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Everybody Calm Down. A Government Hand In the Economy Is as Old as the Republic.

By Robert J. Shiller
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It has become fashionable to fret that the current crisis on Wall Street marks the end of American capitalism as we know it. "This massive bailout is not the solution," Sen. Jim Bunning (R-Ky.) warned Tuesday. "It is financial socialism, and it is un-American." It is neither. The near-collapse of the U.S. financial system and Washington's sudden and massive intervention to try to shore it up certainly mark a major turning point, but a bailout would represent a thoroughly American next step for our economic system -- and one that will probably lead to better times.

Americans may assume that the basics of capitalism have been firmly established here since time immemorial, but historical cataclysms such as the Great Depression strongly suggest otherwise. Simply put, capitalism evolves. And we need to understand its trajectory if we are to bring our economic system into greater accord with the other great source of American strength: the best principles of our democracy.

No, our economy is not a shining example of pure unfettered market forces. It never has been. In his farewell address back in 1796, 20 years after the publication of Adam Smith's "The Wealth of Nations," George Washington defined the new republic's own distinctive national economic sensibility: "Our commercial policy should hold an equal and impartial hand; neither seeking nor granting exclusive favors or preferences; consulting the natural course of things; diffusing and diversifying by gentle means the streams of commerce, but forcing nothing." From the outset, Washington envisioned some government involvement in the commercial system, even as he recognized that commerce should belong to the people.

Capitalism is not really the best word to describe this arrangement. (The term was coined in the late 19th century as a way to describe the ideological opposite of communism.) Some decades later, people began to use a better term, "the American system," in which the government involved itself in the economy primarily to develop what we would now call infrastructure -- highways, canals, railroads -- but otherwise let economic liberty prevail. I prefer to call this spectacularly successful arrangement "financial democracy" -- a largely free system in which the U.S. government's role is to help citizens achieve their best potential, using all the economic weapons that our financial arsenal can provide.

So is the government's bailout a major departure? Hardly. Today's federal involvement offers bailouts as a strictly temporary measure to prevent a system-wide financial calamity. This is entirely in keeping with our basic principles -- as long as the bailout promotes, rather than hinders, financial democracy.

Which, so far, it seems to. Congressional critics may be right to demand more help for homeowners and more accountability for Wall Street blunders, but the core idea of the plan is sound: to protect the financial infrastructure. Remember, Fannie Mae used to be a government entity, and by taking it over, the federal government is merely returning to the status quo ante. The measures to take toxic debts off the hands of financial and insurance firms are intended only to deal with a crisis, not to transform our financial system. The proposals do not represent any landmark change in the American way of prosperity. Everyone should take a deep breath. Changing our thinking about finance does not mean abolishing capitalism, but it does raise questions about what the changes mean.

Whenever the public endures a crisis, ordinary citizens start to wonder how -- and whether -- our institutions really work. We no longer take things for granted. It is only then that real change becomes possible.

So the current crisis got me thinking back to 1990, the year before the collapse of the Soviet Union, when I worked with two Soviet economists, Maxim Boycko and Vladimir Korobov, to try to understand the different belief systems in their country and mine. We carried out identical surveys in Moscow and New York, comparing answers about fundamental notions of capitalism, and published our results in the American Economic Review. We expected to find that the Muscovites possessed scant understanding of how capitalism really works. But we found that they actually understood free-market dynamics better than the New Yorkers. We concluded that the Muscovites had proved more savvy precisely because their system was in crisis -- something that encouraged them to rethink their most fundamental notions.

We Americans are going through a similar change right now. We no longer think that our financial future will be determined by securities brokers or inhumanly large investment banks. The most important question is not, "What form should these temporary bailouts take?" It is, "What are we really learning from all this?"

We should be learning a great deal. The current crisis offers us a singular opportunity to reevaluate fundamentally the safety and permanence of the master financial institutions that we have come to take for granted as part of the national economic landscape. Over these past few turbulent weeks, we have learned that the monolithic investment banks are mortal: They are mostly gone, or absorbed by other banks. We have learned that what we called "cash" and considered perfectly safe is not necessarily so secure.

