After the crisis

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Abstract

The end of the global financial crisis will not produce a return to the conditions regarded as ‘normal’ before the emergence of the crisis. The aim of this paper is to look beyond the immediate problems of stabilising the economy and financial sector and to explore the implications of the global financial crisis for economic theory and public policy. It is argued that the abandonment of the efficient (financial) markets hypothesis implies the need for a social-democratic approach to collective risk management.
1. Introduction

The global financial crisis that began in the US in 2007, and engulfed the entire world economy in late 2008, still has some time to run. It is already clear, however, that there is little likelihood of a return to the conditions regarded as 'normal' before the emergence of the crisis. The disappearance, through bankruptcy, merger or nationalisation of much of the global financial sector, along with the financial assets that sector created, promoted and sold, will not be reversed rapidly. The massive international imbalances that sustained the bubble economy of the past decade must be eliminated if a sustainable recovery is to be achieved, and this process will apply fundamental adjustments. Most importantly, the thinking behind policy approaches that dominated the late 20th century has been shown to be wrong in crucial respects, most importantly in its assumption that, with limited regulation, free markets will yield stable economic outcomes.

For much of the last decade, and particularly in the case of the US response to the dot-com boom and bust, characterised by expansionary monetary policy in the years after 2001, economic policy has staved off the immediate consequences of unsound and unstable economic structures, but has done nothing to address the underlying problems. The result has been to allow imbalances to build up even further, making the inevitable crash even worse. A coherent response to the crisis must include plans for sustainable economic management in the long term.

The aim of this paper is to look beyond the immediate problems of stabilising the economy and financial sector and to explore the implications of the global financial crisis for economic theory and public policy. The paper is organised as follows. Section 2 deals with the development of the crisis, beginning with the resurgence of economic liberalism in the 1970s, itself a response to the economic crisis that ended the Bretton Woods era of fixed exchange rates, Keynesian
macroeconomic policy and social-democratic political advances. Section 2 examines the implications of the crisis for economic thought, the most notable of which is the refutation of the efficient (financial) markets hypothesis. Section 4

2. The development of the global financial crisis

To understand the current crisis, it is necessary to look back to the earlier period of economic crisis in the 1970s, from which economic liberalism emerged as the dominant framework for political and economic discussion in Australia and other developed countries. The resurgence of economic liberalism was driven by the breakdown of the postwar system of financial controls as a result of the growth of unregulated financial markets and the failure of the Keynesian system of macroeconomic management. In the current crisis, over-expanded financial markets have collapsed, necessitating the re-imposition of extensive controls, and the failure of monetary policy has led to a return to Keynesian policies of demand stimulus.

The resurgence of economic liberalism

Until the last quarter of the 20th century, it seemed reasonable to interpret modern political history in terms of the fairly steady advance of socialist and social democratic political ideas and policies. Globally the Great Depression of the 1930s discredited liberal capitalism, seemingly forever. Support for Keynesianism and for more extensive systems of economic planning was greatly enhanced by the experience of the wartime planning between 1939 and 1945.

For the developed countries, the period from 1945 to 1970 was unparalleled in the history of capitalism as one of full employment, rapid economic growth and increasing equality of opportunity and outcomes\(^1\). By 1970, however, the strains that would lead to the breakdown of Keynesian social democracy were already evident.

\(^1\) Despite the exceptional nature of this 'golden age', only limited research has been undertaken into the factors that made the 'golden age' possible and the reasons for its breakdown.
The crucial problem was the failure of Keynesian economic management to control the combination of high inflation and high unemployment referred to as stagflation. The crucial event was the collapse of the Bretton Woods system of fixed exchange rates between 1970 and 1972, in the face of inflationary pressures driven by rising wages and US budget deficits. This was accompanied by the abandonment of Keynesian macroeconomic policies, and their replacement, initially, by the monetarist ideas of Friedman (1968) and later by a more eclectic approach, dominated by interest rate policy, in which the primary target of policy was maintenance of low and stable inflation.

The collapse of the Bretton Woods system began a process of international financial deregulation, which created intense pressure for deregulation of domestic capital markets and for broader policies of economic liberalisation, as critics of Keynesian macroeconomic policies broadened their views into a general critique of government intervention. The dominant role of financial markets drove market-oriented reforms adopted throughout the world in the 1980s and 1990s.

*Signs of crisis*

From the Asian financial crisis of 1997 onwards, the global financial system showed increasing signs of instability. Although relatively modest in scope, the rescue of the hedge fund Long-Term Capital Management in 1998 was an indication of the vulnerability of the system to highly leveraged speculative investment. The spectacular dot-com boom and bust from the late 1990s to 2001 undermined faith in ever-rising stockmarkets and in the financial institutions that had promoted the boom.

