

countries. Being between countries at similar levels of development, these cuts brought about positive outcomes by expanding markets and stimulating productivity growth through greater competition.

In Europe, a new experiment in international integration with far-reaching consequences was conducted. It started with the creation of the European Coal and Steel Community (EGSC) in 1951 by six countries (West Germany, France, Italy, the Netherlands, Belgium and Luxembourg) and culminated in the creation of the European Economic Community (EEC) – a free-trade agreement – through the Treaty of Rome (1957).²⁴ In 1973, the UK, Ireland and Denmark joined the group, which was by then called the EC (European Communities). By bringing peace to a region riven with wars and rivalries and by integrating markets, the EEC contributed to the economic development in the member countries.

The most influential explanation of the Golden Age is, however, that it was mainly the result of reforms in economic policies and institutions that gave birth to the **mixed economy** – mixing positive features of capitalism and socialism.

Following the Great Depression, the limits of *laissez-faire* capitalism came to be widely accepted. It was agreed that the government should take an active role to deal with the failings of unregulated markets. At the same time, the success in wartime planning during the Second World War diminished scepticism about the feasibility of government intervention. Electoral successes by parties of the left in many European countries, thanks to their key roles in fighting fascism, led to the expansion of the welfare state and greater labour rights.

These changes in policies and institutions are seen to have

contributed to the making of the Golden Age in a number of ways – creating social peace, encouraging investment, increasing social mobility and promoting technological innovations. Let me elaborate a little, as this is an important point.

Capitalism Remixed: pro-worker policies and institutions

Soon after the Second World War, many European countries took private enterprises into public ownership or set up new **public enterprises**, or **state-owned enterprises** (SOEs), in key industries, such as steel, railways, banking and energy (coal, nuclear and electricity). These were reflective of the European socialist movements' belief in public control over the means of production as a key element of social democracy, as embodied in the famous Clause IV of the British Labour Party (abolished in 1995 under Tony Blair's 'New Labour' make-over). In countries such as France, Finland, Norway and Austria, SOEs are deemed to have played a key role in generating high growth during the Golden Age by aggressively moving into high-technology industries that the private sector firms found too risky.

Welfare measures, first introduced in the late nineteenth century, were vastly strengthened, with the provision of some basic services nationalized in some countries (e.g., Britain's National Health Service). These were funded by a large increase in taxes (as a proportion of national income). Better welfare measures increased social mobility, increasing the legitimacy of the capitalist system. The resulting social peace encouraged more long-term-oriented investments and thus growth.

Managed capitalism: governments regulate and shape markets – in a variety of ways

Learning the lessons of the Great Depression, governments in all ACGs started to deploy deliberately **countercyclical macroeconomic policies**, also known as Keynesian policies (see Chapter 4), expanding government spending and money supply from the central bank during economic downturns and reducing them during upturns.

In recognition of the potential dangers of unregulated financial markets, as manifested in the Great Depression, financial regulations were strengthened. Few countries went as far as the US in separating investment banking from commercial banking, but they all had restrictions on what banks and financial investors can do. This was an era when bankers were considered to be respectable but boring people, unlike their swashbuckling successors today.*

Many governments practised **selective industrial policy** that deliberately promoted targeted ‘strategic’ industries through a range of measures, such as trade protection and subsidies. The US government officially had no industrial policy but greatly influenced the country’s industrial development by providing massive research funding to advanced industries such as computers (funded by the Pentagon), semi-conductors (US Navy), aircraft (US Air Forces), the internet (the DARPA, Defense Advanced Research Projects

Agency), and pharmaceuticals and life sciences (National Institutes of Health).²⁵ Governments in countries such as France, Japan and South Korea did not stop at promoting particular industries and explicitly coordinated policies across industrial sectors through their Five Year Plans – an exercise known as **indicative planning**, to distinguish it from the ‘directive’ Soviet central planning.

