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# Is a Beautiful System Dying? A Possible Smithian Take on the Financial Crisis and its Aftermath

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## Is a beautiful system dying?

### A possible Smithian take on the financial crisis

*Maria Pia Paganelli*

Adam Smith is often considered the father of capitalism or a passionate promoter of free markets. The invisible hand of self-interest generates prosperity everywhere it is left to work without interference. But then we have 2008. The financial system of the United States seems to break down. All major European economies struggle to remain above water. Iceland, praised for its embrace of free markets in the last few decades, goes down. Alan Greenspan is cited over and over again saying that markets have failed, and nobody knows why. Adam Smith is wrong!

But is Adam Smith wrong? Or is the caricature of Smith wrong?

In this paper I show that Adam Smith is indeed right, even if his caricature is not. The reading of Smith that I present here does not make him seem an optimistic describer of a providential order moved by an always-successful invisible hand. Rather, I will present some of the more pessimistic analyses of Smith, which, unfortunately, seem to be most appropriate to describe and analyze our current affairs. This reading of Smith may provide an explanation for the events that started in the fall of 2008. I fear that the pessimism that one can read in certain parts of Smith may apply to today's situation.

To show how we can look at the financial crisis of today with Smithian tools, I will focus only on a few relevant stylized facts, without any pretence of completeness. Homeowners and other borrowers took on loans too big to be repaid. Accounting frauds generated large profits for some at the expense of many. Many banks and institutions grew too big to fail. And the attempts to mitigate the breakdown of the system generated a large amount of public funds available for grabbing. Smith, in his own time, described this combination of factors which today have weakened the commercial system to a worrying degree.

The 'beautiful system of natural liberty' that Smith describes is a system that may be achieved only under rare circumstances. Smith recognizes systematic biases in human behaviours, ranging from overestimation of probability of success to almost blind admiration for the rich. He recognizes the dangers of concentrated interests. He recognizes the fundamental role of justice and morality in a well-functioning society, so that laws should serve the general population, not the interest of a few at the expense of the many.

Smith makes a few policy recommendations, suggesting that the beautiful system that results from human actions but not human design would be threatened otherwise. Dismissing or failing to recognize its potential weaknesses may lead to it crumbling into ruins.

With this I am not claiming that Smith does not believe that a natural system of liberty is not possible at all. But simply that its achievement is not to be taken for granted. Smith does present the idea of a natural system of liberty which develops with and allows for the further development of economic growth. This point is well known and does not need to be challenged or developed further here. In fact, the strength of Smith's claim is notorious. Smith notices that our nature is not perfect. Perfection is not to be expected for individuals and for institutions. Our bodies are not perfect, and do not need to be perfect for us to live relatively well. Similarly, our institutions are not perfect and do not need to be perfect to direct us toward the natural system of liberty. We are able to achieve an economic system that leads to prosperity and liberty even with our imperfect means. This point has recently been made by Tony Aspromourgos (2009: 245), who claims that 'Smith expresses here a conviction that even under second-best (or worse) constitutions, regimes, and policies, "nature" is still in play, working away for the good'. Smith indeed tells us that:

Some speculative physicians seem to have imagined that the health of the human body could be preserved only by a certain precise regimen of diet and exercise, of which every, the smallest, violation necessarily occasioned some degree of disease or disorder proportioned to the degree of the violation. Experience, however, would seem to show that the human body frequently preserves, to all appearance at least, the most perfect state of health under a vast variety of different regimens; even under some which are generally believed to be very far from being perfectly wholesome. But the healthful state of the human body, it would seem, contains in itself some unknown principle of preservation, capable either of preventing or of correcting, in many respects, the bad effects even of a very faulty regimen. Mr. Quesnai, who was himself a physician, and a very speculative physician, seems to have entertained a notion of the same kind concerning the political body, and to have imagined that it would thrive and prosper only under a certain precise regimen, the exact regimen of perfect liberty and perfect justice. He seems not to have considered that in the political body, the natural effort which every man is continually making to better his own condition, is a principle of preservation capable of preventing and correcting, in many respects, the bad effects of a political economy, in some degree, both partial and oppressive. Such a political economy, though it no doubt retards more or less, is not always capable of stopping altogether the natural progress of a nation towards wealth and prosperity, and still less of making it go backwards. If a nation could not prosper without the enjoyment of perfect liberty and perfect justice, there is not in the world a nation which could ever have prospered. In the

