INTRODUCTION

TO RUIN AND BACK

What went wrong and what we must do to put it right

Capitalism as we knew it ended on September 15, 2008. That much is clear. What we don't know yet is what will replace it and whether that new version will be any better than what went before. The choices we make now will set us on the road either to renewed prosperity or to stagnation and even depression.

On that day, Lehman Brothers, a powerful Wall Street investment bank, declared itself bankrupt. Panic spread rapidly throughout the financial markets. What had once seemed valuable investments suddenly lost most of their value, turning into "toxic assets." The instant loss of value threatened to bring down some of the world's largest financial institutions. This sparked a chain reaction that ultimately led to the worst global economic crisis since at least the Great Depression of the 1930s.

Amid the carnage of bankruptcies, soaring unemployment, and the loss of millions of family homes lay the bloody corpse of a set of ideas that had underpinned the economics of the previous thirty years. This was a period in which it was widely believed

that capitalism based on markets, especially financial markets, could be relied on to deliver unprecedented prosperity. This was the "Great Moderation," an era that began in the 1980s, when the American economy embarked on an extended run of low inflation and steady growth, a trend that went global in the 1990s. As well as creating an army of billionaires, it was believed that this system would lead to a general increase in wealth, including among some of the poorest people on the planet, hundreds of millions of whom would be lifted out of dire poverty.

Faced with the collapse of this version of capitalism, government, which the orthodoxy prior to September 15 had tended to see as the problem, suddenly became the savior. The titans of Wall Street, long accustomed to complaining about big government and its wealth-destroying red tape, threw themselves on the mercy of Uncle Sam and his seemingly bottomless pockets. (The same thing happened in the City of London and other financial centers around the world.) Government, doing what it knows best, hurled money at the problem. It probably had no alternative. Symbolizing how the world had changed, as it bailed out the financial system, the American government became the world's biggest owner of bank shares.

Dealing with the toxic financial assets bequeathed by the bankers was fiendishly difficult. In the months after Lehman collapsed, the Bush and Obama administrations wrestled with various schemes to purge the rottenness from the banks' balance sheets, but recovery was painfully slow.

Yet there is an even bigger problem than toxic assets, and that is toxic ideas. The years that preceded the crisis were dominated by a set of theories that celebrated the wisdom of markets. These ideas, which shaped government policies and underpinned banking practices, were triumphant in the boom years. They had won

broad acceptance because they seemed to work in practice. Capitalism had seen off communism. Countries with more market-oriented forms of capitalism seemed more productive and prosperous than those that were more planned and heavily regulated by the state.

In the wake of the crash of September 2008, the challenge is to figure out whether some, all, or none of these theories should survive the crisis. The bust has pushed an alternative set of ideas to the forefront that call for comprehensive intervention in financial markets and bigger government. Working out which of these ideas are toxic and could poison our future prosperity is the most urgent, and difficult, challenge we face.

To find the road from ruin to renewed prosperity, we must engage in a new battle of ideas to work out which elements of the conventional wisdom of the past thirty years will be needed—perhaps in an improved form—and which ideas should be jettisoned along the way and replaced with something entirely new.

As we try to figure out what to do, we have an advantage: we can learn the lessons from the booms and crashes that have punctuated the history of capitalism with remarkable frequency, stretching back to the great tulip bubble in Holland in the early seventeenth century. Then, a mania for rare flowers drove prices to astonishing levels before they crashed, as people realized that they had spent huge sums not on productive assets but on a few tulip bulbs. Nearly four hundred years ago, as now, people were shaking their heads at the madness of crowds that had challenged the wisdom of markets. Yet the people of Holland made the right decisions after the bubble burst, and as a result Tulipmania was little more than a blip in the Dutch "Golden Age" of prosperity in the seventeenth century. Hopefully we can be as wise in the choices we make.

THE ROAD TO RUIN

Who punched Dick Fuld as he worked out in the gym at Lehman Brothers, where he was the CEO? Indeed, did the widely reported incident involving an employee enraged by the bank's failure actually take place? We may never know for certain. Yet in the weeks after Fuld led the investment bank into bankruptcy and triggered the economic collapse, many Americans wanted it to be true, and plenty would have loved to thump the man nicknamed "the Gorilla." Fuld was known as the scariest man on Wall Street. He had once brawled with the father of a child playing hockey against his son, which made the punishment allegedly meted out in the gym seem all the more fitting.

