Preface

The recession that started in 2008 was not a global recession. The economies of China, India and the emerging economies of East Asia and Brazil experienced continuing economic growth. In 2011 China became the second largest economy and the forecast is that China will overtake the USA by 2050. After 200 years of global dominance, the economies of the West have to face the challenges of the emerging new economies which are at present out-producing, out-exporting and out-growing some of the advanced economies. While global growth depended on 800 million consumers living in the advanced economies, there are now 2 billion new consumers emerging in China and India. The new global economy therefore offers both challenges and opportunities for the advanced economies. The response of the UK and other European countries of reducing spending on education and infrastructure in response to public sector deficits might deal with short-term concerns but will hinder future competitiveness. Equally, while the financial crisis has confirmed the need for a global solution of global financial reforms that are universal and comprehensive, the tendency has increasingly become one of national and domestic policy making. While Basle III is an attempt to outline a definition of capital requirement that is universal, financial institutions are using their governments as a form of lobbying to seek concessions. A process that is influenced by national priorities is therefore likely to create regulatory arbitrage, with financial entities moving to those countries that offer lower regulatory standards.

The interim Vickers Report published in April 2011, the Dodd-Frank Act in the USA of July 2010 and Basle III represent initiatives to deal with the financial crisis. The common themes of the proposed reforms include responding to the high leverage by financial institutions, the growth of derivatives in deregulated markets and the concern of too big to fail. Policy reform proposals include higher capital requirements, increased transparency by putting derivatives on exchanges and clearing platforms, posting collateral and developing living wills for large banks that would allow liquidation in an orderly fashion in case of bank failures.

All of these reforms represent relevant responses in the crisis of 2007. However, with financial institutions now being global entities the issue
of too big to fail would still persist. Governments would not allow the Royal Bank of Scotland, Goldman Sachs or JP Morgan Chase to go into bankruptcy for fear that such an event would be catastrophic for both the financial sector and the real economy. Since the recession, the banks that have survived have become even more concentrated. The top five banks in the USA have assets which are equivalent to 65 per cent of US GDP while in the UK and other European countries the large banks have assets which are three times the size of GDP. There is no way that US policy makers would allow Goldman Sachs with assets worth 950 billion dollars to go into liquidation. This process creates a fear factor and also a dependency relationship between governments and the financial sector.

The financial crisis exhibited major tensions between capitalism and democracy. A capitalism that is defined by the ethic of one dollar, one vote, and a democracy run on the basis of one person, one vote, has generated major issues of inequalities of incomes, but also inequalities in the access to the policy process. Based on the ethic of one dollar, one vote, those on high incomes have quick and ready access to the policy process and the corridors of government where they shape policy at the formulation stage. On the basis of one person, one vote, in the democratic process the majority influence policy making during elections. In contemporary democracy the multitude becomes the quiet audience sitting in the auditorium watching the political actors on the stage and being asked to clap in between acts. Democracy that is limited to election times is, according to Barber (1984), thin democracy as opposed to the commitment of thick democracy and the culture of involvement.

Secondly, the conventional wisdom that has dominated economic thinking during the past three decades of commitment to the free market and rational expectations theory has created a climate in which markets reign supreme; markets are the equivalent to the law of gravity and therefore the outcomes are seen as the natural outcomes of markets rather than political choices. The study of economics, research in economics and publications can no longer be assumed to be independent and impartial when independent Think Tanks’ Boards of Trustees are continually seeking new funding to secure new professorships and new research grants and therefore becoming dependent on financial contributions, and those same contributors have their own ideologies and political priorities, which in turn undermine the concept of independent impartial research. There is, therefore, the legitimate concern of how the present research agenda within independent Think Tanks and how the idea of impartial economics reinforces the particular interests of those contributors who favour free unfettered and deregulated markets (Ferguson 2011a; Turner 2010).
interests and ideology often interact in ways so subtle that is difficult to disentangle them, the influence of interests achieved through an unconsciously accepted ideology. The financial sector dominates non-academic employment of professional economists who, however rigorously independent in their judgements on specific issues, will, because only human, tend implicitly to support or at least not aggressively challenge the conventional wisdom which is in the interests of their industry. Regulators need to hire industry experts to regulate effectively; but industry experts are almost bound to share the industry’s implicit assumptions. (Turner 2010, p. 9)

The financial crisis has confirmed the absence of a public interest. Fragmentation and struggles of who gets what had undermined the principle of the notion of the public interest. In the advanced economies the period since the mid-1980s has been characterized by growing income inequalities and the concentrations of income towards the top 1 per cent of earners and even more concentrated towards the top 0.01 per cent of earners. Income inequality in 2011 is similar in magnitude to levels of inequality in 1929. This process has distorted policy making but is also undermining the democratic process. The rule by a small elite amidst growing poverty and income inequalities does not allow for the possibilities of hope and societal change.