political body, however, the wisdom of nature has fortunately made ample provision for remedying many of the bad effects of the folly and injustice of man; in the same manner as it has done in the natural body, for remedying those of his sloth and intemperance.

(WN IV.ix.28)

The parallels between our natural body and the living body of society are frequent. But they are not always as upbeat. Our body can get sick. And bad policies can make a social and economic body sick. They can even kill it.

The whole system of her industry and commerce has thereby been rendered less secure [by the monopoly of the colony trade]; the whole state of her body politick less healthful, than it otherwise would have been. In her present condition, Great Britain resembles one of those unwholesome bodies in which some of the vital parts are overgrown, and which, upon that account, are liable to many dangerous disorders scarce incident to those in which all the parts are more properly proportioned. A small stop in that great blood-vessel, which has been artificially swelled beyond its natural dimensions, and through which an unnatural proportion of the industry and commerce of the country has been forced to circulate, is very likely to bring on the most dangerous disorders upon the whole body politick. The expectation of a rupture with the colonies, accordingly, has struck the people of Great Britain with more terror than they ever felt for a Spanish armada, or a French invasion. ... The blood, of which the circulation is stopt in some of the smaller vessels, easily disgorges itself into the greater, without occasioning any dangerous disorder; but, when it is stopt in any of the greater vessels, convulsions, apoplexy, or death, are the immediate and unavoidable consequences.

(WN IV.vii.c.43)

Smith seems, therefore, to be both optimistic and pessimistic about the power of nature to generate and sustain a healthy natural system of liberty. On the one hand, nature seems to be powerful enough to allow us to achieve it, however imperfectly. On the other hand, there is nothing that can guarantee the emergence or sustainment of an economic system that generates and maintains prosperity and freedom. History indeed seems to show how rare that emergence is and how difficult its maintenance is. It may not be an accident that Smith was over-pessimistic regarding the possibility of eliminating restrictions from the inland trade in Britain and about the voluntary emancipation of slavery. It turned out that he was wrong, but, nevertheless, he had little reason to be otherwise.

The tendency toward the development of an order of natural liberty, for Smith, is not necessarily linear, or necessary at all. Human history is convoluted and its path zigzags. The natural system of liberty interacts with accidents of history, as well as all of our natural yet at times destructive

human passions. Pratap Bhanu Mehta (2006: 255) may be right when he states that

The bulk of *The Wealth of Nations* is devoted to the thought that for much of their history human beings have not acted on their interests; at least, they have set up systems of regulation and restraints such that only the interests of a few were served. Most important ... the interests of humans are in conflict. For Smith, there is in a sense, nothing natural about the 'system of natural liberty'. If mankind had by degrees, unevenly and uncertainly, emerged from tutelage, it was less of a testament to the power of interest than to unanticipated consequences of actions or to fortuitous combinations of interests.

Smith indeed points out that the system of natural liberty in a sense is not that natural. That is, that what is natural is not the norm. For example, in the introductory chapter of Book III of the *Wealth of Nations*, titled 'Of the Natural Progress of Opulence', Smith explains the 'natural order of things' that brings the progress of opulence to different countries. 'The cultivation and improvement of the country, therefore which affords subsistence, must necessarily, be prior to the increase of the towns, which furnishes only the means of conveniency and luxury' (WN III.i.2): exactly the opposite of what he illustrates in chapter 4, 'How the Commerce of the Towns Contributed to the Improvement in the Country'. In fact, three of the four chapters of Book III tell the story of how the natural order of things was inverted! Smith explicitly warns his readers of this inversion of the natural course of things at the end of the first chapter: 'But though this natural order of things must have taken place in some degree in every society, it has, in all modern states of Europe, been, in many respects, entirely inverted' (WN III.i.9).

