Adam Smith and the 2008 Financial Crisis

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'While some men are born small and some achieve smallness, it is clear enough that Smith has had much smallness thrust upon him.'

Amartya Sen[1]

I. Introduction

'We are here in a very melancholy Situation: Continual Bankruptcies, universal Loss of Credit, and endless Suspicions.'[2] David Hume's solemn words in a letter to his friend Adam Smith in the summer of 1772 reflect the depressing economic climate that occupied the Scottish political economist's mind as he prepared the *Wealth of Nations* (WN) for publication. The Ayr bank had just collapsed, unleashing a financial panic throughout the United Kingdom and gravely affecting many of Smith's close associates.[3] 'Tho I have had no concern myself in the Public

[1] 'Introduction' in *Theory of Moral Sentiments*

[2] Corr., Letter 131 (*From* David Hume)

[3] On June 25th 1772, a prominent bank, Douglas, Heron & Co. crashed, leaving liabilities in excesses of £1 million sterling. The failure was followed by a financial panic in Edinburgh and a severe economic slowdown in Scotland. The financial institution, more often referred to as the Ayr Bank, had been established in 1769 in order to alleviate the capital shortfall in Scotland, which had been experiencing rapid economic development in latter half of the 18th century. The banks policies were far more liberal than its competitors and its failure substantially affected Smith's close friends, with the Bank of England instigating proceedings against the Duke of Buccleuch and others for £300,000 (Hamilton, 1956).

calamities, some of the friends for whom I interest myself the most have been deeply concerned in them," wrote Smith to a companion in parliament later that year, "and my attention has been a good deal occupied about the most proper method of extricating them. In the Book, which I am now preparing for the Press [WN] I have treated fully and distinctly every part of the subject which you have recommended to me."[4] Although Adam Smith was unusually suspicious of the financial sector and advocated for substantive state interventions in banking by today's regulatory standards, his reputation has nevertheless become entangled in the laissez faire doctrine of financial capitalism that is deemed by many to have led to the 2008 financial crisis (FC).

The association between Smithian ideas and the unfettered financial capitalism of the FC is one that is often proclaimed however, but rarely explicated. Not only did Smith embrace a curiously pessimistic opinion of finance, the deeper epistemological and theoretical connection between his thinking and the modern analytical methods of economics used to support calls for the deregulation of financial markets is not immediately clear either. Moreover, the structural explanations of the crisis; the deepening inequality in the United States, the large scale borrowing to fuel consumption, and the insidious relationship between big business and politics are all phenomena that Smith identified in his day as scourges upon society. It is seldom

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Writing of the incident in WN, Smith describes how '[i]n the midst of this clamour and distress, a new bank was established in Scotland for the express purpose of relieving the distress of the country. The design was generous; but the execution was imprudent, and the nature and causes of the distress which it meant to relieve, were not, perhaps, well understood. This bank was more liberal than any other had ever been, both in granting cash accounts, and in discounting bills of exchange' (WN, II, ii, 73).

[4] Corr., 132. (*To* William Pulteney). Although the nature of Pulteney's suggestions is unclear, given the flow of the paragraph, it would not be unreasonable to assume that Smith is referring to comments made on the crisis. Smith refers to 'the public calamities', for example, without mentioning the Ayr Bank, implying that the two have already discussed the issue.

noted that Smith, like Keynes, wrote his great treatise on economics in the aftermath of a financial crisis, indeed that his views were likely influenced by it.[5]

This paper makes the case that the commonly professed relationship between the ideas of Smith and the Financial Crisis of 2008 is misunderstood. First, it questions the association between the theoretical and epistemological foundations of contemporary economics and Smith's ideas, paying particular attention to the relationship between neoclassical economics, the "efficient market hypothesis" (EMH) and the associated laissez-faire doctrine. It argues that three of the central suppositions connecting the neoclassical technique to EMH and laissez faire paradigm;

(1) the axiomatic synonymy of rationality with self-interest;
(2) the foundational belief in the natural order or markets; and
(3) the view of state intervention as ubiquitously harmful;

are perspectives that Smith himself did not hold, despite common claims suggesting otherwise. In fact, his dialectical and interpretative style, uncommon in economics today, shielded him from the exuberant generalizations associated with much of contemporary mainstream economics. Second, it suggests that underlying Smith's now fossilized policy perspectives in WN, concerns can be seen about the nature of financial markets that are remarkably prescient in light of the recent FC. Smith's advocacy of usury laws, for example, anticipates Keynesian arguments emphasizing the limit of the price mechanism in financial markets, while his support of a prohibition on small bills echoes calls today to separate the banking services used

[5] In recent years, it has been speculated that the failure of the Ayr Bank led Smith to become more conservative in his analysis of financial innovation. These suggestions, which focus on differences between Smith's *Lectures on Jurisprudence* (LJ) and WN, have largely remained within the confines of discussions of the history of economic thought.

by the general public from the more risky financial activities engaged in by specialists. Finally, his preference for increasing the number of institutions in the banking system, mirrors the concern today that the financial crisis was exacerbated by the systemic structure of the banking system.