The financial crisis has exhibited the absence of a public interest at a number of levels. Policy makers depend on financial contributions as do political parties. Those with money have the ability to hire accountants, lawyers and tax advisors that ensure policy is shaped in order to serve their narrow particular interests rather than universal public interests. The process of deregulation and forms of economic thinking that favoured the commitment to unfettered markets created a context that put handcuffs on regulators. The problem of revolving doors, of moving between an appointment as a regulator to an appointment with the private sector as an advisor, or to be hired as a lobbyist, means that elected politicians and regulators know that as they step down from government appointments they will eventually retire as millionaires:

The appropriate comparison is perhaps with a powerful magnetic field. When The Force is with them – when, that is, Congressmen and women, their staffs, presidential aides, and federal regulators can be sure of walking out of their offices to become multimillionaires when they retire or step down – expecting them to act consistently in the public interest is idle, even if all representatives were elected on 100% public funding. (Ferguson 2011b, p. 27)

The Credit Rating Agencies (CRAs) rated $4.3 trillion worth of asset backed securities as triple-A and then downgraded 87 per cent of those securities to below investment grade within a period of 24 months. Due to their business model of the issuer pays the CRAs were reluctant to walk
away from a rating. The ethics of IBGYBG – I’ll be gone, you’ll be gone – implied that analysts at the CRAs and the issuers of bonds had to focus on the short term of getting an issue rated, getting the fees, improving their personal incomes and not thinking about the long-term consequences.

Thirdly, financial institutions sold securities to their clients, even when the entities themselves were betting that these same securities would default. The client was treated as the sophisticated investor who knew what level of risk they wanted to absorb. However, clients trusted their banks to sell them something that was good for them.

The financial crisis has also resulted in the breakdown of trust. People had trust in the institutions of government, in their banks and professionals who they thought were there to advise them on what is good for them. The financial crisis showed a breakdown in the trust in mortgage brokers who were being paid high fees by originators of loans to channel borrowers towards high interest rate mortgages. Issuers of bonds were concerned with securitization of bonds, getting a rating and selling these to investors. Investment banks were concerned with minimizing their own exposure and getting rid of high-risk assets so that in selling bonds to investors as a long-term investment the banks themselves were betting that these same bonds would default. The CEOs of the 14 major banks earned incomes of $2.6 billion between 1997 and 2007. The top five CEOs earned $2 billion (Johnson 2011). The Credit Rating Agencies through fees in the rating of asset backed securities, increased their incomes from 3 billion to 6 billion dollars annually, while the CEOs of the CRAs were earning salaries similar to the CEOs of the investment banks.

Since World War II there have been approximately 125 financial crises, with a crisis occurring on average once every three years. One major consequence of the latest financial crisis has been the surge in leveraging in the private sector by both households and private sector entities. The climate of a long period of short-term interests resulted in high borrowing by households and private sector companies (Rheinhart and Rogoff 2009). Deleveraging means a loss of output and increases in unemployment. With the declines in house prices and in equities households are repairing their finances paying off debt and increasing savings. In 2008 and 2009 global GDP shrank by 2 per cent, the GDP in the USA declined by 4.5 per cent and the UK by 6 per cent. The majority of governments in the advanced economies are making decisions about public finances in the context of a smaller economy. The crisis in the financial system has major costs for employment and for social provision, including health and education. There are major declines in GDP which then take years to repair. Despite the frequent occurrence of financial crises, governments have opted to deregulate the finance industry when the natural response would have
The politics of recession

been to seek tighter regulation. This confirms a process of ‘cognitive policy capture’, with governments and policy makers co-opting the expertise of finance to define and shape policy (Johnson 2011). Advocates of free markets have consistently pointed out that it was always better for market participants to regulate themselves. The repeal of the Banking Act of 1933 and the implementation of the Commodity Futures Modernization Act of 2000 created the context for the growth of the over-the-counter (OTC) derivatives markets. This unregulated market grew to notional amounts of $640 trillion between 1997 and 2007, which was equivalent to 10 times global GDP. There is no evidence that the derivatives markets contributed to the growth of global GDP. The growing economies of India and China and the emerging economies did not utilize the OTC markets. Adair Turner (2011), the Chairman of the FSA, pointed out that most of what happened in the financial markets was economically and socially useless, since the majority of transactions were purely speculative about future prices.

