

PRACTICAL WISDOM AND UNDERSTANDING THE ECONOMY: THE FINANCIAL CRISIS AS A CASE STUDY¹

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1. Promoting Social Injustice

One of the most shocking aspects of Irish Famine was the fact that while over a million people died from starvation and the diseases caused by extreme hunger, Ireland exported food. This paradox of a country experiencing wide-spread hunger exporting food has been repeated in many of the famines of the 20th century.² The British officials who both encouraged the exportation of Irish food and also, after the first year, withdrew government aid for the victims of the famine, were guided by the economic orthodoxy of their day (“laissez-faire economics”), which argued that markets work best when the government does not intervene in the free movement of prices and goods. In fact, economists argued that government intervention in free markets is both counter-productive and a violation of the law of nature. For British economists and public officials, Ireland's central problem was an oversupply of people, and the exportation of food from Ireland in the face of “perceived food shortages” was an essential part of the market solving this market imbalance.

A more recent example of the logic of laissez-faire economics leading to morally questionable policy conclusions is the famous “Dirty Industries” memo by former World Bank economist and former Harvard University President, and now head of economic policy for President Obama, Lawrence Summers. In the memo Summers states that neoclassical economic theory recommends that high polluting industries should be relocated from rich countries to poor countries. He gives three reasons why this is a sound policy:

- Since the costs of the negative effects of the pollution are measured in terms of “foregone earnings from increased morbidity and mortality,” the costs are lower in poor countries (since their earnings are lower) than it would be in wealthy countries.
- Poor countries have less pollution, due to their lower level of past economic development. They are thus, according to Summers, “under-polluted.” It would be efficient to transport pollution created in rich countries to poor countries (yet he laments that the transportation costs are too high to do this effectively.)
- Since many of the effects of pollution often happen later in life, and since the life expectancy is lower in poor countries, the negative effects of the pollution will be lower in poor countries.

Summers states: “I think the economic logic behind dumping a load of toxic waste in the lowest wage country is impeccable and we should face up to that.” Summers also states that any argument against relocating dirty industries to poor countries must be rejected because it can be

¹ This is a rough draft, and is not to be quoted without permission.

² See A. Sen's *Poverty and Famines* (1981).

used against all the conclusions of the current economic orthodoxy: “The problem with the arguments against all of these proposals for more pollution in LDCs (intrinsic rights to certain goods, moral reasons, social concerns, lack of adequate markets, etc.) could be turned around and used more or less effectively against every Bank proposal for liberalization.”

Advocating withholding food aid to a country in the grips of famine and “dumping” toxic waste in poor countries are but two examples of the dangers of “theoretical reasoning” in economics. Economists have long evaluated arguments based on the methodology used and not conformity with the facts; on how elegant their models are rather than whether their models are a valid representation of reality. Furthermore, based on the idea that economics is a hard science, economists have excluded ethics as an important criterion for economic actions or outcomes. Thus it has become common for economists to advocate policies that are contrary to common sense and basic morality. Their understanding of the economy is based on theoretical reasoning, and they ignore practical wisdom, because they believe that theoretical reason is what is appropriate for a “value-free” or “positive” science of economics and because they believe that the economy is controlled by fixed natural laws. However, making economics a “positive science” came at a high price for it forced economists to exclude social and historical context; that is the real economy.

In his *Nicomachean Ethics* (and elsewhere) Aristotle makes the important distinction between theoretical or scientific reasoning and practical reasoning. Theoretical reason considers objects or things that cannot be otherwise, things that are invariant. Thus our knowledge of them can be exact and precise, as the object of our analysis is unchanging. The natural world fits easily into this category, as its rules, the laws of nature, are considered fixed and eternal and the objects are either unchanging or change according to set rules which are themselves unchanging. Practical reasoning, however, deals with objects that can be otherwise, that are not invariant, where choice and discretion play a role in the generation of the object of analysis.³

This paper will look at the why and how economists have lost their way; that is how the elimination of ethics and social context has made economic orthodoxy a barrier to understanding the economy. We will use the current Financial Crisis to demonstrate the dangers of relying on theoretical reasoning and ignoring practical wisdom. In the last section will argue that Catholic social thought provides the necessary ethical foundation for a useful economic theory.

