

By George Friedman

Financial panics are an integral part of capitalism. So are economic recessions. The system generates them and it becomes stronger because of them. Like forest fires, they are painful when they occur, yet without them, the forest could not survive. They impose discipline, punishing the reckless, rewarding the cautious. They do so imperfectly, of course, as at times the reckless are rewarded and the cautious penalized. Political crises — as opposed to normal financial panics — emerge when the reckless appear to be the beneficiaries of the crisis they have caused, while the rest of society bears the burdens of their recklessness. At that point, the crisis ceases to be financial or economic. It becomes political.

The financial and economic systems are subsystems of the broader political system. More precisely, think of nations as consisting of three basic systems: political, economic and military. Each of these systems has elites that manage it. The three systems are constantly interacting — and in a healthy polity, balancing each other, compensating for failures in one as well as taking advantage of success. Every nation has a different configuration within and between these systems. The relative weight of each system differs, as does the importance of its elites. But each nation contains these systems, and no system exists without the other two.

Limited Liability Investing

Consider the capitalist economic system. The concept of the corporation provides its modern foundation. The corporation is built around the idea of limited liability for investors, the notion that if you buy part or all of a company, you yourself are not liable for its debts or the harm that it might do; your risk is limited to your investment. In other words, you may own all or part of a company, but you are not responsible for what it does beyond your investment. Whereas supply and demand exist in all times and places, the notion of limited liability investing is unique to modern capitalism and reshapes the dynamic of supply and demand.

It is also a political invention and not an economic one. The decision to create corporations that limit liability flows from political decisions implemented through the legal subsystem of politics. The corporation dominates even in China; though the rules of liability and the definition of control vary, the principle that the state and politics define the structure of corporate risk remains constant.

In a more natural organization of the marketplace, the owners are entirely responsible for the debts and liabilities of the entity they own. That, of course, would create excessive risk, suppressing economic activity. So the political system over time has reallocated risk away from the owners of companies to the companies' creditors and customers by allowing corporations to become bankrupt without pulling in the owners.

The precise distribution of risk within an economic system is a political matter expressed

through the law; it differs from nation to nation and over time. But contrary to the idea that there is a tension between the political and economic systems, the modern economic system is unthinkable except for the eccentric but indispensable political-legal contrivance of the limited liability corporation. In the precise and complex allocation of risk and immunity, we find the origins of the modern market. Among other reasons, this is why classical economists never spoke of "economics" but always of "political economy."

The state both invents the principle of the corporation and defines the conditions in which the corporation is able to arise. The state defines the structure of risk and liabilities and assures that the laws are enforced. Emerging out of this complexity — and justifying it — is a moral regime. Protection from liability comes with a burden: Poor decisions will be penalized by losses, while wise decisions are rewarded by greater wealth. Because of this, society as a whole will benefit. The entire scheme is designed to increase, in Adam Smith's words, "The Wealth of Nations" by limiting liability, increasing the willingness to take risk and imposing penalties for poor judgment and rewards for wise judgment. But the measure of the system is not whether individuals benefit, but whether in benefiting they enhance the wealth of the nation.

The greatest systemic risk, therefore, is not an economic concept but a political one. Systemic risk emerges when it appears that the political and legal protections given to economic actors, and particularly to members of the economic elite, have been used to subvert the intent of the system. In other words, the crisis occurs when it appears that the economic elite used the law's allocation of risk to enrich themselves in ways that undermined the wealth of the nation. Put another way, the crisis occurs when it appears that the financial elite used the politico-legal structure to enrich themselves through systematically imprudent behavior while those engaged in prudent behavior were harmed, with the political elite apparently taking no action to protect the victims.

