The Per Jacobsson Lecture

Markets and Government before, during and after the 2007-20xx Crisis

by

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I. The Market-Government Nexus

1. When the long rise in US housing prices came to an end in December 2006, the newspapers did not announce with six column headlines that a hurricane was coming. Nor did the crisis units of national or international policy bodies call any emergency meeting to open the sealed envelopes with plans for managing the long-predicted 'disorderly reversal'. Perhaps the most lucid understanding of the facts could be found among market participants, if anecdotal accounts of some confidential utterances - comments like 'the gravy train has come to halt!' or 'now, every man for himself!' – are accurate.

Three and a half years later, the crisis is still with us and, like the HIV virus, it shows a pertinacious capacity to renew its destructive potential through continuous mutation. Unsurprisingly, it still lacks an agreed interpretation: after all it took decades to understand the crisis of the 1930s. It also lacks a name, 'subprime' appearing too dismissive; and it lacks precise dates, because we do not see its end. I would call it the 2007-20xx crisis.

Thus, we still need to fully satisfy two complementary requirements: to *understand* and to *act*. My remarks today will be driven by the first of the two and if they are of any use for action (the existential condition in which I have found myself for the greater part of my professional life) it will be because any action presupposes an interpretation of reality: like a vessel, action stands out of the waves only if it is supported by the heavier, albeit invisible, body of an understanding of the forces of history, and of principles and goals helping to manage the opportunities and constraints embedded in the circumstances,.

The theme I have chosen for this lecture reflects the conviction that the market-government nexus lies at the heart of the crisis. It is the place where something went wrong.

In summary, I shall argue that while the crisis seems to come from the market side of the nexus, what really went wrong is on the side of the government. Firstly, government was captured by the myth that finance can regulate and correct itself spontaneously and hence retreated too much from the regulatory and supervisory role that is necessary to ensure stability. Secondly, fiscal and monetary policies fuelled imbalances and inflated bubbles. Thirdly, policy making remained almost exclusively concentrated at the level of the nation state, hence leaving unmanaged the rapid emerging reality of global finance. The crisis has only partially corrected such errors. The exit from the configuration that led to the crisis should be a government which – of course - respects economic freedom, but at the same time exerts its role forcefully, and is not prostrate before the twin idols of the market and the nation state.

The market-government relationship is, of course, as old as society itself. But in the last two centuries it has entered a new era fraught with opportunities and challenges that we do not understand fully and master even less. The 2007-20xx crisis is not an incidental blip on the screen of history, it is a strong call for political and institutional reform.

II. The Thatcher-Reagan Revolution

2. The 2007 fracture has come as the culmination of an era in which economic policy had been guided by a strong belief in the virtues - even 'the magic' - of the market. The era had started at the end of the 1970s with another fracture, when Margaret Thatcher and Ronald Reagan where brought to power by voters frustrated with a weak economy, plagued with inflation and high unemployment and with a government discredited for being both intrusive and ineffective.

In the *political arena*, the 1979 UK, and 1980 US, elections were the tipping point, but the change had been prepared for years in *academia*, by a generation of economists who challenged the ideas and policies of what Paul Samuelson called the neoclassical synthesis – the combination of the Keynesian revolution and traditional economics - laid the analytical foundations of an unconditioned belief in the efficiency of markets and the ineffectiveness of policy activism.

My education, first at university, then as a practitioner, took place in the pre-Thatcher climate. When I began my central banking service in the Bank of Italy at the end of the 1960s, the view proclaimed by the research department and adopted as a guide for decisions and operations was that monetary policy could enforce virtually *any* real rate of interest merely by persistently conducting open market operations. Similarly, it was widely believed that policy could obtain high levels of employment by accepting a little more inflation. Later, as inflation began to bite, administrative controls in the form of ceilings and floors became the principal instrument for influencing the amount and the composition of total credit. In most countries (Germany was the notable

exception) firms and individuals lived in a cage of tight foreign exchange controls. In European countries virtually all public utilities and a large portion of the productive capacity of goods and services sold in supposedly competitive markets was state owned; so was the largest part of the banking industry. In the basket forming the consumer price index most goods were priced not by the market but by decree. Still in 1981, the newly elected government of a leading industrial country such as France, committed by a Treaty to create a common European market, nationalized all the banks and most of the industrial system.