The new dawn: developing countries finally have a go at economic development

The Golden Age saw widespread decolonization. Starting with Korea in 1945 (which was then divided into North and South in 1948) and India (from which Pakistan separated) in 1947, most colonies gained independence. Independence in many nations involved violent struggles against the colonizers. Independence came later to Sub-Saharan Africa, with Ghana becoming the first independent country in 1957. Around half the Sub-Saharan African countries became independent in the first half of the 1960s. Some nations had to wait much longer (Angola and Mozambique in 1975 from Portugal; Namibia in 1990 from South Africa), and some are still waiting, but the vast majority of former colonial societies – now called developing countries – gained independence by the end of the Golden Age.

Upon independence, most post-colonial nations rejected the free-market and free-trade policies that had been imposed on them under colonialism. Some of them became outright socialist (China, North Korea, North Vietnam and Cuba), but most of them pursued state-led industrialization strategies while basically remaining capitalist. The strategy is

* Paul Krugman wrote in 2009: ‘Thirty-plus years ago, when I was a graduate student

in economics, only the least ambitious of my classmates sought careers in the financial world. Even then, investment banks paid more than teaching or public service – but not that much more, and anyway, everyone knew that banking was well-boring’ (‘Making banking boring’, *The New York Times*, 9 April 2009).

known as the **import substitution industrialization (ISI)** strategy – so called because you are substituting imported manufactured goods with your own. This was done by protecting domestic producers from superior foreign competition by restricting imports (infant industry protection) or heavily regulating the activities of foreign companies operating within national borders. Governments often subsidized private-sector producers and set up SOEs in industries in which private-sector investors were unwilling to invest due to high risk.

With independence dates stretching from 1945 to 1973 and beyond, it is impossible to talk about the ‘economic performance of developing countries during the Golden Age’. The usual compromise timeframe for judging developing country economic performance is 1960–80. According to the World Bank data, during this period, per capita income in the developing countries grew at 3 per cent per year, which meant that they kept pace with the more advanced economies, in which growth was 3.2 per cent. The ‘miracle’ economies of South Korea, Taiwan, Singapore and Hong Kong grew at 7–8 per cent per year in per capita terms during this period, achieving some of the fastest growth rates in human history (together with Japan before them and China after them).

One thing to note, however, is that even the more slowly growing developing regions saw considerable progress during this period. During 1960–80, with per capita income growth of 1.6 per cent per year, Sub-Saharan Africa was the slowest-growing region in the world – Latin America grew at

double that rate (3.1 per cent), and East Asia at more than triple that rate (5.3 per cent). However, this is still not a growth rate to be sniffed at. Recall that during the Industrial Revolution, the growth rate of per capita income in Western Europe was only 1 per cent.

The middle way: capitalism works the best with appropriate government interventions

During the Golden Age of capitalism, government intervention increased enormously in almost all areas in all countries, with the exception of international trade in the rich and in the developing countries was much better than before. It has not been bettered since the 1980s, when state intervention was considerably reduced, as I shall show shortly. The Golden Age shows that capitalism’s potential can be maximized when it is properly regulated and stimulated by appropriate government actions.

1973–9: The Interregnum

The Golden Age started to unravel with the suspension of US dollar-gold convertibility in 1971. In the Bretton Woods system, the old Gold Standard was abandoned on the recognition that it made macroeconomic management too rigid, as seen during the Great Depression. But the system was still ultimately anchored in gold, because the US dollar, which had fixed exchange rates with all the other major currencies, was freely convertible to gold (at \$35 per ounce). This, of

course, was based on the assumption that the dollar was 'as good as gold' – not an unreasonable assumption when the US was producing about half of the world's output and there was an acute dollar shortage all around the world, as everyone wanted to buy American things.

