Lessons from the Economic Crises of 2008: how to manage a political solution?

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Abstract:

The main idea is that this crisis may have had a fundamental impact, a vision of the Kuhnian paradigmatic revolution, a Nozickian libertarian versus a Rawlsian vision, or an application of the Senian utilitarian principles in government programmes. The economy will be simultaneously the space of ethics and not just a form of social engineering. In fact, a genuine political science – this is the new escape clause – a redefinition of the capitalist system through a deeper spread of the founding trinomial (P, L, A) of International Organisations (IO), with a view to their greater coordination, and the EU acting with one single, but stronger, voice, as we witness a decline in the USA and simultaneously the affirmation of the BRIC countries at the heart of the G20.

In Section 1, we illustrate what is understood by a crisis; in Section 2, we contextualise this economic crisis by comparing it to previous ones; in Section 3, we seek to define the social impact of this crisis; in Section 4, an analysis is made of the political process underlying this crisis; finally, in Section 5, we propose alternative views of a solution that would prevent the recurrence of similar crises. To achieve this, we suggest the use of greater preventive supervision and the more efficient use of the following policy trinomial: proximity, legitimacy and accountability (P, L, A) in keeping with the logic of International Organisations (IO).

Keywords: Crisis 2008; Future of Capitalism; International Organisations; Proximity, Legitimacy, Accountability (P, L, A); Recurrence of crises; Preventive supervision.

Text presented at the Conference on "**Theoretical Production of the Next Future**"[2]

On 12-13 November 2009; Calouste Gulbenkian Foundation, Lisbon

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[1] Research Unit in Political Science and International Relations (NICPRI), FCT Centre funded by POCI 2010, Évora.

[2] I wish to thank all the participants at the conference for their comments. My special gratitude goes to Emanuel Leão, who, as a commentator on the text, helped me to make it more simple and incisive and to smooth out the rough edges. I also wish to thank Vanessa for re-reading the text.

1. INTRODUCTION: DEFINITION OF CRISIS

Although there is no overall agreement about the definition of the word crisis, there is, however, agreement about one basic aspect of the word crisis: crises tend to be inevitable and are recurrent. Or, in other words, a crisis always appears paradoxically as somewhat unexpected (for, if it were not so, it could have been avoided), but, once it has passed and the whole process has been disentangled, it tends to appear as something that was almost trivial and easily explicable.

A famous adage tends to associate the idea of crisis, in the Chinese pictographic language, with two images, which are simultaneously the idea of a threat and an opportunity. The simultaneous nature of these two ideas expresses the nature of a crisis. In turn, in his classic work on economic growth, Schumpeter (1911) tends to assess the crisis at its beginning through the idea of "creative destruction", a process that expresses the need for and the virtuosities of crises – when there is a recession, several companies will go bankrupt, but this makes it possible to create and release forces (labour, capital and others) for new uses – the key becomes innovation. Schumpeter is the master of innovation and what innovation meant for him could be a new product, a new process, a new market, in short, something new, but with economic value.

The question of economic value is not to be disparaged and there is a whole string of formal economic literature on the subject, rooted in macroeconomics but also with macroeconomic objectives. In this brief essay, I shall not go into detail about these principles, at least in formal terms, but as an economist with a basic neoclassical training, I shall have to touch upon this conditioning factor. Particularly because this paradigm shaped the way in which we looked at the 2008 crisis, and, according to some authors, it was in fact one of its causes and even one of its greatest exponents, as well as of its *modus operandi*.

We should remember that the defence of the market began with Smith (1776), but that even the father of economics, in that informal period, pointed to the need for the State to regulate some activities. In the wake of neoclassical and neoliberal thinking, Friedman (1998) defended the idea that the State, when it does something, either does not do so, should not do so or else does so badly. Hayek (1969) also follows this line of reasoning and promotes non-interventionism. Keynes (1936) formalised the need for the State to play the role of a spender as a way of escaping the liquidity trap. He was one of the first to formalise the need for the State to intervene, and today, with the current crisis, everyone claims to be Keynesian. Rather than pinning labels on people, or being hidebound by archaic economic atavisms, my idea is to explore a little the ideas of a crisis, its (in)evitability, the way in which we may learn something with each crisis and eventually, if this is the case and it proves possible, to extract some pattern from them.