Undoubtedly, the change in direction was long overdue. In spite of its success with the voters, however, the pro-market mindset inspiring the change was by no means dominant. It met with strong resistance not only on the part of those who had a vested interest in the old order, but also on the part of academics, public commentators and influential press. Reagan and Thatcher were not liked by the élite and even their grassroots support was fragile. Reagan was clearly defeated in the midterm vote following his election, while Thatcher's re-election in 1982 was due more to the war in the Falklands than to her domestic policies.

3. The Thatcher-Reagan reforms shifted the line dividing markets from government, enlarging the territory of the former at the expense of the latter. Rules, bureaucratic red-tape and other impediments to the functioning of markets were removed. Perverse incentives discouraging work and efficiency were suppressed. Administrative controls of financial and credit markets were lifted. Exchange rate restrictions were dismantled. A vast programme of privatization expanded private ownership and spread people's participation in entrepreneurial risk: by replacing politically appointed managers of publicly owned enterprises with profit driven managers accountable to shareholders, a new dynamism was injected into the productive sector. Liberalizations in the labour, product, service and capital markets handed back to enterprises (and ultimately to households) both the returns and the risks associated with the functioning of the economy.

In Thatcher's case the pro-market philosophy was initially stronger than her anti-EU prejudice to the point that she gave her approval to the Single Market programme; only later, when she realized that such a programme implied a limitation of national sovereignty, she regretted approving it.

The 'pro-market' revolution must be credited for correcting earlier excesses perpetrated in policy making and in economic thinking. The animal spirits it liberated accelerated growth and imparted renewed dynamism to Great Britain and the United States. The UK moved from the slowest to the fastest track among the European countries and became a sort of model for the policies on the continent.

III. From Radicalism to Crisis

4. It takes time for new ideas to be accepted. Then, at some point, they go from merely being accepted to becoming conventional wisdom and the burden of the proof shifts from their proponents to their opponents. This happened at the turn of the 1990s. The

Thatcher-Reagan ‘revolution’ conquered the minds and set a new policy paradigm only late in the 1980s; and the worse came after both quit power, sometimes from leaders of opposition parties converted to pro-market ideas (like Clinton or Blair).

The winning ideology – as happens – gradually remained without adversaries and lost the moderation, sophistication and sense of proportion that would have been necessary to avoid incidents and, eventually, disaster. When it came to dominate the intellectual and policy arena, it turned into a form of radicalism. Radicalism had a strong root in the field of economic ideas, but it also became a pattern of social behaviour.

Of course, the extraordinary expansion of financial markets and the creation of huge profits in the financial industry were determined by many factors: the increase in wealth seeking profitable investment, the over-expansionary monetary policy, the development of new products and, most important, massive deregulation of the financial sector. These other factors, however, often had an indirect relationship with the evolution of economic theory.

5. Let me therefore dwell, first, on the role played by economic ideas mechanically transferred from the laboratory to the world of practitioners, be they private or public. Choosing among many possible examples, I shall consider the wide acceptance of the hypothesis that financial markets are efficient, i.e. that they always reflect all the available information. The adoption of this hypothesis and the companion one that market forces always move to arbitrage, that is to eliminate any possible deviation from a fully informationally efficient equilibrium, was strongly influenced by the more general contention - belonging more to the realm of political philosophy than to economic analysis - whereby the mechanism offered by the market economy for processing the information required for rational decision making in the areas of production, investment and consumption is superior to that offered by a centrally planned economy.