With the post-war reconstruction and then rapid development of other economies, this assumption was not valid any more. Once people realized that the US dollar was not as good as gold, they had a greater incentive to convert dollars into gold, which reduced the US gold reserve even further and made the dollar look even less reliable. The US official liabilities (dollar bills and Treasury Bills, namely, the US government bonds), which had been only half the size of its gold reserve until 1959, became one and a half times larger by 1967.²⁶

In 1971, the US dropped its commitment to convert any dollar claims into gold, which led other countries to abandon the practice of tying their national currencies to the dollar at fixed rates over the next couple of years. This created instability in the world economy, with currency values fluctuating according to market sentiments and becoming increasingly subject to currency speculation (investors betting on currencies moving up or down in value).

The end of the Golden Age was marked by the First Oil Shock in 1973, in which oil prices rose fourfold overnight, thanks to the price collusion of the cartel of the oil-producing countries, OPEC (Organization of Petroleum Exporting Countries). Inflation had been slowly increasing in many countries since the late 1960s but, following the Oil Shock, it shot up.

More importantly, the next several years were characterized by **stagflation**. This newly coined term referred to the breakdown of the age-long economic regularity that prices fall during a recession (or stagnation) and rise during a boom. Now, the economy was stagnating (albeit not exactly in a prolonged recession, like during the Great Depression) but prices were rising fast, at 10, 15 or even 25 per cent per year.²⁷

The Second Oil Shock in 1979 finished off the Golden Age by bringing about another bout of high inflation and helping neo-liberal governments come to power in the key capitalist countries, especially in Britain and the US.

This period is often depicted as one of an unmitigated economic disaster by free-market economists, who are critical of the mixed economy model. This is misleading. Growth in the ACCs may have slowed down compared to the Golden Age, but, at 2 per cent per capita, income growth rate during 1973–80 was still much higher than any period up to the Second World War (1.2–1.4 per cent) and slightly higher than what followed in the next three decades of neo-liberalism (1.8 per cent for 1980–2010).²⁸ The unemployment rate, at 4.1 per cent average, was higher than that of the Golden Age (3 per cent), but not by much.²⁹ Still, the fact remains that there was enough dissatisfaction with economic performance during this period for there to be radical changes in the following years.

1980–Today: The Rise and Fall of Neo-liberalism

The Iron Lady: Margaret Thatcher and the end of British post-war compromise

A major turning point came with the election of Margaret Thatcher as the British prime minister in 1979. Rejecting the post-Second World War 'wet' Tory compromise with Labour, Thatcher began a radical dismantling of the mixed economy, in the process earning the sobriquet 'The Iron Lady' for her uncompromising attitude.

The Thatcher government lowered higher-rate income taxes, reduced government spending (especially in education, housing and transport), introduced laws reducing union power and abolished **capital control** (restriction on the cross-border movement of money). The most symbolic move was **privatization** – sales of SOEs to private investors. Gas, water, electricity, steel, airline, automobile and parts of public housing were privatized.

Interest rates were raised in order to reduce inflation by dampening economic activities and thus demand. The high interest rate attracted foreign capital, driving up the value of the British pound, thus making British exports uncompetitive. The result was a huge recession, as consumers and companies retrenched, between 1979 and 1983. Unemployment soared to 3.3 million people – this under a government that came to power by criticizing James Callaghan's Labour government's record on unemployment, which went over the 1 million mark, with the famous slogan

'Labour isn't working', invented by the advertising agency Saatchi & Saatchi.

During the recession, a huge chunk of British manufacturing industry, which had already been suffering from declining competitiveness, was destroyed. Many traditional industrial centres (such as Manchester, Liverpool and Sheffield) and mining areas (North England and Wales) were devastated, as depicted in movies such as *Brassed Off* (about coal miners in Grimley, a thinly disguised version of Yorkshire coal town Grimethorpe).

The actor: Ronald Reagan and the re-making of the US economy

Ronald Reagan, the former actor and a former governor of California, became the US president in 1981 and outdid Margaret Thatcher. The Reagan government aggressively cut the higher income tax rates, explaining that these cuts would give the rich greater incentives to invest and create wealth, as they could keep more of the fruits of their investments. Once they created more wealth, it was argued, the rich would spend more, creating more jobs and incomes for everyone else; this is known as the **trickle-down theory**. At the same time, subsidies to the poor (especially in housing) were cut and the minimum wage frozen so that they had a greater incentive to work harder. When you think about it, this was a curious logic – why do we need to make the rich richer to make them work harder but make the poor poorer for the same purpose? Curious or not, this logic, known as **supply-side economics**, became the foundational belief of economic policy for the next three decades in the US – and beyond.

