By George Friedman

Classical political economists like Adam Smith or David Ricardo never used the term "economy" by itself. They always used the term "political economy." For classical economists, it was impossible to understand politics without economics or economics without politics. The two fields are certainly different but they are also intimately linked. The use of the term "economy" by itself did not begin until the late 19th century. Smith understood that while an efficient market would emerge from individual choices, those choices were framed by the political system in which they were made, just as the political system was shaped by economic realities. For classical economists, the political and economic systems were intertwined, each dependent on the other for its existence.

The current economic crisis is best understood as a crisis of political economy. Moreover, it has to be understood as a global crisis enveloping the United States, Europe and China that has different details but one overriding theme: the relationship between the political order and economic life. On a global scale, or at least for most of the world's major economies, there is a crisis of political economy. Let's consider how it evolved.

Origin of the Crisis

As we all know, the origin of the current financial crisis was the subprime mortgage meltdown in the United States. To be more precise, it originated in a financial system generating paper assets whose value depended on the price of housing. It assumed that the price of homes would always rise and, at the very least, if the price fluctuated the value of the paper could still be determined. Neither proved to be true. The price of housing declined and, worse, the value of the paper assets became indeterminate. This placed the entire American financial system in a state of gridlock and the crisis spilled over into Europe, where many financial institutions had purchased the paper as well.

From the standpoint of economics, this was essentially a financial crisis: who made or lost money and how much. From the standpoint of political economy it raised a different question: the legitimacy of the financial elite. Think of a national system as a series of subsystems — political, economic, military and so on. Then think of the economic system as being divisible into subsystems — various corporate verticals with their own elites, with one of the verticals being the financial system. Obviously, this oversimplifies the situation, but I'm doing that to make a point. One of the systems, the financial system, failed, and this failure was due to decisions made by the financial elite. This created a massive political problem centered not so much on confidence in any particular financial instrument but on the competence and honesty of the financial elite itself. A sense emerged that the financial elite was either stupid or dishonest or both. The idea was that the financial elite had violated all principles of fiduciary, social and moral responsibility in seeking its own personal gain at the expense of society as a whole.

Fair or not, this perception created a massive political crisis. This was the true systemic crisis, compared to which the crisis of the financial institutions was trivial. The question was whether the political system was capable not merely of fixing the crisis but also of holding the perpetrators responsible. Alternatively, if the financial crisis did not involve criminality, how could the political system not have created laws to render such actions criminal? Was the political elite in collusion with the financial elite?

There was a crisis of confidence in the financial system and a crisis of confidence in the political system. The U.S. government's actions in September 2008 were designed first to deal with the failures of the financial system. Many expected this would be followed by dealing with the failures of the financial elite, but this is perceived not to have happened. Indeed, the perception is that having spent large sums of money to stabilize the financial system, the political elite allowed the financial elite to manage the system to its benefit.

This generated the second crisis — the crisis of the political elite. The Tea Party movement emerged in part as critics of the political elite, focusing on the measures taken to stabilize the system and arguing that it had created a new financial crisis, this time in excessive sovereign debt. The Tea Party's perception was extreme, but the idea was that the political elite had solved the financial problem both by generating massive debt and by accumulating excessive state power. Its argument was that the political elite used the financial crisis to dramatically increase the power of the state (health care reform was the poster child for this) while mismanaging the financial system through excessive sovereign debt.

The Crisis in Europe

The sovereign debt question also created both a financial crisis and then a political crisis in Europe. While the American financial crisis certainly affected Europe, the European political crisis was deepened by the resulting recession. There had long been a minority in Europe who felt that the European Union had been constructed either to support the financial elite at the expense of the broader population or to strengthen Northern Europe, particularly France and Germany, at the expense of the periphery — or both. What had been a minority view was strengthened by the recession.

The European crisis paralleled the American crisis in that financial institutions were bailed out. But the deeper crisis was that Europe did not act as a single unit to deal with all European banks but instead worked on a national basis, with each nation focused on its own banks and the European Central Bank seeming to favor Northern Europe in general and Germany in particular. This became the theme particularly when the recession generated disproportionate crises in peripheral countries like Greece.

There are two narratives to the story. One is the German version, which has become the common explanation. It holds that Greece wound up in a sovereign debt crisis because of the irresponsibility of the Greek government in maintaining social welfare programs in excess of what it could fund, and now the Greeks were expecting others, particularly the Germans, to bail them out.

