

## USING THE CRISIS TO REMAKE THE MARKET

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The financial crisis of 2008 provides an occasion to advance two projects of vast consequence. One project is to revise the post World War II settlement for the purpose of making international arrangements more hospitable to national divergence, experiment, and alternatives than they are today. The other project is to reshape some of the institutions that define market economies so that they can afford more opportunity to more people.

Debate about the crisis has been dominated up to now by two justified but inadequate and shallow concerns: the need better to regulate financial markets, within countries and worldwide, and the advantage of adopting expansionary monetary and fiscal policies. The stubborn imbalances between trade-surplus and trade-deficit economies have figured as a side show. The most important lesson of the crisis -- the limitations imposed by the way contemporary market economies organize the relation between finance and the real economy -- has hardly appeared at all. Yet nothing we do in the first two areas will work unless we make progress in the last two.

Expansionary fiscal and monetary policy, deployed without regard to the structural imbalances in the global economy, may often prove harmful or self-defeating. Regulation of financial markets may turn out to be ineffective or insufficient if not complemented by measures designed to tighten the links between finance and the real economy. We shall not be able to make the deeper and more radical measures wait until we are finished with the more superficial ones; the latter depend for much of their effect on the former.

Everyone is at the mercy of his ideas. The leaders of the twenty largest economies need not have assembled for us to discover the limits to our insight. When we call the spirits, they may not come.

Consider the shape of the discussion we need, and do not yet have, along a spectrum from the familiar and the less significant to the more far-reaching and the less recognized.

1. Regulation of national and international finance. Finance has turned practices meant to manage risk into devices to increase

gambling. In many of these practices, such as the most elaborate derivatives, the real economy and the financial requirements of production, have ceased to be the reason. They have become instead the pretext. The problem is not that this activity is speculative; speculation has its uses. The problem is that the speculative activity is only tenuously connected with the real economy -- little connected with consumption and even less connected with production...

The subprime catastrophe in the United States, the trigger of the crisis in its American epicenter, was itself an example of the use of mortgage loans peddled to people without the means to pay for them as an excuse to invent a new form of trading and betting.

An additional fact has inflamed the consequences of this inward turning orientation of financial ingenuity: the misguided distinction between highly regulated and thinly regulated financial markets and agents. The justification for this contrast is that professional investors and high net worth individuals need less protection and benefit from more freedom to take risks. It is an argument that fails to take account of the way in which the availability of a free-fire zone of minimal regulation makes possible the circumvention of many of the restraints imposed in the regulated area. Financiers can simply repackage the contractual arrangements of the latter in the financial language of the former.

The implication is that regulation needs to combat the speculative perversion of risk management into risk exploitation and to overcome the self-defeating dualism between regulated and unregulated finance. That would be something. Without a response to the other problems addressed here, however, it would not amount to much.

2. Vulgar Keynesianism: expansionary monetary and fiscal policy. Almost everyone is again a vulgar Keynesian. Low or even negative interest rates and governmental spending are helpful and even indispensable elements of an effective response to the crisis. Their value, however, has been wildly exaggerated out of despair about our ability to come up with anything better.

A policy of low or negative interest rates may make little impression, other than threat of further pain, on economies and individuals who are accustomed to save and who consequently have

large pools of capital at their disposal anyway. To the spendthrifts, such a policy may seem a proposal to inflame the vice that helped them get into the hole in the first place. Moreover, as has long been understood, it fails to provide an effective antidote to the dynamic of debt deflation.

The room for maneuver in fiscal policy would increase with countercyclical arrangements: a commitment to accumulate fiscal surpluses in good times, the better to be able to spend them in bad times. Such arrangements, however, take for granted a world very different from ours, in which an overriding motor of growth has been collusion between the reckless hoarding of some countries and the reckless spending of others.

In the hoarding countries (e.g., China), expansionary fiscal policy is likely to serve as an ancillary prop to the required shift to mass consumption and to production for the internal market. In the spending countries (e.g., the United States), such loose fiscal policy can be predicted to aggravate an already unsustainable dependence on trade deficits and foreign saving.

It is salutary to remember the complexities and contradictions of the real Keynes' views. His occasional writings reveal a man who understood that the ability to influence the investment decision was more important, although politically harder to establish, than the attempt to shape aggregate demand. What we think of as a theory was in fact the result of an opportunistic calculation: to pursue the tack -- the enhancement of aggregate demand -- that seemed most acceptable in the circumstances of the day. If we fail to put this calculation in its place, and to recover what it suppressed, we risk sinking into an anti-pragmatic pragmatism.

3. Structural imbalances in the world economy. Many now speak of a new Bretton Woods. Have they forgotten the Bretton Woods that Keynes proposed as distinguished from the Bretton Woods that was established under American guidance? The almost obsessive goal of Keynes' scheme was to avoid the situation in which now find ourselves, of large economies that run persistently high trade deficits or surpluses. The complicated machinery he proposed was designed to punish inveterate surplus economies. We do not need the complication but we must face the problem, by eliciting distinct responses from the

surplus countries, the deficit countries, and the international organizations.

From the surplus economies, the most effective response is to turn in earnest to production for a mass-consumer domestic market. No country would undertake such a shift simply to please and to enrich foreigners. It is, however, a change justified by many considerations of prudence as well as of justice.

For the deficit countries, the first order of business is to stimulate a rise in household saving. That this aim is hard to accomplish does not mean that it is impossible to reach. To take it seriously would mean, for example, redesigning the tax system to reward saving. Nicholas Kaldor's personal expenditure tax, designed (as an alternative to the personal income tax) to tax, at a steeply progressive rate, the difference between the aggregate income of the tax payer and his invested saving is at once the fairest and the most practical of all the tools available to us.

