Seeds of its own destruction

By Martin Wolf, Financial Times, 3/8/09

Another ideological god has failed. The assumptions that ruled policy and politics over three decades suddenly look as outdated as revolutionary socialism.

"The nine most terrifying words in the English language are: 'I'm from the government and I'm here to help.'" Thus quipped Ronald Reagan, hero of US conservatism. The remark seems ancient history now that governments are pouring trillions of dollars, euros and pounds into financial systems.

"Governments bad; deregulated markets good": how can this faith escape unscathed after Alan Greenspan, pupil of Ayn Rand and predominant central banker of the era, described himself, in congressional testimony last October, as being "in a state of shocked disbelief" over the failure of the "self-interest of lending institutions to protect shareholders' equity"?

In the west, the pro-market ideology of the past three decades was a reaction to the perceived failure of the mixed-economy, Keynesian model of the 1950s, 1960s and 1970s. The move to the market was associated with the election of Reagan as US president in 1980 and the ascent to the British prime ministership of Margaret Thatcher the year before. Little less important was the role of Paul Volcker, then chairman of the Federal Reserve, in crushing inflation.

Yet bigger events shaped this epoch: the shift of China from the plan to the market under Deng Xiaoping, the collapse of Soviet communism between 1989 and 1991 and the end of India's inward-looking economic policies after 1991. The death of central planning, the end of the cold war and, above all, the entry of billions of new participants into the rapidly globalising world economy were the high points of this era.

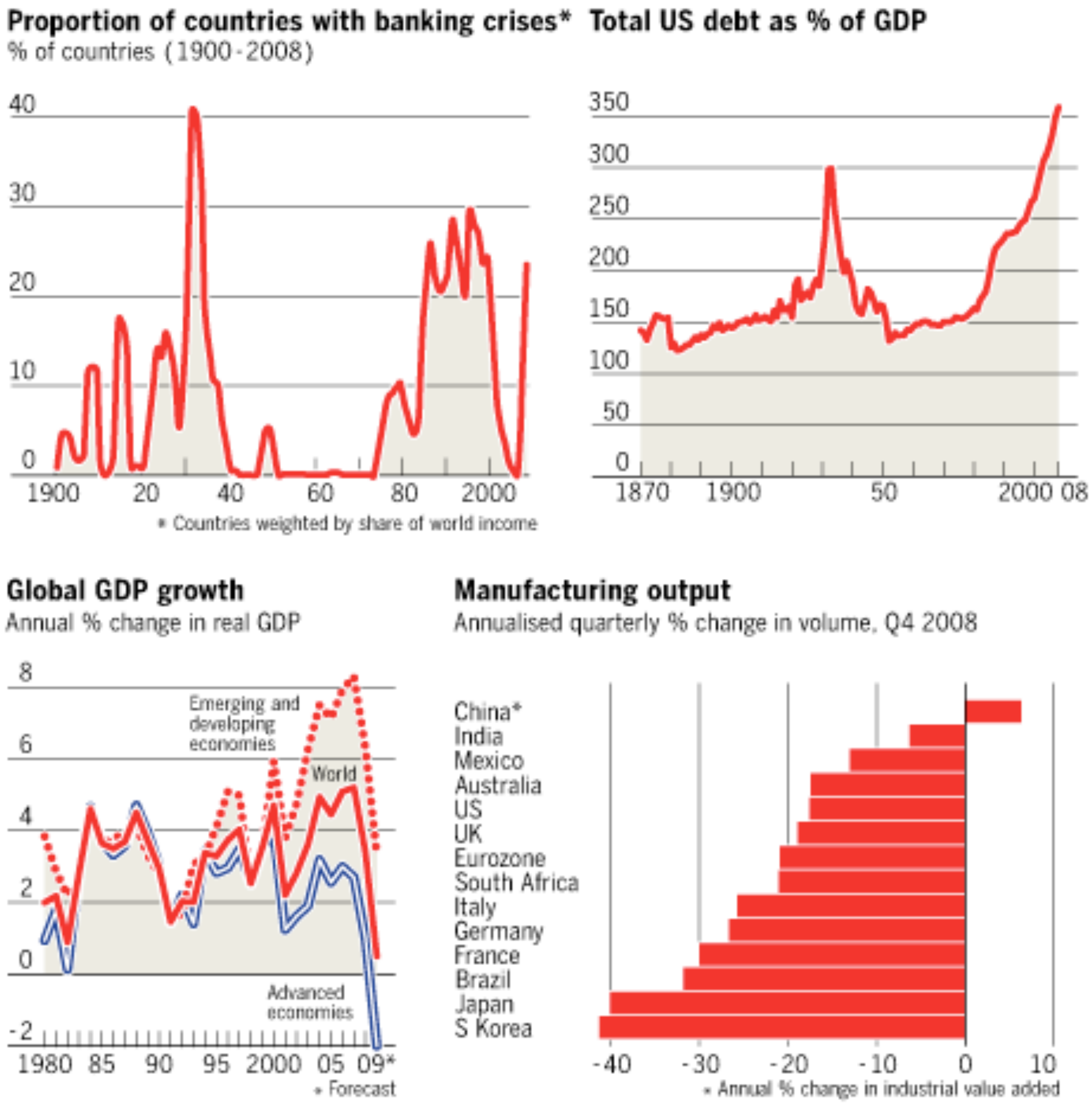
Today, with a huge global financial crisis and a synchronised slump in economic activity, the world is changing again. The financial system is the brain of the market economy. If it needs so expensive a rescue, what is left of Reagan's dismissal of governments? If the financial system has failed, what remains of confidence in markets?

