

EXCERPTED FROM

Exploring the Global Financial Crisis

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1

Exploring the Global Financial Crisis

Alan W. Cafruny and Herman M. Schwartz

In July 2007 IKB Deutsche Industriebank, a relatively small German financial firm, collapsed as a result of losses incurred by borrowing short term to invest in complex, long-term derivatives built on US mortgages. At a time when many commentators were celebrating the emergence of a new economy characterized by efficient and self-correcting financial markets, IKB Deutsche's collapse appeared to be an idiosyncratic or nonsystemic event. Even the chronically sluggish European economy was showing signs of life amid the long capital markets boom that followed the bursting of the high-tech bubble at the beginning of the decade. The German state and banks rallied to the firm's defense, ultimately providing 5 billion euros in emergency lines of credit.

Yet the implosion of the US housing market that started just one month later showed that, far from being idiosyncratic, IKB Deutsche Industriebank's troubles were a prelude to the most prolonged and serious global financial crisis since the Great Depression. In August 2007 the global securitization market for US mortgages began to lock up. Many European banks had bet heavily on the US subprime market. As the crisis deepened, major banks on both sides of the Atlantic began to fail, disproving assertions that the European economy was "de-coupling" from the United States (International Monetary Fund 2007).

As global trade and financial flows plummeted, observers drew comparisons to the Great Depression. By the summer of 2008, one of the largest British mortgage lenders, Northern Rock, went bankrupt and was taken under government control. The fall of Lehman Brothers Bank in September 2008 pushed global stock markets into free fall as the US government bought AIG, the United States' leading insurer; nationalized mortgage giants Fannie Mae and Freddie Mac; and took a controlling interest in Chrysler and General Motors. In Britain, contemporary news photos showed the public lined up in front of Northern Rock's branches, evoking the classic bank panics of the 1930s. Inside the boardrooms of the large

financial firms a similar dynamic was unfolding: like anxious depositors, these firms started to reclaim their deposits, triggering a massive and self-fulfilling wave of bankruptcy among international financial firms. Speaking to an emergency meeting of EU ministers on the same day that the Dutch government nationalized Fortis's Netherlands operations, French Prime Minister François Fillon warned that the world was "on the edge of the abyss" (*Guardian* 2008).

In 1931 the collapse of Austria's Credit-Anstalt had triggered a similar crisis. Central banks responded feebly, and by 1932, banks were collapsing everywhere in the face of depositor runs. The depth and severity of the Great Depression then provoked a national and international politics of extremes. Nationalist and imperial responses to mass unemployment and rural poverty led to the collapse of international flows of goods, capital, and people. Struggles to maintain global market shares and to export surplus capacity provoked the deliberate use of currency devaluations to promote exports and the formation of closed trading blocs. Economic disarray led ineluctably to fascism and war, causing the deaths of 100 million people in World War II.

With the specter of 1931 hovering over them, central banks in the United States, China, and the eurozone responded to the fall of Lehman Brothers Bank in September 2008 with massive emergency lending. The United States and China implemented unprecedented fiscal stimulus programs while individual European countries responded with more modest but still significant fiscal expansion. The US Federal Reserve also provided nearly \$600 billion in dollar-denominated loans to non-US banks so that they could meet dollar-denominated obligations to their creditors. By the end of 2009, financial markets appeared to have been stabilized and world stock markets began to reverse their downward slide. Global trade began to recover, and the crisis-driven trend toward fragmented global financial markets was halted.

State policy has thus far prevented the global economy from going completely off the cliff. Yet, if a full-fledged global depression has thus far been avoided, four years after the start of the crisis there is little evidence that the world economy will return to normal. Unemployment has skyrocketed, developed-country fiscal deficits will exceed normal levels for years to come, capacity utilization remains well under normal levels, and property markets in the United States and much of Europe remain depressed. Stock markets around the world are experiencing massive volatility. Many large eurozone banks in particular are undercapitalized, and some are thought to be effectively insolvent. Depression has been avoided only by a massive releveraging of the public sector. But this releveraging has inhibited governments from undertaking new fiscal measures and discouraged many central banks from reflating asset prices that, given the present political inclination toward austerity, appear to provide the only means of promoting recovery.

