Culture, Government and Markets

Koushik Ghosh, Professor and Co-Chair, Department of Economics, Central Washington University

Abstract

In this paper I explore the nature of self-interest, and the notion that culture in its interactions with self-interest has been instrumental in bringing about the present financial crisis. In particular, I pursue a discussion in the paper that interrogates the question: what is the role of culture in such crises, and the role of government in imposing morality on the markets? This paper argues that government through its institutions has a critical role to play in maintaining vigilance and the telling of the right story to prevent such crises in the future. In particular policymakers should pay attention to research that emphasizes the persistent role of animal spirits in leading us to repeated crashes and should craft institutions that do not assume that individuals are rational economic agents whose pursuit of unmitigated self-interest will lead to the greater good.

Introduction

In an undergraduate economics class on development, in 1980 I had once posed a question to the professor: *In explaining the alternate paths of development for Japan and Indonesia is it worthwhile exploring the issue of religious difference and more broadly cultural difference?* That question was dismissed at that time mainly because there was no room for such a conversation within mainstream economics. In particular, none of the neoclassical models, or the Marxian critiques of colonial development, which were relied upon to explain the different trajectories of development for these two countries, allowed for cultural differences as an important factor (Baran 1957; Friedman 1962). It was a puzzling problem for me. I knew *intuitively* that this was an important variable and yet I could not formulate the question I needed to explore if I were to remain within mainstream economic inquiry. I was discouraged: How was I to navigate a discipline that eliminated some of the most important conceptual exercises as irrelevant in attempting to answer these questions?

This particular conundrum has informed my engagement with the discipline for three decades. In 1989, while I was pursuing graduate work in economics, an international Society for the Advancement of Socio-Economics was formed at Harvard University, under the leadership of Amitai Etzioni (Etzioni 1991). Even though this did provide a new opportunity for discouraged students like me to begin to develop a shared conceptual framework, neoclassical economics clearly remained the entrenched, acceptable and the only respectable form of economic inquiry till 2008. The discomfort that I suffered as I pursued a career of teaching and inquiry using the tools of this discipline made for a career which advanced by the usual rules of academe, but was nonetheless lived on the fringes of this discipline. The identity of scholars is as dependent on labels as any consumer product, if one understands that scholarship has increasingly become a market, ruled by the grand Smithian ideology. Thus scholars such as Amartya Sen, Herbert Simon, Albert Hirschman, Amor Tversky, Daniel

Kahneman, while pursuing socio-economics, are not identified by that label. Yet, their work, published in books and journals such as the Journal of Behavioral Economics, Journal of Economics and Psychology, Economics and Philosophy, are essentially founded in more ancient traditions, which in the West, can be traced back to Kantian philosophy, traditional sociology, as well as humanistic psychology. The application to economic issues of these very ancient tradition of inquiry, however, is entirely contemporary. This particular form of inquiry could have remained on the fringes of traditional economic inquiry and my question about culture could have remained that odd question for decades and my personal discomfort would have remained just that had it not been for the events that unfolded since September 2008. In the space of one summer, the U.S. economy went into a tailspin due to the contagion that began to spread from the subprime sector to other parts of the financial sector and finally the "real" economy.

In considering the "real" economy it is worthwhile to consider that economists are constantly warning others of "money illusion" and the necessity of distinguishing the "real" from "nominal" (monetary) phenomenon, even as they debate whether such an illusion actually exists. The distinction is phenomenally important and since Milton Friedman's presidential address to the American Economic Association in Washington D.C. on Dec 29, 1967, has informed the trajectory of macro-economic policymaking and thus the entire world population, till now (Akerlof and Shiller 2008). The history of such distinctions and debates, however, stretches back at least a century and to the work of Irving Fischer, though one can look back even further to the work of John Bates Clark and begin to trace this revolution in economic thinking to the depression of the 1890s. The question remains as to why a profession that is so obsessed with assessing conceptual confusions so incapable of admitting to factors such as values, beliefs, ideas, psychology and other forces that can broadly be classified for lack of a better vocabulary, in a Keynesian vernacular as *animal spirits*? In this paper, I explore this issue by focusing on the present crisis and argue that it is impossible to understand such a glaring omission and the marginal role that socio-economics has played till now in the development of this discipline, without an understanding of how the notion of self-interest as laid out by Adam Smith, and culture, in particular American culture, has interacted to produce this crisis. In developing this notion, I emphasize the importance of narrative or story telling, since I believe with social psychologists, Roger Schank and Robert Abelson, that the human mind derives its motivation by living through the story of our lives and is built to think in narratives (Schank and Abelson 1995).