Where Economics Went Wrong

As a discipline, economics grew out of the natural law philosophy tradition and was considered a branch of moral philosophy. However, the contemporary orthodoxy is far removed from economics philosophical origins and few modern economists are in the long tradition of the “worldly philosophers.” The modern graduate student in economics will study a good deal of mathematics and yet will rarely study philosophy, the history of economic thought, or the methodology of economics, and more surprising, will have no exposure to economic history, economic institutions or the real economy. In a survey of graduate students at the leading economics programs 98% stated that knowledge of mathematics was important for success in

³ See MacIntyre (1988) chapter 11 on practical reasoning.

economics, while only 3% stated that knowledge of the economy was very important, with 68% stating that it was unimportant (Klamer and Colander 1987). This is evidence that economists see their discipline as requiring what Aristotle called “theoretical” reasoning and not practical wisdom. The abandonment of practical wisdom for theoretical reason in the development and evolution of economic doctrines was prompted by three interconnected forces: the redefinition of “natural law” in the Enlightenment; the desire to emulate the natural sciences (Clark 1992; Mirowski 1989); the desire to eliminate ideology from economics (Myrdal 1954);

Search for the Natural Laws of the Economy

Historians of economic thought have long noted the natural law roots of economy theory. As Joseph Schumpeter (1954, p. 107) noted:

“The first discovery of every science is the discovery of itself. Awareness of the presence of a set of interrelated phenomena that give rise to ‘problems’ is evidently the prerequisite of all analytic effort. And in the case of the social sciences, this awareness shaped itself in the concept of natural law.”

While investigations into economic issues starts with the classical/Catholic natural law tradition, it is the Protestant Natural Law tradition, starting with Hugo Grotius, which laid the foundation of classical, neoclassical and Marxian schools of economics. While the role of the Enlightenment natural law philosophers following Grotius and Pufendorf in the development of economics is widely recognized, what is most often missed is the most significant contributions of the Protestant Natural Law tradition – the elimination of necessity of God; the change of natural law from a moral code to a physical system; and the adoption of extreme rationalism.

One of the main goals of the Protestant Natural Law tradition was to eliminate the influence of the Catholic Church, both politically and intellectually (that is the role of tradition and authority and the magisterium). Thus they worked to reduce and eliminate revelation as informing social analysis, and while they typically did not contradict religion, and often went to great length to reach the same conclusions, they worked to reach their conclusions free from theology and the Church. The key turning point, as Jacques Maritan pointed out, was the work of Hugo Grotius:

We can understand at this point in what the error in the conceptions of a thinker like Grotius consisted. While maintaining that Natural Law presupposed in fact God’s existence, he wrote the celebrated sentence in which he said that even if, on an absurd supposition, God did not exist, Natural Law would continue to exercise its dominion and its authority over us. The fact is that he was concentrating solely upon the order of nature—as deciphered by human reason—and did not perceive the relationship between the order of nature and the eternal reason. (2001, p. 46)

The classical/Catholic natural law tradition is based on a conception of the natural law as a moral code: “natural law is an *ideal order* relating to human actions, a divide between the suitable and the unsuitable, between what is proper and what is improper to the ends of human nature or essence. This is an ideal order or divide which rests on human nature or essence and the

unchangeable necessities rooted in it” (Maritain, *Ibid.*, pp. 29-30). It is not rooted in a physical necessity (such as the law of gravity) that cannot be violated. It is a moral code which is often violated by humans who choose to act contrary to it. The post-Grotius natural law tradition attempted to discover moral or social laws in nature, based on “man in a state of nature”, free of social and historical constraints (Clark 1991).

“*Physics Envy*”

Discovering the laws of nature for the economy and society meant emulating the natural sciences. This took many forms. For Adam Smith this can be seen in his use of the Newtonian system as the prism through which to view the economy (Clark 1992). Thus the market was recast as an equilibrium system, the result of the balances of forces, just as Newton’s laws of motion for physical bodies stated that bodies came to rest when the two opposing forces operation on the object were equal. In Smith market equilibrium came from a balance of supply and demand, with both adjusting to bring disturbances back to equilibrium. On a grander scale, Smith’s overall system involves the balance of self-interest (*The Wealth of Nations*) and sympathy (*The Theory of Moral Sentiments*). Smith also followed Newton’s use of both deductive and inductive methods.

