A CRISIS OF THE SYSTEM

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The current economic and financial crisis is a crisis of the system, not just in the system. A crisis of the system occurs when the built-in stabilizers no longer work, the system produces unpredictable feedbacks, and normal policy instruments fail to steer the system back to its normal range. Think of the world economy as a giant hovercraft, borne aloft by an enormous cushion of debt; and then the motors driving the fans just stop. ¹

Governments have been following the Colin Powell doctrine of “shock and awe”, throwing every policy instrument they can find at the problem (in sharp contrast to the years after 1929, when the failure of state response and inter-state cooperation helped to tip the 1929 downturn into the Great Depression). Governments in Europe, United States and Asia pumped in some $1 thousand billion in giant bank rescues between early October and mid November 2008, by an order of magnitude the biggest ever such intervention. Optimists began to see light at the end of the tunnel.

But the light at the end of the tunnel turned out to be a train. Despite the bank rescue packages, shares plummeted: Citigroup and Goldman Sachs shares lost around half their value between early October and mid November, while Morgan Stanley’s and JPMorgan’s lost around a third. In the same period shares of some major US retailers lost three quarters of their value.

When uncertainty is pervasive the main policy tools – such as the US Federal Reserve’s benchmark interest rate – have much less effect than in normal times. Similarly for built-in stabilizers like bankruptcy protection, which is intended to enable companies to slim down, renegotiate payments to employees and suppliers, and keep going, preserving jobs. Bankruptcy protection is not working because many companies which file for bankruptcy protection cannot obtain enough financing to keep going while they reorganize.

¹ Thanks to Manfred Bienefeld for this metaphor.
The Financial Times’ headline of 21 November read “Fear stalks the world’s economies”. “Fears of a severe recession gripped financial markets yesterday”, it continued. “Economic news across the world was almost uniformly bad….The rising risk of a deflationary crunch … sparked a general sell-off in equity prices and pushed oil prices below $50 a barrel for the first time since 2005”. The article went on to suggest that the deflation will not be of the benign kind, where lower commodity prices boost consumption (the oil price fell from $128 per barrel on 2 June 2008 to $49 on 20 November), but a malign spiral of falling prices pushing up the repayment burden of debt. The Financial Times estimated that well over 80,000 job losses were announced in the major economies in the five working days from November 17 to November 21.

By early December the headline in the International Herald Tribune read, “Data in U.S. suggest worst is yet to come”. The article began, “Despite months of rescue efforts, hundreds of billions of dollars in government spending and an avant-garde apparatus of financial tools, the U.S. economy has only worsened, and at a faster rate than nearly anyone predicted. This recession … now appears virtually certain to be the longest downturn – and possibly most severe – since the end of World War II….More than half a million Americans, from financial analysts to factory workers, lost their jobs in November alone….Most frightening of all is that the worst job losses may be yet to come”.2

The crisis has now jumped far beyond the north Atlantic heartland. Until September there was a chance that East Asia would escape the Atlantic crisis, because East Asian banks had mostly steered clear of the US-originated financial assets containing property mortgages. The hope was that continued growth in East Asia would pull the West out of recession. Japan, the world’s second biggest economy, looked to be an oasis of calm. But then the collapse of Lehman Brothers and Kaupthing in Iceland led to default on yen-denominated bonds (which had been a primary vehicle for the “carry trade” from low interest rate currencies, like yen, Swiss francs and the dollar, into high interest rate currencies). These collapses spooked Japanese banks and caused them to cut back lending.

Japan’s economy is spiralling down as growth slows to zero, exports crumble, and the risk of malign deflation rises. Small and medium enterprises, which employ about 70 percent of the Japanese work force, are especially badly hit by the credit squeeze. Japan’s interest rates are already very low, public debt is extraordinarily high relative to GDP, so the government has little room for manoeuvre. As the carry trade unwinds the demand for yen goes up (despite the deteriorating economy), strengthening the yen against the dollar and euro and making Japan’s exports less competitive, hitting employment further.