Bank of America's near-death experience in 2011 and the lack of significant financial regulation on both sides of the Atlantic showed that "too-big-to-fail" banks still threaten the global economy. Likewise, European banks' vulnerability to default by tiny Greece showed how weak their capital bases were. The tendency toward growing inequality and declining real wages within most of the OECD countries, not least the United States, has been greatly exacerbated by the crisis, further constraining demand and growth.

Four years into the crisis, signs appeared that economic disarray was provoking mass political unrest. *Financial Times* columnist Gideon Rachman (2011) declared 2011 "the year of global indignation" as witnessed in the Arab Spring, riots and sit-ins in Athens and Madrid, months of student and worker marches in Chile, protests in Tel Aviv, looting in Great Britain, anticorruption demonstrations in India, and growing protests in China. Likewise, the political gridlock resulting from the wave of Tea Party Republicans in the United States both reflected and amplified economic disorder. While the Tea Party's origins clearly lay in massive and expensive organizational efforts by a handful of billionaires and multimillionaires, its appeal resonated among many voters amid severe economic stress and profound uncertainty about the future. On the other side, the Occupy Wall Street protests focused attention on America's worsening income inequality.

Thus, the key underlying causes for the crisis persist. The global imbalance between Chinese production and US consumption has moderated but is still above sustainable levels. The cost of financial bailouts added a new and massive layer of sovereign debt on top of unprecedented levels of consumer debt. As a result, the eurozone has been brought to the brink of crisis. In the United States, fiscal stimulus is politically unfeasible. Unconventional expansive monetary policy by the United States has had uncertain effects even as it risks precipitating trade wars with Brazil, China, and other emerging-market nations whose currency is appreciating against the dollar. Within the financial industry, the number and scope of disruptions—from the savings and loan crisis of the mid-1980s, to the Asian financial crisis of the late 1990s, to the bursting of the Internet bubble at the turn of the millennium, and to the present generalized crisis—have increased in proportion to the growth of the financial sector in relation to the broader economy. Yet the existing and inadequate national and international regulation of banking remains essentially unchanged: since 2007 the size of the big banks has grown even as they "stare into the abyss" (*Economist* 2011, 1). With revenue and employment falling in tandem, more and more states have begun to experiment with mercantilist trade and financial policies.

Even if further catastrophic shocks to the global financial system can be averted—and there is no certainty of that—it remains unclear what will give the global economy traction again. Indeed, there appears to be no way back. Compared to every other crisis since the 1930s, this crisis is bigger, broader, and more central. Where prior crises were more narrowly financial

or economic, and indeed often contained in one part of the financial sector, this crisis was simultaneously financial and economic. Where prior crises mostly affected developing countries or a few developed countries (and even then only via currency crises), this one emerged in the developed countries, including the United States. Finally, where prior crises were resolved through the actions of advanced countries' governments and central banks, in this crisis such actions have further destabilized the global economy by converting banking crises into more generalized crises of sovereign debt, as the travails of the eurozone and Standard and Poor's downgrading of US Treasury bonds illustrates. In short, the old normal is dead, replaced by a period of protracted or even permanent crisis.

The Study of IPE: From the Crisis of Bretton Woods to the Global Financial Crisis

As many of the chapters in this volume suggest, the present crisis developed in part as a result of the policies and actions that were undertaken to overcome the crisis of the Bretton Woods system that erupted in the late 1960s and culminated with Washington's abandonment of the dollar-gold system that was its linchpin in 1971. If the present crisis greatly overshadows that of the Bretton Woods system in its potential severity, it is worth noting that the global political and economic turbulence of the late Bretton Woods era led to the founding of the subdiscipline of international political economy (IPE) and gave rise to novel theoretical perspectives and questions that have preoccupied scholarship for the past generation. Indeed, prior to the crisis of Bretton Woods, scholarship within the field of international relations paid little attention to the interrelationship between politics and economics. With the exception of a few heretical Keynesians and Marxists, development theory and policy was considered the province of neoclassical economics. Given the assumption of comparative advantage—an international economy essentially devoid of power relations—economic development or modernization was a subject for specialists in comparative politics, because impediments to development were by definition internal. The study of international relations itself largely bracketed economics and production as factors causing both power and conflict.

