# Adam Smith's market never stood alone

By Amartya Sen
Financial Times - March 10, 2009

Exactly 90 years ago, in March 1919, faced with another economic crisis, Vladimir Lenin discussed the dire straits of contemporary capitalism. He was, however, unwilling to write an epitaph: "To believe that there is no way out of the present crisis for capitalism is an error." That particular expectation of Lenin's, unlike some he held, proved to be correct enough. Even though American and European markets got into further problems in the 1920s, followed by the Great Depression of the 1930s, in the long haul after the end of the second world war, the market economy has been exceptionally dynamic, generating unprecedented expansion of the global economy over the past 60 years. Not any more, at least not right now. The global economic crisis began suddenly in the American autumn and is gathering speed at a frightening rate, and government attempts to stop it have had very little success despite unprecedented commitments of public funds.

The question that arises most forcefully now is not so much about the end of capitalism as about the nature of capitalism and the need for change. The invoking of old and new capitalism played an energising part in the animated discussions that took place in the symposium on "New World, New Capitalism" led by Nicolas Sarkozy, the French president, Tony Blair, the former British prime minister, and Angela Merkel, the German chancellor, in January in Paris.

The crisis, no matter how unbeatable it looks today, will eventually pass, but questions about future economic systems will remain. Do we really need a "new capitalism", carrying, in some significant way, the capitalist banner, rather than a non-monolithic economic system that draws on a variety of institutions chosen pragmatically and values that we can defend with reason? Should we search for a new capitalism or for a "new world" – to use the other term on offer at the Paris meeting – that need not take a specialised capitalist form? This is not only the question we face today, but I would argue it is also the question that the founder of modern economics, Adam Smith, in effect asked in the 18th century, even as he presented his pioneering analysis of the working of the market economy.

Smith never used the term capitalism (at least, so far as I have been able to trace), and it would also be hard to carve out from his works any theory of the sufficiency of the market economy, or of the need to accept the dominance of capital. He talked about the important role of broader values for the choice of behaviour, as well as the importance of institutions, in *The Wealth of Nations* ; but it was in his first book, *The Theory of Moral Sentiments*, published exactly 250 years ago, that he extensively investigated the powerful role of non-profit values. While stating that "prudence" was "of all virtues that which is most helpful to the individual”, Smith went on to argue that “humanity, justice, generosity, and public spirit, are the qualities most useful to others”.

What exactly is capitalism? The standard definition seems to take reliance on markets for economic transactions as a necessary qualification for an economy to be seen as capitalist. In a similar way, dependence on the profit motive, and on individual entitlements based on private ownership, are seen as archetypal features of capitalism. However, if these are necessary requirements, are the economic systems we currently have, for example, in Europe and America, genuinely capitalist? All the affluent countries in the world – those in Europe, as well as the US, Canada, Japan, Singapore, South Korea, Taiwan, Australia and others – have depended for some time on transactions that occur largely outside the markets, such as unemployment benefits, public pensions and other features of social security, and the public provision of school education and healthcare. The creditable performance of the allegedly capitalist systems in the days when there were real achievements drew on a combination of institutions that went much beyond relying only on a profit-maximising market economy.

It is often overlooked that Smith did not take the pure market mechanism to be a free-standing performer of excellence, nor did he take the profit motive to be all that is needed. Perhaps the biggest mistake lies in interpreting Smith’s limited discussion of why people seek trade as an exhaustive analysis of all the behavioural norms and institutions that he thought necessary for a market economy to work well. People seek trade because of self-interest – nothing more is needed, as Smith discussed in a statement that has been quoted again and again explaining why bakers, brewers, butchers and consumers seek trade. However an economy needs other values and commitments such as mutual trust and confidence to work efficiently. For example, Smith argued: “When the people of any particular country has such confidence in the fortune, probity, and prudence of a particular banker, as to believe he is always ready to pay upon demand such of his promissory notes as are likely to be at any time presented to him; those notes come to have the same currency as gold and silver money, from the confidence that such money can at any time be had for them.”

Smith explained why this kind of trust does not always exist. Even though the champions of the baker-brewer-butcher reading of Smith enshrined in many economics books may be at a loss to understand the present crisis (people still have very good reason to seek more trade, only less opportunity), the far-reaching consequences of mistrust and lack of confidence in others, which have contributed to generating this crisis and are making a recovery so very difficult, would not have puzzled him.

There were, in fact, very good reasons for mistrust and the breakdown of assurance that contributed to the crisis today. The obligations and responsibilities associated with transactions have in recent years become much harder to trace thanks to the rapid development of secondary markets involving derivatives and other financial instruments. This occurred at a time when the plentiful availability of credit, partly driven by the huge trading surpluses of some economies, most prominently China, magnified the scale of brash operations. A subprime lender who misled a borrower into taking unwise risks could pass off the financial instruments to other parties remote from the original transaction. The need for supervision and regulation has become much stronger over recent years. And yet the supervisory role of the government in the US in particular has been, over the same period, sharply curtailed, fed by an increasing belief in the self-regulatory nature of the market economy. Precisely as the need for state surveillance has grown, the provision of the needed supervision has shrunk.

This institutional vulnerability has implications not only for sharp practices, but also for a tendency towards over-speculation that, as Smith argued, tends to grip many human beings in their breathless search for profits. Smith called these promoters of excessive risk in search of profits “prodigals and projectors” – which, by the way, is quite a good description of the entrepreneurs of subprime mortgages over the recent past. The implicit faith in the wisdom of the stand-alone market economy, which is largely responsible for the removal of the established regulations in the US, tended to assume away the activities of prodigals and projectors in a way that would have shocked the pioneering exponent of the rationale of the market economy.

Despite all Smith did to explain and defend the constructive role of the market, he was deeply concerned about the incidence of poverty, illiteracy and relative deprivation that might remain despite a well-functioning market economy. He wanted institutional diversity and motivational variety, not monolithic markets and singular dominance of the profit motive. Smith was not only a defender of the role of the state in doing things that the market might fail to do, such as universal education and poverty relief (he also wanted greater freedom for the state-supported indigent than the Poor Laws of his day provided); he argued, in general, for institutional choices to fit the problems that arise rather than anchoring institutions to some fixed formula, such as leaving things to the market.

The economic difficulties of today do not, I would argue, call for some “new capitalism”, but they do demand an open-minded understanding of older ideas about the reach and limits of the market economy. What is needed above all is a clear-headed appreciation of how different institutions work, along with an understanding of how a variety of organisations – from the market to the institutions of state – can together contribute to producing a more decent economic world.

*The writer, who received the 1998 Nobel Prize in economics, teaches economics and philosophy at Harvard University. A longer essay by him on this topic appears in the current edition of The New York Review of Books*