

# The mother of all crashes: commentary with Jonathan Story

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**W**e should not be surprised about the whirl of debate on the causes and consequences of the global financial crash. Jonathan Story is Emeritus Professor of International Political Economy at INSEAD where he has taught since 1974. He also holds the Marusi Chair of Global Business at The Lally School of Management at the Rensselaer Polytechnic Institute in Troy, New York.

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**This commentary argues that we should not be surprised about the whirl of debate on the causes and consequences of the global financial crash. Technology has brought together a fascinating and disparate world in a way, and at a speed we have never before experienced. Our knowledge about the global financial system and what drives it is partial and clouded.**

This knowledge gap applies in particular for our government officials. They are flying blind. The global financial system, rooted arguably in President Richard Nixon's decision of August 1971, to end the dollar's convertibility to gold, has proven extraordinarily resilient and flexible in accommodating the strains and stresses in the world.

We'll look at the present debate about the global crash, notably the calls for more government intervention, the re-introduction of tight regulation, counter-cyclical spending and more global governance. I argue that government fingers are all over this meltdown, and go on to ask what should be done. I suggest in conclusion that we should not be surprised if the world's financial problems disappear as quickly and as unexpectedly as they broke over us. Those who get their own houses in order will be well placed to prosper in the upturn.

The latest IMF report on the world economy has stated what everybody already knew, that the crisis which began in mid-2007 has now become worldwide. Previous crashes have been local in scope and limited in impact on the rest of the world. This one is different in that it began in the US and the UK – two key countries in the global financial system – and it is different because there is not one part of the world which is exempt.

Furthermore, only a handful of economists saw this "Mother of all Crashes" coming, though there were plenty of indications that all was not well. Global negotiations in the WTO stalled on farm policies; bubbles came and went, first the dotcoms, then real estate, followed by the surge in commodity and fuel prices. Unprecedented global imbalances emerged, most notably China's huge current account surpluses. Germany became the world's top exporter, with per capita exports three times that of the US, and dominating the markets of Europe, east and west, with which it ran ever larger surpluses. Oil and gas exporters saw their foreign exchange reserves soar, while raw material exports boomed in Latin America, Africa and Australasia.

## A highly flexible global financial system

There was little reason to believe that the world's dollar-based financial mechanism could not withstand these strains. Since August 1971, when President Nixon ended the dollar's convertibility to gold at \$35 dollars an ounce, the dollar standard had shown extraordinary capacity to digest global turbulence, including the two oil price hikes of 1973 and 1979, followed by the oil price crash of early 1986; the financial meltdowns in Africa and Latin America in the early 1980s; followed by the implosion of the Soviet empire; the devaluations of the Lira and Pound Sterling in 1992, the Mexico crash of 1994, and then the East Asian financial crash in 1997-98. Over this whole 40-year period, the world experienced unprecedented growth and wealth distribution.

Therefore, Asia's financial crash in 1997 came as a shock. For economists the equivalent to what the Soviet Union's collapse was for sovietologists. It was unpredicted and its severity unanticipated. Prior to the 1997 crash, Asia-Pacific countries had received accolades from the World Bank, among others, for the success of their state-led development policies in raising income levels and life expectations of their populations. Their export-orientation and openness to inward direct investment ensured integration into the global economy, a rapid accumulation of know-how, technologies, and a new confidence. Deng Xiao Ping's Open Door policies manifested the communist regime's determination to join in East Asian growth.

The Asian crisis started with the devaluation of the Thai baht in July 1997, spread to Indonesia where General Suharto's regime was coming to a close, ricocheted into Taiwan, Korea and Malaysia, before spreading to Brazil, South Africa and then Russia. Unlike previous meltdowns, this chain of events revived a long dormant debate on the world's financial architecture. This debate was conducted principally among economists, and mainly in the United States. The key conclusion was that the cause of the crash lay not so much in market failure as in government failures of economic policy, and that these failures were compounded by the inadequately coordinated policies between the Asian countries.