Fuld made an obvious instant target for those wanting someone to blame for the economic mess that followed the bankruptcy of his firm. At hearings on the crisis a few weeks later, a congressman lectured an insufficiently contrite Fuld that "if you haven't discovered your role, you're the villain." A visibly shaken Fuld, who had to run a gauntlet of protesters at the Capitol waving CROOK and JAIL NOT BAIL placards, was forced to justify the hundreds of millions of dollars he had been paid to run a bank that had now failed. His defense rested on the fact that much of the money he had been paid was in now-worthless Lehman stock. He in turn lashed out at speculative "short sellers" of the bank's shares for driving the firm into bankruptcy and bemoaned the government's decision to rescue other financial institutions but not his.

Other names were soon added to the roster of those allegedly responsible for the mess. *Time* magazine published a list of "25 people to blame." Along with Fuld, there were people like Angelo Mozilo, the former boss of Countrywide, a lender that had popularized the "subprime" mortgages for poor people, which had

earned him hundreds of millions yet which cost hundreds of billions in losses when those mortgages blew up. Mozilo was indicted for insider trading and securities fraud in 2009. It was also reported that he had arranged for "VIP loans" to be granted on favorable terms from Countrywide to influential lawmakers under a scheme that became known as "Friends of Angelo." Also on the *Time* list was Jimmy Cayne, former boss of another troubled investment bank, Bear Stearns. Six months before Lehman was allowed to fall, Cayne's bank had almost gone under as it struggled to stay afloat after credit markets froze in the second half of 2007. In March 2008, the government had arranged a rescue deal for Bear Stearns by selling it off to JP Morgan. Yet even as Bear Stearns teetered on the brink, Cayne was not locked in his Manhattan office trying to save the company but was playing in a bridge tournament in Detroit (which is nearly as bad as being on the golf course, where he also spent much of his time).

Blame was not confined to presidents and chief executives alone. Joe Cassano, who had led the financial services division of the insurance giant AIG, made it onto the list as the man who had built up the company's lucrative business insuring credit default swaps that imploded as a result of the crisis, lumbering the firm with tens of billions of dollars of losses. A matter of days after Lehman was allowed to go bankrupt, AIG was saved with a $170-billion bailout from the government. The fact that earlier that year Cassano, a cop's son from Brooklyn, had left the firm with a fortune of $300 million in cash and shares, as well as a $1-million-a-month pension, added to *Time's* indignation.

In a nod to the globalization of finance, the magazine also made dishonorable mention of Sir Fred Goodwin, the former boss of Britain's Royal Bank of Scotland (RBS). Known in financial circles as "Fred the Shred" for his ruthless cost cutting, he was renamed "the worst banker in the world" after the crisis. RBS was

second only to Lehman in selling subprime mortgage securities. In a ruthless and reckless pursuit of profit, Sir Fred had seriously weakened RBS's capital reserves when he pushed through a $100-billion takeover of a rival bank in 2007. As a result, RBS was in no fit state to weather the financial storm that began shortly afterward, and it was eventually partly nationalized by the British government.

The list was not limited to financiers. *Time* also turned its fire on politicians and government officials, including former president Bill Clinton, who had allegedly sown the seeds of the crisis by deregulating the financial markets with one hand while pushing them to lend more to risky subprime borrowers with the other. Alan Greenspan, the former chairman of the Federal Reserve, appeared prominently on the list. Greenspan had once seemed so important to the success of the American and indeed the global economy that in 2000, presidential hopeful John McCain said that if Greenspan ever died it would be necessary to "prop him up and put some dark glasses on him, like *Weekend at Bernie's*." Now he stood accused of pumping too much credit into the economy through his lax monetary policy.

Time even blamed foreign communists. Wen Jiabao, the premier of China, it said, was culpable for lending America too much money.

The *Time* blame list reflected the mood of the nation; indeed, it was just one of many similar lists that all tried to pin the blame on a handful of powerful people. *Time* at least acknowledged the role of American consumers ("we enjoyed living beyond our means"). Even so, these lists helped create a popular narrative in which the public was a largely innocent victim of the folly of the powerful.