Joseph Cropsey (2001 [1957]: 73) describes this idea in the following way:

there is nothing in the nature of things which will or might 'inevitably' lead to the coming into being of the natural or the most expedient social arrangement, indeed since history is not the rational expression of nature but in principle may conflict with nature, there arises the need for a statement of the strictly natural, which of course is the substance of the *Wealth of Nations*, a book that delivers the truth about nature.

It is possible therefore to read current events as being in conflict with and threatening the development of the natural system of liberty that Smith describes.

The paper develops as follow. In the next section I present the problem in the loan markets generated by what Smith would have described as our systematic overestimation of the probability of success. The analysis of the motivations that lead us to big commercial frauds follows. The third section describes how Smith envisions a stable decentralized banking system, a vision

that is absent today. The fourth section describes the major threat for Smith's time and ours, the power of lobbies. A section on the solutions that Smith proposes, which unfortunately are weak, is followed by some conclusions.

### Overestimation of the probability of success

Today's financial crisis is often attributed to excess lending. Adam Smith, too, worried about problems in lending markets. For Smith, a properly functioning lending market has to take into account some characteristics of human behaviour. Smith worried that if lending practices are based on an assumption of human behaviour that is different from actual behaviour, lending markets will not function properly and will therefore cause a misallocation and/or destruction of resources rather an increase in them. The problem described by Smith is unfortunately, in part, what we experience today.

For Adam Smith, human beings are systematically biased. In particular, any man in reasonable health would overestimate his probability of success. It is 'the presumptuous hope of success [that] seems to act here as upon all other occasions' (WN I.x.b.33) that causes miscalculation of the probability of success. A man thinks others may fail, but not him. He will therefore overestimate the probability of his success and underestimate the probability of his failure.

The over-weening conceit which the greater part of men have of their own abilities, is an ancient evil remarked by the philosophers and moralists of all ages. Their absurd presumption in their own good fortune, has been less taken notice of. It is, however, if possible, still more universal. There is no man living who, when in tolerable health and spirits, has not some share of it. The chance of gain is by every man more or less over-valued, and the chance of loss is by most men under-valued, and by scarce any man, who is in tolerable health and spirits, valued more than it is worth.

(WN I.x.b.26)

This implies that any project that has a probability of failure that is more than zero would be incorrectly seen as a potential success in the eyes of its proposer. Smith explains the 'irrational' decision of going into certain high-risk professions in terms of this systematic overestimation of success. For example, people who decide to get into smuggling are attracted by the high rate of profits of the successful smugglers and underestimate the very high rate of failure of this profession. They seem to think that the high probability of failure applies to others, not to themselves (WN I.x.b.33). Similarly, gamblers persist in their failures because they systematically overestimate their good luck. Lotteries are, for Smith, a basically sure form of revenue for the state (WN I.x.b.27) exactly because of this reason. Markets where risk is involved,

such as the lending market, are markets that have to deal with this systematic perception bias (Bentham 1952 [1787]).

I do not think it is accidental that Smith proposes regulation in the lending market (Paganelli 2003). If a borrower systematically overestimates his probability of success and he is wrongly convinced he will be able to repay his debt, the lending market may have a problem: too many loans that will not be repaid may be given out. This is particularly true when the lender is lending out someone else's money. And if we add a potential reward for each loan given out, and a lack of punishment in case of failure to get the loan repaid, the problem of moral hazard not only emerges but lacks any obvious remedy.

For Adam Smith, an economic system that disregards, or even worse promotes, the systematic perception bias of our probability of success is a system that can neither prosper nor last.