It is impossible at such a turning point to know where we are going. In the chaotic 1970s, few guessed that the next epoch would see the taming of inflation, the unleashing of capitalism and the death of communism. What will happen now depends on choices unmade and shocks unknown. Yet the combination of a financial collapse with a huge recession, if not something worse, will surely change the world. The legitimacy of the market will weaken. The credibility of the US will be damaged. The authority of China will rise. Globalisation itself may founder. This is a time of upheaval.

How did the world arrive here? A big part of the answer is that the era of liberalisation contained seeds of its own downfall: this was also a period of massive growth in the scale and profitability of the financial sector, of frenetic financial innovation, of growing global macroeconomic imbalances, of huge household borrowing and of bubbles in asset prices.

In the US, core of the global market economy and centre of the current storm, the aggregate debt of the financial sector jumped from 22 per cent of gross domestic product in 1981 to 117 per cent by the third quarter of 2008. In the UK, with its heavy reliance on financial activity, gross debt of the financial sector reached almost 250 per cent of GDP (see charts).

The era of liberalisation contained the seeds of its own downfall - financial crises and an explosion in debt have given way to a deep global recession



Sources: Reinhart & Rogoff 'Banking Crises; an Equal Opportunity Menace' (AEA 2008); Hoisington Investment Management; IMF; Thomson Datastream

Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard argue that the era of liberalisation was also a time of exceptionally frequent financial crises, surpassed, since 1900, only by the 1930s. It was also an era of massive asset price bubbles. By intervening to keep their exchange rates down and accumulating foreign currency reserves, governments of emerging economies generated huge current account surpluses, which they recycled, together with inflows of private capital, into official capital outflows: between the end of the 1990s and the peak in July 2008, their currency reserves alone rose by $5,300bn.

These huge flows of capital, on top of the traditional surpluses of a number of high-income countries and the burgeoning surpluses of oil exporters, largely ended up in a small number of high-income countries and particularly in the US. At the peak, America absorbed about 70 per cent of the rest of the world's surplus savings.

Meanwhile, inside the US the ratio of household debt to GDP rose from 66 per cent in 1997 to 100 per cent a decade later. Even bigger jumps in household indebtedness occurred in the UK. These surges in household debt were supported, in turn, by highly elastic and innovative financial systems and, in the US, by government programmes.

Throughout, the financial sector innovated ceaselessly. Warren Buffett, the legendary investor, described derivatives as "financial weapons of mass destruction". He was proved at least partly right. In the 2000s, the "shadow banking system" emerged and traditional banking was largely replaced by the originate-and-distribute model of securitisation via constructions such as collateralised debt obligations. This model blew up in 2007.

We are witnessing the deepest, broadest and most dangerous financial crisis since the 1930s. As Profs Reinhart and Rogoff argue in another paper, "banking crises are associated with profound declines in output and employment". This is partly because of overstretched balance sheets: in the US, overall debt reached an all-time peak of just under 350 per cent of GDP – 85 per cent of it private. This was up from just over 160 per cent in 1980.

Among the possible outcomes of this shock are: massive and prolonged fiscal deficits in countries with large external deficits, as they try to sustain demand; a prolonged world recession; a brutal adjustment of the global balance of payments; a collapse of the dollar; soaring inflation; and a resort to protectionism. The transformation will surely go deepest in the financial sector itself. The proposition that sophisticated modern finance was able to transfer risk to those best able to manage it has failed. The paradigm is, instead, that risk has been transferred to those least able to understand it. As Mr Volcker remarked during a speech last April: "Simply stated, the bright new financial system – for all its talented participants, for all its rich rewards – has failed the test of the marketplace."

In a recent paper Andrew Haldane, the Bank of England's executive director for financial stability, shows how little banks understood of the risks they were supposed to manage. He ascribes these failures to "disaster myopia" (the tendency to underestimate risks), a lack of awareness of "network externalities" (spill-overs from one institution to the others) and "misaligned incentives" (the upside to employees and the downside to shareholders and taxpayers).

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After the crisis, we will surely "see finance less proud", as Winston Churchill desired back in 1925. Markets will impose a brutal, if temporary, discipline. Regulation will also tighten.