A powerful boost to the confidence in the virtues of the market and mistrust in government came from the 1989-1991 collapse of the communist system. In the view of some, this event was linked to the Thatcher-Reagan policies and, for sure, it was fully consistent with their ideas and slogans. Whether, beyond this, the internal disintegration of the communist system was accelerated by the unsustainable pressure on the economic and social fabric of the East coming from the renewed economic dynamism generated by the pro-market policies of the West is a plausible hypothesis for historians to probe. Whatever its causes, the event appeared as the final proof that resolving market vs. government tensions by suppressing the former and bringing the production and distribution of wealth into the perimeter of government had produced economic misery and political oppression.

In its radical version that came to dominate, the received wisdom was that if it is efficient ‘the market is always right’; we can say, in a loose sense, that it always moves towards equilibrium. Then, the policy maker had nothing to tell the market, he had only to listen and learn. If prices – be they the stock market index, or an exchange rate, or the

price of oil and other primary commodities - move far away from the range that any reasonable observer (including the policy maker) deems to be appropriate, the observer must humbly admit that there must be somewhere something he had missed, which causes the market, in its infinite wisdom, to behave the way it does: it matters little that the same market had - not long before - priced the same goods or services at double or half of today's price. When an entity is granted 'infinite' wisdom it is by definition beyond the capacity of our minds and we enter the realm of faith; 'infinite wisdom' was indeed the expression used by clerics, when I was an adolescent, to persuade the believer to accept a non demonstrable nor self-evident proposition.

If financial markets are 'always right', they also possess a 'natural stability': the financial system is capable of providing by itself the maximum stability that nature permits. It is so because financial institutions and market participants are best placed – much better than policy – to manage risks and unforeseen external shocks. Thanks to financial innovation and improved risk management techniques all assets have become marketable and hence liquid. Large financial and diversified institutions, because of their very size and of the magnitude of the risk they face, have the information, the means and the incentives to manage risk efficiently. From this, the unwarranted conclusion was drawn that there is little need to subject the financial system to special regulations concerning products, institutions and market structures. Markets are self-correcting. Regulation is not only unnecessary, it is also harmful because it imposes extra costs and makes market participants deviate from the path of efficiency.

6. The dominance of the efficient market hypothesis removed other strands of economic theory from the visual angle of policy makers and market practitioners alike. This was the fate of the opposite - and analytically no less respectable - theories according to which finance is naturally *unstable*. The two propositions, backed by as many prominent bodies of economic research, that lost influence were, first, that unregulated banks tend to be undercapitalized; and, second, that financial markets are prone to alternating phases of euphoria with others of panic. Let me briefly review them.

According to the first proposition, banks left to the spontaneous play of profit-maximization, tend to be over-leveraged because of the inability of fragmented depositors to impose discipline on bank managers and shareholders and restrict excessive risk taking. This issue is exacerbated in presence of deposit insurance arrangements aimed at limiting bank runs in front of the banks' commitment to redeem liabilities at par value. The result is that in a free banking world risk is likely to grow over time and a systemic crisis is bound to occur sooner or later. In the William Taylor memorial lecture I had the honour to deliver in 1999 I argued extensively against the resurrection of a 'free banking approach' and suggested that the only remedy against the inherent instability of such a regime was a strict policy of licensing combined with capital requirements. Self-regulation would not be a solution. Narrow banking would not be a solution. The approach I favoured was one in which only banks are allowed to perform certain activities (and this is associated to strict regulation and supervision); but at the same time are free to expand their business in the whole spectrum of financial

business. The idea that financial innovation can be favoured only by non regulating, or by constraining regulated entities to perform only narrowly defined functions and leaving new contracts and business practices flourish out of this precinct, lies at the very foundation of the development of the so-called shadow banking system, one of the main drivers of the crisis.