The economic shocks of the late 1960s and early 1970s profoundly challenged these prevailing assumptions and disciplinary conventions. The collapse of the Bretton Woods system showed that global trade and finance were not technical matters but rather organically connected to international power relations. Dependency theorists rejected modernization theory in favor of models that assumed that center-periphery relations remained exploitative even after decolonization. The search for a new international economic order (NIEO) was predicated on the assumption of a highly

unequal international division of labor characterized by trade and financial relations of dependency and subordination. The stagflation that afflicted much of the North and the ensuing global debt crisis of the South revealed an international economy subject to political disarray, as what could be seen retrospectively as the brief interlude of a golden age gave way to great tension and uncertainty. The specter of political conflict among advanced capitalist states reemerged.

The theoretical perspectives that informed mainstream analyses of the crisis of Bretton Woods corresponded closely to US policymakers' mental map of the world. That mental map was formed during and immediately after World War II as those policymakers sought to reconstruct the world economy in accordance with US interests. US Secretary of State Cordell Hull, perhaps the most influential theoretician of post-World War II US foreign economic policy, had understood the Great Depression as a leadership crisis—the interregnum between British and American hegemony—that led inexorably to protectionist trade blocs and war. The pioneers of the new subfield of international political economy in the 1970s applied Hull's insights to the gathering international economic storms. Focusing primarily on international trade, they thematized the decline of US power and, with it, the problem of leadership for openness and stability (Kindleberger 1973; Gilpin 1975; Krasner 1976). The implication of their approach was that the emergent multipolar world was encouraging mercantilist tendencies that would prove difficult to contain. Reacting to the implicit determinism of this essentially neorealist analysis, others argued that even in the absence of a single global leader, international regimes could promote cooperation and thereby maintain openness and cooperation in a multilateral world (Keohane 1984; Ikenberry 2011).

Beyond the mainstream, a range of alternative analytic perspectives challenged many of the assumptions behind the dominant narrative of decline. Critics of the thesis of US hegemonic decline located the source of global economic disarray not in the decline of US power and leadership but rather in the more forceful and self-interested exercise of US power, especially in the sphere of monetary relations (Calleo 1982; Strange 1982).¹ A vigorous Marxist tradition developed and for a brief period enjoyed considerable status within the discipline of IPE. Marxists defined the crisis not primarily in terms of US hegemonic decline and uneven development, but rather in terms of the contradictions inherent in post-World War II Fordist regulation and inexorable tendencies toward overaccumulation (Harvey 1982; Magdoff and Sweezy 1987).

Yet by the mid-1990s, new and largely unanticipated developments in the international political economy appeared to confound many of these theories and perspectives. Contrary to the expectations of many, a new era of trade liberalization emerged as a result of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), subsequent establishment

of the World Trade Organization (WTO), and a host of regional and bilateral free trade agreements, including most prominently the Single European Market and the North American Free Trade Agreement. The deregulation of capital markets in the United States and Britain ultimately set in motion a corresponding massive increase in global capital mobility, as states either followed suit voluntarily or as a result of IMF-supervised structural adjustment programs. The debt crisis of the developing countries that resulted from the Volcker shocks of 1979 and ensuing monetarism ultimately produced neither greater third-world militancy nor an NIEO but rather acquiescence to the Washington Consensus. The hallmark of the Washington Consensus was the imposition of harsh austerity on debtors. Notwithstanding the human suffering caused by these policies, the gradual industrialization across significant sections of the global South, and most notably the rise of BRICs (Brazil, Russia, India, and China), appeared to confound the expectations of dependency theorists.

The new era of globalization was enhanced first by the entry of 1.2 billion Chinese into the global market economy and then another 300 million more from the former Soviet bloc. These developments, alongside growing migration flows from the South to the North, reinforced the triumph of neoliberalism at the expense of the more embedded form of post-World War II capitalism (Gill and Law 1988). Finally, the thesis of declining US hegemony appeared to be premature; far from being in decline, US structural power appeared to have been prolonged and, in some respects even deepened as a result of “Bretton Woods II.” Because of the depth and attractiveness of its capital markets, the United States could run unending deficits while consuming 25 percent of world output and as much as 75 percent of global capital flows by generating increasingly larger trade deficits with impunity. Whereas the crises of the 1930s and 1970s occurred in the context of intellectual concerns with public goods, political economy, and society, the triumph of neoliberalism of the 1980s represented a return to individualism, as Marx and Keynes were marginalized by reassertion of micro foundations of economic, political, and even cultural life (Rodgers 2011).