With the advent of the Marginal Utility Revolution in the 1870s we see a switch in economic theory and method, in this case following the new scientific theory of the conservation of energy theory. With the theories of Jevons and Walras we have a big step in the direction of mathematical economics and deductive reasoning and a big move away from observation, empirical analysis and social and historical context. The development of economics based on mathematical formalism fully came under the influence of the Vienna Circle culminating in axiomatic general equilibrium, where the theory is completely emptied of any real content, so that logical rigor ensures the truth of the theory. “The axiomatic method is more than just a ‘rigorous’ analysis. Use of this method for the social sciences implicitly assumes that social structures are analogous to those of pure logic” (Clark 1992, p. 164). In his Nobel Lecture, Maurice Allais (1990, p. 5) restated the fundamental assumption upon which neoclassical economics is constructed: “[T]he prerequisite of any science is the existence of regularities which can be analyzed and forecast. This is for example the case in celestial mechanics. But it is also true of many economic phenomena. Indeed, their thorough analysis displays the existence of regularities which are just as striking as those found in the physical sciences. This is why Economics is a science and why this science rests on the same general principles and methods as the natural sciences.”

Method in social analysis is never natural, it comes from the philosophical preconceptions and it influences the development of theories. Using equilibrium as your central organizing idea will lead to a view of the economy as self-regulating and self correcting – supporting *laissez-faire*. Critiquing “*laissez-faire*” meant attacking equilibrium, as we see in the theories of Thorstein Veblen and John Maynard Keynes. Using the natural sciences as your model also influences your theories, for it assumes that social facts or economic facts are essentially the same as physical facts. Yet, as Werner Stark (1962, pp. 12; 218) noted: “Physiology and physics are spurious models in the social sciences because they are concerned with a reality which man finds, not with one which he makes. ... Society is neither a creation of the laws of mechanics

nor a reflection of the laws of biology: it is man's own work, sprung from his will, sustained by his will."

Positive Economics

Creating a scientific economics had the goal that all economists would eventually agree on diagnosis and prescription. Classical and neoclassical economists all felt that they were objective scientists. The Enlightenment had taught social theorists how to expose the hidden "values" or philosophical preconceptions in other theories, cultures, systems, yet they were completely blind to their own. They all held that their views were pure science, free of biases or ideology. Their culture was the natural one. Many have quipped that Adam Smith assumed that everyone was a Scotsman. Jeremy Bentham's utilitarianism laid the foundation for a view of "rational economic man" as the view of man in a state of nature, that is, of the real underlying human nature. "Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. It is for them alone to point out what we ought to do, as well as to determine what we shall do. On the one hand the standard of right and wrong, on the other the chain of causes and effects, are fastened to their throne" (Bentham, 1982, p. 11). While Bentham attacked the circular reasoning of the natural law philosophers, his own work was merely a more sophisticated version of theirs, and as Gunnar Myrdal noted, he merely increased "the diameter of the logical circle" (1954, p. 14).

In the 20th Century the efforts to make economics a "science" meant a "positive" science, that is value-free. John Neville Keynes popularized the division of economics into positive and normative branches, adding also a third branch of practical economics. His central argument was that a scientific economic theory would be necessary in order to effectively pursue better economic policies (branches two and three). Somewhere along the way the servant (scientific economics) became the master. The basic argument for positive economics is that the economy is something that exists as a reality man finds in nature, not one he creates, independent of the observer; the observers, using their senses, can gain knowledge of this objective reality and develop theories (explanations) to describe this reality which, at least theoretically, can be tested and verified or falsified. As Maurice Allais noted in his 1988 Noble lecture "I have been gradually led to a twofold conviction: human psychology remains fundamentally the same at all times and in all places; and the present is determined by the past according to invariant laws. It seems to me that, to a very large extent, the social sciences must, like the physical sciences, be based on the search for relationships and quantities invariant in time and in space" (1990, p. 5).⁴

Throughout the debate on economic methodology and the role of values in theory construction, the positivists have conceded that value judgments play a role in theory construction, but they make a distinction between "characterizing value judgments" and "appraising value judgments." According to the philosopher of science Thomas Nagel a characterizing value judgment "expresses an estimate of the degree to which some commonly recognized (and more or less clearly defined) type of action, object, or institution is embodied in a given instance" (quoted in Wilber and Hoksbergen, 1998, p. 18) while an "appraising value judgment" "expresses approval

⁴ Verification typically comes from the inability to falsify.

or disapproval either of some moral (or social) ideal, or of some action (or institution) because of commitment to such an ideal” (Ibid.). Some value judgments are merely for the purpose of selecting what to examine while others are for evaluating the rightness or wrongness of what is examined. This concession is prompted by the anti-positivist methodologist’s argument that all theory involves value judgments, the most basic of which is the choice of what to theorize about (which is also the choice of what to exclude). But for the positivist, the choice involved is what “brute facts” are to be analyzed.