The Crisis of 2007

The present crisis began to unfold with the fall of Northern Rock in the Fall of 2007 (*The Economist* 2007). Americans, across the Atlantic, paid scant attention to the news, even as the European print media published front page pictures of what looked like a classic bank run in the U.K. The fact that this was a crisis that was built on the sub-prime house of cards and that the origin of the game was in the U.S. did not become a part of American storytelling till almost a year later in the summer of 2008. The Federal Reserve Bank, the central bank of the United states intervened swiftly when the investment firm Bear and Stearns bit the dust in March of 2008 (*The New York Times*, March 17, 2008). Yet, even after Bear and Stearns, the magnificent story of the free market and the hands-off policy mindset did not change. The understanding in the market was that the Fed was at the helm, that the crisis was being contained, and the problem was that there was too much liquidity out there creating froth and that the Fed was going to help dampen that. This was just one firm behaving badly.

The Fed had revealed its prowess before when it had quietly closed down the enormously influential hedge fund, Long Term Capital Management (LTCM) in 2000 (Dunbar 2007). LTCM had the potential of taking down a large chunk of Wall Street with it, and the Fed's intervention staved off a calamity. This was not going to be any different. That was the dominant feeling in the market in March 2008. It is not easy to dispel myths and stories when the telling has been going on for a while. People ignore facts, they do not gather information as they should and they repeat stories to themselves reinforcing either the good news or the bad news till the story changes dramatically for a period of time. To ignore this fact is to ignore human nature. Yet, that particular exercise of ignoring this critically important aspect of human behavior has been a vital component of the storytelling that led to this crisis, and prevented players from changing the story even when it was appropriate to do so.

The dominant economic story, especially in the policy-making circles over the past three decades has been of rational expectations. The new classicists burst on to the scene of macroeconomic policy-making in the 1970s on the heels of Friedman, and the natural rate hypothesis, that forever changed macroeconomics. The natural rate hypothesis laid to the rest the debate over money illusion, because the profession and policy-making bodies such as the Fed generally accepted the notion that people had perfect inflationary expectations, being rational, as Friedman had suggested and thus did not suffer from money illusion. Presence of money illusion presupposes an inability of economic agents to factor in expectation of inflation in making choices. The Phillips curve, which was popular till the 1960's in policy-making circles, despite being inadequate for explaining some macroeconomic phenomenon assumed money illusion (Akerlof, Dickens and Perry 2000). The assumption emphasizes the necessity of not conceiving a world full of heroic rational agents who predict inflation correctly and make choices on that basis. Friedman, and the rational expectations herd insisted that people are rational, formed perfect inflationary expectation, and could not be fooled. The Phillips curve, which was a mainstay of economic policy-making, ceased to make sense, for the Phillips curve assumed money illusion. The curve, also illustrated a long-run tradeoff between unemployment and inflation. If such a tradeoff did not exist, then neither did a reason for activism for government agencies, such as the Federal Reserve Bank (Fed) and the fiscal authorities, to ameliorate the ill effects of unemployment (if there were no political costs for such inaction) and it made sense to focus on keeping inflation low and help unemployment stabilize around the natural rate (Akerlof and Shiller 2008: 45). The profession loved the notion of a rational populace completely free of money illusion, and geared toward utility maximization. It allowed for the elimination of the inconvenient Keynesian notion of animal spirits or irrational behavior in general. For over three decades the entire intellectual-policy making apparatus has tried to tell variations of this particular story of rational expectations (Akerlof and Shiller 2008: 45-46).

Rational expectations, and theories of economics and finance based on that, justifies the hype around the founding of the hedge fund, Long Term Capital Management (LTCM) which assumed that finance-economic models can eliminate *all* risk in speculative investments, by devising the right bets. Assumptions of rationality can even explain why there was limited fallout from the LTCM mega-disaster and why the Fed came out looking like the perfect regulatory body that knew how to contain such crises. The LTCM save provided credence to the story that the Fed can save Wall Street and the economy from devastation without much fallout and hence it was not necessary to contain such *innovations* as LTCM. The free market would work, for the greater good, with minimum intervention, and that there was no systemic risk that could be generated from such assumptions of rationality, and the speculative business models that can be built on that. Systemic risk was present in other places where capitalism was not pure and not supported by carefully crafted institutions. Not so, in the United States!

This is the story that played out again when the Fed decided to intervene in March of 2008, in regards to the investment firm, Bear and Stearns. The stories of Fed interventions till the summer of 2008 exudes confidence in our institutions and their ability to let loose the genie of rational self-interest, but quickly trap it again should it run amok. The story does not allow for the type of crisis that has unfolded since the summer of 2008. It is the inability to return to this original story of the past three decades that is forcing the profession and all and sundry to wake up to a new reality and a new story, thus emphasizing the power of our stories, economic and otherwise. Story telling is one of the great activities of the human animal, and to ignore that would be to ignore a great opportunity at this time to understand human behavior and the limitations of our previously held notions of sacrosanct neoclassical economic models.