To Infinity and Beyond

This entire edifice arguably came crashing down in the summer of 2008. The crash suggested that, contrary to the champions of the new economy and globalization, the structural problems that led to the demise of the Bretton Woods system had not in fact been resolved but rather were simply postponed, only to reappear in more acute forms. Hence, the old questions raised by a previous generation of IPE scholars have reasserted themselves. In addition, a host of new questions has emerged about an international political economy that is infinitely more complex than that of a generation

ago. In what ways does the current crisis of the recent lesser depression resemble the Great Depression in terms of opening up the possibility for reshaping global institutions and practices surrounding the flow of goods, capital, and people? How have conflicts over employment and access to resources among different nations been transformed by the crisis? Why are some regional economies doing better than others? Is the global role of the dollar being challenged, and if so, by what currency? Will economic decline generate massive social movements like those of the 1930s, thereby reasserting the power of labor on a national or international basis, or will we see something closer to the antilabor “white armies” of the 1920s and 1930s? What will happen to the eurozone and the European project? Is it possible to regulate the growing power of finance? Does the crisis originate primarily in the realm of ideas—among policymakers who are in Keynes’s words “in thrall to the ideas of some long-dead economist”—or is it more deeply rooted in the conflicts among social forces generated by the structure of capitalism itself? We have encouraged our authors, where possible, to make comparisons with the 1930s in their elaboration of different aspects of the present crisis.

Plan of the Book

The first part of the book explores different regional experiences of and responses to the crisis. Alan Cafruny and Leila Talani focus on the broader transatlantic and geopolitical implications of the crisis of the eurozone. If in important respects the Economic and Monetary Union (EMU) represented a Franco-German bargain, the eurozone has also served to deepen Europe’s neoliberal turn while also supporting Germany’s covert mercantilism. In this context, the massive austerity that is being inflicted on the southern European countries is likely to condemn the entire eurozone to years of stagnation, accelerating the trend toward nationalism.

R. Taggart Murphy explores the options of China and Japan, the two largest holders of US debt. During the 1990s Japan entered into prolonged stagnation, in part as a result of its support for the dollar. China has in some respects pursued a similar trajectory, purchasing US securities to prop the dollar while exporting to the United States and suppressing domestic consumption. Will China follow Japan in the descent toward stagnation? Murphy argues that the present US-China relationship is unsustainable, but that the endgame is unpredictable.

Peter Kingstone argues that prudence and luck have helped Latin America avoid the worst of the downturn. China’s insatiable demand for raw materials provided the luck, though it exposes Latin America to the risk of a downturn if China’s stimulus-driven economy slows down. But two decades of painful economic reforms also put the major Latin American

economies on a sounder footing in advance of the crisis. The most important change was the transformation of public debt from foreign currency-denominated debt to a local currency basis. Latin America thus avoided the currency-driven increase in debt that historically crippled its economies in global downturns.

Flows of people are often ignored in IPE's holy trinity of money, trade, and multinationals. Ariane Chebel d'Appollonia shows that the lesser depression has only slowed, not halted, migration, unlike the collapse of the 1930s. While the flow of migrants has slowed and their remittances slowed even more, both remain robust. Partly this reflects the differences between stocks and flows. While the flow of migrants has slowed, the stock of immigrants in host countries remains quite large. Being at the bottom of the labor market, they have disproportionately suffered unemployment in the crisis. Yet they continue to support home-country consumption through a vast flow of remittances.

The next section assesses US hegemony in the aftermath of the crisis, focusing on employment, oil, and money. Herman Schwartz argues the US-China relationship has shifted from a symbiotic relationship with respect to employment to a conflictual one. Chinese trade surplus recycling into the US housing market meant that US and Chinese employment could grow together in the 1990s and early 2000s. But from the mid-2000s—well before the crisis—this symbiosis reversed itself as Chinese exports began to erode the mid-level technology industry in the United States. Because these Chinese exports were produced with increasingly capital-intensive production techniques, they also eroded Chinese manufacturing employment. The lesser depression has only intensified this conflict. China has doubled down on its huge investment bet in export-oriented production, yet the United States cannot hope to absorb this output without further declines in employment. On the other hand, US efforts to stimulate its economy through quantitative easing (the Fed's so-called QE2 and QE3) will restrain imports by lowering the exchange rate of the dollar, harming employment growth in China.