Kindleberger (1996) wrote what was perhaps the most successful textbook on the nature of financial crises. Amongst other crises, he analysed the "tulip mania" that broke out in Flanders in the 16th century. He also wrote a financial history of the western world – Kindleberger (1993).

More recently, the historian Niall Ferguson (2008) updated Kindleberger's analysis and did, in fact, write a modern financial history, in which he searches for the origin of financial flows since Antiquity, passing through the Renaissance and relating the Ponzi schemes of John Law (a convicted murderer who ended up becoming more powerful than the king of France), and in which the cause of crises was always the motivation for earning more money. This idea of optimisation and the conditioned optimum ended up becoming established in economic theory. See the case of its greatest exponents − Stokey, Lucas and Prescott (1989), Sargent (1987), Ljungqvist and Sargent (2008). The idea of speculative bubbles was studied in formal terms by Flood and Garber (1994), while the inevitability of rational expectations, in which there was "perfect foresight", was applied to monetary theory by authors such as Farmer (1993).

There have always been diverging opinions amongst authors in the conventional analysis of economic theory and Sargent himself discussed the validity of rational expectations. Being one of its founding fathers, he wrote a book about the idea of "bounded rationality", originally defended by the Nobel Prize-winner Herbert Simon. This concept simply means that for a given space of parameters, the agent makes his calculations rationally, but after certain thresholds have been reached he ceases to behave rationally (or at least this rationality no longer leads him to make conventional calculations).

One of the most important factors in modern economic theory, which derives from the psychology, or rather the ethology, of the crowd is the so-called "herd behaviour". Agents tend to imitate one another: when some sell, the others also tend to sell and vice-versa. Curiously, there are key players in the market − Warren Buffet, one of the most successful magnates of the financial world, tends to say: "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful". It is in this expectation of anticipating the market that he gambles (and all the others follow him) on being the first to predict the turn in the market, but then everyone ends up imitating him.

There are also less conventional theories, namely those of the French mathematician Benoît Mandelbrot (1991), who applied fractal and chaos theory to financial markets (Mandelbrot and Hudson, 2006). Peters (1994) followed the same line of reasoning: the fundamental idea of chaos has to do with the sensitivity of the initial conditions in a dynamic system that is non-linear and deterministic; it is enough to slightly change the initial conditions for the predictions to change completely – it is similar to the effect of the butterfly that by fluttering its wings causes a typhoon on the other side of the Pacific Ocean.

To avoid being accused of not defining the term "crisis", it is enough, in technical terms, to mention that this can be understood as a **successive fall of the GDP over two or more quarters** or a fall in other variables, such as employment. What we are witnessing here is a form of tacit knowledge[3]: every economist considers this definition as their starting point for defining a crisis, a simple recession. This will be looked at in more detail, for the present crisis, in Section 4.

Rather than actually providing an exact definition of a crisis, my idea in this section has been to demonstrate that roughly 80 to 85% of conventional theoretical production is neoclassical and that this theory did not succeed in predicting or at least dealing with the crisis. It is not a question of imputing responsibilities to neoclassical theory, since its supporters include most of us, but rather of noting an important shortcoming in this theory. The different theories presented here seek to show that there are also other theories besides the neoclassical one ("herd behaviour", chaos and fractal theory) and that these can explain some of these peculiarities. This is the famous argument of the **black swan**. Nassim Taleb (2007) wrote a book about probability theory in which he discusses the likelihood of the highly improbable occurring. In short: because, until the end of the 19th century, nobody had ever seen a black swan, it was assumed that all swans were white, so that the chances of observing a black swan were highly improbable. When the first black swan was discovered in Australia and New Zealand, the highly improbable occurred, and it was demonstrated empirically and analytically that, due to the fact that there were no previous observations, the highly improbable can, in fact, occur. What does this have to do with the crisis? Our crisis did, in fact, have both an origin and an impact that were highly improbable, but it did actually occur.