Less clear is whether policymakers will contemplate structural remedies: a separation of utility commercial banking from investment banking; or the forced reduction in the size and complexity of institutions deemed too big or interconnected to fail. One could also imagine a return of much banking activity to the home market, as governments increasingly call the tune. If so, this would be "de-globalisation".

Churchill called also for industry to be "more content". In the short run, however, the collapse of the financial system is achieving the opposite: a worldwide industrial slump. It is also spreading to every significant sector of the real economy, much of which is clamouring for assistance.

Yet if the financial system has proved dysfunctional, how far can we rely on the maximisation of shareholder value as the way to guide business? The bulk of shareholdings is, after all, controlled by financial institutions. Events of the past 18 months must confirm the folly of this idea. It is better, many will conclude, to let managers determine the direction of their companies than let financial players or markets override them.

A likely result will be an increased willingness by governments to protect companies from active shareholders – hedge funds, private equity and other investors. As a defective financial sector loses its credibility, the legitimacy of the market process itself is damaged. This is particularly true of the free-wheeling "Anglo-Saxon" approach.

No less likely are big changes in monetary policy. The macro-economic consensus had been in favour of a separation of responsibility for monetary and fiscal policy, the placing of fiscal policy on autopilot, independence of central banks and the orientation of monetary decisions towards targeting inflation. But with interest rates close to zero, the distinction between monetary and fiscal policy vanishes. More fundamental is the challenge to the decision to ignore asset prices in the setting of monetary policy.

Many argue that Mr Greenspan, who succeeded Mr Volcker, created the conditions for both bubbles and subsequent collapse. He used to argue that it would be easier to clean up after the bursting of a bubble than identify such a bubble in real time and then prick it. In a reassessment of the doctrine last November, Donald Kohn, Fed vice-chairman, restated the orthodox position, but with a degree of discomfort.

Mr Kohn now states that "in light of the demonstrated importance to the real economy of speculative booms and busts (which can take years to play out), central banks probably should always try to look out over a long horizon when evaluating the economic outlook and deliberating about the appropriate accompanying path of the policy rate". Central banks will have to go further, via either monetary policy or regulatory instruments.

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Yet a huge financial crisis, together with a deep global recession, if not something far worse, is going to have much wider effects than just these.

Remember what happened in the Great Depression of the 1930s. Unemployment rose to one-quarter of the labour force in important countries, including the US. This transformed capitalism and the role of government for half a century, even in the liberal democracies. It led to the collapse of liberal trade, fortified the credibility of socialism and communism and shifted many policymakers towards import substitution as a development strategy.

The Depression led also to xenophobia and authoritarianism. Frightened people become tribal: dividing lines open within and between societies. In 1930, the Nazis won 18 per cent of the German vote; in 1932, at the height of the Depression, their share had risen to 37 per cent.

One transformation that can already be seen is in attitudes to pay. Even the US and UK are exerting direct control over pay levels and structures in assisted institutions. From the inconceivable to the habitual has taken a year. Equally obvious is a wider shift in attitudes towards inequality: vast rewards were acceptable in return for exceptional competence; as compensation for costly incompetence, they are intolerable. Marginal tax rates on the wealthier are on the way back up.

Yet another impact will be on the sense of insecurity. The credibility of moving pension savings from government-run pay-as-you-go systems to market-based systems will be far smaller than before, even though, ironically, the opportunity for profitable long-term investment has risen. Politics, like markets, overshoot.

The search for security will strengthen political control over markets. A shift towards politics entails a shift towards the national, away from the global. This is already evident in finance. It is shown too in the determination to rescue national producers. But protectionist intervention is likely to extend well beyond the cases seen so far: these are still early days.

The impact of the crisis will be particularly hard on emerging countries: the number of people in extreme poverty will rise, the size of the new middle class will fall and governments of some indebted emerging countries will surely default. Confidence in local and global elites, in the market and even in the possibility of material progress will weaken, with potentially devastating social and political consequences. Helping emerging economies through a crisis for which most have no responsibility whatsoever is a necessity.

The ability of the west in general and the US in particular to influence the course of events will also be damaged. The collapse of the western financial system, while China's flourishes, marks a humiliating end to the "unipolar moment". As western policymakers struggle, their credibility lies broken. Who still trusts the teachers?

These changes will endanger the ability of the world not just to manage the global economy but also to cope with strategic challenges: fragile states, terrorism, climate change and the rise of new great powers. At the extreme, the integration of the global economy on which almost everybody now depends might be reversed. Globalisation is a choice. The integrated economy of the decades before the first world war collapsed. It could do so again.

On June 19 2007, I concluded an article on the "new capitalism" with the observation that it remained "untested". The test has come: it failed. The era of financial liberalisation has ended. Yet, unlike in the 1930s, no credible alternative to the market economy exists and the habits of international co-operation are deep.

"I've a feeling we're not in Kansas any more," said Dorothy after a tornado dropped her, her house and dog in the land of Oz. The world of the past three decades has gone. Where we end up, after this financial tornado, is for us to seek to determine.

This is the first part of an FT series entitled the Future of Capitalism