China too is slowing quickly, export growth falling, unemployment is soaring, and the government is increasingly worried about social protests spreading like wildfire. A recent newsreport said, “[T]he closure of thousands of factories as export demand evaporates has dealt a serious blow to China’s confidence. President Hu Jintao has gone so far as to say that turning the challenges posed by the credit crisis into opportunities would be a test of the Communist Party’s capacity to govern.”

Meanwhile, the next big blow-outs are likely to occur in East and Central Europe, in the swathe of countries from the Baltics to Ukraine, Hungary, the Balkans, and extending down to Turkey. They share the condition of falling currency, high foreign debt, and banking systems which are largely foreign-owned (where responsibility for lender-of-last resort support is unclear). Around the world investors are pulling out of peripheral currencies and rushing to the relative safety of US dollars, euros or yen.

The weakness of policy instruments means that the Great Recession will probably last for two or three more years, and the new system which emerges by 2015 will work rather different to today’s. To decide what kind of financial system to aim at it is important to understand the deep causes of where we are.

II. DEEP CAUSES

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Contrary to a lot of commentary, the subprime mortgage debt in the US, and even Alan Greenspan’s exceptionally loose monetary policy during the 2000s, were triggers or accelerators rather than deep causes, inner wheels rather than outer wheels.

The first deep cause was the increasing concentration of world income and expenditure at the top, as seen in the rising share of the top few percentiles and the rising share of profits relative to wages. One manifestation was the proliferation of billionaires not only in the OECD but also in “emerging markets” like China and India.

Income concentration at the top was the result, in large part, of the freeing of capital movements in the 1980s (the removal of exchange controls), and the subsequent entry into the world market of billions of people in the labor forces of China, India and the communist bloc. Both developments strengthened the hand of the owners and managers of capital, and weakened the hand of workers and trade unions. Wages tended to lag productivity growth. The result was a tendency towards insufficient aggregate demand and an “underconsumption” crisis. The tendency was offset only by an expansion of credit and debt, which kept the growth of spending in line with the growth of output.4

Enter the second deep cause, the New Wall Street System (NWSS), which began to emerge in the 1980s and came to fruition in the 1990s and 2000s. This system – with investment banks, hedge funds, private equity funds, pension funds, insurance companies at its core – enabled Wall Street firms to create gigantic pools of credit, or “private” money. With this private money their core business strategy was to blow up asset bubbles in sequence. First they injected so much credit into a particular asset market in a particular country as to blow up a bubble; then they took profits and burst the bubble (making what could be called a “trubble”); then they moved on to another asset category or country, blew up another bubble, took profits, burst the bubble; and so on. The key actors comprised only a handful of giant firms, which could easily concert their actions; the others followed along behind. It was a fantastically profitable strategy for the insiders, most of the time. The current crisis is unusual for the big

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losses of assets and jobs suffered by a substantial proportion of the insiders, following from their gigantic gains in the bubble years.

This is the short story of Japan in the 1980s; East Asia in the 1990s; information technology stocks in the US in the 1990s; the housing market in the US, UK and many other countries in the 2000s; the carry trade in Iceland and Hungary in the 2000s; and most recently the oil bubble in 2007-08.

The NWSS multiplied the concentration of world income at the top, in the share of profits, and in the financial sector. It also helped to underwrite the legitimacy of free market economics (“neoliberalism”) as the dominant economic creed in the north Atlantic economy and wherever the World Bank, IMF, and Anglo-American university economics departments had influence. Neoliberalism in turn sanctioned limited and light financial regulation, on the argument that competitive financial markets are largely self-regulating. But it was not so much an argument as an axiom: the axiom that market prices reflect all known information about assets. The axiom was taken as an article of faith and kept largely insulated from empirical examination. 5

With limited and light regulation, the stock of private money grew to exceed the stock of central bank money by 10 times and more. Central banks played along with the growth of this stock of private money in the name of deregulation and privatization, and remained focused on the growth of central bank money as though they had no responsibility for the other.