Economists seeking to motivate juxtapositions between supporters and critics of the free market have carelessly referred to Smith's work for years. As the discipline seeks to respond to the failures highlighted by the FC however, a more careful consideration of his writings would offer long forgotten, but nonetheless attractive avenues for exploration.

II. The Crisis and Laissez Faire: The Modern Analytical Method

In his seminal paper on capital market equilibrium, Nobel Laureate William Sharpe reflected upon the requirement that economic theory be built upon realistic foundations. 'Needless to say,' he admitted, the model contains 'highly restrictive and undoubtedly unrealistic assumptions. However, since the proper test of a theory is not the realism of its assumptions, but the acceptability of its implications, and since these assumptions imply equilibrium conditions which form a major part of classical financial doctrine, it is far from clear that this formulation should be rejected.'[6] Thus the kind of thinking that many regard as the central cause of the FC and thus the worldview that many popular accounts claim Smith inspired, embroiling him in the FC's making.

[6] 1964, pg. 434. Referenced in Crotty (2008); For the most famous rejection of the need for assumptions to be realistic, see Friedman (1966).

Though many analyses have been given,[7] perhaps the most influential argument to date is the claim that financial markets somehow failed. While the character of these failures is often emphasized differently, the view is generally shared that aspects of the modern analytical technique played a causal role. Some focus specifically on misguided beliefs about the nature of individual behavior, while others criticize more generally, the faith held by many economists, in market efficiency. These worldviews affected policy. Had free-market 'fundamentalists', emphasizing EMH, not held such dominance and abused the neoclassical technique to motivate idealized models, critics argue that regulations dating back to the Glass-Steagall Act would not have lost their intellectual legitimacy and been recklessly stripped away.

Smith is frequently attributed with first espousing this way of thinking. Roubini and Mihn (2010), for example, set out their thesis by placing Smith's ideas at the center of the problem. Much of mainstream's economics obsession 'with showing how and why markets work – and work well' is a 'preoccupation [that] arguably

[7] A voluminous literature seeking to explain the FC's origins has quickly developed. Some highlight developments in the political economy of the United States arising from the increasing inequality in the country. Rajan (2010), for example, argues that its roots lie in misguided attempts to increase home ownership through state intervention in the housing market. Others focus on parallel deregulation of the financial sector and increases in industry lobbying (Johnson, 2010; Igan, Mishra, and Tressel, 2011). In contrast to these structural explanations, others emphasize the role played by mistaken faith in the effectiveness of markets. The specific failures emphasized varies in different accounts but some prominent explanations include: "Animal spirits" - contagion of 'irrational exuberant' beliefs about the future development of the housing market inflated prices and generated a bubble, which subsequently burst leaving people with liabilities on properties no longer worth the value of the original loans (Shiller, 2008); "Originate-to-distribute" - Innovations in finance created perverse incentives encouraging predatory lending. Loans would be sold by one financial institution, repackaged and sold on so that the burden of risk taken on by anther (Akerlof and Shiller, 2009); "This time it's different" - mistaken beliefs about the economy's maturity fostered the view that it was no longer vulnerable to financial panics (Reinhart and Rogoff, 2009); "Too big too fail" - Some institutions were of such systematic importance to the economy that their failure would impose greater costs on the economy than a bail out, encouraging reckless behavior (Stiglitz, 2010); "Asymmetric Information" – The complex derivative market left financial institutions uncertain of the value of their assets. Once an awareness of the problem began to develope, this ambiguity fueled an outright panic. "Reversal of the Null" – academic practices shifted from scrutinizing the effectiveness of the market to focus on the state, the methodological implications of which, brought into question the capacity of the state to rectify market failures (Moss, 2011).

dates back to the origins of the profession of economics, beginning with the Scottish thinker Adam Smith.' Similarly, Gorton's *Slapped by the Invisible Hand: The Panic of 2007*, directly alludes to Smith's thinking as a cause of the crisis.

But did Smith truly think and write about the world in the way these critics claim and put forward a brand of economics that mirrors its contemporary form?

III. The Agent: Smith's 'Self Interest' Axiom

The first association between Smith and the kind of thinking that caused the crisis comes about from the view that he is responsible for establishing the foundations of contemporary economics' reductionist methodology, and in particular the belief that he saw man as somehow innately self-interest. In relating Smith's view of the individual to the crisis, we can compare it to EMH.[8] This body of work encapsulates the worldview that critics have attacked, embracing much more powerful and narrow assumptions about individual behavior than simple 'rational' self interest. In particular, it holds that individuals in financial markets have access to all the relevant information (and are capable of making sense of it) and thus able to develop correct economic expectations from which they can act upon to maximize the private benefit they derive from a given market activity.