### Overweight on wealth

The second problem we hear blamed for today's crisis seems to be financial fraud. Ponzi schemes, insider trading, creative accounting, or questionable practices are so often in the news that it seems that the success of markets is just an illusion. Smith, again, warns us against fraudulent practices because they may undermine the system of natural liberty of which he is so fond.

Smith believes that mankind is driven, among other things, by the desire to receive the approbation of others. We receive approbation in two ways: by behaving morally and by parading wealth. Wealth glitters while virtue is modest. That is to say that wealth is easily recognizable, while virtue is not. An increase in wealth, like an increase in virtue, generates approbation. A decrease in wealth, like a decrease in virtue, generates disapprobation. But because we can easily see the wealth, and we can recognize virtues only with difficulty, a large increase in wealth would generate more approbation than the approbation lost due to the immoral means used to generate that wealth (Paganelli 2009). Smith indeed tells us:

We frequently see the respectful attentions of the world more strongly directed towards the rich and the great, than towards the wise and virtuous. We see frequently the vices and follies of the powerful much less despised than the poverty and weakness of the innocent. ... Two different roads are presented to us, equally leading to the attainment of this so much desired object [respect and admiration of mankind]; the one, by the study of wisdom and the practice of virtue; the other, by the acquisition of wealth and greatness. Two different characters are presented to our emulation; the one, of proud ambition and ostentatious avidity; the other, of humble modesty and equitable justice. Two different models, two different pictures, are held out to us, according to which we may fashion our own character and behaviour; the one more gaudy and glittering in its colouring; the other more correct and more exquisitely beautiful in its

outline: the one forcing itself upon the notice of every wandering eye; the other, attracting the attention of scarce any body but the most studious and careful observer. ... The great mob of mankind are the admirers and worshippers, and, what may seem more extraordinary, most frequently the disinterested admirers and worshippers, of wealth and greatness.

(TMS I.iii.3.2)

In Part VI of TMS, Smith repeats the same claim: the great mob of mankind is more fascinated by the greatness of the rich than by the wise and virtuous, because the glitter of wealth is more visible and more easily recognizable.

[Our] fascination of greatness ... is so powerful, that the rich and the great are too often preferred to the wise and the virtuous. ... The undistinguishing eye of the great mob of mankind can well enough perceive the [plain and palpable difference of birth and fortune]: it is with difficulty that the nice discernment of the wise and the virtuous can sometimes distinguish the [invisible and often uncertain difference of wisdom and virtue].

(TMS VI.ii.1.20)

Indeed 'the same principle' that makes 'the great mob of mankind ... look up ... with a wondering ... and foolish admiration' at 'wealth and greatness' makes us admire the success of great conquerors. We do not distinguish between 'such splendid characters as those of a Caesar or an Alexander ... [and] that of the most brutal and savage barbarians, of an Attila, a Gengis, or a Tamerlane' because they are all successful (TMS VI.iii.30).

So Smith gives a description of the incentives to commit *large* financial frauds: the gains in approbation from the increase in wealth are more than the losses generated by the decrease in virtue. In TMS I.iii.3, a chapter titled 'Of the corruption of our moral sentiments, which is occasioned by this disposition to admire the rich and the great, and to despise or neglect the persons of poor and mean condition', and written after the completion of the *Wealth of Nations*, Smith tells us that

The candidates for fortune too frequently abandon the paths of virtues ... They often endeavour, therefore, not only by fraud and falsehood, the ordinary and vulgar arts of intrigue and cabal; but sometimes by the perpetration of the most enormous crimes, by murder and by assassination, by rebellion and civil war, to supplant and destroy those who oppose or stand in the way of their greatness.

(TMS I.iii.3.8)

We have a plausible explanation for why financial scandals are in the billions of dollars rather than just in the hundreds. Smith seems to indicate that this kind of behaviour is more observable where there are large 'profit'

opportunities. A poor society does not have the opportunity to generate as many incidents like these, simply because there is not much to possess. But when we have a large economic expansion, probably starting from a real change such as the IT revolution, we have large opportunities for monetary gain. Everybody is making millions. Why aren't you?