7. The second proposition states that markets tend to overshoot and undershoot. This holds particularly true when they trade storable goods (asset markets), because these offer more scope for speculation-driven transactions, that is for transactions whose ultimate motive is not a commercial need but profit from trading. In these transactions the assessment which is relevant to making a profit refers not so much to the 'fundamentals' as to the accuracy with which the individual player predicts, or bets on, the behaviour of the other players. The speculator neither is nor should be interested in 'the right price' of an asset, but in 'where the market will go'. If he thinks that – over the time horizon relevant for his investment – the market will continue to move farther away from what he deems to be the 'equilibrium price', by helping the market to move towards equilibrium - as the efficient market theory predicts - he will make a loss, not a profit.

Surely, commerce-driven and speculation-driven transactions are hard to separate because an element of speculation (choosing the best moment to buy or sell) is present in both. Moreover, without a component of speculation-driven transactions financial markets would probably not be sufficiently deep or liquid to perform their allocation function efficiently. However, if this component grows too large, markets may become more unstable. It is so because those who bet are not independent observers. The market is a horse race in which the winner is not the strongest horse or the best jockey, but the one on whose victory most watchers have placed their bets. This is not ordinary gambling, it is a special gamble in which the pellet spins at the command of the players.

As temporary departures from equilibrium, bubbles are part of the ordinary nature of the market. If markets were efficient they would be determined by outside events or news that traders immediately incorporate in their information processing function, thus re-establishing equilibrium. However, the bubbles we are concerned with are not of an ordinary nature. They are those which, instead of being promptly burst by traders, are inflated by them through the process of self-fulfilling expectations.

It remains true that, sooner or later, the market burst bubbles. In the end, fundamentals matter. But if this happens late rather than soon, a number of unpleasant things happen. One is misallocation of resources. Another, related to the former, is the heavy cost of the correction.

8. Let me now turn from the role of economic theories to what could be called the human factor, or social behaviour, in the market-government relationship.

The market has subjected government not only in the mindset, but also as a value in life and as a guide for social behaviour. An increasing share of the best and the

brightest was attracted to the profit making activities rather than to public service or research. In the 'learn, earn, serve' triptych which, according to an old saying, describes the life-path of an accomplished gentleman, the middle term acquired prominence in the aspirations of the educated youth entering the labour market. The social status of the public servant and even of the scholar resisting the blandishments of business correspondingly declined.

Public servants absorbed pro-market radicalism in classrooms before graduation, then in the discourse of political leaders to whom they owed appointments and promotions, then in patterns of social life where the 'industry' outshone the 'bureaucracy'. The capture of the regulator, adequately described in forgotten academic papers, belongs to the realm of sociology and psychology before becoming an intellectual credo and a guide for action. Officials imbued (admittedly, often excessively imbued) with the sacrality of government were succeeded by clerks highly trained, but too chary not to spoil the party of the private sector.

I have myself observed the impervious reluctance of a generation of economists to use key economic concepts such as equilibrium exchange rate, core inflation, neutral interest rate, output gap or structural deficit. They were putting forward difficulties in the measurement and definitional controversy, but the root of their reluctance was the self-cancellation of the policy maker's judgement: only the market knows, only credibility counts, and if you speak against the market, your credibility is destroyed.

A significant aspect of this environment is the strong bias towards rules in the 'rules vs. discretion' debate. The pro-market revolution preaches that policy must be guided by rules, paradigms, frameworks and strategies; it tells us that, to be credible, the policy maker must be predictable, that he should never surprise the market. These imperatives, I must confess, have always struck me as over-simplistic. Of course, the policy maker must be credible; for sure, the policy maker needs a method; undoubtedly, discretion must not degenerate into capriciousness. But this does not mean plugging in the automatic pilot and letting it fly the aircraft. Nor does it allow us to confuse iron firmness over the mission and the objective, with fetishism over instruments and operating procedures. Of course the market does not like to be surprised, but why should it be seconded? Why on earth should the conduct of a business be allowed greater discretion than the conduct of a policy? Equating credibility to rules and rules to predictability looks to me like yet another aspect of the subjugation of policy by the market.

