

A crisis in search of a narrative

By Daniel Yergin

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Now that capitalism's worst crisis since the 1930s is ebbing away, what about capitalism itself? Three decades ago the world began moving towards markets and an increasingly open world economy. Is that over?

Certainly, there is less talk about the "magic of markets". The focus is on what goes wrong with them, along with bitterness, suspicion and outright hostility. Around the world governments are retaking substantial parts of the commanding heights of their economies, although in an improvised way, more like the fire department than a master plan.

Even in the US, the balance has changed. Washington is now also the capital for the automotive, energy and finance industry. Europe is resuscitating the "mixed economy". In China, the state's role has re-expanded. Is the balance between state and market being dramatically reordered back towards the state? Will people decide that they need the state to protect them against the markets, or will they conclude that the crisis proved the ultimate robustness of markets?

What emerges as the dominating narrative of the crisis will have a profound impact on the answers. "Narrative" goes beyond the dramatic stories of how it unfolded. It provides the explanation for what happened and the framework for organising thinking for the future. There are a dozen or so Great Recession story lines.

(1) Too much leverage – wantonly made available with inadequate and misplaced regulation and inadequate credit ratings, reinforced by low interest rates – created an unstable and over-built edifice of debt that collapsed from its own enormous weight.

(2) Rapid innovation in financial instruments did not mitigate risk, but rather concentrated and magnified it in ways that few anticipated and that were not properly regulated.

(3) Regulation failed to cover the "shadow banking" sector and proved inadequate for the complex, cross-border "too big to fail" institutions. Regulatory regimes perversely encouraged banks to off-load debt and thus to be less attentive to the risks.

(4) Policies that aggressively promoted homeownership and government-sponsored enterprises like [Fannie Mae](#) , amplified by predatory and deceitful private sector lending practices, created an unsustainable universe of subprime mortgages.

(5) High indebtedness turned the US into a sort of supernova emerging market nation, fuelled by the global savings glut, which made it vulnerable to a super-explosive debt crisis far bigger than the emerging market crisis of the late 1990s.

(6) The oscillating balance between “fear and greed” went to extremes in terms of greed; risk was underpriced and under-appreciated. There was a penalty on prudence and a potential death sentence for companies convicted of “stodginess”. Compensation grew too large, blinding individuals and institutions to the growing risks.

(7) Investor psychology, fed by easy credit, created Shilleresque bubbles in real estate, energy and other sectors that eventually burst, devastatingly.

(8) Since every boom contains the seeds of the next bust, the best global growth in a generation created hubris, ensuring a major downturn.

(9) Globalisation created vulnerabilities that were not understood – most notably in the syndication of debt, but also in global supply chains, which worked as transmission belts in reverse, shuttling the impact of the downturn back up the chain.

(10) Spiking commodity prices, principally for oil, created burdens for lower-income groups and helped knock [Detroit](#) flat on its back well before the failure of [Lehman Brothers](#).

(11) For those so inclined, the crisis offered proof that the market system is destined to crisis as it is rigged, reflecting what they see as capitalism’s intrinsic evil.

There is one other explanation – what the historian Gordon Prange identified as the number one reason for the attack on Pearl Harbour in 1941 – the conviction that “it could never happen”. As late as 2006, it was widely agreed the kind of disaster that was about to unfold was simply impossible.

Others can tell additional stories. Many overlap; some contradict. What emerges as the dominant narrative will be affected by the speed and scale of recovery. Yet, for

the next few years governments will play a larger role in their economies and will hunt for regulatory formulas that “ensure” this kind of crisis does not reoccur.

The narrative will be shaped by how people internalise risk. Will the Great Recession be followed by the New Caution, changing people’s spending and saving habits, lowering future growth? Will prudence loom larger in financial markets? People who lived through the Great Depression were deeply averse to risk and were loath to buy stocks or keep too much money in one bank.

While the Great Recession will have nowhere near that effect, its impact will last for years. People have discovered – or rediscovered – that Wall Street is not a one-way street. Markets can go down as well as up. Especially traumatic is the way people found out that the “social contract” around pensions and retirement funds, promising ever-rising value, is not an enforce-able contract they can count on. This gives the idea of “risk”, which had been so marginalised, a tangibility, contributing to that New Caution.

Market systems depend upon confidence: in the sturdiness of markets, the quality of their rules and ability to deliver results. But that confidence – indeed trust – has to be earned back. The narrative that emerges will be crucial to that confidence. It will also provide a guide to avoiding a return engagement when memories are fading, as memories do, and the tide of risk begins to rise again.

The writer is chairman of IHS Cambridge Energy Research Associates. His books include ‘The Prize’, now in a new edition, and ‘Commanding Heights: the Battle for the World Economy’