This notion that brute facts exist merely to be discovered by economic theorists is not one that has gained much support from methodologists or philosophers of science. In fact, if one were to read only the literature on the positive/normative dichotomy in economics one would have to conclude that the positivists lost the debate. Yet this has not been the case within the economics profession. One reason is that the vast majority of economists know nothing of this debate or of economic methodology and philosophy. It is not part of most graduate economics programs in the United States. Secondly, the strongest argument for the positivist view that economic theory is value-free is that the consequences of it not being value-free are too horrible to contemplate. Not only would it weaken neoclassical economic theory’s hold over the economics profession, it would reduce economists from their high perch on the social science tree, bringing them down to the level of sociologists and political scientists. This would force them to abandoned the view of a neatly order world driven solely by market forces, always tending towards an equilibrium. Instead of mathematical rigor, economists would have to concentrate on social and historical context. This is a high price for a profession that sometimes seems more interested in precisely understanding what cannot exist (the idealized market) than with imperfectly understanding what does exist.

The positive/normative dichotomy is a false dichotomy, and has been recognized as such by economic methodologists for some time. As Gunnar Myrdal long ago noted, all economic theory and observation are value laden and cannot help being so (Myrdal, 1969). Even the simplest observation requires a viewpoint from which to observe, and this viewpoint is not and cannot be based solely on past “objective” observation of “brute facts.” All observation requires theory to help bring “order” to the chaos of daily life. We need a theoretical system to tell us what to observe and to assimilate and give meaning to our observations. Theories and models help us to categorize reality, but these categories are humanly created and are always based on value judgments. This is not a radical point, and most, if not all, philosophers and historians of science would readily accept it. Only neoclassical economists seem, as a group, to ignore this fact.

Take, for instance, the seemingly harmless statement: “The rate of unemployment is 9.7%”. While this might seem like a simple statement of “brute facts,” a closer investigation reveals that it is very much a value laden statement. As stated above, the first value judgment is the selection of the phenomena of “unemployment” as something in need of investigation and measurement. Yet “unemployment” or the “rate of unemployment” are not natural facts, things that exist independent of theory. They are social constructions, put together to deal with particular economic outcomes which are deemed unacceptable or less than optimal. It first involves defining “what is unemployment?” It is not a phenomenon of nature with natural or objective characteristics, like gold or water. There is no politically or ethically neutral definition of what is

“unemployment.” Different countries have different definitions due to their differing political histories. The political aspects of defining unemployment become apparent when governments attempt to change the definition, usually at a time of high unemployment (in an effort to reduce the official rate by redefining it). The limitations of the official measurement of unemployment are well known to the economics profession, and competent economists studying the problem of unemployment go beyond this single measure.⁵ My point, however, is that constructing the measure is a discretionary act, one greatly influenced by values and the theorist’s “vision” of the economy; in this case it is the assumption of a “labor market” with a price clearing mechanism. The classical economists, under the influence of “Say’s Law of Markets,” which rejected the possibility of prolonged recessions and high unemployment, did not develop a measure of labor market slack. Their vision of the economy and society rejected the problem. Writing at the end of the classical period, Karl Marx adhered to a different vision (based on Hegelian dialectics) of the economy and society, one based on social disharmony (class struggle) and economic disequilibrium (the famous contradictions of capitalism) and thus developed the idea of the “industrial reserve army” to explain the observed phenomena of numerous individuals out of work. A theorist’s philosophical preconceptions always influence how they explain the economy.

Economic reality is anything but invariant in time and space. The world of economic invariants, (general equilibrium theory), is a far cry from any actual economy. In fact no phrase has ever done more injustice to the understanding of capitalism than “equilibrium.” As Jonas Kornai (1971, p. 28) has noted:

In reality, there are mammoth corporations and the role of government is great. GE [general equilibrium] theory assumes atomized markets and ‘perfect’ competition. In reality, there exist sharp conflicts of interest. GE theory sees peaceful harmony in the market. In reality there is concentration and rapid technical progress. GE theory ‘disregards’ increasing returns of scale, one of the most significant aspects of technical progress and one of the fundamental explanations of concentration. In reality, the information structure is highly intricate and complex.

