A Social Democratic Response to the Financial Crisis (draft)

There is by now a consensus that the current global financial crisis is the worst in the last 25 years and may well be the worst since the Great Depression. As solutions are proposed, there is strong pressure from Wall Street to make sure that their way of doing business is protected. They don't want to see finance suffer from too much regulation.

In times of crisis, we all have to pull together; sacrifices may be asked of us all. But in a democracy, that does not mean silent ascension to whatever is proposed. The voices of Social Democrats and those who reject the free market mantra of the US, should be listened to as the debate about how to proceed moves forward . We must be allowed to help formulate the government responses to the crisis. There are stark differences of opinion as to the best way to proceed—just look at the differences between the measures taken by the UK's Gordon Brown over those proposed by US President George Bush and Treasury Secretary Tim Paulson.

Four principles guide the social democratic response: solutions to the crisis must be consistent with basic values of social justice and social solidarity as well as basic notions of fairness. The bonds of social solidarity go across national boundaries; we cannot take actions which help ourselves at the expense of those in the developing world. They must reflect an understanding of the necessary balance between government and markets. And any response must respect basic principles of democratic due process, including full transparency.

The response of the US should have focused more on helping the millions of Americans who were losing their homes, ensuring that the economy not go into the predictable (and predicted) recession into which it is now sinking, and minimizing the inevitable resulting hardship. The US has one of the worst unemployment schemes in the advanced industrial countries, but President Bush still refuses to extend unemployment benefits beyond 39 weeks. Three quarters of a million Americans will shortly be without benefits. America is one of the few countries that does not recognize access to medicine as a basic human right; and when Americans lose their jobs, they lose their health insurance. President Bush even vetoed a health insurance program for uninsured children in July 2007, saying the country could not afford it; yet somehow, more than a trillion dollars were found to finance Wall Street's bailouts. This says something about priorities and values.

The American bail-outs were arranged behind closed doors; some were bailed-out, others not; some were bailed out under punitive terms, others walked away with marked increases in marked value as a result of government capital injections. Some of the financial institutions being helped were told to change their management, others were not. The only consistency is the lack of consistency and non-transparency, and the failure to do anything direct about the underlying problems. While money was being poured into the banks, they were allowed to pour money out to their shareholders in dividends. No obligation to increase lending was imposed.

The Social Democratic response begins with concerns about equity; but the social democratic response is based on a deeper understanding of market economics than do the responses of the right. The failure, for instance, of President Bush to take effective actions to stimulate the economy and to stem the wave of foreclosures will hurt even the banks, as more and more mortgages will go into foreclosures and more and more loans will go sour.

The social democratic response begins too from the perspective that the economy and financial markets should serve the citizens of our society. They are a means to an end, not an end in themselves. It is not necessarily the case that what is good for Wall Street is good for the rest of the economy.

Moreover, any response cannot be based on trickle down economics—the notion that helping those at the top will benefit all has been repeatedly rejected. The U.S. response was predicated on exactly that proposition: throw enough money at Wall Street, and eventually, some of the benefits may eventually help ordinary Americans.

If managers of firms have incentives for distorted accounting, excessive risk taking, or a focus on short term profits they will take risks and focus only on the short-term. Non-transparent stock options and bonuses based on short term aggravate this problem. Market failures arise from conflicts of interest and lack of good information that can ensure sound allocation of resource allocations. Where there is a separation ownership and control, managers do not necessarily act in the best interests of shareholders, let alone other stakeholders. Unregulated markets do not act in society's best interests. American financial managers' unbridled pursuit of self-interest—greed—has imposed a high cost on all of us.

We will not be able to restore confidence in our financial markets unless we change their behavior, through regulation. Regulation must be comprehensive. Regulatory institutions too have to be reformed; too often, the regulatory process has been captured by those who were supposed to be regulated. The voice of those injured as a result of inadequate regulation—pensioners who lose their life savings, homeowners who lose their homes, workers who lose their jobs—has to be paramount. Such regulation could encourage real innovation, not the kind focusing on regulatory, accounting, and tax arbitrage that has marked America's financial markets in recent years, or the derivatives that were suppose to manage risk but instead created it; but innovations that might allow average citizens to remain in their homes in the face of the economic vicissitudes which they face. Banks were allowed to become to big too fail and that was dangerous of all of us.

It is ironic that Social Democrats are sometimes accused of not understanding market fundamentals. After all it was the great economist John Maynard Keynes who some 75 years ago, saved capitalism from the capitalists. It was Keynes who explained how government action could help the economy recover from the Great Depression. Today, his ideas have become part of conventional wisdom, agreed to by the right and the left. Once again, social democrats are providing a roadmap for saving capitalism from the capitalists. Their proposals for recovery, and for preventing another such calamity, will in time by accepted as conventional wisdom. But time is of the essence: the quicker that governments can rally behind these ideas, the shorter will be our downturn, the quicker will be our recovery, and the fewer the number of innocent bystanders whose lives and dreams will be dashed in this tragic episode. We are living in a man-made crisis that was made in the U.S.A. It could have been avoided, had Social Democratic principles been more widely adopted and implemented.

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