The flip side of the conflict over employment is a conflict over natural resources, of which oil remains the most important. Timothy Lehmann argues that notwithstanding dramatic developments in biofuels and solar technology, many of which have originated in China, petrochemicals will remain at the center of global energy rivalry for decades to come. US hegemony was constructed on the basis of its control over the petrochemical core in the Middle East. Such a foundation suggests that Sino-American rivalry is likely to persist as the United States seeks to maintain China's subordinate role while China attempts to entice oil-rich countries into its own orbit.

Hubert Zimmermann investigates the possibility that the euro can replace the US dollar as the international reserve currency. He comes to a

contradictory conclusion, in the good sense of contradiction. The existence of the euro has helped Europe weather the crisis precisely because it allowed the European Central Bank (ECB) to expand the monetary base and extend the same kind of cheap credit that the Fed was able to create in the teeth of the storm. Yet this very behavior reduces the euro's ability to replace the dollar, by showing that it too is not immune to political pressure for expanded liquidity. The euro is not some gigantic version of a Swiss franc or gold bar.

The final part of the book presents some critical perspectives on the origins of and responses to the crisis. Maria Ivanova examines the role that housing played in the post–Great Depression US economy. She argues that housing became increasingly important in sustaining US growth as the economy shifted out of a Fordist growth pattern into a post-Fordist pattern characterized by slow-growing income for the bulk of the population and the underlying tendency toward overaccumulation. The collapse of the housing bubble means that the United States needs a new source of growth, but Ivanova is pessimistic that one can be found. The implication of her analysis is that monetary alchemy in the form of Keynesian demand management will not be sufficient to bring the economy out of crisis. As in the Great Depression, renewed growth requires a new, socially validated redistribution of income toward the average consumer or worker.

Anastasia Nesvetailova complements Ivanova's analysis by showing how unsustainable levels of credit creation funded demand in the 2000s. Using Hyman Minsky's theory about the inherent instability of capitalist finance, Nesvetailova shows how innovation led to increasingly risky speculative behavior in credit markets. Illiquid assets were liquefied, allowing enormous increases in lending against those assets. These loans (and the related impaired assets) are at the heart of the crisis. Nesvetailova argues that current regulatory responses are unlikely to resolve the most important systemic risks around global finance.

Finally, massive social movements marked the Great Depression. Both the left and the right were able to draw on historic repertoires of protest and violence. Those repertoires are exhausted in most developed countries. Yet the lesser depression has seen new forms of social protest in both rich and poor polities. The US Tea Party movement represents a common form of elite-funded right-wing populism, akin to but so far less violent than similar movements in Australia and Canada during the 1930s. Magnus Ryner and Matt Davies analyze whether a left populism is still possible in today's world. They make a strong argument that class still matters, but that the apparently undifferentiated capital and labor of the nineteenth century that Marx analyzed is gone (if it ever existed). Instead, different kinds of capital and labor now confront each other over a thoroughly transnational battlefield. Different production relations in different parts of the world create

different class structures and thus different possibilities for collective action. But the increasing salience of self-employment makes them pessimistic about the chances for even regional, let alone global social movement from below.

Our volume aims at but does not achieve a comprehensive presentation of the issues. Indeed, we recognize that firm answers to the questions that we and our authors raise are not possible at the present time. Put aside the quip attributed to Zhou Enlai about the significance of the French Revolution (“too soon to tell”) and the fact that sharp debates persist about the origins and response to the Great Depression. We are still too close to the crisis—indeed, still in the middle if not, to paraphrase Winston Churchill, merely at the end of the beginning. Nevertheless, it is essential to begin assessing how the international political economy is changing. Like a person in an unlit room at night, our choice is to stand still and go nowhere, or to reach out with hands and feet and feel our way past what is in front of us, perhaps discerning not only that there are obstacles to the resolution of the crisis but what those obstacles are.

Notes

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1. The nature and extent of US hegemonic power was the subject of volume 5 of the IPE Yearbook (David Rapkin, ed. *Studies in Global Leadership and Hegemony* [Boulder, CO: Lynne Rienner, 1990]).