In following the dictates of theoretical reasoning, economists have excluded historical and social context, the insights from the other social sciences and most importantly, what we have learned over the centuries about human nature and society from philosophy and theology. Moreover, they have imparted their own utilitarian vision of human nature and society, with market values having more importance than other values. Hence, like Dr. Summers, economists regularly reject other considerations (intrinsic rights to certain goods, moral reasons, and social concerns). Rationalism, in the end, pushed economists to ignore reality.

Practical Wisdom and the discovery of the moral natural order

⁵ That is the official rate of unemployment can go up (generally a bad thing) because the economy is improving (because more people are optimistic and thus entering the labor force) or it can go down (which is usually a good thing) because the economy is slowing down and thus people are leaving the labor force (no longer looking for work).

The Catholic natural law tradition does not hold that human reason is enough to discover the natural law, or that the natural law is independent from divine law.⁶ As Jacques Maritain has noted:

Eighteenth-century rationalism assumed that Natural Law was either discoverable in Nature or *a priori* deduced by conceptual and rational knowledge, and from there imposed upon human life by philosophers and by legislators in the manner of a code of geometrical propositions. No wonder that finally “eight or more new systems of natural law made their appearance at every Leipzig booksellers’ fair” at the end of the eighteenth Century, and that Jean-Paul Richter might observe that “every fair and every war brings forth a new natural law” (Rommen, 1947, p. 107). I submit that all the theories of Natural Law which have been offered since Grotius (and including Grotius himself) were spoiled by the disregard of the fact that Natural Law is known through inclination or connaturality, not through conceptual or rational knowledge (2001, p. 23).

It is important to recognize that human reason does not discover the regulations of natural law in an abstract and theoretical manner, as a series of geometrical theorems. Moreover, it does not discover them through the conceptual exercise of the intellect, or by way of rational knowledge. I think that the teachings of St. Thomas here should be understood in a much deeper and more precise fashion than is usual. When he says that human reason discovers the regulations of natural law through the guidance of the inclinations of human nature, he means that the very mode or manner in which human reason knows natural law is not rational knowledge, but knowledge through inclination. .. Through the channel of natural inclinations the divine reason imprints its light upon human reason. This is why the notion of knowledge through inclination is basic to the understanding of Natural Law, for it brushes aside any intervention of human reason as a creative factor in Natural Law” (Ibid., pp. 33-4; 43).

Maritain notes that our understanding of the natural law comes first through social activity: “For the knowledge of the primordial aspects of natural law was first expressed in social patterns rather than in personal judgments. This knowledge has developed from the inside, within the double protecting tissue of human inclinations and human society” (Ibid., p. 35-6).

Trying to discover the “natural laws” of the economy required economists to exclude social and historical context, they had to ignore the particulars in their search for universals. Many would argue it was due to the facts being inconvenient. In this perspective, economic “facts” are treated, must be treated, as if they were natural facts, and not as social occurrences, thus ignoring the social nature of economic activity and the evolutionary nature of the economy. As Maritain has noted: “One of the main errors of the rationalist philosophy ... has been to regard positive law as a mere transcript traced off from natural law, which would supposedly prescribe in the name of Nature all that which positive law prescribes in the name of society. They forget the

⁶As St. Thomas Aquinas noted: “Human reason is the norm of the human will, according to which its goodness is measured, because reason derives from the eternal law which is the divine reason itself. It is evident then that the goodness of the human will depends much more on the eternal law than on human reason” (Quoted in *PT* 38).

immense field of human things which depend on the variable conditions of social life, and on the free initiative of human reason, and which natural law leaves undetermined” (Maritain, 2001, p. 62).

Often, economists equated scientific with mathematical, and thus the adoption of mathematical formalism as the dominant language of economic theory. As Robert Heilbroner has observed, the efforts to increase the level of mathematical sophistication in economics has added rigor, but alas also mortis (Heilbroner 1979). Three centuries of trying to make economics look like physics eventually led to the adoption of axiomatic general equilibrium theory during the 20th century and a complete break with understanding economic history and economic institutions. In the past three decades ignoring the “real economy” encouraged and justified the deregulation of the financial markets, and other policies that increased income inequality, which eventually led to the financial meltdown and crisis we are currently experiencing.

It is one of the great ironies of the history of economic ideas that the pursuit of scientific rigor has weakened economic theories explanatory value and the rejection of values and ethics as a central concern of economists has made economic orthodoxy a mere ideology.

An Overview of the Financial Crisis⁷

“The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes” (Keynes, 1936, p. 372).