When radicalism becomes the ordinary social behaviour of the moderates, there are reasons to be concerned.

9. Was the crisis a market failure or a government failure? The essential goods that were lost in this crisis are systemic stability, high employment and - in some cases and certain countries - social justice. It is known, it was known, although increasingly denied in public discourse, that such goods are *not* provided by the market itself and can *only* be reached with the help of government, through active public policies. In a narrow technical sense we can speak of a market failure. However, when the market failure is

known and patently described in the manual – like a disease for which the standard treatment is fixed by medical protocols – government, not the market is to be blamed for failing to act. In this broader sense, the crisis should be seen as a failure of government rather than of the market. So, let now turn our attention to government.

IV. Government Response and Reform

10. If the years before the crisis were years of over-reliance on markets and mistrust in government – or, more simply put, too much market and too little government – what we have seen in 2008 and 2009 has been a spectacular comeback of government, often cried for by the same quarters that had for so long pushed for deregulation and *laissez faire*. In a few months we saw an inversion of the pendulum similar and opposite to the one that occurred thirty years before when mistrust in markets and over-reliance on government underwent a correction.

This description, however, can be refined if we look more deeply into the matter and, instead of speaking loosely of government, we dwell on its *action* and its *jurisdiction*.

Consider, first, the *action* of government. Most, perhaps all, economic policy actions rely on one or other of four instruments: first, fiscal policy, i.e. taxing and spending; second, monetary policy, i.e. ensuring the proper exercise of the three functions of money; third, command and control, i.e. regulating and supervising economic activities; fourth, public ownership, i.e. directly managing enterprises.

Now, if we use this taxonomy to look at the three decades that ended with the crisis, we see that – in spite of the proclaimed imperative that it should 'stay out' – government shrank in the third and fourth function (regulation and ownership), while in the first and second (money and budget) it expanded significantly. Deregulation and privatizations were the war-horse of the Thatcher-Reagan programme; but public debt and money over time swelled up. The combination of very expansionary macroeconomic policies with very 'liberal' microeconomic ones is in fact the policy-mix which led to the crisis.

11. The response to the crisis was a stepping-up of all the four instruments: more public deficit, more liquidity, more regulation, more public ownership. On the *macro* side, governments and central banks were generally conscious of the risk of repeating the policy mistakes of the 1930s and did not hesitate to provide strong monetary and fiscal stimulus to aggregate demand, which stopped the fall in activity. On the *micro* side – regulation and public ownership – an ambitious agenda for re-regulation was adopted internationally: tightening of capital requirements, the introduction of liquidity ratios and overall limits to leverage, public discipline for rating agencies, rules for high-risk financial products, and other measures. As for public ownership, it was correctly understood that the management of a crisis like this required not only a lender, but also a last-resort buyer. The replacement of private capital with public capital has nothing to do with the advent of collectivism predicated by Marxian economists; it is a pragmatic,

temporary and reversible move addressed to the rescue of capitalism. Nor is it an additional burden laid on the tax payer's shoulders; on the contrary, it is a good investment in undervalued assets bound to appreciate, which will eventually result (and, in some countries, already has resulted) in a substantial gain for the taxpayer. This holds true also for the purchase of securities by the central bank, which – in spite of naive affirmations to the contrary - per se are no more expansionary than ordinary repurchase agreements.

12. This response has to be considered for what it is: *crisis management*, not *crisis prevention*, not the construction of the more resilient, more stable, less crisis-prone economic and financial system for the future. Although they cannot and should not be kept completely separate, crisis management and crisis prevention are quite different modes of the government machine.

What is appropriate in the crisis management mode may be detrimental in the more structural and lasting perspective of prevention.

For example, the huge expansion of *liquidity* and *public debts* may be justified as temporary measures, but should be rolled back as soon as the situation permits. The delicacy of designing a successful exit strategy lies precisely in the fact that the short-term and the longer-term requirements of macro policy have opposite signs.