Those Powerful Mega-Bankers

The fact that the Federal Reserve Bank chairman Ben Bernanke is being presently blasted by the U.S. House of Representatives is an indication of the level of confusion that now inhabits the existing story-telling circles (*The Wall Street Journal* 2009). The interesting thing is that Bernanke is being attacked both from the left as well from the right. The right is attacking him because they are concerned about the interventionism of the Fed and the left is attacking him because they consider his actions too opaque and too friendly to Wall Street insiders. Basically, the political apparatus of the U.S. has become highly suspicious of the economic apparatus and would like to have greater participation in building what they consider to be the political-economic story, and the economic future of the country and the world. Bernanke cannot win this fight because he has the impossible task of convincing the U.S. Congress that the Federal Reserve actually knows how the story unfolds. After the devastation of the past 12 months and the U.S. budget spiraling down trillions, the story needs to be reworked. It is no longer possible to defend the story of the last thirty years. Yet, to speak of "animal spirits" is unseemly and greatly disturbing to a group that has been bred on Friedman scriptures for over thirty years, and lived in the gilt-edged glass palaces that they think the *free* markets built. In reality of course these markets were built with the help of regulators who allowed themselves to be swayed by ideology and allow the demolition crews to go to work on the walls that were built after the Great Depression to prevent such a crisis.

In 1999, just a decade ago, the mega bank, Citibank was born, tearing down Glass-Steagall, the wall that U.S. Congress had built decades ago, after the great crash of 1929. It was meant to keep commercial and investment banking separate and thus regulate the excesses of self-interest because it was made clear in 1929 that unfettered self-interest did not lead to the greater good but the greater ill, Adam Smith notwithstanding .The most important government appointed regulator who stood by while the demolition crews of Sanford Weill, the CEO of Citi got to work, was Alan Greenspan, then the chairman of the Federal Reserve Bank. But it also got the blessings of Larry Summers, who then was Treasury Secretary (*The New York Times*, November 5, 1999). Sanford Weill combined the investment banking house of Salomon Smith Barney, Travelers Insurance, and Citibank all under one roof thus paving the way for the creation of a shadow banking sector, that performed like the banking sector without regulation, all in the name of innovation that was supposed to create enormous wealth. (*The New York Times*, January 29, 2009.) Greenspan and other leaders let that happen because they were so utterly mystified by the power of the market's ability to bring about good for the many through the workings of the invisible hand. The lessons from history were left in the dust for the belief in unmitigated self-interest, as the greatest value was enormous. The culture that led to the demolition of Glass-Steagall is but an example of how persistent beliefs are that governments and regulations are the problem, and that people left to themselves in the pursuit of commerce will lead to best social outcomes.

Cultural Underpinnings of Policy and The Role of Government

Whether Bernanke and the Federal Reserve comes out of this experience damaged or more powerful may be far less significant than how the world and especially U.S. policy makers and the public begin to reconceive the role of government in markets. Free markets after all has been sold as a panacea for all sorts of problems from climate change to health care, education and social security, eroding for thirty years the institutions that took decades to build. Since the Great Depression, which enabled countries on both sides of the Atlantic in particular to conceive a role for government in maintaining markets and in intervening when necessary, the world has taken seven decades to arrive at a similar brink mainly through active dismantling of structures that were built to prevent such chaos. The only reason why such dismantling was possible is because of the story that politicians and capitalists mainly residing in the financial districts of the world began to tell over three decades ago. Keynesian interventionism, it must be understood, is cultural anathema to much of America, to people who still celebrate their revolutionary wars every 4th of July with much fanfare, and in fact had numerous Boston-inspired tea parties on April 15th, 2009, the last day in the U.S. to pay taxes, demonstrating their desire to be independent of the onerous tax burdens of the Obama administration that is trying to address issues such as global warming, a deepening recession with a double digit unemployment rate, a once-in-a-century (one hopes) financial crisis, a health care time bomb (*The New York Times, April 16, 2009*).

Despite their love for Masterpiece Theater, the Osborne's' and Jerry Springer neither the BBC nor soccer has achieved adulthood in the U.S. Recently, President Obama in distinguishing himself from other Presidents, and in demonstrating his savvy with the media pointed out that he read the Financial Times before it was popular to do so (*The Financial Times* 2009). The fact is that this popularity too is very recent, and other than the minuscule news elite of this populous nation, very few people read it. Despite the obvious correlates between the U.S. and the U.K. the fact is that culture has permeated east across the Atlantic at a far faster pace since the Great Depression than it has done in the opposite direction. Margaret Thatcher, notwithstanding, Reagan is still credited in the U.S. for bringing down the Berlin Wall. Gorbachev did appear, however, a few times in some Louis Vuitton advertisements (*The New York Times, November 5, 2007*). The message, for the past three decades, has been a clear one: *it is the government that is the source of the problem*. The financial architecture that was built in reaction to the Great Depression, was slowly eroded using the singular political message of the American Revolution (freedom), and the ideological gift of "self-interest" from Adam Smith (greed) thus helping to build the most commercial of republics of the world.