For the international community, the priority should be to find a simple proxy for the complicated machinery with which Keynes wanted to restrain the neo-mercantilism of the surplus countries: one that would be easier to impose and to administer and less laden with the centralized, global restraints that both conservatives and progressives have good reason to resist. The surplus countries should be required to float their currencies, with a minimum of governmental meddling in the currency markets, once their surplus reaches certain relative and absolute thresholds. The absolute criteria would relate to the overall impact on the global economy. The relative criteria would refer to the ratios between the surpluses (or deficits) and the GDPs of the major trading partners involved in the unbalanced trade relationships.

4. The relation between finance and production. The least mentioned and the most important part of an adequate response to the crisis has to do with the relation between finance and the real economy.

In all major economies in the world, the production system is largely self-financing. Many empirical studies have shown that in these economies over 80% of the funding of production by established

firms is internally generated. It relies on the retained earnings of these firms.

This seemingly innocuous finding suggests a question that is as unasked as it is fundamental. If production is largely self-financing, what is the purpose of all the money in banks and stock markets? The point is supposedly to mobilize the accumulated saving of society to support ongoing or new output as well as to finance consumption by those who do not have the ready cash to buy what they want to consume.

The trouble is that, under the arrangements by which we now organize the relation between finance and production, most of this capital has only an episodic or indirect relation to the funding of productive activity in the real economy. It is episodic, for example, in the form of initial public offerings. It is indirect to the extent, for instance, that the market valuation of companies establishes benchmarks for the bank credit these companies can obtain. On the theory that the main goal of the mobilization of the saving of society through the capital markets is to finance production, and thus to render fertile the sacrifice of delayed consumption, venture capital should be a major part of what these markets do. In fact, in every country in the world, including the United States, venture capital represents a tiny portion of financial activity.

So finance, instead of turning outward to the real economy, turns inward to itself, that is to say, to a trading of positions that often has the real economy more as its pretext than as its concern. In good times, finance may cause little trouble and provide little help. In bad times, however, brought about by the excesses of its self-absorbed trading practices, finance threatens to damage everyone outside its inner directed world.

The crisis should therefore serve as an invitation to reform the arrangements governing the relation between finance and the real economy. The purpose of the reform should be to tighten the links between saving and production, and to guarantee that more of the former is put at the service of the latter.

A key premise of this idea is that the link between finance and the real economy is variable. It is not guaranteed by some analytical

truth about economies. It varies according to the institutional arrangements that may either tighten or loosen it.

No matter how banal and self-evident this proposition may seem, it contradicts prejudices enshrined in an established language as well as in dominant points of view. According to the national-accounting categories established, after the Second World War, under the influence of Keynes' disciples, aggregate saving must equal total investment. They are categories that make it difficult to formulate the problem I have described, much less to solve it.

That the problem arises in the world, and cannot be dissolved by words, is readily shown by any number of historical examples. When, at the time of Andrew Jackson, the United States disbanded the National Bank and established the most decentralized system of credit that had ever existed, Americans were not regulating finance. They were changing the institutions that shaped its relation to the real world of production and consumption. They were doing what present analysis and vocabulary supposes to be impossible but is in fact repeatedly indispensable. The reconstruction of the institutional arrangements governing the relation of finance to production should be seen for what it is: a species of the remaking of the institutions that define the character of the market economy and that shape its social consequences.

We should use the financial crisis as a provocation to rearrange the place of finance in our economic lives, and we should treat such a rearrangement as an occasion to begin experimenting with other aspects of market institutions. The purpose of the first part of this response should be not only to mitigate future crises but also to marshal capital the better to recover now and prosper later. The aim of the second part of this response should be to create versions of the market economy that better serve the goal that much of the world seeks: a decisive broadening of opportunity -- more markets and more types of markets (organized according to different rules, rather than according to a single blueprint), open to more people, in more ways.

There is no formula for how to begin, only the need to identify and to assess the most promising and feasible experiments. Some such experiments would use a limited part of the pension saving of society, under both defined-benefit and defined-contribution pension regimes,

to do, on a larger scale, the work of venture capital. That means experimenting with the ways of investing money as well as with the uses to which money is put: government initiated practices of venture capital and private equity, mimicking the market and placed under independent, professional, and competitive management. It is a direction worth taking even when the source of capital is a governmentally controlled defined-benefit pension system (like the Social Security system of the United States).

Other experiments would use the direct and indirect power of the state to make or to influence the investment decision (the tack Keynes put aside when, out of sheer pragmatic calculation, he decided to emphasize the case for the management of aggregate demand and to treat the political guidance of the investment decision as politically inaccessible.). In countries with state owned development banks, the first-line experiment is to direct such banks to lend and to invest, especially in the small and medium-sized firms that are the most important instruments of growth with a broad social base. Even in such countries, however, much more will be required. The regulation of financial institutions and the design of tax incentives and disincentives should work together to encourage investment in the real economy and in the financing of both established and novel lines of production rather than to favor any particular sector of that economy. Skepticism about sectors is as salutary as the divorce of financial speculation from the agenda of production is harmful. We can do something about this divorce, not by using government to suppress the market but by using government to change part of the way we organize markets.

Such initiatives would represent a small down payment on a large shift in the focus of ideological controversy. It is not enough to regulate the market economy. It is not enough to counterbalance inequalities generated in the market by resorting to compensatory redistribution through tax and transfer. It is necessary to change piece by piece and step by step, the institutions that relate finance to the real economy if we are to recover from the present crisis in a way that helps us avoid future crises. Other ideals, of inclusion and opportunity, will require us to enlarge the scope of this practice of institutional reconstruction. The crisis is a chance but it is also a

crutch. The task of the imagination will be to do the work of crisis without crisis.