When Leo XIII stated that “nothing is more important than knowing the world as it is” he was calling for the use of practical wisdom. Any study of economic history will clearly demonstrate that change and development, and not equilibrium, are the most characteristic feature of capitalist economies. Economic and financial crisis are not the exceptional cases in economics, they are a common feature, found wherever capitalism is found. Thus if we want to understand how the economy works we need to have explain economic variations and not merely equilibrium states. The classical and neoclassical economists ignored the question of economic variations with the orthodoxy doctrine of “Say’s Law of Markets” which can be simplified into “supply creates its own demand”, which means that if someone offers a good for sale to a market they are at the same time bringing the same amount of purchasing power to the market (the money they would get from the sale of the good they are offering for sale) and thus there cannot be an economic crisis due to insufficient demand (recession, depression, crisis). John Kenneth Galbraith joked that before 1936 you could not get a teaching position if you had criticized Say’s Law, whereas after Keynes’ General Theory you could not get a teaching position after 1936 if you accepted Say’s Law, except at the University of Chicago. If your theoretical reasoning excludes the possibility of something happening, then your theoretical work will ignore the problem. Practical wisdom focuses on the real world of change and variation.

⁷ This section adapted from “A Christian Perspective on the Financial Crisis” *American Economist*, 2009, Spring.

Since the earliest “capitalist period” in the beginning of the 17th century, which is often called the “Age of Crisis,” booms and bust have been the norm not the exceptional case. Many of these collapses are well known, such as the Tulip Mania; Mississippi Bubble; and South Sea Bubble. Below we see a list of the crises for just the United States of America:

Economic Crises in USA, 1790-1930s

- Panic of 1792
- Panic of 1819
- Panic of 1825
- Panic of 1837 (5yrs)
- Panic of 1847
- Panic of 1857
- Panic of 1866
- Panic of 1873 (4 yrs)
- Panic of 1884
- Panic of 1890
- Panic of 1893
- Panic of 1907
- Great Depression (10 yrs)

At a recent conference on Lonergan’s economic theory one of the speakers noted the United States has been in recession for one third of its history, hardly confirming “Say’s Law.” The recessions after WWII and the rise of the Welfare State and Keynesian economics are very mild in comparison, and one can argue that many of them were caused by the government as a matter of policy to fight inflation, just as Michal Kalecki predicted in his famous article “The Political Aspects of Full Employment” in 1943. Financial crises returned again after the world went off the Bretton Woods system (which provided for fixed exchange rates, thus dramatically reducing the level of risk in financial markets). With the election of Reagan and Thatcher we start an era of deregulation, including financial deregulation, increasing the number and severity of financial crises. Below is a partial list of the 40+ financial crises world-wide in the past 30 years.

Reagan/Thatcher Deregulation Era

- Latin American Debt Crisis 1980s
- Japanese Asset Bubble (1986-2000)
- S & L Crisis of 1980s and 1990s
- Finnish Banking Crisis of 1990s
- Swedish Banking Crisis of 1990s
- Asian Financial Crisis 1997
- Russian Financial Crisis 1998
- Argentinean Crisis 1999-2002
- Dot Com Crash 2000-1
- Financial Meltdown 2007-2011

The major deregulation actions were: the repeal of the Glass-Steagell Act (which created a barrier between banking deposits and risky lending); the elimination of all “Bucket Laws” in the 2000 budget, which allowed for wide spread and unregulated gambling on financial instruments, that is it allow for the explosion of financial derivatives and prevented their regulation; and the 2004 change in the level of leverage allowed for Investment banks; which had been 12 to 1, but Paulson of Goldman Sacs convinced the Congress and White House that this was too restrictive, so they raised it to 40 to 1.

While the deregulation efforts were certainly driven by the self-interest and power of the financial industry, it was justified by neoclassical economics and new developments in financial theory. Neoclassical economics teaches that markets are efficient and thus should have minimal government intervention. The efficient-market hypothesis, which states that market prices reflect all known information, gain greater strength when new techniques in finance (Capital Asset Pricing Model) purported to correctly measure and price risk. This allow financial derivatives, such as credit default swaps, to spring up under the guise of spreading risk to those who were willing to bear it, when in fact, as we know now, it merely papered over the risk. In many ways the current crisis is very similar to the Great Depression, especially the role belief in economic theories which didn’t conform to how the real economy functioned.