The argument developed in this book points to a structural explanation of the financial crisis. The concept of social structures connects with concerns about relationships of power and influence, the role of ideology and inequalities. The financial crisis was a crisis of economic ideas. Rational expectations and efficient markets theories that had become the intellectual paradigm in policy making provided institutions of government with philosophies and ready-made policy options. The economists who produced these models were well aware of the limitations of their models and yet failed to point these out to the policy practitioners.

The increases in house prices after 1997 – house prices were rising at an average of 10 per cent per year – provided households with the opportunity to exchange the savings and equities in their homes for liquid cash, which they could then utilize for personal consumption. The increases in house prices provided a context of dissaving and increased consumption, as households looked at their homes as their portfolios and as ATM machines. Households took $2.3 trillion of equity out of their homes for increased debt. However, it would be misleading to attribute the financial crisis to the housing bubble or the defaults with the sub-prime mortgages. The total write-offs within sub-prime mortgages were between $500 billion and $1 trillion, which should have been absorbed within a global economy of $65 trillion. The total costs to the government in bailing out the financial sector was $14 trillion.

The OTC derivatives markets and the processes of securitization contributed to the financial crisis because of their complexity, their opacity and the lack of market prices, since most of these swaps were private, customized and unique bonds. Derivatives amplified uncertainty and
eventually caused a bank run on the investment banks when the REPO markets asked for high collateral and higher haircuts in accepting asset-backed securities. The crisis at Bear Stearns Lehman Brothers and AIG reflected the uncertainty. In the case of AIG the insurance company sold some $80 billion of credit default swaps (CDS) for a premium of $8 billion. Since AIG did not have to post daily collateral, there was no attempt to calculate daily prices movements of the derivatives markets. The CDS was not statutory insurance. The CDS reflected daily changes in the market. The absence of collateralized debt obligation (CDO) transactions made it difficult to price these instruments, therefore when Goldman Sachs asked for increased collateral from AIG, AIG disputed the amount. The attempt to put the OTC market on transparent futures exchanges and on central clearing platforms has met with resistance for broker dealers and from end users. The opaqueness of the system has generated fees for the brokers and also reduced the costs for end users. The derivatives market proved to be highly fragile during the financial crisis and the need for higher capital requirements and posting collateral would at least start to internalize the risks posed in the OTC markets.

The costs of the present financial meltdown have been high in terms of increases in unemployment shrinking GDP, falling revenues, and major increases in government debt ratios which have overspill ed into debates about reducing public expenditure on education, health and social security spending. All these reductions will impact the quality of life of the elderly, the sick, the unemployed and young people in education. None of these groups caused the financial crisis but now seem to be paying the price for it.

It remains to be seen whether new economic thinking will emerge to replace the paradigm of market liberalism that has dominated thinking for the past three decades. There has always been a plurality of theoretical models of how economies work; the issue is not the absence of alternatives but rather the attempt to explain how these alternatives are marginalized. The financial crisis, therefore, teaches the lesson that that there are political choices and alternatives, as opposed to theories of inevitability of outcomes. The claim made by rational expectations theorists that their economics had solved the problem of stabilization has proven to be misleading during the present recession. The paradigm of free markets did not predict the present financial crisis nor did it provide for the possibility for crisis. Furthermore, free market advocates have offered little policy choice for dealing with the crisis (Summers 2011). Those who seek to break out of the present orthodoxy need to reclaim the ethics of Keynes and start to kick up a fuss. Free unfettered markets work in some sectors, but it cannot be assumed that market completion is the only solution and the
only alternative. Markets do produce the dynamic for change for social progress but there needs to be a return to the classical political economy of Adam Smith, Ricardo and Keynes: a political economy that tried to explain how economies worked but left issues of income distributions as contestable issues of political choices, as opposed to the recent ideology that suggested there are no alternatives but to accept the outcomes of markets.

During the writing of the book I broke my leg in two places in the Lake District, which meant the research had to stop as most of the time I had to lie down with my leg in heavy plaster. I need therefore to thank Felicity Plester and the team at Edward Elgar who have continued to support me in writing this book. In writing this book I have many debts to my wife Eileen who has been patient and supportive, and my children who never complained about me talking about the book during the past two years. I want to thank colleagues and friends who read chapters and who listened patiently to some of my arguments in developing this book. However, in the end, I take full responsibility for what I have written.

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