There were two components of this argument. One identified the source of the crash in the "crony capitalism" of the Asian states; the other rooted the crash in the dubious proposal to spread liberalization of capital markets to developing countries. But as Professor Jagdish Bhagwati of Columbia University wrote, "a dense network of like-minded luminaries among the powerful institutions – Wall Street, the Treasury Department, the State Department, the IMF, and the World Bank most prominent among them – have hijacked the argument in favour of free trade markets and applied it to promote free capital mobility everywhere." These luminaries, he was suggesting, considered that there was one-policy-for-all.

## The 2007-08 crash

This time round, the boot has been on the other foot. After decades of US-sourced lessons on the benefits of running free market economies, assorted commentators have had a whale of a time. Consider Prime Minister Rudd of Australia. Taking time off from his job, he wrote a 7000 word essay in The Monthly magazine of February 2009, entitled "The Global Financial Crisis". He identifies the root of the crash as "the great neo-liberal experiment" driven by blind ideology and states who failed to regulate free-wheeling financial markets. Salvation must come from strong government intervention, the re-introduction of tight regulation, counter-cyclical spending and more global governance.

These points are worth elaborating on one by one. It is true that as of 1977-78, market-driven economic ideas began to receive a better hearing than they had in decades. But the reason for this renewed interest was the desperate straits industrialized states found themselves in with bloated budgets, devalued currencies, rising unemployment and disaffected publics. In the 1980s, centre-right as well as centre-left governments looked to extend the reach of markets as a way out of the mess. They did so in their own ways and with great variations in emphasis, most notably in labour markets which characteristically remained much as they had been, with the exception of the United Kingdom where the

conservative governments of the 1980s introduced statutory law to labour relations for the first time in the country's history.

There was no sign of any return to night-watchmen states, with the exception of China where in the mid-1990s, government tax revenues fell to 11 per cent of GNP. In developed countries, general government expenditures remained in a spectrum of 40 to 60 per cent of GNP. By 2008, government expenditures across the developed world were slightly above what they had been in the early 1980s. What had changed was a general retrenchment of governments from owning physical assets, and their conversion into regulators of markets. This is where many of the roots of the present crisis may be located. Regulations passed by legislatures, particularly in the US and the UK, sought to extend home ownership by making it easier for banks to lend, with less concern about the borrower's longer term creditworthiness.

In general, financial market regulation toughened over the decades from 1980 to 2008. This was particularly the case in the UK, where Chancellor Lawson supervised the putting in place of a tight regulatory framework, paralleling the subjection of labour markets to statutory law. Indeed, the regulatory framework introduced by Gordon Brown was arguably less strict, and when put to the test of the markets in 2007-8, failed completely. Similarly, it was the Clinton administration in 1999 that scrapped the Glass-Steagall Act, whereby commercial and investment banks were separated. The Clinton-Blair "third way" amounted in effect to giving a freer hand to lightly-regulated financial institutions. Indeed, the Sarbanes-Oxley Act, passed in 2002 under the first Bush administration, significantly extended the regulator's powers in the hope of preventing corporate and accounting scandals, surrounding the failures of Enron, Tyco, Adelphia, Peregrine Systems and WorldCom.

The bottom line of this current crash is that government fingers are all over it. The US Federal Reserve Bank engineered expansionary monetary policies in order to accelerate recovery from the 2001-2 crash, thereby encouraging financial institutions to lend and companies and households to borrow. High household debt in the UK and the US was facilitated by the re-distributive ambitions of legislatures and governments. While financial regulation tightened in the US, it became lighter under successive Blair-Brown governments in the UK. Global imbalances played their part too: high Chinese savings – the counterpart to the high current account surplus – were induced by the dismantling of Maoist welfare provision by state enterprises and communes.

In Europe, the problems have been compounded by the success of German business in working hard to raise the productivity of capital and labour, re-establishing the country as a production platform for manufacturing, despite high labour and non-labour costs. Germany's corporate cross-shareholding structures have given way to firm-centred shareholder value practices, while German producers have outsourced and integrated manufacturing operations with partners in central-eastern European neighbours. Only the smaller countries of northern Europe have equalled or surpassed Germany's productivity performance. The Mediterranean countries, Italy, Spain, Greece and Portugal, trapped in monetary union, have nowhere to hide their lesser productivity performance, other than to watch unemployment rise or wages fall, or more likely-both.