Equally temporary ought to be the *nationalization* of financial institutions. In Germany, Commerzbank was already nationalized once, in the 1930s, as part of the banking crisis of the time and re-privatized before the end of the decade. The same happened in Italy to a bank carrying the same name (Banca Commerciale Italiana); in that case re-privatization occurred only sixty years later. If truly acting as buyer of last resort, government should step-in only when private shareholders have lost the entire value of their shares and exit as soon as profitability has been restored.

As to *financial regulation* gauging the response is a more complex matter. Firstly, I am one of those who think that supervision, not regulation, was the main problem: stronger enforcement of the existing rules (supervision) would have sufficed to avoid the disaster; understandably, most supervisors have motives to argue differently. Secondly, finance and supervision have already been restructured by the crisis itself, albeit sometimes in the wrong direction: to give two examples, compared to the pre-crisis situation the financial industry is now concentrated in even fewer, presumably too-big-to-fail, institutions, and financial supervision is more nationally segmented. Thirdly, the results of the exercise in re-regulation have yet to come and are not easy to predict. No doubt, rules will b,e tightened, but with what degree of consistency across the world? The urge for reform comes more from local infections than from pandemic disease and reformers are more responsive to national constituencies than to the call for global governance. Finally, the influence of market sentiments on the reform effort remains considerable: for example, the market has moved from obliviousness to alarmism over the capital adequacy of financial institutions, thus pushing bank, market or insurance regulators to propose what appears

excessively severe tightening. The outcome of the current calibration exercise remains to be seen.

13. Obviously, economic policy should subject its four instruments to a unitary and consistent design. This is easy for crisis *management*, where the objective is the single, simple and uncontroversial one of stopping the meltdown of the financial and productive system. It is difficult for crisis *prevention*, where the objective is a composite of goals, which strongly depends on political compromises and varies across the world.

The crisis has caused so much damage because the correction of the unsustainable course has been protracted for too long, and a key facilitator of that protraction has been globalization; indeed, the crisis is global in its origin, not only in its consequences. Coherent prevention therefore requires a truly global policy, decided and implemented as effectively as national policies. I fully realize, of course, how difficult it is to move from a Hobbesian to a Kantian world. I have not forgotten the days when I was in office. However, nothing excuses us – as responsible individuals – from the intellectual and moral duty of adopting a truly cosmopolitan perspective and from engaging in the thought experiment of devising the first best response. This first best is nothing less than a global policy.

A global programme should revolve around the notion of 'globally sustainable growth' and recognize the hard constraints imposed by the requirement of sustainability. In my view, there are three such constraints: an economic and financial one, a social one, and an environmental one. All of them, sooner or later, bite. All have become ultimately global, not merely local. This holds true for financial stability, peace, security, migrations, multiculturalism, scarcity of natural resources and climate change. A sudden halt in the growth process may equally be caused by a terrorist attack or by a series of hurricanes, by millions of people dying because of the rising price of rice or by financial panic spreading around the clock.

I shall not elaborate here on the specifics of sustainable global growth, which is not the main theme of this lecture. In passing, however, I need to note the profound difference between the growth of the poor and that of the affluent. The former consists in their gaining their first access to primary comforts: sufficient daily ingestion of calories, wearing shoes, bringing running and clean water, sanitation, electricity into the home; and, later, in acquiring a motor vehicle, domestic appliances, etc. The latter mainly consists in the unnecessarily frequent replacement of still functioning consumer durables. The former is a change in lifestyle, the latter is a lifestyle. The affluent on earth number approximately one billion; the poor number six billion, one of which is starving while three are rapidly emerging from poverty. Following the collapse of the illusion that poverty could be defeated by suppressing the market, growth has spread in a spectacular way in only one generation, largely by expanding economic freedom, unleashing animal spirits, allowing goods, persons, capital and services to cross political borders. For governments, which are still confined within those borders, the challenge consists in keeping this dynamic within the bounds of sustainability.