As in the UK, interest rates were jacked up in an attempt to reduce inflation. Between 1979 and 1981, interest rates more than doubled from around 10 per cent to over 20 per cent per year. A significant portion of the US manufacturing industry, which had already been losing ground to Japanese and other foreign competition, could not withstand such an increase in financial costs. The traditional industrial heartland in the Midwest was turned into 'the Rust Belt'.

Financial deregulation in the US at this time laid the foundation for the financial system we have today. The rapid increase in **hostile takeovers**, in which a company is taken over against the will of the existing management, changed the whole corporate culture in the US. Many of those taking over were 'corporate raiders' only interested in **asset stripping** (namely, the sales of valuable assets, regardless of the impact on the long-term viability of the company), immortalized by Gordon 'Greed-is-good' Gekko in the 1987 movie *Wall Street*. To avoid such a fate, firms had to deliver profits faster than before. Otherwise impatient shareholders would sell up, reducing the share prices and thus exposing the firm to greater danger of hostile takeover. The easiest way for companies to deliver quick profit was through **downsizing** – reducing the workforce and minimizing investments beyond what is necessary for immediate results, even though these actions diminish the prospect of the company in the longer run.

The Third World debt crisis and the end of the Third World Industrial Revolution

The most lasting legacy of the high interest rate policy in the US in the late 1970s and the early 1980s – sometimes

called the Volcker Shock, named after the then chairman of the US central bank (the Federal Reserve Board) – was *not* in the US but in the developing countries.

Most developing countries had borrowed heavily in the 1970s and the early 1980s, partly to finance their industrialization and partly to pay for the more expensive oil, following the Oil Shocks. When the US interest rates doubled, so did international interest rates, and this led to a widespread default on foreign debts by developing nations, starting with the default of Mexico in 1982. This is known as the **Third World Debt Crisis**, thus known because the developing world was then called the Third World, after the First World (the advanced capitalist world) and the Second World (the socialist world).

Facing economic crises, developing countries had to resort to the Bretton Woods Institutions (the IMF and the World Bank, just to remind you). The BWIs made it a condition that borrowing countries implement the **structural adjustment programme** (SAP), which required shrinking the role of the government in the economy by cutting its budget, privatizing SOEs and reducing regulations, especially on international trade.

The results of the SAP were extremely disappointing, to say the least. Despite making all the necessary 'structural' reforms, most countries experienced dramatic growth slowdown in the 1980s and the 1990s. Per capita income growth rates in Latin America (including the Caribbean) collapsed from 3.1 per cent in 1960–80 to 0.3 per cent in 1980–2000. In Sub-Saharan Africa (SSA), per capita income fell during this period; in 2000, it was 13 per cent lower than in 1980. The

result was an effective arresting of the Third World Industrial Revolution, which is the name that Ajit Singh, the Cambridge economist, used in order to describe the economic development experience of developing countries in the first few decades following decolonization.

Only Chile did well out of neo-liberal policies of the 1980s and the 1990s, but at considerable human cost under the Pinochet dictatorship (1974–90).³⁰ All the other success stories of this period were economies that used state intervention extensively and liberalized only gradually. The best examples of this were Japan, the 'tiger' (or 'dragon', depending on your animal preference) economies of East Asia (South Korea, Taiwan and Singapore) and, increasingly, China.