This after all is the country, which Alexis de Tocqueville saw as one in which despite great wealth people lived with a frown across their brow (Tocqueville 1835). That frown is the frown of what economists call *utility maximization* (Mankiw 2008). Unfortunately, all utility is maximized under constraints and the government, many Americans still believe as they did during the revolutionary wars is still considered the big bad wolf at the door, the biggest constraint of them all. The biggest fear in America is that of the big bad state that acquires all and devours all. This story was told during the revolution in the eighteenth century, repeated during the 19th century, when America convulsed with Civil War and almost came apart (it still remains apart in significant ways even as it comes together). It was told again in the 20th century as communist states sprung across the globe. Today, in the 21st it may be easier in the wake of the financial crisis to develop a new activist state but the doubts about state activism are deep in the U.S. Only time will tell whether the Obama administration and the present Congress will be able to craft a financial architecture that will be able to withstand the power of the other story that most Americans have been telling each other for centuries, which is one where markets become the only vehicle for unleashing of the individualist spirit and the impulse to wealth.

This is the story that has great appeal in many parts of the world. This is the story that has been sold the world over as a fairy tale; this is the story that leaders of successive British governments, due to the close relationship they enjoy with the U.S. government has been trying to tell its constituents for about three decades with varying degrees of success. This is also the story that helped create the sub prime-mortgage crisis, which was built on the originate-and-distribute model of U.S. mortgage lending, in the housing market (securitizing home mortgages and reselling them, thus transferring the risk from the original lender to other investors). This is the story that enabled to sell the extremely deregulated snake-oil-type financial products built on this model as *innovations*. This is also the reason why the U.S. financial sector is being able to both stall the present administration, and influence the process of re-regulation so vigorously, despite the havoc this architecture has wreaked on both the U.S. and the world economy. It is this particular story, the values and its cultural correlates that ultimately inform the present policy-making exercise. The extent to which that the rest of the world is able to resist the mythology of markets as espoused by the U.S. policy-making apparatus for decades, will determine whether a new regulatory architecture will evolve that will make such meltdowns less likely in the coming decades.

The fact that the risks of the original home mortgages in the U.S. were sliced and diced by math whiz kids and finally bundled into securities that were then sold to other parties is the basis of the originate-and-distribute model of risk dispersion that is the very epicenter of this crisis. There is no surprise here and Keynes warned the world about it, after the 1929 crash in observing that, "When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done" (Keynes 1936:159). Keynes further warned of the dangers of instability as one shifts from the long term to the short-term perspective, which is what one does with business models that focus on maintaining liquidity by transferring risk. Keynes explains such a shift as being caused by the development of the securities market. (Keynes 1936:149).

The sub-prime mortgage crisis is not a once-in-a-century unpredictable crisis as a shocked Alan Greenspan explained to Congress. It was entirely predictable, as any attention to the Keynesian notion of animal spirits reveals which is the reason why it is important to be wary of financial markets. The fact that such caution was abandoned for the last three decades allowing for instance for Glass-Steagall to lapse, can only be explained by the tenacity of a culture that sees the market as the most important vehicle for achieving what people have been led to believe as the most important goal, the maximization of wealth, through the pursuit of self -interest Robert Lane, in analyzing the story market participants typically tell each other in market economies, makes the following observation: " To increase one's happiness in market economy one's preferences should include support for market methods; one should believe in market fairness and one's own efficacy in the market. As it turns out, for some people these beliefs and preferences are indeed so stable that they survive every kind of misfortune in the market…even those who lose their jobs because of business failure or recession often continue to believe in that portion of the market ideology holding that one is responsible for one's own fate, a belief that only increases their misery" (Lane 1991: 108). Yet, despite the tenacity of ideology and reinforcing stories that Lane correctly identifies, there are critical points in history when an opportunity arises to tell a new story. Such a time is now.

The Europeans in particular, and all those who have been exposed to this financial contagion do need to begin telling their stories, that affirm the need for a different role for government in managing markets. It is in that telling that story that a new story about markets may emerge. The world is better poised to do that since it is a more multi-polar world than in recent decades, but that particular leadership in telling other stories needs to be taken seriously. To think that models, as they exist at this time, matter more than the stories we tell each other that creates the cultural scaffolding (which can only be sometimes described, rather than controlled as one can do with variables in models), is to ignore the reality of interconnections between, psychology, culture, financial markets and real economies. It is important also to pay close attention to *animal spirits* and a Keynesian approach for analyzing markets, if one is to craft a more sensible world. It is also essential to allow for a stronger government involvement in the managing of markets, on both sides of the Atlantic if one is to craft a more stable world. That essentially requires that one abandon the mythology that was sold in the U.S. and the world over for sometime: that the government is the problem, that markets are best left alone at all times, that market participants are rational and that almost everything can be privatized and that such privatization will lead to the best allocation of resources in almost all instances.

