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Guided by an invisible hand

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The bank meltdown marks a turning point in our thinking about how the world works writes the Nobel Laureate. In some ways this is the biggest crisis in 80 years

Make no mistake: we are witnessing the biggest crisis since the Great Depression. In some ways it is worse than the Great Depression, because the latter did not involve these very complicated instruments - the derivatives that Warren Buffett has referred to as financial weapons of mass destruction; and we did not have anything close to the magnitude of today's cross-border finance.

The events of these weeks will be to market fundamentalism what the fall of the Berlin Wall was to communism. Last month in the United States almost 160,000 jobs were shed - making more than three-quarters of a million this year. My guess is that things will get considerably worse. I have been predicting this for some time, and so far, unfortunately, I have been right.

There are several reasons for my pessimism. The extreme credit crunch is a result of the banks having lost a lot of capital. And there is still uncertainty about the value of the toxic mortgages and other complex products on their balance sheets. The US economy has been fuelled by a consumption binge. With average savings at zero, many people borrowed to live beyond their means. When you cut off that credit you reduce consumption. This, in turn, will dampen the US economy, which helps keep the global economy growing. The American consumer has not only sustained the US economy, he has sustained the global economy. The richest country in the world has been living beyond its means and telling the rest of the world it should be thankful because America fuelled global economic growth.

There are further reasons for my pessimism about short-term economic prospects, in America and Europe. In the second quarter of this year, growth in the US would have been negative were it not for the growth in exports. But with the slowdown in Europe and problems in Asia it is difficult to see how we can maintain net export growth. The strengthening of the dollar - due not to greater confidence in the US but to reduced confidence in Europe - will make matters worse. The fall of energy prices will help a little, but not enough.

Treasury Secretary Hank Paulson has now come up with a new bailout scheme. The original plan - buying up the thousands of "troubled assets" (read: bad loans and complex products based on them that Wall Street created) - was badly designed and rife with problems. How would they have been priced? Call in the same Wall Street experts who got us into the mess and mispriced risk before? It is a heads I win, tails you lose situation.

The worry is that the taxpayer will be left holding the short end of the stick.

The British approach, which Paulson seems to be following, is far better, involving capital injections into banks, with preferred shares to protect against losses and warrants to share in some of the upside potential. This is the approach that I - along with most US economists and people with good street sense, like George Soros - had been saying America should adopt.

Ironically, though Paulson wouldn't listen to us, he seems to have listened to Gordon Brown.

Many of the problems our economy faces today are the result of the use of misguided models. Unfortunately, too many took the overly simplistic models of courses in the principles of economics (which typically assume perfect information) and assumed they could use them as a basis for economic policy. Many central banks use the notion of inflation targeting - that they should focus exclusively on inflation, raising interest rates when inflation increases. But I would argue that central banks have a broader responsibility; they are supposed to ensure the stability of a country's economy. While monetary authorities in the US and elsewhere focused on price stability, they allowed the financial system to undertake risks that put the whole economy in jeopardy.

This crisis is a turning point, not only in the economy, but in our thinking about economics. Adam Smith, the father of modern economists, argued that the pursuit of self-interest (profit-making by competitive firms) would lead, as if by an invisible hand, to general well-being. But for over a quarter of a century, we have known that Smith's conclusions do not hold when there is imperfect information - and all markets, especially financial markets, are characterised by information imperfections. The reason the invisible hand often seems invisible is that it is not there. The pursuit of self-interest by Enron and WorldCom did not lead to societal well-being; and the pursuit of self-interest by those in the financial industry has brought our economy to the brink of the abyss.

No modern economy can function well without the government playing an important role. Even free marketeers are now turning to the government. But would it not have been better to have taken action to prevent this meltdown? This is a new kind of public-private partnership - the financial sector walked off with the profits, the public was left with the losses. We need a new balance between market and government.

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