2. CONTEXTUALISATION OF THE 2008 CRISIS

The 2008 crisis, contrary to what was to be expected, had precedents and some economists predicted what was to come, namely Nouriel Roubini[4], a more neoclassical author, and, from the other side of the political spectrum, Hyman Minsky. Many of my colleagues in the profession have argued that this crisis was foreseeable, since the speculation taking place in the property market and the so-called bubble were clearly documented in bank reports.

There is, however, something unusual about this crisis: the argument of moral risk and adverse selection. The problem is that the crisis was caused by a dreadful and shocking lack of information, a lack of coverage for the risk and failures in supervision. Joseph Stiglitz, the winner of the Nobel Prize for Economics in 2001 for his contributions (written in conjunction with Michael Spence and George Akerlof) towards a new branch of microeconomics, the information economy, argued that one of the causes of this crisis was the fact that the banks

[3] Borrowing from the text of Peter Hanenberg at this afternoon's session: "We know more than we can tell."

[4] In fact, he predicted that something was going to happen, but he did not say when, how or how much. My thanks to Emanuel Leão for this comment. However, we were faced with a situation of Knightian uncertainty and not one of risk, and perhaps it was for this reason that Roubini did not manage to respond to this triple challenge.

were “too big to fail”. Or, in other words, investment banks and insurance companies were operating on such a large and exaggerated scale that it would not be feasible for the capitalist system as a whole to accept their failure. Stiglitz argues that one of the ways of curing these malaises would be precisely to partition the banks and the insurance companies and divide them up into smaller agents.

The world was on the brink of a nervous collapse when the Lehman Brothers went bankrupt in October 2008. In his book *The Crisis and Beyond?*, Jacques Attali (2009) dedicates one of the chapters to the possible bankruptcy of the capitalist system and tries to diagnose the causes of its crises. Like Stiglitz, he stresses the excessive size of banks and insurance companies, and gives a few rather utopian suggestions for solving the crisis: world government with responsibility and worldwide legitimacy, and a world currency. Of course, utopias are always impossible to attain, but humankind has always lived from utopias. The 20th century was perhaps one of the centuries with most utopias: Nazism, Fascism, Communism, although it also witnessed the triumph of Capitalism.

Yet, while the capitalist utopia is one of the survivors of the 20th century, the beginning of the 21st century witnessed one of the worst crises in living memory. In the 20th century, the only comparable crisis was the one that took place in 1929. The major work of reference about this crisis is the book by Kenneth Galbraith (1972).

One of the most interesting aspects of the 1929 crisis and one of the most emblematic stories was that of John Rockefeller, who on the eve of the 1929 Crash went to have his shoes polished and, at a certain point, the shoeshiner, in the heart of Wall Street, began to explain to him the most advantageous investments. The immediate upshot was that Rockefeller sold all of his stocks, later explaining that if the shoeshiner already understood the stock market, then it was time for him to retire. This astuteness saved him from bankruptcy.

Abel Mateus (2009) describes the evolution of the crisis in detail, from its origins to the current situation. Braga de Macedo (2008) also describes the origins of the crisis and its transformation from a financial crisis into a state of genuine systemic panic.

Epistemology speaks to us of two types of science: normal science, in which a certain paradigm that is accepted as true is explored, and the scientific revolution, in which the paradigm is called into question – see Kuhn (1962). More than explaining the scientific method, this contextualisation allows us to state that the times of crisis that we are currently living through are, in fact, times of a systemic crisis, or, in other words, this is in fact a scientific revolution, in this case a revolution in economic, social and political science, in which what is being called into question is the real nature of the capitalist system. Calling paradigms into question is healthy and will certainly be one of the ways out of the crisis. The capitalist system that has emerged after the 2008 crisis is certainly a different one. Will it be richer? Will it be more immune to the occurrence of crises? What is the real role of the State? Friedman and Galbraith, both recently deceased, always had the dialectic tension of their opposition to the role of the State, an idea that has been perpetuated by their ideological heirs.