So we are groping around for something else to trust. We should be open to thinking about a new set of financial arrangements -- a better financial democracy -- that can restore the public's faith in the economic principles espoused by Washington more than two centuries ago. Here are some key features:

1. Handle moral hazard better. The term "moral hazard" refers to the pernicious tendency some people have of failing deliberately if they think it's advantageous to do so. Moral hazard is used to justify teaching people a lesson for their failures -- the same logic that once justified "debtors' prisons." (Yes, we really did have them.) But over the course of the 19th century, Americans grew more realistic about laying blame for economic catastrophes and started eyeing other parties besides the hapless and the bankrupt. The demise of the debtors' prisons reflected Americans' changing ideas about the meaning of a contract.

By rescuing Wall Street tycoons who succumbed to the lure of an irrationally exuberant housing bubble, the bailouts today do pose something of a moral-hazard problem. But we can more than repair it by defining a new generation of financial contracts, with a continuation of our evolving thinking about moral hazard, reflecting greater enlightenment, greater understanding of human psychology and the means to deal with financial failure. For example, I have proposed replacing the conventional mortgage with what I call the "continuous-workout mortgage" -- one that would spell out in advance the conditions under which borrowers would see their debt reduced in a rocky economy. These conditions would be designed to minimize moral hazard: The borrowers would not be able to make the debt reduction happen deliberately.

2. To limit risks to the system, build better derivatives. Some of today's derivatives -- the complex bundles of toxic real estate loans that helped drag Lehman Brothers down -- turned out to be "financial weapons of mass destruction," as the legendary investor Warren E. Buffett warned back in 2003. The problem isn't derivatives per se but a certain kind -- derivatives that spun a massive web of over-the-counter contracts, relying on the solvency of countless banks and other institutions, and ultimately endangered the entire financial system when they fell apart. Some kinds of derivatives, such as those maintained by futures exchanges using procedures that effectively eliminate the risk that the other party in the agreement will default, are more useful -- and far safer -- than others. It is high time to redesign derivatives to avoid what Buffett called "mega-catastrophic" risks.

3. Trust markets, not Wall Street titans. If institutions can be said to have charisma, such giants as Lehman

Brothers and Merrill Lynch certainly had it in spades. But these firms proved not to be the sole source of financial intelligence. They were merely meeting places for smart, financially savvy people -- and for some reckless folks besides. We need to learn to trust people and markets rather than institutions. This means developing better markets that will allow us to hedge against the kinds of risks that dragged us into this crisis, such as real estate gambles.

4. Ideas matter. Maybe next time, we will listen more closely to financial theorists who think in abstract, general terms. Consider the Long-Term Capital Management debacle in 1998, when the Federal Reserve leaned on financial titans to rescue a massive hedge fund and stave off global fallout. Lots of people hold that the moral of the LCTM story was the failed thinking of two of the firm's founders, Robert Merton and Myron Scholes, both of whom were Nobel Prize-winning financial theorists. In fact, the collapse of LTCM was largely due to the overconfidence of bond trader John Meriwether and some of his other LTCM colleagues, who were gambling in the markets. The disgraced Merton has been working for the last decade trying to build better risk-management systems, mostly to little avail. Maybe he will be heard now. People still seem to want to trust businessmen who have made bundles and have a huge investment bank behind them, rather than listen to experts who are thinking about the fundamentals of risk management. We would have been better off this month if we'd been ignoring the former and listening to the latter.

These and other improvements in the contemporary economy -- a better financial information infrastructure (so that people can gauge risks better), broader markets (so that people can manage big risks, such as real estate loans) and better retail products (such as continuous-workout mortgages) -- will need to be discussed, debated and delivered in the days ahead. If we move smartly, Americans can have a better, more robust financial democracy along the lines of the system envisioned by our first president. The current crisis does not mean the end of American capitalism. But if we are lucky, it will mean an important step in its evolution.

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