Similarities between Great Depression and Current Financial Meltdown	
Causes of the Great Depression, 1930s⁸	Causes of Financial Meltdown, 2008⁹
1. Income Inequality	1. Growing economic inequality
2. Bad Corporate Structure	2. Macro Economic Imbalance
3. Bad Banking Structure	3. Financial Deregulation
4. Foreign Imbalances	4. Free Market Fundamentalism
5. Poor State of Economic Intelligence	5. Economic Interdependence
6. Actions of the Fed	6. Built in de-stabilizers

The Crisis Plays Out

The outlines of the financial meltdown are now clear. After 9/11 the Federal Reserve Bank lowered interest rates to historic lows, which caused money managers to look for higher returns elsewhere, while maintaining low levels of risk. To meet this new demand, Wall Street came out with new financial instruments, especially the securitization of U.S. mortgages. U.S. Mortgages seemed ideal due to their historically low foreclosure rates and the fact that since the Great Depression housing prices have never fallen nationally, although regional housing markets have declined. Furthermore, the financial industry was armed (or so it thought) with new

⁸ Galbraith, *The Great Crash*.

⁹ UN Expert Group, *Financial Crises*, 2009.

“techniques” for estimating risk, so that they felt that they could effectively neutralize risk. Given the almost unlimited demand for these instruments (Collateralize Debt Obligations, or CDOs) by Wall Street, the home mortgage industry set out to meet this demand, progressively lowering standards: from “low doc” to “no doc” to “liar loans” and finally to “Ninja loans.” Today we see these “no income, no job, no asset” mortgages were clearly a bad idea, yet at the time very few market insiders raised a warning flag.

To add to this mass delusion, the credit rating agencies systematically ignored the real risk inherent in these assets (likely following their own self-interest) and gave CDOs filled with subprime loans AAA ratings, which gave investors (especially international investors) a false sense of security. Furthermore, the growth in Credit Default Swaps (CDS) also gave the financial sector the false sense that they had eliminated risk, a false sense because these instruments are insurance without reserves to back them up. To make matters worse, the institutions that invested in CDOs also sold CDSs, greatly compounding their risk. It is estimated that the market for CDSs is \$50-60 trillion, yet since it is an unregulated market no one really knows for sure. With the threat of risk neutralized, financial institutions, and individuals, took on more historic levels of leverage.

Today many are blaming the overly greedy and fraudulent mortgage brokers, hedge fund managers and bank executives, while others place the blame on Freddy and Fanny Mac and Congress’ desire to increase home ownership rates. There is no doubt that greed certainly contributed to the financial meltdown (which we will discuss below), and it was assisted by the reduction in the restraints on greed by the government and by individual self control (moral standards), with many government officials and market participants fully believing the “greed is good” philosophy.

This unregulated greed was accompanied by an unbalanced economy, which many Post Keynesian economists have been writing about for some time. One of the best explanations of the financial meltdown is a paper by Randy Wray (2008), which was presented to a conference at the Levy Institute in April of 2008, months before the decline in equities. Wray, James Galbraith and others at the Levy Institute have been writing about these imbalances for years. Students of Keynes and Hyman Minsky have long known that a crisis such as what we are experience is the natural result of what can be called “money manager capitalism,” the organization of the economy by money managers, for money managers. Increasingly economic activity became separated from the goal of meeting human needs and improving social welfare.

Underlying the financial “innovations” was the problem of rising income inequality which leads to rising instability. What John Maynard Keynes said during the Great Depression is still true today: “The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes” (Keynes, 1936, p. 372). This rise in wealth and income inequality created a huge pool of money in need of “high returns” and it also creating a need for the poor and middle class to borrow money to maintain their living standards. This rise in income inequality happened in most rich countries (ILO 2009), and to an even greater extent in the poor countries.

As Keynes explained, capitalist economies typically do not generate enough purchasing power to produce full employment, *given the distribution of income*. It only achieves near full employment when there are substantial “injections” into aggregate demand, which can come from large government deficits, high investment rates, large trade surpluses, or, as has been the case for the past seven years, increased consumer debt. The greater the inequality, the greater the need for these injections. None of these injections are sustainable in the long run, thus you get fluctuations. As Hyman Minsky noted, if there is a period of sustained stability, economic actors take the natural path from hedge finance (investing out of savings) to speculative finance (borrowing to invest) and then to ponzi finance (borrowing to meet debt obligations). What is different about the current crisis is that households also followed this path with gusto. Household debt to disposable income ratio in the USA exceeded 120%, and what is most outstanding is that many European countries far exceeded us (Denmark is over 200%). This natural tendency of capitalist economies is confirmed by all experience, yet it contradicts the faith in markets of policy makers and most economists, thus both the Clinton and Bush administrations deregulated financial markets and allowed greed even greater freedom.