14. This leads to the *jurisdiction* of government, an issue that has been far too neglected in the 'markets and government' debate. To my mind, it is not exaggerated to say that the policy failure was due as much to a faulty *jurisdiction* of governments as to errors in *action*.

In a market economy the jurisdiction of government has a straightforward definition: it consists in providing 'public goods', the locution economists use for the goods the market cannot not produce spontaneously.

In this locution, the pitfalls lie mainly in the adjective (*public*). Regarding the noun (*good*), let me flash only a few observations. First, economic goods are qualified as such by scarcity and need, by the utility they bring to people, hence their subjective nature. Second, subjectivity may be collective, not only individual; in other words, the need may derive from humans living together and sharing mutual dependence and aspirations, including the desire to temperate mutual aggressiveness. Third, a market failure is a necessary but not a sufficient condition for government to step in, because devices other than government intervention may grant the provision of certain public goods: solidarity, respect for private property or the conservation of nature may be produced by social habits, to a greater or lesser extent in different times and societies. This should be taken into account when drafting the 'agenda' of government. Fourth, and most important, some public goods are strongly complementary to private goods: the absence, or insufficient provision, of certain public goods (such as the enforcement of contracts or financial stability) prevents the market from providing private goods.

15. Turning to the adjective (*public*), the role of government is defined by the answer to the question: what does 'public' mean? The answer I suggest is this: 'public' identifies the human group sharing consumption of the public good in point, and from this it follows that government must be multi-level. Let me explain why I regard this proposition as critically important to understanding the crisis and designing a better world.

Humans sharing common interests constitute groups of different sizes on a scale that goes from the condominium to the population of the world. Goods like a garden, the judiciary system, navigation on the Rhine, or the biosphere, are 'public' for different jurisdictions such as a town, a country, a continent or the planet.

It follows that also the government – as the provider of public goods – needs to be structured at different levels in order to operate in different jurisdictions and to refer to different constituencies. Government must be plural and multi-level. The Jacobin aspiration to concentrate public power in the hands of a single ruler produces both oppression and ineffectiveness.

The present crisis stems largely from the inconsistency between the increasingly cross-national span of markets – be it regional or global - and the persistently national span of government: lack of an international monetary order providing a degree of macroeconomic discipline, regulatory competition among financial centers to attract bits of the global financial industry, etc. This defective aspect of the relationship between markets and government – one of the most important flaws in the market-government

nexus leading to the crisis – cannot be simplistically described as a 'lack' or an 'excess' of government. The defect lies in the *level* rather than in the *quantum* of government and has deep roots in the field of practices and in that of ideas.

In the field of *practices*, the dominance of the nation-state model is supported by the powerful vested interests associated to the preservation of its monopoly of economic policy: national bureaucracies, public policy agencies, political processes, tax and spend activities are all predominantly geared to the nation state irrespective of the fact that its power is insufficient to manage an increasing part of the objectives it declares. In the field of *ideas*, the model of state subconsciously adopted by most is the one issued of the Treaty of Westphalia in 1648: the state should be uniform inside its border and exempt from any right of interference from the outside of the borders. In the concluding chapter of his *General Theory* Keynes wrote a much quoted passage on 'practical men [being] the slaves of a defunct economist.' Unfortunately, sophisticated economists, public officials, authors of editorials and market traders are the slaves of a defunct *political* thinker or historian; hence their unshakable faith in the Westphalian model.

A priori, a combination of too much national and too little international policy power was not the only conceivable liberal response to the market repression of the preceding era. Unfortunately, however, the brand of economic liberalism that returned to power thirty years ago was not that of internationalist liberal thinkers like Lionel Robbins, Friedrich Hayek or Luigi Einaudi, who had combined strong pro-market economic convictions with a profound critique of the nation state derived from the lessons of World War I. It was of the, to my mind, far cruder, less solid and essentially nationalistic brand uncritically attached to the nation state model, naively preaching that everyone 'keeping the house in order' was the necessary and sufficient condition for assuring international order, living and thinking as if a century of world history had not demonstrated its fatal flaws.