In the modern public corporation, shareholders — the corporation's owners — rarely control management. A board of directors technically oversees management on behalf of the shareholders. In the crisis of 2008, we saw behavior that devastated shareholder value while appearing to enrich the management — the corporation's employees. In this case, the protections given to shareholders of corporations were turned against them when they were forced to pay for the imprudence of their employees — the managers, whose interests did not align with those of the shareholders. The managers in many cases profited personally through their compensation system for actions inimical to shareholder interests. We now have a political, not an economic, crisis for two reasons. First, the crisis qualitatively has moved beyond the boundaries of a cyclical event. Second, the crisis is rooted in the political-legal definitions of the distribution of corporate risk and the legally defined relations between management and shareholder. In leaving the shareholder liable for actions by management, but without giving shareholders controls to limit managerial risk taking, the problem lies not with the market but with the political system that invented and presides over the limited liability corporation.

Financial panics that appear natural and harm the financial elite do not necessarily create political crises. Financial panics that appear to be the result of deliberate manipulation of the

allocation of risk under the law, and from which the financial elite as a whole appears to have profited even while shareholders and the public were harmed, inevitably create political crises. In the case of 2008 and the events that followed, we have a paradox. The 2008 crisis was not unprecedented, nor was the federal bailout. We saw similar things in the municipal bond crisis of the 1970s, and the Third World Debt Crisis and Savings and Loan Crisis in the 1980s. Nor was the recession that followed anomalous. It came seven years after the previous one, and compared to the 1970s and early 1980s, when unemployment stood at more than 10 percent and inflation and mortgages were at more than 20 percent, the new one was painful but well within the bounds of expected behavior.

The crisis was rooted in the appearance that it was triggered by the behavior not of small town banks or third world countries, but of the global financial elite, who took advantage of the complexities of law to enrich themselves instead of the shareholders and clients to whom it was thought they had prior fiduciary responsibility.

This is a political crisis then, not an economic one. The political elite is responsible for the corporate elite in a unique fashion: The corporation was a political invention, so by definition, its behavior depends on the political system. But in a deeper sense, the crisis is one of both political and corporate elites, and the perception that by omission or commission they acted together — knowingly engineering the outcome. In a sense, it does not matter whether this is what happened. That it is widely believed that this is what happened alone is the origin of the crisis. This generates a political crisis that in turn is translated into an attack on the economic system.

The public, which is cynical about such things, expects elites to work to benefit themselves. But at the same time, there are limits to the behavior the public will tolerate. That limit might be defined, with Adam Smith in mind, as the point when the wealth of the nation itself is endangered, i.e., when the system is generating outcomes that harm the nation. In extreme form, these crises can delegitimize regimes. In the most extreme form — and we are nowhere near this point — the military elite typically steps in to take control of the system.

This is not something that is confined to the United States by any means, although part of this analysis is designed to explain why the Obama administration must go after Goldman Sachs, Lehman Brothers and others. The symbol of Goldman Sachs profiting from actions that devastate national wealth, or of the management of Lehman wiping out shareholder value while they themselves did well, creates a crisis of confidence in the political and financial systems. With the crisis of legitimacy still not settling down after nearly two years, the reaction of the political system is predictable. It will both anoint symbolic miscreants, and redefine the structure of risk and liability in financial corporations. The goal is not so much to achieve something as to create the impression that it is achieving something, in other words, to demonstrate that the political system is prepared to control the entities it created.

The Crisis in Europe

We see a similar crisis in Europe. The financial institutions in Europe were fully complicit in the global financial crisis. They bought and sold derivatives whose value they knew to be other

than stated, the same as Americans. Though the European financial institutions have asserted they were the hapless victims of unscrupulous American firms, the Europeans were as sophisticated as their American counterparts. Their elites knew what they were doing.

Complicating the European position was the creation of the economic union and the euro by the economic and political elite. There has always been a great deal of ambiguity concerning the powers and authority of the European Union, but its intentions were always clear: to harmonize Europe and to create European-wide solutions to economic problems. This goal always created unease in Europe. There were those who were concerned that a united Europe would exist to benefit the elites, rather than the broader public. There were also those who believed it was designed to benefit the Franco-German core of Europe rather than Europe as a whole. Overall, this reflected minority sentiment, but it was a substantial minority.