If we take Smith's argument seriously, is our economic situation sustainable? Are laws and regulations really enough to constrain our innate desire to receive the approbation of others, even if that implies doing the wrong thing? Are stricter laws really going to prevent another Madoff from arising if the opportunity for material gains is so large? Or does our wealthy system contain the seeds of its destruction, since trust in other individuals as well as in institutions and in the system itself will eventually crumble, as many accusations we hear today seem to indicate?

### Overconcentration of banking

A third factor that seems to have challenged the stability of the system before the fall of 2008 is the presence of banks and financial institutions that are too big to fail. When we read what Smith considers a successful banking system, we read the opposite of what we observe today. For Smith, a successful banking and financial system is a system composed of many small banks rather than few large banks. Smith's rationale is the following.

Banks may be short-sighted and may have the tendency to over-issue credit to try to increase their profits (WN II.ii.43). So not only are creditors, because of their overestimation of the probability of their success, tempted to ask for over-issuing of credit, as we saw above, but banks are also tempted to over-issue credit.

In addition, Smith tells us that certain commercial activities may have high profits. When they do, they attract merchants' attention. Merchants ask for money to participate in these profitable trades. But as more and more merchants enter these markets, profits are eaten away (over-trading) and with them the resources to pay the banks back (over-issuing). When wise banks reject a credit extension, traders use 'shift of drawing and redrawing' to raise the money used to over-trade (WN II.ii.65). That is to say, 'over-trading of some bold projectors ... was the original cause of ... excessive circulation of paper money' (WN II.ii.57). This story is not that different from what we have read in the newspapers in the past few years.

Over-issuing of credit for Smith is dangerous. Banks have to be ready to fulfil their obligation at all times. But if they over-issue, they might not be as ready. And if they signal hesitation or difficulties, they might generate bank runs (WN II.ii.48). Furthermore, if a bank that has over-issued tries to fulfil its promises, it faces an outflow of funds larger than its inflow. The acquisition of reserves to fulfil its demand might quickly become very expensive. It is therefore in the bank's interest not to over-issue, because, to keep its coffers ready, it would have to spend what it would gain, if not more, by over-issuing.

And the bank, losing profits, would decrease the amount of issuing (WN II.ii.49–51). The implication is that neither merchants nor banks should over-issue, as it may bring all into bankruptcy.

But this does not prevent banks from over-issuing (WN II.ii.41–87). One reason for over-issuing, besides the problems just mentioned, says Smith, is the bank's ignorance – banks do not always understand what they are doing and what is best for them (WN II.ii.53). Indeed Smith tells us more than once that 'every particular banking company has not always understood or attended to its own particular interest, and the circulation has frequently been overstocked with paper-money' (WN II.ii.56).

Smith explains that banks may not understand what they are doing because projectors fool banks when traders draw and redraw upon one another. If they do it from the same banks, the bank may realize what is going on. But traders use different banks, and might add more projectors to the circle. Distinguishing between a 'real bill of exchange' and a 'fictitious' one becomes more difficult. And when a banker realizes he is discounting 'fictitious bills', it is too late (WN II.ii.72). Additionally, banks, like everybody else, tend to overestimate their probability of success and underestimate their probability of failure. They tend to overestimate the inflow of money and underestimate their outflow (WN II.ii.76). This, again, is not a story unique to the eighteenth century....

Smith seems to maintain an optimistic attitude as long as there are *many small* competing banks, as competitive markets are generally good teachers (Cowen and Kroszner 1994; White 1995). Many small competing banks should be able to constrain the tendency to over-issue because if depositors fear over-issuing, they can withdraw their deposits and bring them to more prudent banks. Additionally, and most importantly, the advantage of competing banks is that they are many and small. This means that if one of them fails because its behaviour was indeed imprudent, the effects will be limited. The consequences of the failure of a small bank will be small, unlike the potentially catastrophic consequences of the failure of a big bank (Paganelli 2006).