The wall comes crashing down: the collapse of socialism

Then, in 1989, a momentous change happened. That year, the Soviet Union started to unravel, and the Berlin Wall was torn down. Germany was reunited (1990), and most Eastern European countries abandoned communism. By 1991, the Soviet Union itself was dismembered. With China gradually but surely opening up and liberalizing since 1978 and with Vietnam (unified under the Communist rule in 1975) also adopting its 'open door' policy (Doi Moi) in 1986, the socialist bloc was reduced to a few die-hard states, notably North Korea and Cuba.

The problems with the socialist economies were already well known: the difficulty of planning an increasingly diverse economy, incentive problems arising from weak links between performance and reward and widespread politically

determined inequality in an ostensibly equal society (see Chapter 9). But few, including the most anti-socialist commentators, had thought that the bloc would implode so quickly.

The ultimate problem was that the Soviet bloc economies had tried to build an alternative economic system based on essentially second-rate technologies. There were, of course, areas like space and arms technologies where they were leading the world (after all, in 1957 the Soviet Union put the first ever man in space), thanks to the disproportionate amount of resources poured into them. However, when it became evident that it could only offer its citizens second-rate consumer products – as symbolized by Trabant, the East German car with plastic body, which quickly became a museum piece after the fall of the Berlin Wall – the citizens revolted.

In the next decade or so, the socialist countries in Eastern Europe made a headlong dash to transform themselves (back) into capitalist ones. Many thought that the 'transition' *could be* made quickly. Surely, it was just a matter of privatizing SOEs and reintroducing the market system, which is after all one of the most 'natural' human institutions? Others added that the transition *had to be* made quickly, in order not to give time to the old ruling elite to regroup itself and resist change. Most countries adopted 'Big Bang' reforms, trying to bring capitalism back overnight.

The result was nothing short of a disaster in most countries. Yugoslavia disintegrated and descended into wars and ethnic cleansing. Many former republics of the Soviet Union experienced deep depressions. In Russia, the economic collapse and the resulting unemployment and economic

insecurity caused so much mental stress, alcoholism and other health problems that it is estimated that millions more people died than would have been the case if the pre-transition trends had continued.³¹ In many countries, the old elite simply 'changed their suits' and transformed themselves from party *apparatchiks* into businessmen, enriching themselves hugely by acquiring state assets at knock-down prices through corrupt practices and 'insider dealings' in the privatization process. The Central European countries – Poland, Hungary, the Czech Republic and Slovakia – fared better, especially after they joined the European Union in 2004, thanks to being more gradualist in their reform and to their better skill bases. But even in the case of these countries, it is difficult to hail the transition experience as a great success.

The fall of the socialist bloc ushered in a period of 'free-market triumphalism'. Some, such as the American (then) neo-con thinker Francis Fukuyama, pronounced the 'end of history' (no, not the end of the world) on the grounds that we had finally conclusively identified the best economic system in the form of capitalism. The fact that capitalism comes in many varieties, each with particular strengths and weaknesses, was blissfully ignored in the euphoric mood of the day.

One world, ready or not: globalization and the new world economic order

By the mid-1990s, neo-liberalism had spread throughout the world. Most of the old socialist world had been absorbed into the capitalist world economy, either through the 'Big

Bang' reforms or, as in the case of China and Vietnam, through gradual but constant opening up and deregulation. By this time, market opening and liberalization had also progressed considerably in most developing countries. In most countries, this happened rapidly due to the SAP, but there were some others where it happened more gradually through voluntary policy changes, such as in India.

Around this time, some important international agreements were signed that signalled a new era of global integration. In 1994, the NAFTA (North American Free Trade Agreement) was signed between the US, Canada and Mexico. It was the first major free-trade agreement between developed countries and a developing country. In 1995, the Uruguay Round of the GATT talks was concluded, resulting in the expansion of the GATT into the WTO (World Trade Organization). The WTO covers many more areas (e.g., intellectual property rights, such as patents and trademarks, and trade in services) and has more sanctioning power than the GATT did. Economic integration progressed further in the EU, with the completion of the 'Single Market' project (with the so-called 'four freedoms of movement' – of goods, services, people and money) in 1993 and with the 1995 accession of Sweden, Finland and Austria.* The combined result was the creation of an international trading system that was much more geared towards freer (although not entirely free) trade.