This story, which is at best a caricature, apportions the blame to four categories of rogue: bankers, speculators, regulators, and politicians.

The story begins with bank chiefs, filled with hubris, earning fortunes by taking reckless short-term bets using mountains of debt and complex financial instruments that they didn't understand. When, too late, they finally realized that collapse was inevitable, they lied to the public that their banks were still sound.

In turn, as their institutions teetered, the bankers, including Fuld and Cayne, blamed financial speculators such as hedge funds for driving down the price of their shares—conveniently forgetting that for years their banks had made a fortune by financing the same speculators.

Regulators joined in the blame game. Christopher Cox, the chairman of the Securities and Exchange Commission when things started going wrong in the autumn of 2008, banned the speculative so-called short selling of shares that he said "can allow manipulators to force prices down." For many people, it was the fault of regulators such as Cox who had been asleep at the wheel and ignored reckless practices that had contributed to the bubble, such as the lack of rigor in the lending process.

Under fire, the regulators tried to shift the blame onto politicians, for taking away their powers through deregulation, depriving them of the financial tools necessary to do the job. They claimed that politicians had been cheerleaders for the asset price bubble.

Playing the blame game has its attractions. As *Time* explained, "The venting of spleen is not a science—it's a joy." It is a game that has been played after every crash in history. When the bubble in the price of shares in the South Sea Company burst in 1720, a British parliamentarian equated the crimes of the company directors to the killing of a close relative and called on them to be punished by "being sewed into sacks, with a monkey and a snake, and drowned." By comparison, being punched in the gym, or even serving the long jail terms that American courts can mete out for financial wrongdoing, should count as a lucky escape.

There is some truth to this popular account of the crisis: some of these high-profile individuals did make mistakes and, maybe, even committed crimes. Perhaps blaming them allows the catharsis society needs to get over the crisis. Yet we know for certain that punching, fining, or even jailing a few of these "villains" is not going to repair our broken economic system.

Ultimately, playing the blame game is a distraction from what really needs to be done. So, too, is another common reaction to bubbles bursting—the retreat to old orthodoxies rather than seriously attempting to separate out the good ideas from the toxic ones. Market capitalism has always divided opinion between fundamentalists, who believe the market can do no wrong, and skeptics, nowadays a loose coalition of socialists, antiglobalization activists, labor interests, and even environmentalists. If we are to figure out what really caused the financial crisis and what needs to be done to fix things, we need to move beyond preconceived ideas and orthodoxies and take an open-minded look at the evidence.

With Lehman's collapse, however, critics of the market orthodoxy wallowed in schadenfreude. As well as the usual suspects such as radical filmmaker Michael Moore and French president Nicolas Sarkozy, there were also the "Dr. Dooms," the popular name for those who had warned that a crisis was coming and now claimed to have been vindicated. Among these were billionaire hedge-fund bosses George Soros and John Paulson (who alone made a reported $3.7 billion in 2007 short selling financial shares); former trader and author of the best-selling *The Black Swan,* Nassim Nicholas Taleb; and the apocalyptic economist Nouriel Roubini. Some cheered the return of big government, and a few even dusted off their copy of Karl Marx and Friedrich Engels's *Communist Manifesto.* For these critics, despite all the wealth and jobs created and the millions of people around the

world lifted out of poverty over the preceding decades, the kind of market-based capitalism that had dominated the previous thirty years had finally been revealed as toxic. The financial system at the heart of capitalism had turned out to be nothing more than a giant Ponzi scheme, and the bankers who presided over it at best incompetent and at worst criminal. Government now had to cut out the cancer, reverse deregulation, slash how much bankers are paid, and stringently control how they do business.

At the opposite end of the political spectrum, the champions of the old orthodoxy were not downcast for long—though the crisis showed why their characterization of private markets as good and government as bad had always been overly simplistic. Dusting off their own holy book, Ayn Rand's classic libertarian novel *Atlas Shrugged,* they bellowed that whatever the government offered as a cure would necessarily be worse than whatever sickness had afflicted capitalism. Arthur Laffer, Ronald Reagan's favorite economist, warned that the government's meddling would lead to "the end of prosperity," and economist and CNBC pundit Larry Kudlow accused the Obama administration—within weeks of its taking office—of declaring war on business and enterprise.