Smith, immersed in the Scottish empirical tradition like his friend Hume, was by no means a theoretician of this kind, and would have been skeptical of such an intellectual programme. His worldview differs substantively in three ways. First, Smith does not claim that individuals exhibit 'maximizing' behavior like the

[8] See Fama, E. (1970)

contemporary neoclassical method does. This focus on maximizing behavior is particularly useful for mathematical models, allowing economists to use constrained optimization to solve problems, but unnecessary for the dialectical mode of inquiry that Smith was engaging in. Second, the assumption of perfect information is antithetical to Smith's epistemology. His writings are filled with examples of people learning about the world around them through conversation, observation and reading. He sees the flow of information as endogenous to his worldview, fundamentally dictating the nature of the relationship between the individual and their environment.[9] Third, mathematical models exhibit a generality that would be difficult to marry with Smith's particularism. The characters in Smith's writings are not dominated by one parsimonious passion, but are governed, rather, by a complex plurality of motivations, for example 'generosity, humanity, kindness, compassion, mutual friendship and esteem'.[10]

This final distinction conflicts with the common portrayal of Smith as a champion of self-interest. For many, the relationship between his ideas and EMH manifests itself in his association with a more fundamental methodological component of contemporary economic analysis, through the often held belief that he championed both the existence and virtue of self-interest. Indeed, before the theory of EMH even arrives at the individual's optimizing behavior or ability to access and comprehend information, it is first built upon the axiomatic synonymy between rationality and self-interest, a basic assumption of neoclassical analysis, the prevailing

[9] Smith's discussion on the development of moral sentiments sheds some interesting light on how he believes that people make sense of the world. TMS I 1.1, for example, describes how people develop moral sentiments for others by observing them. In other words, perfect moral sentiments do not simply exist nor can they be assumed, they are learnt through experience. Thus 'perfect information' assumptions, as found in EMH would make little sense within his worldview.

[10] TMS I 2.4

doctrine of contemporary economics that is seen as having progressed from Smith.[11]

George Stigler's now famous proclamation that the '*Wealth of Nations* is a stupendous palace erected upon the granite of self-interest' has come to serve as the embodiment of this belief. According to Stigler, Smith considered self-love to be something innate and virtuous, that if 'given even a loose rein,' it could 'perform prodigies.'[12] Indeed, despite the recent push back by intellectual historians, the notion that Smith had a 'fundamental axiom,' which could be reduced to a view of 'self-interest as the governing motive throughout time and space as far as concerns man in his economic affairs,' continues to hold considerable sway today.[13]

There are a number of difficulties in associating Smith with the self-interest axiom. Most immediately, the opening words of TMS, a work he published both before *The Wealth of Nations* (WN) and edited for republication after directly contradict it:

> 'How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.'[14]

Indeed, given that the historical context in which Smith was writing was one that largely embraced a vision of man as an essentially self-interested creature, it is curious that Smith has been chosen as its advocate. As Fleischacker puts it, 'if we

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[11] Gregory Mankiw (2011), for example, motivates his discussion of the discipline in his widely used undergraduate economics textbook *Principles of economics* with the suggestion that Smith's analysis can be summed up as follows: 'participants in the economy are motivated by self-interest and that the 'invisible hand' of the marketplace guides this self-interest into promoting general economic well-being' (Pg. 12)

[12] (Pg. 136) Stigler, G. 1982.

[13] Hollander, S. 1977.

[14] TMS I.i.i

were to arrange a spectrum of early modern views on the importance of self-interest, with Hobbes and Mandeville at one end, Smith would belong well past the center toward the other.'[15]

Advocates of "Smith the champion of self-interest" needless to say, look past his work on moral philosophy and the context in which he was writing, usually focusing on one passage in WN, his most oft quoted words:

> 'It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens.'[16]

The above lines, according to the 'self-interest' perspective, demonstrate that Smith saw human nature as fundamentally motivated by self-interest. Even here though, there are a number of reasons to question whether Smith's words comfortably lead to the self-interest axiom.

To begin with, as Sen notes, the passage is 'addressed only to one very specific issue, namely *exchange* … and, in particular, the *motivation* underlying exchange (rather than what makes normal exchanges sustainable, such as trust and confidence between the two parties)'.[17] Smith makes no suggestion that this motivation guides *all* interpersonal behavior. If he sought to pursue a universal vision of self-interested human nature, then surely he would done so in a more comprehensive manner found

[15] (pg. 84-87) Fleischacker, 2004

[16] WN I.ii 2-3

[17] (pg. xi) Sen, A. 2009 [TMS Intro]

elsewhere in his writing. Fleischacker highlights the absurdity of making a generalizing inference:

> '*Of course* we address the butcher and the baker in terms of what they can get from us! Who would ever have supposed otherwise? If Smith's point was that people are *always* motivated by self interest he should have used a less obvious example – shown us, perhaps, like Mandeville, that charitable actions are really motivated by self interest, or, like contemporary economist Gary Becker, that parents are so motivated in relation to their children.'[18]