The New Wall Street System generated and depended on an ever rising inverted pyramid of creditor-debtor relations relative to the base of “real economy” transactions. Here it connects with the third deep cause: an international monetary system which – thanks to almost unrestricted capital movement across borders and the US dollar as a purely paper currency (which is therefore unrestrained on the supply side) -- permitted the growth of huge creditor-debtor payments imbalances between countries, notably between the US as the biggest international debtor and East Asia, joined more recently

by Latin America, as big creditor countries. These payments imbalances combined with the New Wall Street System to generate the proliferation of new and opaque financial instruments, which helped to blow up the rising inverted pyramid of creditor-debtor relations, including the carry trade.

The unwinding of the resulting mountain of credit-debt obligations is the central driver of the global crisis. If it were not for the inverted pyramid of credit and debt, economic recession and bankruptcies in one sector or country would not have the contagion that they do. It is when companies, households and sovereigns are caught up in credit-debt relationships that the bankruptcy of one company or country raises the risk of default elsewhere in the system, prompting defensive action which spreads the problem to other assets and other countries.

III. POLICY RESPONSE

The top policy priorities now should be coordinated demand expansion, and the destruction of trillions of dollars of toxic assets. Without coordinated demand expansion the downturn in global demand will leave much of the world with excess industrial capacity, which puts downward pressure on prices and profits, raises non-performing loan ratios, and cuts investment, employment and consumption. But at least the mechanics of coordinated demand expansion are well known. It is not at all clear how the trillions of toxic assets can best be destroyed, in part because the pain will be so widely shared – most of us are tied to these toxic assets through pension plans, savings, and directly owned assets (or assets we thought we owned).

The challenge is to ensure that the politics in which the unwinding and asset destruction takes place and in which a new monetary system emerges is social democratic rather than neoliberal or fascist. There is a real danger – as the 1930s parallel suggests – that the economic disruption and loss of material well-being propels extreme political movements to state power. To the extent that these extreme movements gain power, the resulting jittery insecurity between states might not only delay recovery but also produce a dysfunctional world economy by 2015. This is the answer to those
who say that the current crisis is a good and necessary correction, because financial systems need a crisis every 10-15 years for the same reason that forests need periodic fires to stay healthy.

Who will steer the big reforms in the international monetary system? Financially the US is in no position to lead; President Bush even found himself begging President Hu Jintao to keep buying bonds, or so Chinese officials love to tell, as though they were all listening in on the telephone call. The IMF is requiring austerity as the condition for its assistance (Iceland’s central bank had to put up its interest rate to 18%), at the same time as the industrial countries are, rightly, emphasising expansion – suggesting that the IMF learnt little from its interventions in the East Asian crisis of 1997-98 and that it continues to function as the arm of the G7 to impose what they say rather than what they do. The G20 communique of mid November allowed the G7 states, notably the US and the UK, to escape blame for the way that their governments, regulators and the New Wall Street System generated the crisis, by diverting attention onto side issues of “transparency” and the need to finish the Doha Round. The communiqué confirmed that the G20 is little more than a puppet of the G7, and not a viable apex body for global economic governance.

We need an apex body which is both smaller and selected by more legitimate criteria, with some rotating seats, perhaps selected by regions. In the meantime countries should be pressing ahead with regional arrangements to defend themselves, perhaps with regional currency units (as is being considered in East Asia) and with coordinated expansion of domestic demand as an alternative to export-to-the-West demand. At the multilateral level one tiny sign of progress would be for the IMF to replace its now fashionable phrase, “sustainable macroeconomics” with the phrase “counter-cyclical macroeconomics”, a subject to which it has paid disastrously little attention.