To escape from the current crisis, it is essential to move on from such comfortable but inadequate old orthodoxies. Blame and denial will not help us figure out what went wrong, or how to fix it. Fresh thinking is required.

FIVE WRONG TURNS

In the history of capitalism, crises have happened again and again, although they have not always had terrible consequences;

often crises have been followed by a quick return to prosperity. Yet sometimes prosperity has been slow to return, and things have gotten far worse before they got better, usually as a result of taking one or more of the five common wrong turns on the road from ruin.

The first wrong turn is to assume that bubbles are a wholly negative product of random outbreaks of madness, rather than a consequence of the innovation process that can add to our prosperity in the long term. Perhaps the most influential book on bubbles of the past was Charles Mackay's Victorian classic *Extraordinary Popular Delusions and the Madness of Crowds*. Most accounts of the current crisis draw, usually unconsciously, on Mackay's interpretation of bubbles as events where supposedly smart people lose their senses.

Capitalism is fundamentally an optimistic system that taps into the deep human desire to strive for a better life. Innovation and entrepreneurship are usually at the forefront of fulfilling that desire. That is why, ironically, capitalism so often experiences bubbles—for it is the hope that gets you in the end.

Throughout history, bubbles have often started with a common hope—that a rise in prices reflects a significant advance that means the old valuation rules no longer apply. Since the original seventeenth-century bubble in tulip bulbs, the world has seen manias for, among other things, trade with the New World, railways, radio, Internet companies, emerging-market debt, and, several times over, real-estate finance. What is most remarkable about these bubbles is that these "technologies," with the possible exception of tulips, each represent an economic breakthrough that did indeed generate great benefits. Yet each time, there came a point when rational hope mutated into an irrational exuberance that sucked more cash into the market until investors realized that this could not go on forever and the bubble burst.

Bubbles seem to be a frequent reaction to new ideas, as we figure out the true value of an innovation and how to put it to best use. It should perhaps be no surprise that the markets struggled to work out the true value and true risks of the Internet or financial innovations such as securitized assets. Crashes are part of the learning process.

Mackay exaggerated the disastrous consequences of bubbles. In fact, many bubbles have burst without doing significant economic harm and may even have helped accelerate the process of figuring out how to use innovations. When bubbles burst and are followed by a wider economic crisis, as happened in 2008, the danger is that we overreact and try to banish the innovations that sparked the boom, rather than learning how to use them wisely.

The second wrong turn is to believe that government must avoid bailing out the financial sector in the middle of a crisis. Governments often come to the rescue after bubbles burst, using taxpayers' money to save the financial institutions whose own risk taking caused the problem. This can provoke understandable outrage at the time. It can also cause a problem of "moral hazard": that by providing a publicly funded safety net, government actually encourages the markets to be more reckless in the future. Yet in this crisis, then U.S. treasury secretary Hank Paulson's biggest blunder was to let Lehman Brothers go under in a mistaken attempt to discourage moral hazard. There is nothing wrong with making shareholders and creditors pay for their errors; indeed, it is right that they do. By allowing Lehman to collapse in such a disorderly manner, however, Paulson unleashed panic in the already-spooked financial markets. Lehman had deals right across the banking sector and also within the so-called shadow banking sector (which did many of the same things as banks but were free of the heavy regulations imposed on banks) made up of hedge funds and other financial services companies

that together keep credit flowing around the economy. Almost every financial institution of any significance in the world was thrown into shock by the decision to let Lehman go, and the already frigid credit markets froze solid as everyone asked, "Who is next?" The possibility of government support does distort the behavior of financial markets. Governments do need to find ways to ensure that when people knowingly take excessive financial risks, they suffer the consequences of their actions. The middle of a crisis is the worst time to do that, however.

In the first great crisis of Anglo-Saxon capitalism, the South Sea Bubble of 1720, investors poured in money to the point that the company became "too big to fail" and were rescued from their folly by the British government. Market purists might rail at the decision by the politicians of Georgian Britain to spend taxpayers' money rescuing foolish investors, yet the dire consequences for everyone of leaving the financial system to melt down were evident after the Wall Street Crash of 1929, when inaction by the government led to the failure of the American banking system. The Great Depression that followed was an unnecessary economic cataclysm.