At the same time, popular disillusionment with economic liberalism became more pronounced. In the United Kingdom and New Zealand, and to a lesser extent in Canada, centre-left governments elected in the 1990s moved away from the radical economic liberalism of their predecessors in favour of policies variously described as ‘Third Way’ or ‘modernised social democracy’, while the
free-market rhetoric of parties such as the US Republicans was modified with talk of ‘compassionate conservatism’.

Despite these signs of decline, economic liberalism remained the dominant ideology of the early 20th century. Quiggin (2005) noted the weakness of economic liberalism but concluded

‘no clear alternative has emerged to replace economic liberalism. For the moment, governments appear to be “muddling through”, dealing as best they can with the problems posed by unbounded demands for public services and strictly limited willingness to pay for such services through higher taxes.

In the booming financial sector, boosted by easy credit and financial innovation, the warning signs were disregarded. The modest Sarbanes-Oxley reforms, introduced to improve corporate accounting in the light of the dot-com fiasco, were derided as an unnecessary over-reaction, a view that was repeated up to, and even during, the meltdown of September 2008.

The collapse: 2007 and after

Although many economists predicted that the combination of a housing bubble, and large current account imbalances was bound to lead to a severe correction (Quiggin 2004, Setser and Roubini 2005, few if any predicted the way in which the crisis would unfold. Bell and Quiggin (2006) noted the dangers of unrestricted financial innovation, but observed ‘In the absence of a severe failure in the financial system of the United States, it seems unlikely that ideas of a new global financial architecture will ever be much more than ideas.’

The first signs of such a failure emerged in 2007 when home-buyers who had taken out ‘sub-prime’ housing loans in the United States began to default in substantial numbers. Although much discussion is still focused on sub-prime loans, it became apparent over the course of 2008 that these were simply the weakest borrowers and therefore the first to fail. The entire financial system was characterised by unsound lending and by reliance on complex financial
structures to obscure, rather than manage risk. Every part of the system, from commercial real estate to corporate debt to consumer finance was affected.

2008 saw the failure or rescue of such firms as Countrywide (which had financed around 20 per cent of the US mortgage market), along with most other non-bank mortgage originators, investment banks Bear Stearns, Lehman Brothers and Merrill Lynch, the world’s largest insurance company, AIG, and the nationalisation of mortgage securitisation firms Fannie Mae and Freddie Mac. European financial institutions including the Royal Bank of Scotland, ABN Amro and the entire financial system of Iceland also failed.

Markets for financial instruments such as collateralised deposit obligations (CDOs), auction-rate securities, and bond insurance have failed altogether. Those financial markets that continue to operate do so only on the basis of massive infusions of credit from central banks.

3. Implications for economic thought

Since the economic crises of the early 1970s derailed the system of fixed exchange rates and Keynesian macroeconomic management established at the Bretton Woods conference in 1944, the economic and political landscape has been dominated by a massive expansion in the size, scope and international integration of financial markets. The growth of financial markets has supported, and been supported by, market-oriented ideologies variously referred to as Thatcherism, economic rationalism, neoliberalism and the Washington consensus.

As usual with dominant ideologies, these labels are most commonly used in a pejorative sense, by opponents of the dominant view. Perhaps the most popular term used in favourable descriptions of the free-market approach has been ‘economic liberalism’, and, because this term is also reasonably accurate as a description, it will be used here.

The global financial crisis has undermined the central supports of economic liberalism, both microeconomic and macroeconomic. The central microeconomic
claim supporting economic liberalism is that markets, and particularly financial markets, do a better job of allocating investment resources and managing risk than can be achieved by government action. This claim, is commonly referred to as the efficient markets hypothesis.

The central macroeconomic support for economic liberalism was the consistent and relatively stable economic growth, accompanied by strong growth in employment, observed in the period since the recession of the early 1990s. This improvement in performance was described by Bernanke (2004) as the Great Moderation.

*The efficient markets hypothesis*

A great many claims for the superiority of market processes for the allocation of scarce capital resources, and for the management of risk, have been put forward. These claims all depend, in one way or another, on the efficient (financial) markets hypothesis. Broadly speaking, the efficient markets hypothesis says that the prices generated by capital markets represent the best possible estimate of the values of the underlying assets.

The efficient markets hypothesis has been stated in a variety of forms, some stronger than others (Fama 1970). In evaluating the case for economic liberalism, the important issue is the ‘semi-strong’ version which says that asset prices are at least as good as any estimate that can be made on the basis of publicly available information. It follows, in the absence of distorting taxes or other market failures, that the best way to allocate scarce capital and other resources is to seek to maximise the market value of the associated assets. Another way of presenting the semi-strong efficient markets hypothesis is to say whether or not markets are perfectly efficient, they are better than any other possible capital allocation method, or at least, better than any practically feasible alternative.

