Comments on the World Situation
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When Homer returns to tell the story of our epoch, he may say that the Russian mathematicians swept out of Muscovy in 1991, and presented themselves before the gates of Wall Street bearing the gift of quantitative risk management models. They were received with joy, went to work and in less than twenty years, destroyed the place entirely. It was, he will say, the greatest Trojan Horse operation since Troy.

So President Gorbachev, in the long run you may get credit, not only for the end of state communism, but for the collapse of neoliberal capitalism as well.

On a more serious note, it can and should be said that the success of the postwar mixed economies depended in part on the challenge from the East, because this imposed a discipline that strengthened social democracy, made regulation acceptable, obligated the pursuit of fraud, supported research, education and investment in public infrastructure, and generally kept the destructive and unstable and predatory forces of capitalist finance in check. The decline of that challenge unleashed those forces already in the late 1970s – the displacement of Keynes and Galbraith by Hayek and Friedman – placing burdens on private markets that they could not withstand, and opening the door to the wave of speculative abuse and financial frauds that ultimately destroyed the system.

To be precise, I do not claim that American governments from Reagan to George W. Bush dismantled the New Deal, because they didn't. But the second Bush presidency especially administered the state in the interest of a predator class. Public purpose was forgotten or abandoned; public agencies were run for the convenience and profit of the private political clients of the administration. Finally this conduct destroyed the confidence and trust that sophisticated markets, especially financial markets, require to survive. The result was the forced nationalization of the credit markets worldwide in late 2008, and a concomitant violent collapse in credit-dependent effective demand.

The violence of the slump, in terms of industrial production and world trade, reproduces closely the early 1930s and even approaches the scale of the industrial collapse of the USSR in the early 1990s. The effect on the population is less severe, because governments are larger, automatic stabilizers in the form of huge fiscal deficits exist, Keynesian policies are quickly revived, and anyway people have accumulated physical wealth to fall back on. The rise in unemployment is limited by exit from the labor market – and its decline later on will be impeded as people return to the search for jobs.

But as we are painfully discovering right now, there is no mechanism for early recovery and return to high employment. As households receive cash income from government programs and tax cuts, their instinct is to save, rather than spend. The banks can earn a good return by borrowing from the central bank at zero and lending back to the government and other secure debtors at three or four percent, they have no need for the income from loans to risky private businesses or households. And there are several mechanisms, including the large overstock of housing and the oncoming fiscal crises of state, local, and in Europe national governments that will continue to make matters worse.

I could add here that in China, where the crisis violently shrunk the export sector and knocked down real estate values, an active policy is helping to stabilize the situation but the larger response is to adapt to rather than to offset the crisis. And in any event we cannot be sure from official statistics what the real situation in China actually is.

The crisis is still quite new, and while the political leadership in the United States has already changed the habits of the political class have not. So we have a response dominated by reliance on short-term measures, life support for big banks, and a hope that things will return to normal before long. I feel quite confident that this will not happen. What we therefore face is a long period of hardship and disillusion, accompanied by a cacophony of snake-oil merchants and cranks peddling every sort of wild idea, until ideas finally adjust and an energetic leadership emerges. European leadership is especially stuck in a world of budgets-to-be-balanced and palpably anxious to declare the crisis over with, in order to sit down to lunch.

Is there a "European model" – more sane and stable and humane than the "Anglo-Saxon" one – which can assure that the crisis will not be felt so severely on this continent? In my view, there is not. What we have, is a legacy system, the residue of Cold War social democracy, still functioning in important respects in some countries, but under remorseless budget pressures and lacking a system of Keynesian governance capable of making a fast and effective response to the collapse of under-regulated and over-leveraged private banks. In Eastern and Central Europe, the end of communism already greatly weakened the welfare state, so that safety nets were worn very thin well before the crisis.

Ultimately, we need to work out two things. The first challenge is how to manage high-employment continental economies with a strong safety net and without the unstable speculative leadership of the financial sector, which cannot be expected to resume its former role of financing economic expansion any time soon. The second challenge is how to develop institutions capable of setting an effective course for the investments we require to cope especially with our problems of energy security and climate change. There is plenty to do along both lines, but we have not thought through how to do it, nor even how to measure effectively what we are achieving. The faith that markets will spring up to cope with all this touchingly evokes a similar period in another part of the world, less than twenty years ago.

So I would suggest that we have two broad tasks: to define the goals for the construction of a new economic world, and to begin to outline the means to achieve those goals, nationally and internationally. The essential recognition is there this is not a task of transition or disaster management. It is not a temporary situation from which our economies will naturally emerge, taking a final form already given to us by theory and practice. That was the illusion of 1991. It is interesting that, in our own crisis today, this illusion has been so faithfully reproduced.