Like it or not, the financial system is the lifeblood of the capitalism on which our prosperity depends. When the ability of the financial system to lend money, keep savings safe, and make payments is threatened, government needs to step in. In the aftermath of Treasury Secretary Paulson's decision to let Lehman go, the foundations of the economy were shaken in ways that threatened everybody. Letters of credit for business dried up, and even the ability of consumers to borrow to buy a car or go to college threatened to disappear. The lesson was clear: in the middle of a crisis, the risks of getting tough on moral hazard far outweigh the benefits.

The third wrong turn is to focus on addressing the financial

symptoms of a crisis without tackling the underlying economic causes. While some have tried to blame the current crisis on financial innovation alone, huge imbalances in the global economy drove the boom as American borrowers took on massive, unsustainable amounts of debt, funded largely by emerging economies such as China. This has made the bust much worse.

Some crises are purely financial, but some of the most damaging crashes throughout history were caused by fundamental imbalances in the world monetary system. The gold standard had a major part to play in the prolonged depression at the end of the nineteenth century and was a factor in the Wall Street Crash of 1929 and the Great Depression that followed.

Since World War II, the world has operated on what has been effectively a dollar standard. In the 1990s, the emerging economies of Asia, Latin America, and the former Soviet Union were buffeted by financial crises as they tried to maintain the credibility of their economies with dollar investors. While their own policy errors were part of the problem, the volatility of the dollar and failure of the rich countries to help them out persuaded many of these countries that international capital was too hot to handle.

For the past decade, as a result, emerging economies, led by China, have stopped borrowing from America and have become creditors instead. The dollar standard may have made sense when America's economy was truly dominant. Now, as other economies rise in importance, the dollar's preeminence has become more of a liability than an asset for the United States, and the world. Finding a better system for managing how money flows around the world is essential to creating a stabler financial system.

The fourth wrong turn is to think that the economy will always naturally recover on its own from a financial crisis. "You're right, we did it. We're very sorry. But thanks to you, we won't do it

again." This was how the now chairman of the Federal Reserve, Ben Bernanke, honored the ninetieth birthday of the great monetarist economist Milton Friedman in 2002, in recognition of Friedman's work to explain how the Fed's failure to rescue the banks, not the Wall Street Crash of 1929, had caused the Great Depression.

Although this seemed obvious to Bernanke—whose support for throwing money around to stop the economic meltdown, if necessary (as Friedman had suggested) dropping cash out of helicopters to get people spending again, earned him the nickname "Helicopter Ben"—it did not seem that way to many of his critics. Nor was it obvious to the Japanese government in 1990, when a crash in real-estate prices spread to the financial sector and, through a failure of government to face up to the problem and act decisively, resulted in a lost decade of economic stagnation.

The economy can often bounce back remarkably quickly, even after spectacular financial crashes such as Black Monday in 1987 and the bursting of the dot-com bubble in 2000—with a bit of official encouragement in the form of interest-rate cuts. Sometimes, however, when a crisis is big enough and when the banking system fails, a financial crash can turn into a prolonged economic slump, as it did in the Great Depression and during Japan's "lost decade."

In this latest crisis, governments everywhere, from America to Vietnam, have leaped in with large, and expensive, economic stimulus packages, saying that they have learned from past crises. This has drawn a lot of criticism from fiscal conservatives, who warn about the long-term consequences of such profligacy. Certainly it seems paradoxical that borrowing more is a solution to an economic crash brought on by excessive debt, though solution it is. A particularly thorny challenge is how to restore the banking

system to health as quickly as possible and get credit flowing again. It is relatively easy for governments to give banks money; it is much harder to get the banks to lend it out again, especially to the parts of the economy that need it most, at a price they can afford. Governments are prone to duck the difficult questions for financial reasons to keep the cost down, as well as political ones (solutions such as public ownership are controversial).

Getting this right is certainly a tough challenge. Government may be tempted to keep its foot on the gas for too long, starting another bubble and an inflationary spiral. The greater threat, however, is denial, which could lead to prolonged economic misery.