The utility of the passage runs in to further trouble however. Smith is clear in his skepticism that even the propensity in human nature 'to truck, barter, and exchange one thing for another' is 'one of those original principles' of human nature.[19] It 'seems more probable,' he suggests, that these propensities are 'the necessary consequence of the faculties of reason and speech.' There are two issues of note worth considering here. First, Smith is making a limited claim that *appeals to self-interest* manifest themselves through the medium of trucking and bartering, invoking the ability to put oneself in another's shoes as much he his championing self love. Second, these propensities are derived from human beings' *natural* faculties of speech and reason. In other words, man's truly innate and timeless qualities are not the quasi-self interested propensity to truck and barter but rather the ability to speak and reason.[20] It is interesting that without these same 'original principles' that Smith

[18] (Pg. 90) Flieschacker, S. 2004.

[19] Smith even outlines an exception, suggesting that just as the 'spaniel endeavors by a thousand attractions to engage the attention of its master who is at dinner, when it wants to be fed by him,' it is sometimes the case that human beings use 'the same arts with his brethren, and when he has no other means of engaging them to act according to his inclinations, endeavors by every servile and fawning attention to obtain their good will.' WN I.ii 2

[20] For further discussion, see (pg. 324) Sen and Rothschild, 2006

shows in TMS help foster sympathy, the potential for interpersonal activity predicated on self-love would also dissipate.

The relationship between the view of the individual found in EMH and that of Adam Smith, is at best weak. Smith did not engage in the kind of reductionism found in contemporary economics. He did not see individuals as exhibiting utility maximizing behavior. He would never have assumed they accessed perfect information about the world. Indeed, while he allowed for people to be motivated by self interest, he never generalized this, and also emphasized the variety of other emotional and psychological capacities of human behavior.

IV. Equilibrium Analysis: Smith's "Invisible Hand"

The second aspect of EMH commonly traced back to Smith is its assumption that competitive markets contain an underlying natural order, such that they are guided, as if by an 'invisible hand', to generate 'optimal' equilibrium outcomes.

Smith's association with this idea is often invoked in adulation. Arrow's opening remarks in his Nobel Memorial Lecture, for example, suggesting that the fascination with coherence in the economy has been a recurring theme 'from the time of Adam Smith's Wealth of Nations in 1776', can be seen as an effort to place Smith as the father of equilibrium theory.[21] Since the crisis however, Smith's metaphor of the invisible hand has suffered considerable criticism. Akerlof and Shiller, for instance, offer their account of the FC as a push against the philosophical framework put forward by Smith. 'The economics of Adam Smith is well understood' they argue,

[21] Arrow, K. 1972

their thesis 'marks a break with this tradition.' According to the authors, 'economic theory should be derived not from the minimal deviations from the system of Adam Smith but rather from the deviations that do occur and that can be observed.'[22]

Given the vast differences in their method of inquiry, it is not immediately clear how equilibrium theory and EMH share more than a superficial association with the ideas of Adam Smith. These modern approaches trace their roots back, not back to Smith but rather to the marginalist revolution, which began in the late 19th Century with the work of economists like Walras. As Jaffé remarks, 'we may think of Walras's *Eléments* as a sprightly centenarian, still hobbling about and insinuating itself into all sorts of current economic literature where it persists in playing a living role', Smith's WN on the other hand, 'has meanwhile been relegated to the role of a venerated dead ancestor, whose memory is saluted on successive centenaries out of respect, but whose words no longer enter as an active ingredient in present-day theoretical discourse.'[23] For the time being, Smith's WN is not methodologically relevant to contemporary economics.

It is interesting, moreover, that the marginalists had little time for Smith. Walras mentions WN only twice in *Eléments*, first to disparage Smith's description of the discipline of economics and second to ridicule his theory of value. In some accounts, he is even blamed for delaying the progress of economics in its current direction. According to Kauder, though the rudiments of marginalism can be found in the work of thinkers writing before Walras, Jevons and Menger began to seriously develop the technique, Smith had the effect of moving it off course:

[22] (Pg. 5, pg. xxiii-xxiv) Akerlof, G. and Robert Shiller. 2010.

[23] Jaffé (1977)

> '[T]he tragedy of these writers was that they wrote in vain, they were soon forgotten. No scholar appeared to make out of these thoughts the new science of political economy. Instead, the father of our economic science wrote that water has a great utility and a small value. With these few words Adam Smith had made waste and rubbish out of the thinking of 2,000 years. The chance to start in 1776 instead of 1870 with a more correct knowledge of value principles had been missed.'[24]

Some economic historians have sought to place Smith as a forerunner to this intellectual tradition,[25] but there are two main reasons to disassociate the two. The first relates to Smith's argumentative style. While the formal methodology found in marginalism and contemporary economics is grounded in the logic of mathematics, Smith's method of analysis on the other hand, establishes itself as a dialectic. His writing is steeped with the contextual sensibilities of the legal and historical tradition. His claims are typically loaded with qualifications and considerations of potential objections. As Fleichsachker remarks, in Smith's Aristotelian style of argument: 'A view is set up, obstacles to that view are surveyed and overcome, and the original view returns as if "of its own accord" once the obstacles have been cleared away.'[26] This can be contrasted not just with later developments in the economics, but even with the work's that Smith himself would have read, such as Cantillon's *Essai Sur la nature du commenrce en general*, a far more technical treatise than Smith's polemic.