The financial crisis came at Europe in three phases. The first was part of the American subprime crisis. The second wave was a uniquely European crisis. European banks had taken massive positions in the Eastern European banking systems. For example, the Czech system was almost entirely foreign (Austrian and Italian) owned. These banks began lending to Eastern European homebuyers, with mortgages denominated in euros, Swiss francs or yen rather than in the currencies of the countries involved (none yet included in the eurozone). Doing this allowed banks to reduce interest rates, as the risk of currency fluctuation was pushed over to the borrower. But when the zlotys and forints began to plunge, these monthly mortgage payments began to soar, as did defaults. The European core, led by Germany, refused a European bailout of the borrowers or lenders even though the lenders who created this crisis were based in eurozone countries. Instead, the International Monetary Fund (IMF) was called in to use funds that included American and Chinese, as well as European, money to solve the problem. This raised the political question in Eastern Europe as to what it meant to be part of the European Union.

The third wave is represented by crisis in sovereign debt in countries that are part of the eurozone but not in the core of Europe — Greece, of course, but also Portugal and possibly Spain. In the Greek case, the Germans in particular hesitated to intervene until it could draw the IMF — and non-European money and guarantees — into the mix. This obviously raised questions in the periphery about what membership in the eurozone meant, just as it created questions in Eastern Europe about what EU membership meant.

But a much deeper crisis of legitimacy arose. In Germany, elite sentiment accepted that some sort of intervention in Greece was inevitable. Public sentiment overwhelmingly opposed intervention, however. The political elite moved into tension with the financial elite under public pressure. In Greece, a similar crisis emerged between an elite that accepted that foreign discipline would have to be introduced and a public that saw this discipline as a betrayal of its interests and national sovereignty.

Europe thus has a double crisis. As in the United States, there is a crisis between the financial and political systems. This crisis is not as intense as in the United States because of a deeper tradition of integration between the two systems in Europe. But the tension between masses and elites is every bit as intense. The second part of the crisis is the crisis of the European

Union and growing sense that the European Union is the problem and not the solution. As in the United States, there is a growing movement to distrust not only national arrangements but also multinational arrangements.

The United States and Europe are far from the only areas of the world facing crises of legitimacy. In China, for example, the growing suppression of all dissent derives from serious questions as to whom the financial expansion of the past 30 years benefits, and who will pay for the downturns. It is also interesting to note that Russia is suffering much less from this crisis, having lived through its own crisis before. The global crisis of legitimacy has many aspects worth considering at some point.

But for now, the important thing is to understand that both Europe and the United States are facing fundamental challenges to the legitimacy of, if not the regime, then at least the manner in which the regime has handled itself. The geopolitical significance of this crisis is obvious. If the Americans and Europeans both enter a period in which managing the internal balance becomes more pressing than managing the global balance, then other powers will have enhanced windows of opportunities to redefine their regional balances.

In the United States, we see a predictable process. With the unease over elites intensifying, the political elite is trying to stabilize the situation by attacking the financial elite. It is doing this to both demonstrate that the political elite is distinct from the financial elite and to impose the consequences on the financial elite that the impersonal system was unable to do. There is precedent for this, and it will likely achieve its desired end: greater control over the financial system by the state and an acceptable moral tale for the public.

The European process is much less clear. The lack of clarity comes from the fact that this is a test for the European Union. This is not simply a crisis within national elites, but within the multinational elite that created the European Union. If this leads to the de-legitimization of the EU, then we are really in uncharted territory.

But the most important point is that almost two years since a normal financial panic, the polity has still not managed to absorb the consequences of that event. The politically contrived corporation, and particularly the financial corporations, stands accused of undermining the wealth of nations. As Adam Smith understood, markets are not natural entities but the result of political decisions, as is the political system that creates the allocation of risk that allows markets to function. When that system appears to fail, the consequences go far beyond the particular financials of that event. They have political consequences and, in due course, geopolitical consequences.

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