The fifth wrong turn is to rush into more regulation of the financial markets without proper analysis of what went wrong and what can really be done to fix it. The demand for tougher regulation is the automatic response to every crisis, and this one is no exception. Some commentators want to reverse the financial deregulation of the last thirty years; others would go even further and redesign the entire financial system, with a much greater emphasis on government control.

Governments know that the public believes that "something must be done" after a crisis, but all too often throughout history governments have done the wrong thing. In the same year as Britain's South Sea Bubble, France had its own financial crisis, following the newfangled financial innovation of paper money. France responded to the Law Panic of 1720—named after the Scotsman John Law, who was behind the new economic plan—by abandoning paper money entirely, which stalled its economic development. Similarly, strict regulation of the financial sector was a central plank of President Roosevelt's New Deal reforms to tackle the Great Depression, yet many of these regulations proved to be wide of the mark. Some reforms, such as trying to stabilize

the banks by forcing them to hold much more capital, made the Depression worse; others, such as splitting up the banking sector into separate investment and retail banks, imposing arbitrary caps on interest rates, and tightly regulating the stock market, hobbled the U.S. economy for nearly half a century.

Fixing what has really gone wrong rather than lashing out at all things financial is a key challenge for governments after the crisis. The events of the autumn of 2008 show that the system of regulation needs to be fixed. Working out how, without doing collateral damage to our economic dynamism, is a tougher task. Imposing inevitably arbitrary limits on how big banks can get and how much bankers are paid has a certain populist appeal, but there is no reason to think that either of these measures would have prevented the current crisis or would stop a future one. Rushed regulatory reform is likely to be light on rigorous analysis and heavy on poorly designed solutions, which will make the road from ruin longer and harder.

Learning these five lessons from history will help us avoid the mistakes of the past. Yet the challenge we face is about more than avoiding the wrong turns on the road from ruin. We should also be guided by four road signs that point the way to renewed prosperity.

THE ROAD FROM RUIN

The current crisis is an opportunity to build a capitalism that is better than the version that failed on September 15. If the biggest mistake we could make after the crisis would be to abandon capitalism, the second-biggest mistake would be to assume that capitalism does not need to change.

There are four big ideas that must shape our decisions as we create this new, improved capitalism. These are the signs that will guide us on the road to renewed prosperity: rethink economics; redesign global governance; put values back into business; and promote financial literacy.

The current crisis of capitalism is the result, first, of a tragedy of economics, a dismal failure at the heart of what the nineteenth-century writer Thomas Carlyle famously called the "dismal science." If we are to get rid of toxic ideas, economics is the place to start, because the ideas coming out of university economics departments play a powerful role in shaping the actions of many bankers and policymakers. The dominant policies of the era of capitalism that ended when Lehman Brothers collapsed, ranging from how interest rates were set to how financial markets were regulated, were underpinned by a set of economic ideas based on a view of people as essentially rational—*Homo economicus* rather than *Homo sapiens*.

At the heart of this orthodoxy was the efficient market hypothesis: the view that financial markets work so well at sharing information that it is impossible for markets to be wrong. Put simply, according to the efficient market hypothesis, bubbles cannot occur. Or—in terms of that rare thing, an economics joke—a believer in efficient markets would not pick up a $20 bill left on the sidewalk because if it really was $20, someone else would have picked it up already.

Yet the markets have been proved to have catastrophically mispriced such assets as mortgage-backed securities in a way that directly contradicts the efficient market hypothesis. Some economists had already spotted the flaws. One of them, Robert Shiller, had been talking to policymakers for more than a decade about how insights from psychology suggested that markets could behave irrationally. As far back as 1996, the then Fed chairman,

Alan Greenspan, coined the phrase "irrational exuberance" to describe the booming stock market after a presentation by Shiller. Another, Daniel Kahneman, was even awarded the Nobel Prize in 2002 for his work showing that humans are prone to miscalculate probabilities, which will distort market behavior. Yet these insights, and other new ideas in economics, did not shake the widespread faith in the omniscient market. In practice, even Greenspan continued to believe that markets were essentially right.

Abandoning the efficient-market orthodoxy does not mean abandoning markets, or abandoning financial innovation. Markets are still an excellent tool for allocating resources efficiently. But they are not perfect. Policymakers and financiers need an improved version of economics that more accurately reflects the complexity and even irrationality of the human beings who make up the economy. If the insights of this new economics can be harnessed to financial innovation, we may be able to develop new financial products to help us manage the risk of bubbles better.