The nationalist bias of the pro-market revolution can of course be explained. Both the Thatcher and the Reagan governments were bent on reviving the flagging self-confidence of countries suffering from economic decline and loss of international influence. Both attracted votes with a combination of strong government and strong market: hands-off vis-à-vis the economy, hands-on in the reaffirmation of national power. A non-democratic version of the same combination had been practiced years earlier in Chile by the Pinochet regime.

The fact of the matter is that the thirty years of growing laissez-faire and globalization were also years of declining international cooperation. This was epitomized by the shift from international institutions to 'forums', i.e. from the strong, treaty based, binding form invented in the mid-1940s, to the soft, voluntary and narcissistic form of periodic meetings of self-appointed groups, without the support of any staff committed to 'the interest of the world', and without any power to take binding decisions. I have myself participated in countless communiqué-sessions of various Gs, in which the declaration that the course was 'unsustainable' was accompanied by no action.

16. The weight carried by the Westphalian bias has popped up dramatically in these weeks and months in which the crisis has moved to Euroland. Seen as the 'land of the euro' (and the early adoption, in 1998-99, of the word 'land' by the media was deliberately and characteristically opposed by the EU institutions) Europe has none of the flaws comprising the unsustainable mix that led to the crisis; no significant fiscal or external deficits, no high indebtedness of the household sector, no collapse of its banking sector. Yet it is under heavy attack by the market because the market does not believe in the robustness of the post-Westphalian project that Europe has been pursuing for sixty years now; and the skepticism of the market is shared and reinforced by a global array of economists and commentators, who predict the end of the euro because they do not believe that 'a currency without a state' can survive. The European politicians facing them maintain the opposite and equally mistaken view that it can last forever without further steps towards political union. What the two share is the primitive belief that the Westphalian model is eternal and indestructible.

V. Croesus and the Emperor

17. It took centuries to define and set up the appropriate constitutional relationship between the State and the Church. The process was so long because politics and religion are linked and separate at the same time and both aspire to capture the totality of the person. They must be kept apart because they have to do with as fundamentally different aspects of human experience as power and faith and when the two contaminate each other both deprave. Yet they are bound to interact and mutually interfere because social bonds, authority, freedom, rules are implicated in both.

In our time, economic activity occupies the centre stage of society in a way similar to what religion did a thousand or more years ago. The present search for a constitutional order in the relationship between the economic dimension of society and government bears analogies with the ancient struggle between the King and the religious sects and clerics, or between the Emperor and the Pope (ancient struggle, note, for Europe and America, but still unresolved just beyond our borders).

The industrial revolution, the rise of mass production, the creation of large and impersonal markets, in the *economic* sphere; and concurrently - in the sphere of *government* - the advent of democracy and, more generally, of mass participation in political life, have disrupted market-government relationships that had lasted for centuries. More recently, the self-same technological revolution - in the field of information and communication - has produced a mutation in the mechanisms whereby opinions are formed and expressed, a mechanism which is at the very heart of the proper functioning of *both* markets and governments.

Political and economic activity too are linked and separate at the same time. They too are corrupted by contamination, but need to relate to each other. Power and wealth are two fundamentally different categories and yet each may determine the fate of the other. The present crisis is not only a powerful reminder that the relationship between markets and government is still largely unsettled, it is also an event that may disrupt economic prosperity and democratic freedoms.

The combat between the Emperor and Croesus is marked by alternating phases of supremacy of one or the other. A peaceful and mutually respected constitution is still to be found. In the past century we have seen the high social costs incurred when politics subjugates the market, not only through the totally repressive experiment of communism but also through the excessive interference of the pre-Thatcher-Reagan years. At the beginning of this century, the crisis started in 2007 shows what disasters can occur when the market subjugates the government. A successful exit from the present troubles can only be found by fundamentally rethinking the relationship between markets and government in a global world.