The three main factors underlying the economic crisis: greed, rising inequality and the “bad” creation of wealth, are all ethical as well as economic issues. The underlying ethics of neoclassical economics (utilitarianism and post modern ethical relativism) are also part of the problem as they support the philosophy that greed is good. What is needed is a solid ethical foundation upon which a just economy can be constructed.

What Can Catholic Social Thought Offer to our Understanding of the Economy?

“The time has come for a new and deeper reflection on the nature of the economy and its purposes” John Paul II

Catholic social thought is not an alternative economic theory or model. Yet it does have many insights into economic actions and the economy which promote a better understanding of the economy. The first insight CST offers is the need to use practical wisdom rather than exclusively rely on theoretical reasoning, which in the end becomes merely ideologically driven analysis. Economists must first learn how the actual economy works.

The second insight goes to the heart of all social theory—the nature of the human person. Christian anthropology conflicts greatly with the “rational economic man” model. This is due to revelation and reason. The Christian view of the human person starts with the *Imago Dei*, man being made by God in God image. This view highlights: human dignity; reason, free will and our social nature. An empirical investigation into what it means to be a human person confirms the last three attributes. Neoclassical economics view of the human person only includes reason, yet it is an extreme perfect information view of rationality, well beyond any individual or group capability. The fact of the matter is that Christian Anthropology is more accurate than the neoclassical view (or any other) and is thus the necessary starting point for any useful social or economic analysis. Human dignity has to be taken by faith, something that philosophers are increasingly learning, much to their dismay.

With the *Imago Dei* as the starting point, CST teaches us that self-interest isn't what holds society together; it is solidarity that leads us to promote the common good. Following Mandeville's "fable of the bees" economists have argued that private vice leads to public virtue. If nothing else, the financial meltdown exposed the lie of this doctrine. Greed is not enough to bring order to societies or markets. Economists forgot that Adam Smith's doctrine of self-interest was balanced by his "sympathy principle," and that free markets require virtuous people. Markets, however, do not create virtuous people, thus they must be kept under control at the micro level by religion and at the macro level by government regulation.

CST teaches that wealth needs to be created, distributed and used according to the dictates of Christian morality. Many of the causes of the current financial crisis can be traced back to the unethical creation, distribution and use of wealth. Neoclassical economics rejects that wealth can be created, distributed or used unethically as long as it is the result of "free choices" yet choices are rarely free and economic and political power greatly influence economic outcomes. The fact that wealth grew at more than twice the rate of output from 1997-2007 shows that such wealth creation was not due to "expanding the economic pie for all" but was due to redistribution. The fact that so many were getting rich while so many were getting poorer shows that the CST principle of the Universal Destination of Goods was not being adhered to. This created the growing income inequality which, as John Maynard Keynes argued, is the core factor in any economic crisis.

When economics becomes divorced from ethics and morality it loses its ability to be useful, because it loses its touch with reality. Economic actions are necessarily ethical actions and cannot help being so, for they involve choosing (which requires criteria of choice -- values) and because all economic actions are necessarily social actions, working or exchanging with others. When we act with others we need to take their interests into consideration so that our actions benefit both of us. That is, we need to "do unto others as we would have them do unto us." Christian ethics is the most complete and developed ethical system in terms of this basic principle, thus it provides economists with a solid foundation upon which to construct their theories and for us to build our economies. This is what CST can offer economists, and we need it now more than ever. As much as the financial crisis was brought about by structures and policies, it was even more so brought about by individual motivation of greed. The current crisis is at root a "crisis of meaning;" the failure of a culture of death and a civilization of individualism. While we certainly need more financial regulation and better economic understanding and policies, what we need more than anything else is conversion, a change of hearts. We need to distinguish between intermediate ends and final ends. Economists concentrate on means to ends and run into trouble when they assume that these means to ends are the final ends. Wealth and goods are "good" to the extent that they promote higher ends. These higher ends economics cannot give us. As John Henry Newman noted, the economist must turn to the higher sciences of theology and philosophy to get insight into the final ends and the true source of happiness. Economics can only hope for partial truths or little truths, but never the whole truth, who, as St. John tells us, is not an idea or theory or philosophy, but is a person, Jesus, the way, the truth and the light.

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