Behavioral Economics Becomes Respectable Again

For decades behavioral economists jostled for attention in mainstream economic journals, but this crisis has opened up new admissions and an opportunity for considering well established critiques of neoclassical economics within the mainstream. In a recent interview, the behavioral economist, Robert Frank, criticized the notion that informs this entire ideological enterprise, namely that markets have rational participants. In making the point he mentioned the work of Thaler, whose own work was inspired by psychologists, Amor Tversky and Daniel Kahneman. The work of these psychologists illustrates that due to cognitive errors, people repeatedly did not figure out the right answer even when they had all the facts, thus delivering a devastating blow to the notion of rationality that is used as a building block for economic models and policy prescriptions.

In a concrete example Frank pointed out yet another conundrum of rational choice. Using the example of school choice for kids, he considered the choice of a parent between saving for retirement versus paying for a good education for his children. In using the example of the U.S. where property taxes typically pay for education in the school districts, he points out that if every parent chooses the best school district and do not save for retirement, all it does is bid up house prices in the better school districts, with half of the kids still ending up in the worst schools. So what is perfectly rational at an individual level can be entirely senseless on a community level.

This present crisis illustrates the complete failure of the entire policy-making apparatus to listen to all those who offered such insights for about three decades, and because those at the helm, such as former Federal Reserve Bank chairman, Alan Greenspan, were so mesmerized by the rationality assumptions that informed their free-market ideology that they dropped all the caution one would expect of such leaders. However, instead of blaming and scapegoating it is better to understand why such people failed to play heed, and the answer can be found resoundingly in the culture that ultimately plays a critical role in which stories we decide to emphasize. In the case of Greenspan, it is important to recognize his devotion to Ayn Rand (*The New York Times*, September 15, 2007).

Despite the rationality massage that policy makers were so keen to deliver to the public, academics such as Shiller had pointed out that securities traders display irrational behaviors on a consistent basis and that there are patterns of irrational behavior in such markets. Since the present sub prime mortgage crisis, is a securitization problem that relied on an originate-and-distribute model for mortgage loans, it would have been more helpful to listen to Shiller or Edward Gramlich for that matter (Shiller 2000). Edward Gramlich, a former Federal Reserve Bank governor had warned Greenspan and the FRB repeatedly that the sub prime crisis was a ticking time bomb, to no avail (Gramlich 2007). At the annual Jackson Hole meeting of the Federal Reserve Bank, in 2005, Raghuram Rajan, a chief economist of the International Monetary Fund was chastised by our present National Economic Advisor, Lawrence Summers, for sounding the alarm bells on the free market excesses of the financial sector (*The New York Times*, April 9, 2009). Rajan's point was that financial market development had made the world a riskier place. Somehow, the lessons of Thailand and the financial crisis of the summer of 1997, was seen even then by the policy-making elite of the Western economies as a peculiar problem of crony capitalism in East Asia and not consistent irrational behavior of market participants (Agenor, Pierre-Richard, Miller Marcus, Lines, David and Axel Wilber 1999). This too is an issue of culture. To consider ones systems and defenses as being more secure, more immune than in other parts of the globe till proven otherwise. Policy making after all is critically dependent on the stories we decide to repeat and those that we decide to ignore.

Morality and Markets

That gets us to the crux of the issue, the issue of morality, of the individual versus the community. The fact is that animal spirits, which is how Keynes refereed to irrational behavior in markets, is quite rampant. Given that to be the case, one must continuously maintain ones vigil. Yet, our regulatory systems, which always tend to come alive during such systemic crises, repeatedly get overwhelmed by other stories, mainly the one of the overbearing state, which is always the default regulatory body (*The New York Times*, August 6, 2009). The state becomes this unbearable weight on peoples' ability to earn a decent living, due to the unique rent seeking behavior that only a state can engage in. While that criticism of the state is entirely true, the notion that somehow self-interest driven notions of economic management delivers the greater good for the many is an utterly naive idea precisely because as John Kenneth Galbraith had correctly observed, that unfettered competition, not mitigated by sate regulation leads to a battle for monopoly in the market (Galbraith 1985). Just as the state can display all the ill traits of monopolies, so can the markets. To believe in the salvation of self-interest is to repeat stories of the greed and corruption that such systems spawn, and the history of duplicity and greed and social evils that come in their wake. Bernie Madoff whose recent swindle will award him the status of a legend in the annals of corruption is not an anomaly (*The New York Times*, June 30, 2009). Jeffrey Skilling of Enron, who among others cleaned out Enron is not an anomaly (*The New York Times*, April 3, 2008). William Rockefeller, whose duplicities have slipped out of collective memory and the folklore of the Internet generation, was not an anomaly (Chernow 1998.). They are predictable consequences of a system that is built on a culture of self-interest as being the most important value (Lux 1990: 96).

