his insights, the world has avoided an economic catastrophe such as that which over-took it in the years from 1929-1933'.

The interventions that have rescued the global capitalist system consist of two main elements. First, there are the massive fiscal stimulus packages introduced by the G20 countries and multilateral institutions that will add up to $5 trillion by end 2010, combined with monetary measures like interest cuts and loan guarantees to pump up the flow of credit. The second element consists of the massive bailout packages introduced to recapitalize banks and some hard hit industries, estimated at close to $3 trillion in the United States alone. Large swathes of the financial sector and the automobile industry, including such iconic institutions like Citibank and General Motors, have in effect been nationalized in the very country that leads the world capitalist system. Bailouts of this magnitude have raised fundamental questions of moral hazard that strike at the foundations of the system. The second big lesson that comes out of the 2008 crisis is that some of these institutions are now so large that if they collapse, then they will bring down the whole edifice of the market system as we know it. The collapse of Lehman almost did it till the US Treasury and the Federal Bank stepped in to prevent the collateral collapse of other major financial institutions.

Does that mean that these institutions that are 'too big to fail' can now act as imprudently and irresponsibly as their greed dictates in the happy knowledge that the authorities will always bail them out? Unfortunately yes. As Greenspan recently remarked, crises will happen so long as there is greed The potential failure of giant financial institutions is a systemic risk which can only be avoided through such bailouts, unless of course systems are put in place to regulate the activities these financial institution, especially the non-bank financial institutions. The third lesson then is that these institutions need to be closely regulated. What is the likelihood of that happening? The outlook is mixed. On the positive side President Obama announced his intention to reform and integrate the US financial regulatory system, including oversight of systemic risks posed by the large financial institutions, a regulator for financial products sold to consumers, etc. Something like the Financial Services Authority in the U.K. or the new Financial Stability and Development Authority(FSDA) now being planned in India. FSDA, to be chaired by the Finance Minister, will bring under one umbrella all the financial sector regulators including RBI, SEBI, IRDA, and PFRDA.

It was precisely the absence of such an integrated regulatory authority that allowed the US sub-prime housing mortgage bubble to grow unnoticed till it burst. The Wall Street investment banks had made sure they remained outside the purview of the Glass- Steagel Act, under which commercial banks have been prudently regulated in the US. They were able to do this primarily because of the revolving door relationship between Wall Street and the US Treasury. Hank Paulson, who had lobbied for the investment banks as head of Goldman Sachs, was Treasury Secretary (for us Finance Minister) when the crisis started , just as Robert Rubin had been before him. The same lobby is blocking the establishment of an integrated global financial regulatory system and this resistance is expected to hobble any real progress in the forthcoming Pittsburgh meeting of the G20 on 24 September. Whether or not President Obama has the will and the capacity to break the back of this Treasury- Wall Street nexus remains to be seen. It also remains to be seen whether rating agencies like Standard & Poor, Moody's etc. will be brought under regulation. The risk ratings given by these agencies should serve as early warning systems to alert the market about about emerging systemic risks. Unfortunately, these agencies failed their clients completely during the current crisis as they had earlier during the Asian financial crisis of 1997 – 1998.

The fourth lesson, that concerns us more directly, is that the world is now at the cusp of a new global economic order, the crisis having accelerated the relative decline of the old G7 countries vis-à-vis the emerging economy members of the G20, especially China and India. India must firmly grasp this opportunity. It must do so with confidence but without undue exuberance or arrogance. It must also act strategically to position itself well within the emerging new order.

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