By 2015 the global financial system should have a stronger role of states and multilateral organizations, reflecting taxpayers’ obligations to rescue banking systems in crisis. It should have a closer correspondence between the domain of markets and the domain of regulation, and in particular closer correspondence
between the size of a country’s or region’s banks and the size of lender-of-last resort facilities (which implies big changes in the European Union). It should give less of a premium to “innovation” and profitability as hallmarks of a good financial system, and more of a premium to stability. More of the banking system should be required to have a substantially larger base of deposits relative to loans. The upshot would be smaller banks, and a smaller financial sector relative to GDP.

The new system should entail more coordination of exchange rates, probably in the form of currency blocs, in which money is politically grounded (with political authorities having some influence on interest rates) and currencies are linked in ways that reflect “real” differentials in productivity and wealth, as distinct from speculation. It should include arrangements for commodity markets which curb the role of spot markets in determining commodity prices, because spot markets create a casino for speculators and arbitrageurs but produce few benefits for the rest.

In the meantime analysts should be exploring the feasibility of an international or regional payments union, as was discussed at Bretton Woods and as was established for the core European countries at the end of the 1940s. The payments union would enable international transactions in each party’s own currency, as an alternative to today’s floating dollar standard and free private capital movements – the combination which lies at the root of the casino aspects of the present financial system.

All these reforms have in common that they reduce the chance that financial centers like Wall Street and the City of London will again be able to hold the real economy to ransom, extracting double digit rates of return from economies growing, for the most part, in the low single digits.

IV. PLANNING

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As the earlier discussion of deep causes suggests, lowering the propensity to financial crisis will not be achieved only by changes within the financial system, because the roots of the propensity to financial crisis lie outside it – a point which the current emphasis on the need to strengthen regulation ignores. The inverted pyramid of credit-debt relationships reflects the global allocation of production in which most low-wage manufacturing is carried out in China, and China can land manufacturing products around the world at a fraction of the cost of domestic or other foreign producers (the “China price”). The mainstream static comparative advantage theory says it is therefore sensible for other countries to import these goods from China and then find something else to do. In the words of Sir Terence Burns, Prime Minister Thatcher’s economic advisor, “If we can’t make money by manufacturing things, we’d better think of something else to do”.7

The absurdity of this argument is captured in a Financial Times article suggesting that China’s rise in labor-intensive manufacturing is having a net positive effect on Latin America. It cites an analyst saying, “the China connection could even pave the way for Latin America to capitalise on its strengths as a low-cost producer of raw materials. If that happened it could open the way to the re-emergence of a development model based on the classical economic concept of comparative advantage rather than on more recent ideas such as import substitution.” The analyst went on to say, “China gives a new hope to Latin America to be a viable part of the world”.8 As though Latin Americans – beyond the richest 1 percent -- will become more prosperous by specializing more in minerals, soya and coffee.

Indeed, the biggest unwind facing the world is not the inverted pyramid of creditor-debtor relationships, but the gross distortions to the allocation of productive capacity around the world caused by nearly unrestricted movement of goods, services and finance. Too much manufacturing capacity is concentrated in China, too little in Latin America, Sub-saharan Africa, and much of the OECD world.

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7 “Profile: Sir Terence Burns, not merely a civil servant”, Independent, March 16, 1991, 16.
The US and especially Britain have come to rely too heavily on finance and other services as their manufacturing sectors shrink. This is a recipe for massive payments imbalances and for the NWSS to grow rich on the back of the resulting credit-debt relationships. The result is as we have seen -- recurrent bubbles and trubbles, people being fired in large numbers, causing vast swings of mood from euphoria to anxiety and depression.

The basic problem is the way that globalization has advanced much faster in the economic than in the political domain. With political authority mostly confined to the nation state, producers are free to arbitrage wage and capital costs and place production wherever they find it most profitable, regardless of the “external” effects of their decisions on their own and other populations. The global market, in other words, disenfranchises people from influencing decisions which deeply shape their material welfare. The feeling of powerlessness afflicts people of both developed and developing countries. A Britisher and an Indian both know that their legislature can do little to influence the terms on which corporations interact in a global market, and that the WTO and bilateral trade agreements further shrink the capacity of their legislatures to exercise discipline over foreign companies operating in their territory.