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 those malicious runs, which the rivalry 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.

(WN II.ii.106)

So a bank should fail, if it behaved imprudently. The bankruptcy of a bank is a very powerful lesson to its banker and to other banks. By allowing a bank to fail, the market teaches its participants what should be done and what should not be done. Once banks understand what they have 'not always understood', they will not over-issue. And because every man is driven by his desire to better his condition, there is no reason to believe that banks will forever 'not attended to [their] own particular interest' (Skaggs 1999). Unfortunately, this face of the market does not seem to be allowed to show itself today. If we are not learning from our mistakes, can we ever learn at all?

Perhaps even if there is a possibility of learning from our mistakes, David Hume (1985 [1752]: 363) was correct when he claimed:

So great dupes are the generality of mankind, that, notwithstanding such a violent shock to public credit, as a voluntary bankruptcy in ENGLAND would occasion, it would not be long ere credit would again revive in as flourishing a condition as before. ... And though men are commonly more governed by what they have seen, than by what they foresee, with whatever certainty; yet promises, protestations, fair appearances, with the allurements of present interest, have such powerful influence as few are able to resist. Mankind are, in all ages, caught by the same baits: the same tricks, played over and over again, still trepan them.

### Lobbying

Another factor that Smith sees as fundamental for the sustaining of a system of natural liberty is a functioning system of justice. This, for Smith, implies that the laws that are passed are laws that favour the majority of the people, not just a small group. If that is not the case, the system of justice becomes a system of monstrous injustice, poisoning the beautiful system of natural liberty.

We are indeed told in TMS that 'Sometimes the interest of particular orders of men who tyrannize the government, warp the positive law of the country from what natural justice would prescribe' (TMS VII. iv.36), and in WN that

To hurt in any degree the interest of any one order of citizens, for no other purpose but to promote that of some other, is evidently contrary to that justice and equality of treatment which the sovereign owes to all the different orders of his subjects.

(WN IV.viii.30)

But, unfortunately this is exactly what some great merchants and manufacturers do when there are large profit opportunities generated by government-granted monopolies. A system of justice, when taken over by

lobbies, degenerates. The government grants favours to organized interests at the expense of the rest of society, causing the most severe injustices:

The cruellest of our revenue laws, I will venture to affirm, are mild and gentle, in comparison of some of those which the clamour of our merchants and manufacturers has extorted from the legislature, for the support of their own absurd and oppressive monopolies. Like the laws of Draco, these laws may be said to be all written in blood.

(WN IV.viii.17)

Smith indeed accuses big merchants and manufacturers of conspiring against the public, explaining that they are 'an order of men whose interest is never exactly the same with the public, who generally have an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it' (WN, I.xi.10).

The virulent dangers of lobbying are many, such as, but not limited to, those in WN, IV.i.10: IV.ii.38; and IV.iii.c.10 (Stigler 1971; Evensky 2005). An additional source of worry for Smith is that lobbies are able to convince others that special organized groups are not enemies of society but defenders and promoters of the wealth of the country (e.g. WN IV.iii.c.13).

The cupidity of interest groups springs and grows the more wealth there is to grab through the protection of the government. And unfortunately this is what seems to be the case today, with the stimulus money. We have an undreamt of sum of money available for those who lobby the most.

### Solutions?

Is there hope, then? Or is the Western-style economic system as we know it about to become a part of history? Smith, in attempting to address the problems of his day, appeals to both the self-organizing forces of markets as well as to the feeble public spirit of the legislator. But if markets are suffocated by regulations, and if hell is indeed paved with good intentions, we are left with little hope to hold onto.

Commerce itself seems to be able to generate some remedies (WN IV.vii.c.47–54. See also Rosenberg 1990), as does our weak civic spirit (TMS IV.1.11). The legislator should not fall for the flattery of the lobbyists but should preserve the system of natural liberty out of reverence toward its beauty. Unfortunately, this seems to be just a dream.