In their book *Animal Spirits*, Akerlof and Shiller (2009) paint the picture of the 2008 crisis. They begin by describing the strangeness of the boom in the property market, in which Shiller argues that, in the far-off days of 2006, he was at a wedding of a distant cousin, in Trondheim, in Norway, and that the latter had bought a (conventional) house for a million dollars! Shiller, *a posteriori*, says that this should have set alarm bells ringing and he should have realised that something was wrong in those Scandinavian lands and in the rest of the housing market. Basically, they argue that, with a little more perspicacity, they were obliged as economists to foresee that there was speculation in the property market. Furthermore, they later describe the whole process leading up to the collapse of both the American system and the world system. However, their fundamental contribution is that of using the idea of "animal spirits", a phrase coined by Keynes, characterising them through four variables: **confidence, fairness, corruption and bad faith, and money illusion**. The interaction between these variables is what explains the changes in the mood of economies, which in this way can justify the change in the fundamental values of economies. Akerlof and Shiller also enunciate eight fundamental questions for understanding "animal spirits" and the current crisis of 2008:

i) Why do economies fall into depression?
ii) Why do central bankers have power over the economy, insofar as they do?
iii) Why are there people who can't find a job?
iv) Why is there a tradeoff between inflation and unemployment in the long run?
v) Why is saving for the future so arbitrary?
vi) Why are financial prices and corporate investments so volatile?
vii) Why do real estate markets go through cycles?
viii) Why does poverty persist for generations among disadvantaged minorities?

Each of these questions is answered in the course of a whole chapter, with an analysis being made from the point of view of **confidence, fairness, corruption and bad faith, and money illusion**.

Krugman (2009) contextualises the 2008 crisis in the light of all the previous ones, the 1995 crisis in Mexico, the 1997 crisis in Asia, the 2000 crisis in Argentina, having previously announced the return of the depression economy.

We should, however, remember John Kenneth Galbraith's book *The Great Crash* (1972). The book concludes as follows: "When the military historian ends his chronicle he can rest. He is not asked to consider the possibility of a renewal of the war against the Indians, Mexicans or the Confederation. […] But the economy is taken more seriously. Thus, the economic historian is invariably called upon to say whether the misfortunes that he describes will afflict us again and how they can be avoided." (p. 279).

He further adds: "Since a speculative collapse can only follow a speculative boom, one might expect that Wall Street would lay a heavy hand on any resurgence of speculation." (p. 285). My own personal note: after this, in 1987, with a new serious crisis and with the implosion of the speculative bubble of the dot.com companies in 2000, more stock market crises arose. But none of them had anything near the consequences of the 1929 crisis.

Galbraith says that the crisis had an impact that lasted for 10 years. Beginning in 1930, it was not until 1940 that the American GDP recovered its pre-crisis level. In some years, unemployment rose as high as 30% of the active population, affecting 13 million economic agents, and, at other moments of the crisis, it oscillated around 8 million unemployed.

The book does, in fact, end with a warning to be prudent on the stock market: "The public would be warned sharply and often of the risks of buying stocks for the rise. […] As noted, all this might be logically expected. […] But now, as throughout history, financial capacity and political perspicacity are inversely correlated." (p. 286). I shall now return to the fundamental point with which I began this paper, the inevitability and recurrence of crises. The great novelty of this 2008 crisis was its systemic nature. We are still far from being able to know for certain, namely in practical and theoretical terms, how the capitalist system will re-emerge from this crisis. The regulation of the banking system and of the financial system in general will never be the same again. Short-selling[5] has tended to be suspended temporarily, in order to avoid destabilising speculation in bear markets[6].