Also the idea of globalization emerged as the defining

* Being 'neutral' countries in the Cold War, these countries had kept their distance from the EU, despite being in Western Europe.

concept of the time. International economic integration of course had been going on since the sixteenth century, but according to the new globalization narrative, this process has reached an entirely new stage. This was thanks to the technological revolutions in communications (the internet) and transportation (air travel, container shipping), which were leading to the 'death of distance'. According to the globalizers, countries now had no choice but to embrace this new reality and fully open up to international trade and investments, while liberalizing their domestic economies. Those who resisted this inevitability were derided as the 'modern Luddites', who think they can bring back a bygone world by reversing technological progress (see above). Book titles like *The Borderless World*, *The World Is Flat* and *One World, Ready or Not* summed up the essence of this new discourse.

The beginning of the end: the Asian financial crisis

The euphoria of the late 1980s and the early 1990s didn't last. The first sign that not everything was fine with the 'brave new world' came with the financial crisis in Mexico in 1995. Too many people had invested in Mexican financial assets with the unrealistic expectation that, having fully embraced free-market policies and having signed the NAFTA, the country was going to be the next miracle economy. Mexico was bailed out by the US and the Canadian governments (who didn't want a collapse in their new free-trade partner) as well as by the IMF.

In 1997, a bigger shock came about with the Asian financial crisis. A number of hitherto successful Asian economies – the

so-called 'MIT economies' (Malaysia, Indonesia and Thailand) and South Korea – got into financial troubles. The culprit was the bursting of the **asset bubbles** (asset prices rising well above their realistic levels, based on unrealistic expectations).

While they had been more cautious than other developing regions in opening up their economies, these countries opened up their financial markets quite radically in the late 1980s and the early 1990s. Now facing fewer restrictions, their banks borrowed aggressively from the rich countries, which had lower interest rates. In their turn, the rich-country banks saw little risk in lending to countries with decades-long excellent economic records. As more foreign capital flowed in, asset prices went up, which enabled firms and households in the Asian countries to borrow even more, using their now more valuable assets as collateral. Soon the process became a self-fulfilling prophecy, as the expectation of ever-rising asset prices justified further borrowing and lending (sounds familiar?). When it later became clear that those asset prices were unsustainable, money was pulled out, and financial crises ensued.

The Asian crisis left a huge scar in the afflicted economies. In economies where 5 per cent growth (in per capita terms) was considered a 'recession', output fell in 1998 by 16 per cent in Indonesia and 6–7 per cent in the other economies. Tens of millions of people were thrown out of work in societies where unemployment means penury, given the small size of the welfare state.

In return for the bail-out money from the IMF and the rich countries, the crisis-stricken Asian countries had to

accept a lot of policy changes – all in the direction of liberalizing their markets, especially their financial markets. While it pushed the Asian economies themselves on in a more market-oriented direction, the Asian crisis – and the Brazilian and the Russian crises that immediately followed it – actually planted the first seed of scepticism about post-Cold War free-market triumphalism. There were serious discussions about the need to reform the global financial system, much of them along the same lines as the ones that we have seen following the 2008 global financial crisis. Even many leading advocates of globalization – like the *Financial Times* columnist Martin Wolf and the free-trade economist Jagdish Bhagwati – started questioning the wisdom of allowing free international capital flows. All was not well with the new global economy.

The false dawn: from the dot.com boom to the Great Moderation

When these crises were brought under control, talk of global financial reform receded. In the US, a major push in the other direction came in the form of the 1999 repeal of the iconic New Deal legislation, the 1933 Glass-Steagall Act, which structurally separated commercial banking from investment banking.

There was another moment of panic in 2000, when the so-called dot.com bubble – in which internet-based companies with no prospect of generating any profit in the foreseeable future had their shares valued at absurdly high levels – burst in the US. The panic soon receded, as the US Federal Reserve intervened and cut interest rates

aggressively and the central banks of other rich economies followed suit.