The Greek narrative, which is less noted, was that the Germans rigged the European Union in their favor. Germany is the world's third-largest exporter, after China and the United States (and closing rapidly on the No. 2 spot). By forming a free trade zone, the Germans created captive markets for their goods. During the prosperity of the first 20 years or so, this was hidden beneath general growth. But once a crisis hit, the inability of Greece to devalue its money — which, as the euro, was controlled by the European Central Bank — and the ability of Germany to continue exporting without any ability of Greece to control those exports exacerbated Greece's recession, leading to a sovereign debt crisis. Moreover, the regulations generated by Brussels so enhanced the German position that Greece was helpless.

Which narrative is true is not the point. The point is that Europe is facing two political crises generated by economics. One crisis is similar to the American one, which is the belief that Europe's political elite protected the financial elite. The other is a distinctly European one, a regional crisis in which parts of Europe have come to distrust each other rather vocally. This could become an existential crisis for the European Union.

The Crisis in China

The American and European crises struck hard at China, which, as the world's largest export economy, is a hostage to external demand, particularly from the United States and Europe. When the United States and Europe went into recession, the Chinese government faced an unemployment crisis. If factories closed, workers would be unemployed, and unemployment in China could lead to massive social instability. The Chinese government had two responses. The first was to keep factories going by encouraging price reductions to the point where profit margins on exports evaporated. The second was to provide unprecedented amounts of credit to enterprises facing default on debts in order to keep them in business.

The strategy worked, of course, but only at the cost of substantial inflation. This led to a second crisis, where workers faced the contraction of already small incomes. The response was to increase incomes, which in turn increased the cost of goods exported once again, making China's wage rates less competitive, for example, than Mexico's.

China had previously encouraged entrepreneurs. This was easy when Europe and the United States were booming. Now, the rational move by entrepreneurs was to go offshore or lay off workers, or both. The Chinese government couldn't afford this, so it began to intrude more and more into the economy. The political elite sought to stabilize the situation — and their own positions — by increasing controls on the financial and other corporate elites.

In different ways, that is what happened in all three places — the United States, Europe and China — at least as first steps. In the United States, the first impulse was to regulate the financial sector, stimulate the economy and increase control over sectors of the economy. In Europe, where there were already substantial controls over the economy, the political elite started to parse how those controls would work and who would benefit more. In China, where the political elite always retained implicit power over the economy, that power was increased. In all three cases, the first impulse was to use political controls.

In all three, this generated resistance. In the United States, the Tea Party was simply the most active and effective manifestation of that resistance. It went beyond them. In Europe, the resistance came from anti-Europeanists (and anti-immigration forces that blamed the European Union's open border policies for uncontrolled immigration). It also came from political elites of countries like Ireland who were confronting the political elites of other countries. In China, the resistance has come from those being hurt by inflation, both consumers and business interests whose exports are less competitive and profitable.

Not every significant economy is caught in this crisis. Russia went through this crisis years ago and had already tilted toward the political elite's control over the economy. Brazil and India have not experienced the extremes of China, but then they haven't had the extreme growth rates of China. But when the United States, Europe and China go into a crisis of this sort, it can reasonably be said that the center of gravity of the world's economy and most of its military power is in crisis. It is not a trivial moment.

Crisis does not mean collapse. The United States has substantial political legitimacy to draw on. Europe has less but its constituent nations are strong. China's Communist Party is a formidable entity but it is no longer dealing with a financial crisis. It is dealing with a political crisis over the manner in which the political elite has managed the financial crisis. It is this political crisis that is most dangerous, because as the political elite weakens it loses the ability to manage and control other elites.

It is vital to understand that this is not an ideological challenge. Left-wingers opposing globalization and right-wingers opposing immigration are engaged in the same process — challenging the legitimacy of the elites. Nor is it simply a class issue. The challenge emanates from many areas. The challengers are not yet the majority, but they are not so far away from it as to be discounted. The real problem is that, while the challenge to the elites goes on, the profound differences in the challengers make an alternative political elite difficult to imagine.

The Crisis of Legitimacy

This, then, is the third crisis that can emerge: that the elites become delegitimized and all that there is to replace them is a deeply divided and hostile force, united in hostility to the elites but without any coherent ideology of its own. In the United States this would lead to paralysis. In Europe it would lead to a devolution to the nation-state. In China it would lead to regional fragmentation and conflict.

These are all extreme outcomes and there are many arrestors. But we cannot understand what is going on without understanding two things. The first is that the political economic crisis, if not global, is at least widespread, and uprisings elsewhere have their own roots but are linked in some ways to this crisis. The second is that the crisis is an economic problem that has triggered a political problem, which in turn is making the economic problem worse.

The followers of Adam Smith may believe in an autonomous economic sphere disengaged from politics, but Adam Smith was far more subtle. That's why he called his greatest book the Wealth of Nations. It was about wealth, but it was also about nations. It was a work of political economy that teaches us a great deal about the moment we are in.