After the Great Depression, the Bretton Woods Conference of 1944 created a system of global economic governance that still exists today, largely unreformed. This architecture, with the International Monetary Fund (IMF) and World Bank at its heart, was designed for a global economy that was dominated by America, and in which the dollar was unchallenged as the world's reserve currency. Today a new global architecture is needed that reflects the new balance of strength in the global economy—including institutions that give a voice in economic decision making to rising powers such as China and India.

The most pressing financial challenge is for the dollar to relinquish its role as the world's reserve currency. For much of the past sixty years, the dollar's dominance was only a problem for the rest of the world. In the last decade, it has become a problem for

America, too. The dollar's supremacy made it the safe haven for the reserves of developing countries such as China, which led to the flow of capital into America that stoked the credit boom. For any other country, the spiraling indebtedness would have led to a weakening of the currency that would have triggered measures to stop the boom. Instead, the dollar's status as the global reserve currency meant that China simply bought more dollars to lend back to America, and the cycle continued.

A global reserve currency would free the rest of the world from tying their finances to decisions made by Washington to meet the needs of the U.S. economy, and it would free the U.S. economy from the distorting effects of being the world's savings bank. This is not going to be easy, but the sooner we start to move in this direction, the better.

A new Bretton Woods should be only the first step in building a system of global governance able to deal with the challenges of the twenty-first century. Our prosperity is also threatened by a rise in protectionist sentiment, which could result in a costly pause or even reversal in the trend toward freer trade. Lowering and removing trade barriers, many of which were erected during the Great Depression, which they helped to make worse, has brought huge economic benefits in the past half century. However, these gains have not been shared equally across the world. America needs to lead the way in freeing up agricultural trade so that poor countries can share in the benefits of globalization. Failure to do so would risk a breakdown in global trade that would harm us all.

In the same way, the world needs new institutions to keep capital flowing freely across borders in times of financial stress. The global fallout of the storm that ravaged Wall Street in the autumn of 2008, as capital fled emerging markets, throwing their economies into deep recession, was graphic evidence of the consequences of the globalization of finance. The IMF, as it stands,

has failed as the world's emergency "lender of last resort" and needs to be remade so that vulnerable countries have confidence that they will get the support they need in times of crisis.

If we fail to tackle these global economic challenges, we will feel the consequences through rising illegal migration and greater global instability and wars. That would be even more true of failing to tackle the most pressing global economic challenge of all: climate change. This is a problem caused by how we run our economies and can be resolved only by fundamental changes to our economic structures. There is no greater threat to our prosperity. Although this is not a problem directly related to the financial crisis, a root-and-branch reform of the institutions of global economic governance may give us our best opportunity to create the framework to solve this potentially devastating problem.

Solutions to big global-governance issues will have to come from our political leaders, but bigger government cannot be the answer to everything (indeed, the reforms we need require better government rather than bigger government). The crisis was also the result of a general failure of leadership in the business world. Too often corporate executives excused themselves from asking deeper questions about where things were going by focusing on rising quarterly profits as the only yardstick of good capitalism. This failure of values at the heart of capitalism needs to be addressed by the capitalists themselves.

Capitalism has been a victim of its own success. The defenders of the free market, as part of the ideological battle with communism, built up capitalism into more than just an effective economic tool. Like the promoters of the efficient market hypothesis, capitalism's advocates trumpeted it as perfection and in doing so lost touch with reality. Free marketeers loved to quote the words of their founding father, the eighteenth-century Scottish thinker and author of *The Wealth of Nations,* Adam Smith,

that "it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest." This was bastardized into a mentality that "greed is good," or that just about anything that is profitable is necessarily morally right. Smith would have been appalled—his *Theory of Moral Sentiments* specifically attacks this idea. For Smith, moral values must be an integral part of successful capitalism.

The defenders of unrestrained capitalism have also conflated short-term profitability with long-term success. As the financial crisis showed, this is not good capitalism. Yet too many banking executives have defended their actions on the grounds that they could not go against the conventional wisdom of the industry. Even those with a professional duty to consider the longer term, such as accountants and credit-ratings agencies, too often got caught up in the excitement of short-term triumphs and failed to question what executives were doing.