Yet, people tend to repeatedly cast aside their worries about animal spirits or irrationality in markets. When making money and more of it, and considering the individuals choice as more important than the community's become the dominant stories, and the most relevant stories, a culture is born that reasserts the primacy of such stories. Unless one is ready to grapple with this real issue it is impossible to take an evolutionary approach to regulation or policy-making in areas of economics and finance. In a world where crises are increasingly transnational, whether they involve auto companies, financial crises, and ultimately global warming, the question of how to balance the individual versus the community needs to be raised again as the primary question of policy-making that just cannot be solved only through insights about market failure obtained from neoclassical economics or the recently respectable field of behavioral economics, which points to research that shows concern for fairness, corruption among others s factors that affect economic decisions. They must be addressed within the broad realm of ethics and philosophy, along with psychology, sociology, politics and economics. We need to recognize that the policy and regulatory apparatus that was crafted over recent decades has been singularly influenced by Smith ‘s naive notion that the invisible hand of competition inexorably channels what he labeled as despicable motives (greed and self-interest) to social good. To simplistically rely on Adam Smith’s Wealth of Nations as the bible of modern economic policy making, amounts to casting our future into the futility of repeated crashes, with the next one holding out the possibility of being more catastrophic than the last. It is important to attempt an evolutionary approach and thus engage a broader array of enquiry to craft a more sensible approach to government, regulation, and markets. That, however, is dependent ultimately on the stories we deicide to tell each other about this crash and the crashes that came before this one. Those stories will determine the culture that ultimately will inform the models, whether or not economists can explicitly include the essences of such stories as variables in the models with which they attempt to navigate policy. That discussion is of paramount importance at this juncture for that discussion that begins to see economic agents as irrational in the narrow sense of neoclassical economics, and begins to conceive of humans as ultimately being able to achieve the greater good despite self-interest rather than because of it is the story that should inform the new policy landscape that should be shaped by states and governments. Without that discussion in public forums, such new governments that attend to the greater good will not emerge.

Conclusion

In assessing this particular financial crisis, it is necessary to focus on the notion that animal spirits and general irrational behavior has played an important role as it always does during such crashes that repeat themselves in modern economies every few decades. Unfortunately, due to an increasingly globalized world, these crashes are today truly global in nature, thus having the scope of damage typically associated with pandemics and contagions. Economists recognized that particularly after the 1997 crash, which had a devastating effect on Asia. Yet, for another decade, there existed a great naiveté in Western economies despite this experience, that somehow the Western economies were immune to such a catastrophe. That is, till 2007. Over the past two years it has become clear that while capitalism has been the cause of great social upliftment, due to a fatal flaw in its understanding, that can be traced back to Adam Smith, it remains one of the most vulnerable of arrangements to achieve the greater good. In particular, it is due to a cultural myopia that promotes the notion of self-interest, and thus fails to demand the very important role that government can play in mitigating such unfettered capitalism, with benevolence, and a concern for the many. This notion is also very much a Smithian idea if one decides to confine oneself to the Western tradition of economic conceptualization. Unfortunately, this idea of benevolence that smith also expounded never took hold despite Smith's later efforts in that direction (Lux 1990: 97). Thus Smith's initial inability to perceive any benevolent motives in commercial enterprise, served to propel an enormous ideological campaign on behalf of the commercial class, and most recently in a most virulent form in the United Sates, the most commercial of republics, thus leading to this present crisis. The fact is that this is but one of many episodes of economic catastrophes that result from Adam Smith's mistake despite noble intentions. As Lux points out, "the penetration of this mistake, this transvaluation, into the roots of our culture has affected our basic modes of perception and understanding" (Lux 1990: 81) thus repeatedly leading capitalist economies astray and heaping enormous misery on many. It is well worth pondering at this juncture just how important benevolence is, and emphasize that it is the forces limiting self-interest that are most important for achieving the greatest economic and social good. Over the past few decades research in the areas of behavioral economics and more broadly socioeconomics has revealed that fairness, honesty and caring does matter and that people are not rational players. This is in direct contravention to the notion of the rational economic agent that informs neoclassical models in economics and informs policy. These ideas of behavioral economics and socioeconomics continue to remain on the fringes of policy discussions in think tanks and governments. They have not caught on and neoclassical economics remains the scaffolding over which ineffective policies, whether they relate to financial crisis, or global warming, continue to be draped. That plays out in the world at large and will cause untold harm in the coming decades since crises today are increasingly transnational. The reason for such stubborn resistance to critiques of neoclassical economics, and assumptions of rationality can only be explained by appealing to the notion of culture. A culture that promotes narrow self-interest as the primary value will inevitably and effectively resist any information that contradicts that cultural premise. Joan Robinson understood the power of Smith's naive description of the path to achieve social good, when she remarked, "This is an ideology to end ideologies, for it has abolished the moral problem. It is only necessary for each individual to act egotistically for the good of all to be attained" (Robinson 1964:54).