Smith's suspicion of quantitative modes of inquiry as compared with today's generation of economists extends beyond the use of formal analysis to the reliance

[24] (pg. 650) Kauder. E. 1953.

[25] (Pgs 19-33) Jaffe, 1977

[26] (pg.11)

upon statistics.[27] As Fleischacker notes, his empiricism is closer to that of an historian, and frequently uses textual analysis or anecdotal evidence in order to gleam facts in support of his arguments. In seeking to demonstrate that cattle were used as an early 'common instrument of commerce,' for instance, Smith alludes to the fact that Homer describes the cost of the armour of Diomede in number of oxen. Sentences later, he cites anecdotal evidence in order to suggest that nails are being used as a means of exchange; there is 'a village in Scotland where it is not uncommon, *I am told*, for a workman to carry nails instead of money.' It would be reasonable to suggest that Smith used this argumentative technique due to the lack of reliable statistical evidence available at the time, but it is noteworthy that his works mirror the style of Gibbons's *Decline and Fall of the Roman Empire*, much more than they do Petty's *Political Arithmetick.*[28]

The second reason to hesitate in associating Smith's ideas with those of marginalism and today's mainstream economics is that he may not have had as much faith in the idea of equilibrium and natural economic order as is often suggested. To begin with a practical matter, whether or not Smith actually held this worldview may in fact be irrelevant. Marginalism developed decades before Smith's reference to the invisible hand had gained popular use.[29] Coupled with the fact that they appeared to pay little attention to his work except to disparage his thinking, it is unlikely that Smith's relatively off hand references to an invisible hand motivated the central axiom of their thinking. If the fascination with economic equilibrium and market efficiency that economists hold today can be traced further back than to the

[27] As Sutter and Pjesky (2007) show, unless he substantially increased the quantitative elements of his study, Smith would face considerable difficulty seeking to publish his work in today's top economic journals. Tribe (1999), moreover argues, that Smith is best regarded as a critical theorist

[28] (pg. 37) Fleischacker, 2004

[29] (pg. 118) Rothschild, 2001

marginalists (to the ideas that inspired them), then it is doubtful that its resting place lies with Smith but rather with the Physiocrats.

More importantly however, it is unclear how serious Smith was in his references to the invisible hand. While many economist and intellectual historians suggest that he conceived of the idea much as we do now, a serious proclamation of the coherent nature of socioeconomic world, Rothschild offers a push back against this perspective, making the intriguing claim that Smith's reference to the invisible hand is best thought of as a 'mildly ironic joke.'[30] Citing the plethora of references to hands, invisible or otherwise, and invisibility handed or otherwise, which Smith is likely to have been familiar with, Rothschild notes that 'the invisible hand' had curiously negative connotations. Indeed, there are three reasons to doubt Smith's interest.

> '[O]n grounds of the disregard it implied for the futility of individual lives, the reverence it implied for all-wise theorists, and the conflict it suggested with his own description of the political pursuit of self interest. The religious connotations of the invisible hand – its evocation of the Christian God, or of the Stoic providence, or the existence of a divine order.'[31]

The one reason to suspect that Smith was fond of the invisible hand, Rothschild claims, is 'on the grounds of its loveliness'; much the same reason that many economists appear to find it so fascinating today. Smith's philosophy of science however, did not lend itself easily to supporting systematic theories based on their beauty alone. Though Smith admired the elegance of systematic thinking, he nevertheless believed that good scientific theories must manifest themselves in the

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[30] ibid pg. 116

[31] ibid pg. 136

real world. Rather than considering his work within the context of an abstraction, as Cantillon does for example, Smith's works are filled with historical and geographical references, upon which he imposes his ideas. Where big theories do not fit the particular circumstances, they are disregarded.

V. The Market and the State: Smith's Laissez Faire

In his vast survey of the history of economic analysis, Schumpeter suggested that the reason Smith's WN continued to enjoy such a celebrated reputation as an 'epoch-making, original achievement' had nothing to do with its contribution to the methodology of economics. The work, in fact, did not 'contain a single analytical idea, principle or method.' Its notoriety, rather, has come about from the normative fervor with which it was written, the 'policies he advocated – free trade, laissez-faire, colonial policy and so on.'[32] If Schumpeter's analysis is correct, even if Smith did not provide contemporary economics with the analytical techniques that motivated its policy prescriptions, associations with the crisis may nevertheless be justified.