The glimmers of wealth presented by organized interest groups seem to overwhelm political leaders, like everybody else.

The external graces, the frivolous accomplishments of that impertinent and foolish thing called a man of fashion, are commonly more admired than the solid and masculine virtues of a warrior, a statesman, a philosopher, or a legislator. All the great and awful virtues, all the virtues

which can fit, either for the council, the senate, of the field, are, by the insolent and insignificant flatterers, who commonly figure the most in such corrupted societies, held in the utmost contempt and derision.

(TMS I.iii.3.6)

Even if commerce seems to provide large enough benefits to compensate for its downsides, the damages of rent-seeking are going to last. Once privileges are granted, they will not be taken away. Indeed Smith is convinced that the 'formidable' powers merchants and manufacturers have 'intimidate the legislature' (IV.ii.43) so much that

To expect, indeed, that the freedom of trade should ever be entirely restored in Great Britain, is as absurd as to expect that an Oceana or Utopia should ever be established in it. Not only the prejudices of the publick, but what is much more unconquerable, the private interests of many individuals, irresistibly oppose it.

(WN IV.ii.43)

The damage great merchants and manufacturers inflict upon society is permanent (Tullock 1975).

That the system of natural liberty so much wished for is not the norm is confirmed by the different levels of growth that we observed. Smith tells us indeed that an economy that has been in an expansionary state may not be expansionary forever. It may become sedentary or even recede. North America, in Smith's time, was an example of an expansionary economy, China of a sedentary one, and Bengal of a declining one. The reason for these differences is, for Smith, based both on accidents of history and, especially, on differences in the quality of the government. When the government falls into the hands of interest groups an economy may very well decline:

The difference between the genius of the British constitution which protects and governs North America, and that of the mercantile company which oppresses and domineers in the East Indies, cannot perhaps be better illustrated than by the different state of those countries.

(WN I.viii.26)

All major forms of civilization eventually perished, either deliberately by human hands or inadvertently as a side effect of other events. If the feudal system and the temporal power of the church have been brought down by the silent revolution of commerce and the childish vanity of the nobles and the high clergy, why can't the capitalist system be brought down by the loud attacks of lobbies and the vanity of those who claim to have perfect knowledge of human rationality and to be able to control the economy and correct the 'mistakes' of the market?

It may very well be that, as Mehta (2006: 257) claims,

Establishing the 'system of natural liberty' under which every man is 'left perfectly free to pursue his own interest his own way' is thus for Smith a *task*, rather than something that comes naturally (WN IV.ix.51). The paradox is that the very motive, self-interest, that allows that system to produce the beneficial consequences it does, constantly threatens to undermine it. It is the pursuit of their interests that leads merchants to demand monopolies and privileges that harm society; yet, those very same interests can, under the right institutional conditions, produce beneficial outcomes. *The Wealth of Nations* is an account of how the interests of all might be harmonized, not a claim that they are always, or naturally, in harmony.

### Conclusions

Adam Smith describes the beauty of a natural system of liberty, which later has often been associated, correctly or not, with capitalism. This beautiful system of natural liberty is robust under certain conditions but fragile under other conditions, as Smith recognizes. It is robust in the sense that as a system that emerged spontaneously over centuries, it enjoys the strengths of a system that is not limited by the design of human reason. On the other hand, it is subject to shocks as a result of human hubris. The belief that we are better than everybody else, either because of our presumptuous hope of success or because of our vain parade of wealth, may lead us to disregard some structural foundations of the system of natural liberty, undermining it. Combining our systematic perception biases with perverse incentives that motivate us to disregard the precepts of justice and favour ourselves at the expense of others or of society may cause structural cracks to an otherwise solid system. Excess borrowing, excess lending, excess concentration in the banking industry, excess lobbying, and excess fraudulent activities are all worries that Adam Smith had for his time. And the same worries may apply to our time as well.

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