This crisis offers the opportunity to correct this fundamental cultural misperception that is very much a fundamental American cultural misperception and one of its biggest exports to the rest of the world. Culture matters, as does stories that teach us about culture. If we are to craft a more sensible set of regulations and institutions that will have the ability to stave off such crises in the future it is necessary to re-tell the story of self-interest, and begin speaking of benevolence as a necessary and essential mitigating force. It's important to not leave that up to charitable institutions but incorporate that in the way we regulate and build institutions that watch over markets. It is equally important to reconceive the role of government to so that we do not lurch from one disaster to the next by failing to seize this moment.

References

Akerlof, G. and R. Shiller. 2008. *Animal Spirits: How Human Drives the Economy and Why it Matters for Global Capitalism.* Princeton University Press.

Agell, Jonas and Per Lundborg. 2003. “Survey Evidence on Wage Rigidity and Unemployment: Sweden in the 1990s.” *Scandinavian Journal of Economics* 105 (1): 15-29.

Agenor, Pierre-Richard, Miller Marcus, Lines, David and Axel Wilber.1999. Ed., *The Asian Financial Crisis: Causes Contagion and Consequences*. Cambridge (U.K.): Cambridge University Press.

Akerlof, George A., and William T. Dickens. 2007. “Unfinished Business in the Macroeconomics of Low Inflation: A Tribute to George and Bill by Bill and George.” *Brookings Papers on Macroeconomics* 2:31-48.

Akerlof, George A., William T. Dickens and George L. Perry. 2000. “Near-Rational Wage and Price Setting and the Long-Run Phillips Curve.” *Brookings Papers on Economic Activity* 1: 1-44.

Bailey, Norman J. 1975. *The Mathematical Theory of Infectious Diseases and Its Applications.* London: Griffin.

Baran, Paul. 1957. *The Political Economy of Growth*. New York: Monthly Review Press.

Bernanke, Ben S. 2008. “Developments in the Financial Markets.” Testimony before Committee on Banking, Housing, and Urban Affairs, U.S. Senate. April 3. http//www.federalreserve.gov/newsevents/speech/testimony/bernanke2+0080403a.htm

Bernanke, Ben S., and Alan Blinder. 1992. “The Federal Funds Rate and the Channels of Monetary Transmission.” *American Economic Review* 82(4): 901-21.

Bernanke, Ben S., Thomas Laubach, Frederic Mishkin, and Adam Posen. 2001. *Inflation Targeting: Lessons from the International Experience.* Princeton, N.J.: Princeton University Press.

Bernanke, Ben S., Jean Boivin, and Piotor Eliasz. 2005. “Measuring the Effects of Monetary Policy: A Factor-Augmented Vector Autoregressive (FAVAR) Approach.” *Quarterly Journal of Economics* 120(I): 387-422.

Blanchard, Olivier, and Lawrence Summers. 1987. “Hysteresis in Unemployment.” *European Economic Review* 31(I/2): 288-95.

Brunnermeier, Markus K., and Christian Julliard. 2006. “Money Illusion and Housing Frenzies.” National Bureau of Economic Research Working Paper 12810, December.

Chernow, Ron. 1998. *Titan: The Life of John D. Rockefeller, Sr.* New York: Random House.

Clark, John Bates.1895. “The Gold Standard of Currency in the Light of Recent Theory.” *Political Science Quarterly* 10(3): 383-97.

Caporaso, James A. and David P. Levine. 1992. *Theories of Political Economy.* Cambridge (U.K.): Cambridge University Press.

Delhaise, Philippe.1999. *Asia in Crisis: The Implosion of the Banking and the Financial System*. New York: Wiley.

Descartes, Rene’. 172. [1664]. *Traite’ de l’ Homme*. Paris: La Gras. English translation; T.S. Hall, *Treatise of Man*. Cambridge, Mass.: Harvard University Press.

Dougherty, Peter. 2002. *Who’s Afraid of Adam Smith? How the Market Got Its Soul*. Hoboken, N.J.:Wiley.

Du Bois, W.E.B. 1965. *The Souls of Black Folk*. Greenwich, Conn.: Fawcett.

Dunbar, Nicholas. 2000. *Inventing Money: The Story of Long-Term Capital Management and the Legends Behind it.* New York: Wiley.

The Economist. 2007. "Northern Rock: Lessons of the Fall." October 18.http://www.economist.com/displaystory.cfm?story_id=9988865.

Etzioni, Amitai 1991: "Socio-Economics: A Budding Challenge." In Amitai Etzioni and Paul R. Lawrence ed., *Socio-Economics: Toward a New Synthesis*. New York: M.E. Sharpe, pp. 3-10.

The Financial Times. 2009. Press Release. June 15.

Frank, Robert. 2008. "Lessons from Behavioral Economics: Interview with Robert Frank," *Challenge*, May-June: 80-92.

Friedman, Milton. 1982 [1962]. *Capitalism and Freedom*. Chicago: University of Chicago Press.

__________. 1968. "The Role of Monetary Policy." *American Economic Review* 58 (I): 1-17.

Fisher, Irving. 1928. *The Money Illusion*. New York: Adelphi.