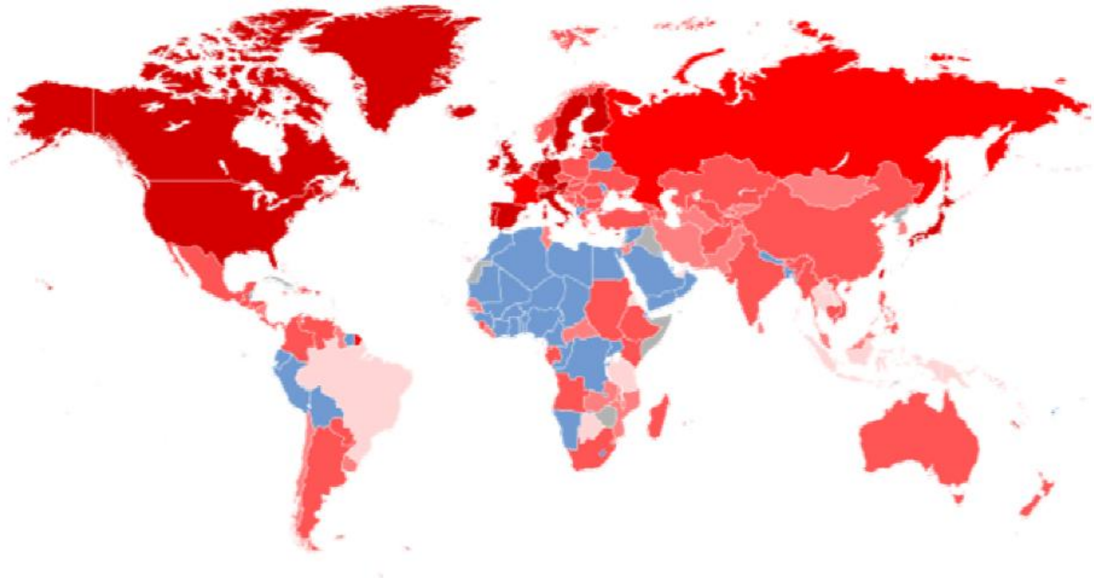
3. SOCIAL IMPACT OF THE 2008 CRISIS

We are far from being able to assess the full social impact of the crisis. But in Map 1 (taken from Wikipedia) we can already see the impact of the crisis in the world. In the most industrialised countries, the greater their financial leverage, the greater have been the social consequences of the crisis. The most extreme case was that of Iceland, one of the countries that was always in the top 5 of the Human Development Index (HDI), but which simply collapsed with the crisis and, as the EU was not able to help the country in time, it ended up being generously helped by Russia. In the map, a deeper level of recession is shown in darker red, while those countries that actually grew are shown in blue.

[5] "Short-selling" consists of selling securities (that one does not have) today at a high price, in the hope that this sale (not only our individual sale, but that of the whole market) will cause the price of the securities to fall in the future, in order to buy them cheaper at that future date and thus settle the debt. This practice of operating in this way in the futures market was greatly condemned and gave rise to severe losses on the stock market. I wish to thank Emanuel Leão for the detail of the temporary suspension of short-selling. In my view, one of the regulatory measures to be taken should be precisely that of prohibiting the practice, for it tends to encourage some destabilising speculation.

[6] Market in which prices are falling (bear market) − the bear, when it attacks, knocks its opponent down; the bull, when it charges, lifts its opponent up (market in which prices are rising).

MAP 1 –SOCIAL IMPACT OF THE CRISIS OF 2007-2009



2007-2009_World_Financial_Crisis.svg (SVG file, nominally 636 × 336 pixels, file size: 1.81 MB)

KEY:

Countries in official recession (two consecutive quarters)

Countries in unofficial recession (one quarter)

Countries with economic slowdown of more than 1.0%

Countries with economic slowdown of more than 0.5%

Countries with economic slowdown of more than 0.1%

Countries with economic acceleration; (Between 2007 and 2008, as estimates of December 2008 by the International Monetary Fund)

N/A

Source: http://en.wikipedia.org/wiki/File:2007-2009_World_Financial_Crisis.svg

4. POLITICAL PROCESS UNDERLYING THE CRISIS

As we know, politics is not just the art of the possible, but also the art of compromise. This crisis has revealed one of the most important problems of current international relations and of the world economy itself – the problem of coordinating policies. As Zakarya (2008) says, the USA, with its role of hegemonic leader, despite being in decline, has attempted to play the key leading role in such coordination.