The biggest challenge in restoring economic stability, therefore, is to strengthen society’s capacity to regulate market competition to ensure that it advances a common good whose content is defined by political debate – so that the content of the common good in the private sector of the economy does not simply reduce to “maximum efficiency of resource use as determined in free markets”.

As long as the world continues to be fragmented politically into nation states, the choice of the degree to which capitalism should be subject to social controls must be made mainly at the level of nation states. This makes some forms of “protection” unavoidable. Political leaders and economists fulminate against “protectionism”, as in the G20 communique of mid November. But protectionism is already here, including in the “free market” US and UK, not just in farm subsidies but also in the recent bank bailouts. And either the big three US automakers will get public assistance to avoid going out of existence – another kind of protection – or mobilized groups will
demand much wider protection in response to the cascading job losses.

At the national level the challenge is to establish a public planning capacity, even though “planning” has been a dirty word for decades. Planning just means an independent capacity of a government to think, not dominated by lobbies representing the private planning of corporations. The government must be able to think about the long-term national interest, to plan new systems in a way that uncoordinated market actors cannot, and to translate it into indicative targets and organizational responsibilities.

To do this, the government should create a focal point in the public sector for coordinating action between the political, business and trade union leaders whose interests count most in the definition of the common good. The aim is to shift their incentives and information so as to prompt them to take account of desirable national objectives which they have a hand in formulating. Their buy-in to the process tends to reduce transactions costs and raise confidence in investing throughout the economy.

In France the Treasury within the Ministry of Finance and the sectoral committees led by the Planning Office from 1946 to the early 1970s constituted this focal point; in South Korea, the Economic Planning Board; in Singapore the Economic Development Board and the National Wage Council. Such a focal point is especially important in developing countries where market signals are either weak or direct investment in ways contrary to transformative growth.

The planning process should aim to create several kinds of governance capacities. The first is the capacity to formulate a strategic vision for the economy’s future -- stable -- growth. The second is the capacity to derive market-based incentive schemes from the strategic plan, targeted at priority activities or sectors. The incentives may operate through credit, taxes, and industrial zones. Protection may also have a role, especially in developing countries, even though protection too has been a dirty word for decades. It needs to be reconsidered because it tends to be easier to administer than other policy instruments, and also provides a relatively easy way to raise tax

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revenue. Several leading economists now endorse the strategic use of protection as one instrument of industrial policy.

The art of using these instruments well lies in the third main governance component, the capacity to discipline the beneficiaries by withdrawing support either when they no longer need it to be competitive or when the support is not having the desired effect. The more automatic the better. For example, tax incentives can be targeted at specific products at the economy’s production frontier, such that as more producers become able to meet stated product criteria the criteria are raised to keep them focused on the frontier. Export performance, or the gap between international and domestic prices and quality can be used as performance objectives against which to take withdrawal decisions. In this way the circle can be squared: producers are encouraged to make certain kinds of investments by the anticipation of higher returns, while still being subject to competitive pressure. ¹⁰

At the multilateral level, the challenge is to adapt multilateral rules to enable states to carry out this kind of role. At present, WTO rules and the prescriptions of organizations like the World Bank, the IMF, and the OECD tend to discourage it. They imply that developing countries are just like developed countries except that they are held back by certain pathologies (like “corruption” and “weak property rights”); once these pathologies are removed with the help of “good governance” programs the economies will grow to catch-up with the developed ones. The empirical evidence runs against this view. As developing countries get more power in international economic governance they should use it to win more latitude for state-led development strategies. And developed countries should move in the same direction, to establish national focal points where key actors can come together to formulate strategies in place of the present array of ad hoc responses. ¹⁰