In many respects, WN echoes its Physiocratic contemporaries' advocacy of laissez-faire. The book's primary function, for example, is to call for substantial reforms to free the corn trade and dismantle the mercantilist system. Moreover, Smith writes of the rarity for actions that purportedly seek to achieve the public good, to actually do so, giving the impression that he would tend to favor limited government.[33] Furthermore, when outlining the general competencies of government, Smith is clear in his desire to restrict its functions to specific distinct tasks that fit

[32] (Pgs. 184-185) Schumpeter, 1996

[33] WN IV. ii. 9

'according to the system of natural liberty,' of which 'the sovereign has *only* three duties to attend to'[34] (my emphasis).[35] If claims that Smith championed self-interest and put forward the rudiments of the efficient market hypothesis and equilibrium theory are misguided, his association with Laissez Faire is perhaps more justified.

Smith was no ideologue however, and as we have seen is typical of his method of inquiry and rhetoric, WN does not seek to provide a comprehensive generalizing account of Laissez Faire. The dialectical style, which distinguishes his thinking from neoclassical analysis, also helps shield him from making extreme Laissez Faire claims. While Smith does place special emphasis on the importance of the functions of the state operating within the context of the system of natural liberty, he nevertheless outlines on numerous occasions when state activity is necessary to ensure that the demands justice are met.

For example, he supports laws that regulate coinage and mint, facilitate temporary monopolies, cap interest rates, establish public schools and tax wool exports amongst others. Interestingly, he highlights the advantage of laws that oblige the owners, of town buildings to put in place protections between houses to prevent

[34] IV.xi. 51

[35] In putting forward his most theoretical and comprehensive account of the role of the state in the last book of WN, Smith describes its functions as threefold. First of these is the state's responsibility to protect its citizenry 'from the violence and invasion of other independent societies.' This sits comfortably with the laissez faire doctrine. Second of these competencies is 'the duty of establishing an exact administration of justice.' As is seen throughout WN, this involves varying degrees of intervention in different contexts, from the workplace, to currency, to foreign trade. Smith's Laissez Faire views encountering qualifications. Finally, the state has an obligation to take ownership over the 'erecting maintaining certain public institutions and certain public works.' This involves public goods such as roads, bridges and canals but schools and post offices. While Smith makes clear that his vision of government is more limited than that which he sees around him, it is notable that these three core general principles (and the latter two, in particular) fit comfortably with contemporary western states across the spectrum, from the more socially orientated Scandinavian nations to those which embrace a more limited form such as the United States. There is little to be found in Smith's general principles, therefore, that give us reason to believe that Smith to believed in an extreme version of Laissez Faire, a paradigm that would have been unlikely to include the third function.

the spread of fire, evoking anticipations of the contagious nature of crises.[36] In his classic account of the subject, Viner considers whether WN contains a generalizing doctrine of Laissez Faire:

> 'The Wealth of Nations, though it was from one point of view only a segment of a larger and systematic treatise on social philosophy, was at the same time a tract for the times, a specific attack on certain types of government activity which Smith was convinced, on both a priori and empirical grounds, operated against national prosperity, namely, bounties, duties, and prohibitions in foreign trade; apprenticeship and settlement laws; legal monopolies; laws of succession hindering free trade in land. Smith's primary objective was to secure the termination of *these* activities of government. His wider generalizations were invoked to support the attack on *these* political institutions'.[37]

Indeed, that Smith's views relating to international commerce contrasted starkly from his attitude toward workplace regulation and, in particular, financial regulation strongly supports Viner's thesis.

Smith's application of laissez faire principles to certain circumstances but not to others might appear illogical or inconsistent. There are however, two reasons for this. First, he limits perhaps the primary case for laissez faire, by frequently highlighting examples that show that social order can naturally lead to sub-optimal outcomes.[38] If events, when left to play out without interference by the state, often tend to undermine general welfare rather than augment it, then the central supposition of the laissez faire doctrine seems to fall. It is reasonable therefore, according to

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[36] II.ii.94

[37] (Pg. 218) Viner, J. 1927

[38] ibid

Smith, for the state to intervene upon occasion in order to ensure the common good is realized.

The second cause for divergence between Smith's thinking and the Laissez Faire doctrine relates to the empirical tradition in which he developed his thinking and normative convictions he held regarding the plight of the disadvantaged. A philosopher associated with the common sense tradition, Smith saw that regulations sometimes had the capacity to help the poor. While many laws were designed to help the privileged few (in particular mercantilist policies) at the expense of the many, others, that regulated work practices and finance for example, could have the inverse effect. What guides Smith's assessment of the usefulness of government intervention is not only the manner by which it affects natural liberty, but how he made sense of its impact on the people around him. Consider the workplace, for example. Smith felt that laws pertaining to employment tended to favor employers.[39] In principle however, he thought that regulations that were 'in favour of the workmen', were 'always just and equitible' but 'sometimes otherwise when in favour of the masters.'[40]