Galbraith, John, K. 1985. *The New Industrial State* (4th ed.). Boston: Houghton Mifflin.

Gramlich, Edward M. 2007. *Subprime Mortgages: America's Latest Boom and Bust.* Washington, D.C.: Urban University Press.

Hirshman, Albert O. 1977. *The Passions and the Interest: Political Arguments for Capitalism Before Its Triumph.* Princeton: Princeton University Press.

Kahneman, Daniel, and Amor Tversky .2000. *Choices, Values and Frames.* Cambridge, Mass: Cambridge University Press.

Kant, Immanuel. 1920 [1796]. *Theory of Ethics*. Trans. T.K. Abbott. In Theodore M. Greene ed., *Kant: Selections*. New York: Scribner's Sons.

Kashyap, Anil K., Raghuram G. Rajan, and Jeremy C. Stein. 2008. "Rethinking Capital Regulation." Paper prepared for the Federal Reserve Bank of Kansas City Economic Symposium, "Maintaining Stability in a Changing Financial System," Jackson Hole, Wyoming, Aug 22.

Keynes, John M. 1936. *The General Theory of Employment, Interest and Money*. New York: Hartcourt, Brace and World.

Lane, Robert E. 1991. *The Market Experience*. Cambridge, Mass.: Cambridge University Press.

Levine, David. 1978. *Economic Theory*, Vol I. London: Routledge and Kegan Paul.

Lux, Kenneth. 1990.. *Adam Smith's Mistake: How a Moral Philosopher Invented Economics and Ended Morality*. Boston: Shambhala Publications Inc.

Mankiw, Gregory, N. 2008. *Essentials of Economics (5th ed.)*. U.S.: Cengage Learning.

The New York Times. 1999. "Congress Passes Wide Ranging Bill Easing Bank Laws." November 5. http://www.nytimes.com/.../congress-passes-wide-ranging-bill-easing-bank-laws. html.

____________. 2007. "Ayn Rand's Literature of Capitalism." September 15. http://www.nytimes.com/2007/09/15/business/15atlas.html

___________.2007. "Louis Vuitton Ad Shows Gorbachev Accompanied by Subversive Text." November 5. http://www.nytimes.com/2007/11/05/business/media/05vuitton.html

_______. 2008. "JP Morgan Pays $2 a Share for Bear Stearns." March 17: A 1.

____________. 2008. "Enron's Skilling Asks Court to Overturn His Conviction." April 3. http://www.dealbook.blogs.nytimes.com/.../enrons-skilling-asks-court-to-overturn-his-conviction/.

_________. 2009. "Sanford Weill: Weill Cuts Back on Citi Perks." January 29.

http://www.dealbook.blogs.nytimes.com/.../weill-cuts-back-on-citi-perks/
____________. 2009. "Making Banking Boring." April 9. http://www.nytimes.com/2009/04/10/opinion/10krugman.html.
___________. 2009. 'Tax Day is Met with Tea Parties." April 16, 2009: A 16.
The New York Times. 2009. "Madoff is Sentenced to 150 Years for Ponzi Scheme" June 30 :A1.
___________. 2009. "Geithner Takes Regulators to Task on Turf Battle." August 6: B1.
Rajan, Raghuram and Luigi Zingales . 2003. *Saving Capitalism form Capitalists*, New York: Crown Business Division of Random House.
Rand, Ayn. 1964. *The Virtue of Selfishness. A New Concept: A New Concept of Egoism*. New York: New American Library.
Robinson, Joan. 1964. *Economic Philosophy*. New York: Anchor Books.
Santayana, George. 1955. [1923]. *Skepticism and Animal Faith*. New York: Dover.
Schank, Roger C. and Robert P. Abelson. 1995. "Knowledge and Memory: The Real Story." In Robert S. Wyer Jr., ed., *Knowledge and Memory: The Real Story*. Hillsdale, N.J.: Erlbaum, pp. 1-85.
Sen, Amartya. 1970. *Collective Choice and Social Welfare*, Edinburgh: Oliver and Boyd.
Shiller, Robert J. 2000. *Irrational Exuberance*. Princeton, N.J.: Princeton University Press.
Simon, Herbert. 1985. "Human Nature in Politics: The Dialogue of Psychology with Political Science." *American Political Science Review* 79: 293-304.
Smith Adam. 1776. *An Inquiry into the Nature and Causes of the Wealth of Nations.* London: Ward, Lock, Bowden & Co.
Thaler, Richard H. 1994. *Quasi-Rational Economics*. New York: Russell Sage Foundation.
Tocqueville, Alexis de. 2000. [1835] *Democracy in America*. Harvey Mansfield and Delba Winthrop, trans., ed., Chicago: University of Chicago Press.
The Wall Street Journal. 2009. "Bernanke Blasted in House." June 26: A 1.

Published by the Forum on Public Policy