The EU was faced with, and still faces, the problem of coordinating 27 policies: the Commission led by Barroso is the executive branch, there is a Mr CFSP, Mr Solana, but the fact remains that Europe still speaks with a dissonant voice. In another study – still in progress, see Rocha de Sousa (2009) – I attempt to argue that it is more feasible at the political level to have just one representation of the EU at International Organisations (IO), just like the IMF, World Bank, WTO, amongst others, because speaking with just one single voice already results from a previous attempt at the coordination of the policies of the EU-27. Thus, by focusing on that single policy, the EU will have more strength and power to attain that same objective – it is an application of the economic theory of "single-mindedness", as first introduced by Mulligan and Sala-I-Martin and subsequently developed by Canegrati.

The change in the American administration, the election of President Obama and his precociously awarded Nobel Peace Prize, made it easier for greater responsibility to be taken for choosing more proactive State-supported economic policies. President Obama wishes to guarantee a minimum national system of universal healthcare, which for Europeans is something that is already taken for granted as an acquired right, and, through his secretary Geithner, he has also sought to justify most of the bailouts of banks. The fundamental problem, as we now know today, illustrated by Stiglitz, and noted most particularly in the case of AIG, was that of the banks being "too big to fail". The nationalisation of *Fannie Mae* and *Freddy Mac* illustrates the solution to the problem. The dilemma of choosing the right mix between Market and State is not only an economic dilemma, but also one that is genuinely a question of political and moral philosophy – it is also a question of values, i.e. a question of normative economics. On one side of the barricade, we have the neoclassical libertarians, such as Friedman, Hayek and Berlin, while on the other side we have Keynes, Schumpeter, Sen and Rawls.

5. A PREVENTIVE SOLUTION? AN ESCAPE CLAUSE? THE P, L, A TRINOMIAL IN INTERNATIONAL ORGANISATIONS

One of the critical points of Rawls' *Theory of Justice* (1972) is its beginning from a situation of a veil of ignorance, i.e. admitting that *a priori* individuals could be emptied of all their prejudices, capabilities and potentialities, in order to accept that they were all in a potential situation of starting on a completely equal footing. We know that, in fact, things are not like this. Sen (2009) criticises this position in his most recent book (quoted by Purnell (2009). Although, in fact, the solution of the role of social welfare defended by Rawls is very interesting: the maximum welfare for those who are worst off (the "underdogs"). Since policies are designed with the aim of integrating those who are worst off in society, if this is done in an interactive fashion, we have a dynamic Pareto criterion for improvement. Sen is a utilitarian critic of Rawls, but the Indian philosopher-economist manages to influence the design of public policies, namely the one that is currently being followed by Gordon Brown (2009). The English Prime Minister has confessed that his educational and social policies were profoundly influenced by Sen's idea of capabilities.

From the political point of view, it is also necessary to refer to the contribution made towards the idea of the minimal state by Nozick (1974). With his anarchic-liberal ideals, Nozick defended the idea that, if the State exists, this should only occur as a last resort and that men should regulate themselves.

But let us return to the IO. The critical and fundamental point is that it will be necessary for these to be thoroughly refounded and reformulated, in order to be able to respond to the P, L, A trinomial, or, in other words, proximity, legitimacy and accountability. One of the greatest causes of this crisis was precisely the failure of this trinomial, which showed itself in the essential divorce between the accountability of the institutions and the citizens thrown into debt by a property market caught at the peak of a rising speculative bubble, which ended up collapsing. Companies themselves also showed serious ethical shortcomings – we just have to think about the case of the AIG bonuses, immediately after the government bailout.

The main idea is that this crisis may have had a fundamental impact, a vision of the Kuhnian paradigmatic revolution, a Nozickian libertarian vision versus a Rawlsian vision, or an application of the Senian utilitarian principles in government programmes. The economy will be simultaneously the space of ethics and not just a form of social engineering. In fact, a genuine political science – this is the new escape clause – a redefinition of the capitalist system through a more in-depth application of the founding trinomial (P, L, A) of International Organisations (IO), with a view to their greater coordination, and the EU acting with one single, but stronger, voice, as we witness a decline in the USA and simultaneously the affirmation of the BRIC countries at the heart of the G20.

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Translation by John Elliott