This raises an important question about the context in which Smith was writing. Would Smith would have extended his views on state intervention in the 18th century to the 20th century? Before the advent of universal franchise and the age of mass politics, the activities of the state could reasonably be presumed to largely favour the wealthy voting constituency, rather than the poor, who had little political power. Indeed, Smith's advocacy of laissez-faire was grounded in a desire to help the

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[39] 'The masters, being fewer in number, can combine much more easily; and the law, besides, authorizes, or at least does not prohibit their combinations, while it prohibits those of the workmen. We have no acts of parliament against combining to lower the price of work; but many against combining to raise it'. WN I viii (12)

[40] (pg 163) WN I x.ii

many who lived on low wages by cutting the prices of food. Universal suffrage reoriented the political economy of the state, such that its beneficiaries are now often those very same people that Smith sought to defend, providing social security, healthcare, education. If his advocacy of laissez faire was based, not only on a abstract beliefs about how the world worked, but on common sense attempts to understand the influence that institutions were having on the people he was observing around him, as it appears to be, it is unlikely that Smith would see the need for laissez faire reforms today in the way he did over two centuries ago.

VI. A Very Melancholy Situation: Smith and Finance

The final section aims to show the relevance today of Book II of WN in the wake of the FC. While Keynes's *General Theory* is generally placed in its historical context as a response to a great financial crisis, the same cannot be said of Smith's writings on monetary theory in WN. With the exception of broad historical associations between its publication and the beginning of the industrial revolution, the economic environment in which WN was written is rarely given a great deal of attention in the voluminous references to his work. The consideration, in particular, that Scotland was experiencing both a remarkable and turbulent period of financial innovation, which may have influenced Smith, has until recently largely been overlooked.[41] The lack of attention to the financial context of Smith's writings is surely attributable to the subsequent fossilization of Smith's quite historically specific views on money and its seeming irrelevance to the contemporary financial system –

[41] For an interesting analysis of the evolution of Smith's views see; Checkland (1975), Gherity (1994) and Rockoff (2009).

with discussion of 'small bills' and distinctions between 'real' and 'fictitious' money - making it difficult to extract principles of relevance to the recent crisis.[42] However, while Smith was writing at a time when the financial architecture underpinning the economy was only beginning to resemble the contemporary fiduciary system, the underlying motivation for the regulatory measures that Smith proposes highlights his concern for phenomena that continue to plague the financial system today and which many claim played a prominent role in the FC.

In seeking to regulate the excesses of finance, Smith emphasized the utility of two state interventions in particular.[43] First, he supported the use of usury laws, advocating the imposition of a ceiling on the interest rate.[44] This view is grounded in the association between the risk of a loan and the premium that it demands (high interest rates will only be demanded of particularly risky loans): If 'the legal rate of interest' was left 'so high as eight or ten per cent.', argued Smith, then 'the greater part of the money which was to be lent, would be lent to prodigals and projects, who alone would be willing to give this high interest rate'. According to Smith, the price mechanism in the market for money would poorly allocate resources if left unregulated, failing to put capital to its most productive use.[45]

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[42] As Laidler (1981) has noted, Smith failed to leave a lasting impression on financial economics.

[43] Smith advocates other regulations, for example that wages should be paid in money, rather than in kind (I.x.ii.61) or that coins should be stamped (I.iv.8), which are less relevant to this particular discussion.

[44] 'In a country, such as Great Britain, where money is lent to government at three per cent. And to private people upon good security at four, and four and a half, the present legal rate, five percent., perhaps, as proper as any' WN II. iv. 13.

[45] It is interesting that Smith's support of usury laws represents a remarkably fundamental critique of the usefulness of the price mechanism in the financial economy. While arguments that seek to separate 'High Street' banking from 'Wall Street Banking', are grounded in fears that risk may be inappropriately borne by people who merely wish to keep their money safe, they do not question the basic functioning of the price mechanism. Here, on the other hand, Smith is claiming the allocation for money is uniquely unsuited to the price mechanism. This skepticism, foreshadows the work of Keynes and contemporaries such as Robert Shiller.

Smith's emphasis on the utility of usury laws in mitigating loans to finance prodigals' consumption is striking, given that many accounts of the crisis place the development of finance-driven-consumption at the heart of the explanation of the FC. Indeed, his clear distaste for such practices, places him quite immediately at odds with those who advocated financial innovation as a means to alleviate the stagnation of US workers' wages.[46] Though this is largely put forward as a conservative explanation of the FC, it nevertheless conflicts with quite fundamentally with the reductionist permanent income hypothesis (a neo-classical doctrine associated with right leaning economists), and anticipates the Keynesian view that individuals are capable of making rather irrational decisions in the financial markets. As Smith argues '[t]he man who borrows in order to spend will soon be ruined, and he who lends to him will generally have occasion to repent his folly.'[47] That Smith allows for financial agents' voluntary self interested actions to be welfare diminishing, unambiguously separates him from those advocating laissez faire financial capitalism.