From then on, the early years of the millennium seemed to be going swimmingly well in the rich countries, especially in the US. Growth was robust, if not exactly spectacular. Asset prices (prices of real estate, company shares and so on) seemed to be going up forever. Inflation remained low. Economists – including Ben Bernanke, the chairman of the Federal Reserve Board between February 2006 and January 2014 – talked of the ‘Great Moderation’, in which the science of economics had finally conquered **boom and bust** (or the economy going up and down by large margins). Alan Greenspan, the chairman of the Federal Reserve Board between August 1987 and January 2006, was revered as the ‘Maestro’ (as immortalized in the title of his biography by Bob Woodward of Watergate fame) who had a near-alchemical skill in managing a permanent economic boom without stoking inflation or courting financial trouble.

During the middle years of the 2000s, the rest of the world finally started to feel the ‘miracle’ growth of China of the preceding two decades. In 1978, at the beginning of its economic reform, the Chinese economy accounted for only 2.5 per cent of the world economy.³² It had minimal impact on the rest of the world – its share of world merchandise (goods) export was a mere 0.8 per cent.³³ By 2007, the corresponding numbers had risen to 6 per cent and 8.7 per cent.³⁴ Being relatively poorly endowed with natural resources and growing at breakneck speed, it started sucking in food, minerals and fuel from the rest of the world, and the effect of its growing weight was felt more and more strongly.

This gave a boost to the raw-material exporters of Africa and Latin America, finally allowing these economies to make up some of the ground they had lost in the 1980s and the 1990s. China also became a major lender and investor in some African countries, giving the latter some leverage in negotiating with the BWIs and the traditional aid donors, such as the US and the European countries. In the case of the Latin American countries, this period also saw a departure from the neo-liberal policies that had served them so poorly in several countries. Brazil (Lula), Bolivia (Morales), Venezuela (Chavez), Argentina (Kirchner), Ecuador (Correa) and Uruguay (Vasquez) were the most prominent examples.

A crack in the wall: the 2008 global financial crisis

In early 2007, alarm bells were rung by those who were worried about the (non-)repayment of mortgage loans that are euphemistically called 'subprime' (read 'having high chance of default'), made by US financial firms in the preceding housing boom. People with no stable income and chequered credit histories were lent more money than they could afford to pay back, on the assumption that house prices would keep going up. They would be able to repay their loans, it was reckoned, by selling their houses, if worse came to worst. On top of that, thousands or even hundreds of thousands of these high-risk mortgage loans were combined into 'composite' financial products, such as the MBS and the CDO (no need to know what they were at this stage – I will explain them in detail in Chapter 8) and sold as low-risk

assets, on the assumption that the chance of a large number of borrowers simultaneously getting into trouble must be much lower than that for individual borrowers.

Initially, the problem mortgage loans in the US were estimated to be \$50–100 billion – not a small amount but an amount that can be easily absorbed by the system (or so many claimed at the time). However, the crisis erupted properly in the summer of 2008, with the bankruptcy of the investment banks Bear Stearns and then Lehmann Brothers. A huge financial panic swept the world. It was revealed that even some of the most venerable names in the financial industry were in big trouble, having generated and bought huge numbers of dubious composite financial products.

The 'Keynesian spring' and the return of the free-market orthodoxy – with a vengeance

The initial responses of the major economies were very different from those following the Great Depression. Macroeconomic policies were Keynesian in the sense that they let huge budget deficits develop – at least not by cutting spending in line with falling tax revenues and in some cases by increasing government spending (China did this most aggressively). Major financial institutions (e.g., the UK's Royal Bank of Scotland) and industrial firms (e.g., GM and Chrysler in the US) were bailed out with public money. Central banks brought interest rates down to historical lows – for example, the Bank of England cut its interest rate to the lowest level since its foundation in 1694. When they could not cut their interest rates any more, they engaged in

what is known as **quantitative easing** (QE) – basically, the central bank creating money out of thin air and releasing it into the economy, mainly by buying government bonds.