Thinking long term also requires a broader vision about what makes a successful company. While the primary responsibility of business is to create value for its shareholders, business does not exist in a vacuum. Business cannot shuffle off responsibility for the environment or for the wider good of society as a whole onto government. Though it is often possible for firms to increase their profits in the short run by doing things that hurt society, long-term profit maximization for business as a whole requires that companies operate sustainably and give back to society, to discover the secrets of "doing well by doing good."

The idea that long-term success requires a broader vision than short-term profitability was already permeating parts of the business world before the crisis. We have called this movement philanthrocapitalism, which encompasses a values-driven approach through corporate and individual giving, responsible commercial practices, and even socially oriented business models that trade off

profitability for social benefits. For too long, capitalism's supporters have been content to agree with its opponents that it is a system built solely on greed. Business needs to rediscover the long term, including its responsibility to build a better society, which will ultimately allow well-run firms to enjoy greater financial success.

Company bosses may protest that their shareholders do not want them to pursue long-term value and that what really interests them is higher short-term profits, which are rewarded by higher share prices. They have a point. Perhaps the most striking absence of long-termism—and arguably the weakest link in the entire economic system—is in the leadership of the institutional shareholders who manage the retirement savings of all of us. Yet they more than most shareholders should be focused on what the value of companies will be in ten, twenty, or thirty years' time and how the businesses they invest in can shape the society in which their customers will retire.

We live in a world of massively increased financial complexity in which the great majority of people seem to be incapable of making sensible, prudent decisions about what to do with their money. The poorer customers, with subprime mortgages that they could not afford, were not the only ones who took on too much debt in the false belief that the good times would roll on forever. Once-affluent retirees who thought that they would never have to work again and that they could live on the profits from their investments have been severely hit by the collapse in the stock market, which they thought would keep going up in value. Some have even had to go out and find a job again.

The mass failure of prudence, or financial literacy, by most of us is not just a problem for our personal finances. Society faces complex economic choices and tradeoffs. Since the crisis of autumn 2008 it has emerged that members of the Bush administration, such as Treasury Secretary Paulson, at times did not pursue

policies that they thought would work best because they believed that the public would not have understood and supported them.

Looking ahead, our governments have added hugely to the public debt. This will take decades to pay off, presenting voters with hard decisions to make about the balance between higher taxes and lower expenditure. The danger is that the public will choose the options that look least painful in the short term yet would have the most damaging long-term consequences, such as letting inflation get out of control as a way of reducing the real value of public debt. The same is true of the debate about the future of the financial sector. Populist regulation of the banks, particularly of bankers' salaries, risks hobbling our economies with unnecessary bureaucracy.

If we are to resist the temptation of easy populism, we need a mature, reflective debate about the choices that will make or break our future prosperity. Part of the answer rests with the media, which swung during the crisis from cheerleaders of boom to prophets of doom. Thoughtful journalism from the new and old media alike has been in short supply. The media, along with politicians and businesses, need to raise the level of debate to match the gravity of the decisions we face.

Part of the answer also rests with all of us. Constitutional theorists have long recognized that in the field of politics, a well-informed and well-educated citizenry is an essential bulwark against tyranny and is a mainstay of our democratic system. We teach civics in our schools to prepare children for the responsibility of being citizens. Yet we have done little to make people competent economic citizens. This needs to change.

This is the moment that will shape the twenty-first century, and we stand at a crossroads. Behind us lie the ruins of the discredited

old capitalism. In one direction is the path of denial: to do nothing to revitalize the financial system or to stimulate the economy, to just let the crisis run its course in the hope that we come out stronger. This was the road taken in 1929 and again in Japan in the 1990s. Hopefully the lessons of those disasters have been learned, for it is the road to depression. The more crowded route of blame heads in the opposite direction: to hand control of the economy back to government, with higher taxes, lots of regulation, and maybe a dose of inflation. This was the road taken by France in the eighteenth century and again in New Deal America. It is the road to stagnation. Straight ahead lies perhaps the more difficult choice, because it is one without a road map of old orthodoxies. It will involve preserving the much that is good in capitalism while finding ways to make it work better. This is the road from ruin to renewed prosperity.