### What to do?

The initial response has been for politicians to grab for whatever tools they have found in the kit they inherited. For the UK and the US, the response has been to pile debts upon debts. Over the past thirty years, the US – and to a much lesser extent, the UK – has acted as the consumer of last resort. Both countries have become structural importers, running consistent trade account deficits. Barack Obama's reflationary plan promises to sustain consumption on the assumption that the Chinese can continue to finance US indebtedness. Meanwhile, US households have cut back on consumption, along with households elsewhere in the developed world. That has hit the chronic surplus countries of Japan, China, the East Asian export champions and Germany particularly hard.

Another policy proposal has been for chronic trade surplus countries to stimulate domestic demand. Japan did this throughout the 1990s to no effect. Structurally, the country remains a chronic exporter. The German government, having spent years seeking to control expenditures extended by the cost to absorb eastern Germany, has no intent of expanding outlays. The only country with considerable margin to expand domestic demand is China. The government controls the financial system, which in turn is joined at the hip of the party-state to the fiscal system. In 1998, the government responded to the East Asian crash by embarking the country on a thirty year infrastructure programme. This programme still has years to run, but is slowly being supplemented by government policies to encourage consumption in the townships and deprived rural areas. There are upwards of 900 million people in China still living on \$2 a day, or less. Their consumption potential is enormous. But it can only come slowly – a luxury in time the world economy does not have.

Another plank of the industrial country governments is to revive bank lending. But the Lehmann crash of September 2008 spooked the inter-bank markets and liquidity dried up. Given the long years of financial innovation in financial markets, banks are reluctant to trade because they know that prior to the crash they traded products whose contents they ignored. Restoring confidence in the markets requires governments to create asset management institutions to inherit toxic products, and to allow financial institutions to start trading again. There have been signs of improvements in bank balance sheets, but they will only lend when consumer optimism returns. That is not for a while yet.

While consumers wait, politicians are running around like headless chickens hoping that through their hyper-activity, something will improve. Gordon Brown's hope is that the G-20 meeting in London will have provided a sign to the markets that the governments are in control, know where they are going and will provide an agenda for action. The trouble is that governments have very different interests and ideas about what should be done, and if truth be told, will have to address the deep-seated problems which have been allowed to grow and fester in their own economies.

In Japan, this would mean finally fulfilling the proposals made in a mid-1980s government report to liberalize the country, become a net trade importer, and specialize as Asia's service centre. In Germany, it would require German business to be less effective and efficient, or contrariwise for South European countries to become as efficient as their German counterparts. In the UK, it would require a devaluation combined with a major redeployment of national resources from the government to the business sector. Devaluation has occurred, but cutting back on government would happen over Gordon Brown's politically-dead body.

### What should we expect?

If you ask economists about where the world is heading, you get four responses. One is that this crisis is V-shaped. Recovery will happen by this summer as Obama's reflation bites, global demand resumes and business resumes. A slightly more pessimistic answer is that this crisis is U-shaped: recovery will occur in 2010, or maybe 2011 – time for consumer confidence to return. An even more pessimistic view is that this crash is L – shaped, that the base of the L is prolonged, and that we are in for ten years of a hard-slog. The doomsayers say that the crisis is I shaped, that we are in 1931 and that we are far from hitting bottom.

We can do better. The most important thing is to keep your eyes on what counts. If countries turn protectionist, then the web of global credits and debts becomes unhinged. If China slides into chaos, then one of the world's major success stories of the past 30 years turns to dust. In Germany, the paradox is that Germany has moved into de facto leadership, but is so dependent on European markets that it has become the victim of its own success.

Germany does not lead Europe. It is led by Europe with which it is indelibly interdependent. China does not exert leverage over the US T-bond market; it is a prisoner of it, as is the US of Chinese savings. That is why the G20 meeting in London was so

important. It signifies that the world leaders acknowledge that the world is the only boat we all have.

Even more, the London summit should have indicated that national governments have limited influence beyond their own borders. Getting their own houses in order is the main contribution they can make to the global economy. Trying to predict the infinite complexity of the world markets by taking this or that action assumes that governments can identify what the outcomes are. They were surprised by this crash, as they were surprised by the East Asian crash of 1997-98. It is not unreasonable to expect that they may well be surprised by the speed of a world turn-around.

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