Soon, however, free-market orthodoxy came back with a vengeance. May 2010 was the turning point. The election of the Conservative-led coalition government in the UK and the imposition of the Eurozone bail-out programme for Greece in that month signalled the comeback of the old balanced budget doctrine. **Austerity** budgets, in which spending is cut radically, have been imposed in the UK and in the so-called PIIGS economies (Portugal, Italy, Ireland, Greece and Spain). The success of the Republicans in pushing the Obama government in the US to accept a huge spending cut programme in 2011 and the reaffirmation of the anti-deficit bias of the core European countries in the form of the European Fiscal Compact, signed in 2012, pushed things even further in that direction. In all these countries, but especially the UK, the political right are even using the argument for balancing the budget as an excuse to severely prune back the welfare state, which they have always wanted to reduce.

The consequences: the lost decade?

The 2008 crisis has had devastating consequences, and its end is nowhere in sight. Four years after the crisis, at the end of 2012, per capita output remained lower than in 2007 in twenty-two of the thirty-four member countries of the OECD (Organization for Economic Cooperation and Development), the Paris-based club of rich countries (with

a handful of developing country members).^{*} GDP per capita in 2012, when filtering out the effect of price inflation, was 26 per cent below the 2007 level in Greece, 12 per cent below in Ireland, 7 per cent below in Spain and 6 per cent below in the UK. Even in the US, which is said to have recovered better than other countries from the crisis, per capita income in 2012 was still 1.4 per cent below the 2007 level.[†]

With the austerity budget, the prospect for economic recovery in many of these countries is dim. The problem is that a radical cut in government spending in a stagnating (or even shrinking) economy holds back recovery. We have already seen this during the Great Depression. As a result, it may take a good part of the decade before many of these countries can get back to what they used to be in 2007. They could well be in the middle of a 'lost decade', as was experienced in Japan (the 1990s) and in Latin America (the 1980s).

It is estimated that, at its depth, the crisis created 80 million extra unemployed people worldwide. In Spain and Greece, unemployment shot up from around 8 per cent before the crisis to 26 per cent and 28 per cent respectively in the

* The OECD was founded in 1961, and comprises most Western European countries, Turkey, the US and Canada. By the mid-1970s, Japan, Finland, Australia and New Zealand were added. Since the mid-1990s, several former socialist countries (e.g., Hungary and Estonia) and some richer developing countries (Mexico and Chile) have joined it.

† At the time of writing (early January 2014), the figures for 2013 were not out, but, on a provisional estimate made on the basis of the OECD data, in the third quarter of 2013 per capita output remained lower than in 2007 in nineteen out of the thirty-four OECD member countries.

summer of 2013. Youth unemployment is well over 55 per cent. Even in countries experiencing 'milder' unemployment problems, such as the US and the UK, official unemployment rates reached 8–10 per cent at their heights.

Too little too late?: prospects for reform

Despite the scale of the crisis, policy reforms have been slow in coming. Despite the fact that the cause of the crisis lay in excessive liberalization in the financial market, financial reforms have been rather mild and are being introduced very slowly (over several years, when the US banks had a year to comply with the much tougher New Deal financial reforms). There are areas of finance, such as the trading in overly complex financial products, in which even mild and slow reforms are not being introduced.

Of course, this trend could be reversed. After all, in both the post-Depression US and Sweden, the reforms came only after a few years of economic downturn and hardship. Indeed, the electorate in the Netherlands, France and Greece voted out pro-austerity parties in the spring of 2012; Italian voters did likewise in 2013. The EU has introduced some financial regulations that are tougher than what many people had imagined likely (e.g. financial transaction tax, cap on financial sector bonuses). Switzerland, frequently considered the haven of the super-rich, passed a law in 2013 preventing high rewards for top managers with mediocre performances. While there remains a lot more to be done in relation to financial reform, these are actually developments that would have been considered impossible before the crisis.

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