The second state intervention in financial markets advocated by Smith is a prohibition on the distribution of 'small bills' (paper money representing small value). Although the law makes little sense today given the legitimacy the state now holds in backing certified legal tender, Smith's view is nevertheless motivated in large part by a remarkably contemporary concern. As Gherity argues:

> 'In essence, he argues that small notes are more risky than large notes because the ability to issue small notes encourages "many mean people" to become bankers and because people are not as careful about accepting

[46] Rajan (2010) has put forward this account in Fault Lines.

[47] WN II. Iv. 2

> small notes issued by persons of doubtful credit. Poor people in particular are hurt by the frequent bankruptcies of these "beggarly bankers."'[48]

Just as Gleass-Steagall sought to separate conventional "High Street" banking from "Wall Street" due to the higher risk entailed in investment banking, Smith believed that the proliferation of small bills would engage the public with excessive risk that they were not well placed to assume.

The parallels between Smith's monetary theory and the analysis that has been put forward in response to the FC run deeper, however. Commentators highlighting the danger of banks considered 'too big too fail' are echoing prescient concerns put forward to by Smith.

> 'The late multiplication of banking companies in both parts of the United Kingdom, an event by which many people have been much alarmed instead of diminishing, increases the security of the publick. It obliges all of them to be more circumspect in their conduct, and, by not extending their currency beyond its due proportion to their cash, to guard themselves against malicious runs, which the rivalship of so many competitors is always ready to bring upon them. It restrains the circulation of each particular company within a narrower circle, and reduces their circulating notes to a smaller number. By dividing the whole circulation into a greater number of parts, the failure of any one company, an accident which, in the course of things, must sometimes happen, becomes of less consequence to the publick. This free competition too obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away. In general, if any branch of trade or any division of labour, be advantageous the free and more general the competition, it will always be more so.'[49]

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[48] pg. 435 (1994)

[49] WN II.ii

If Smith tended to favor laissez faire policies, he made an exception for the financial sector more than any other, advocating not just ‘tweaks’, but fundamental adjustments to the price mechanism. The broad correspondence between Smith’s view of finance and the Keynesian perspective, which has dominated critiques of the FC, is interesting. The financial world, according to Smith, is one dictated by the ‘fortune, probity and prudence’ of bankers, embroiled in uncertainty and mystified by complexity.[50] It is a world inhabited not only by prudent investors, but also by prodigals and projectors determined to redirect society’s resources to their wasteful endeavors. Smith’s financial actors are dictated not by “animal spirits” of the sort emphasized by Keynes and his disciples however. Rather, they are guided by more distinctly human sentiments -prudence, avarice, pride, anger, sympathy, self-love. For Smith, in contrast to most economists writing in the twentieth century, saw the multidimensional nature of the human spirit as a tool of understanding rather than a hindrance in model building.

VII. Conclusion

When Adam Smith passed away in the summer of 1790, he left the world with a reputation ‘as a sort of subversive’, ‘a friend of French philosophy,’ an inspirer, even, of the French revolution.[51] Smith was a moral philosopher who had turned his hand to political economy “in order to pass away the time” and in doing so had put forward a sweeping treatise that sought the overthrow of the prevailing mercantilist

[50] WN II x.28

[51] Rothchschild, E. 1992.

regime. A radical, Smith's arguments were motivated, above all else, by concern for the poor.[52]

His work has since come to be seen, however, as much more than an eighteenth century polemic. Not only is he now regarded as the founding father of modern economics, he is considered, perhaps more importantly, to be the great protector of its contemporary epistemology and moral foundations. Smith the reformer, writing at the dawn of the revolutionary age, has quietly transformed into one of the most conservative defenders of the late twentieth century's economic institutions. His reputation has become embroiled in the FC and the fundamentalist laissez faire economic thinking thought to have precipitated it. He has become synonymous with a brand of political and economic ideology that caters to the wealthy, is institutionally conservative and suspicious of programmatic efforts to achieve social justice; an armchair philosopher for big business, periodically rolled out to defend capitalism whenever its ugly underbelly comes under fire from liberals and socialists. Adam Smith, according to this view, could never be a friend of the poor and on no account the enemy of big finance.

It is argued here that the popular portrayal of Smith today is misunderstood. Economics has advanced a great deal since Smith wrote WN, but in its pursuit of objectivism and scientific status, it is has carelessly, perhaps, abandoned some of the most important and interesting aspects of his work. Smith did not champion or put forward a theory of self-interest, nor did he hold fundamentalist views on laissez faire or see the world as being ubiquitously guided by a benevolent invisible hand. Rather, he recognized that self-love existed and could be useful, that regulations were often

[52] For a discussion of this, see Sen (2011)

harmful and that some degree of natural order existed in the economy, but refrained from strong generalizations of the kind common in economics today. Indeed, that which distinguishes him most from contemporary economics, his dialectical style of argumentation, his careful analysis of history, allowed him to meticulously fit big social theories into a complex world.

Smith's work did not motivate the economic thinking that led to the FC. Had he been read more closely, not only would this be clear to economists, his ideas might also have helped avert the crisis.

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