The efficient markets hypothesis also has implications for labour market outcomes. The massive growth in inequality observed in the United States, and,
to a lesser extent, other developed countries, has been driven, in large measure, by huge increases in salaries, bonuses and other incomes in the financial sector. These increases have flowed through, to some extent to broader groups of professionals and managers, while wages for less educated workers have stagnated.

According to the efficient markets hypothesis, high incomes for financial sector workers must reflect the social value of their activities in risk management and capital allocation. More generally, increasing inequality is the price of strong economic performance.

Econometric evidence supports the weak form of the efficient markets hypothesis, but points to difficulties with the stronger versions. A number of studies have suggested that the volatility of asset prices is greater than is predicted by semi-strong and strong forms of the hypothesis (Shiller 1989).

While econometric tests can be given a rigorous justification, they are rarely conclusive, since it is usually possible to get somewhat different results with a different specification or a different data set. Most people are more likely to form their views on the efficient markets hypothesis on the basis of beliefs about the presence or absence of 'bubbles' in asset prices, that is, periods in which prices move steadily further and further away from underlying values. For those who still believed the efficient markets hypothesis, the recent crisis should have shaken their faith greatly.

Although the consequences were less severe, the dot-com bubble of the late 1990s was, in important respects, are more clear-cut and convincing example of an asset price bubble. Many commentators said (Quiggin 2003), that this was a bubble. However, those, like George Soros, who tried to profit by short-selling lost their money when the bubble lasted longer than expected. This outcome undermines the claim that rational speculators will prevent the emergence of an unsustainable bubble and supports the aphorism (commonly attributed to Keynes) that 'the market can stay irrational longer than you can stay solvent'.
More important than asset markets themselves is their role in the allocation of investment. As Keynes (1936) said in his *General Theory of Employment Interest and Money*, this job is unlikely to be well done when it is a by-product of the activities of a casino. So, if the superficial resemblance of asset markets to gigantic casinos reflects reality, we would expect to see distortions in patterns of savings and investment. The dot-com bubble provides a good example, with around a trillion dollars of investment capital being poured into speculative investments. Some of this was totally dissipated, while much of the remainder was used in a massive, and premature, expansion of the capacity of optical fibre networks, driven by fraudulent accounting. Eventually, most of this ‘dark fibre’ bandwidth was taken up, but, in investment allocation, timing is just as important as project selection.

The dot-com bubble was just one component of a massive asset price bubble that began in the early 1990s and is only now coming to an end. Throughout this period, patterns of savings and investment made little sense. Household savings plunged to zero and below in a number of developed countries (including nearly all English-speaking countries) and the resulting current account deficits were met by borrowing from poor, but rapidly growing, countries like China. Standard economics would suggest that capital flows should go in the other direction. The massive growth of the financial sector itself, which accounted for nearly half of all corporate profits by the end of the bubble, diverted physical and particularly human capital from the production of goods and services.

*Inequality and economic performance*

During the decades of economic liberalism, the inequality of income and wealth in developed countries grew substantially². Growth in inequality was evident in the United States from the middle 1970s, and in several English-speaking

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² It is far more difficult to assess the change in inequality for the world as a whole. Very poor countries have generally become even poorer since the 1970s, but many poor countries have experienced rapid growth in average incomes. Most notably China and India, with a combined population of over 2 billion have experienced strong growth, combined however with growing inequality. Assessments of changes in global income distribution depend largely on assessments of the rate and distribution of income growth in these two countries (Milanovic 2003).
countries (most notably the United Kingdom and New Zealand) from the 1980s onwards. Growth in inequality was slower to emerge in other developed countries, including Australia, but was evident in most countries by the early 21st century.

The most obvious manifestation of growing inequality was the huge increase in income and wealth accruing to the top 5 per cent of the population, particularly in the United States. Piketty and Saez (2006) estimate that the share of income accruing to this group rose from around 20 per cent in the postwar period to 30 per cent at the end of the 20th century. Within this group, the top 1 percent increased their share of total income from 8 per cent to 15 per cent, and the top 0.01 per cent from 0.5 per cent to 3 per cent. The share of the remainder of the top decile (percentiles 6-10) remained roughly constant. All other individuals lost ground in relative terms. Atkinson and Leigh (2006) provide estimates for Australia showing a less marked, but still significant, growth in inequality.

For those in the bottom half of the US income distribution, by contrast, wages and household incomes have been risen only marginally since the 1970s (DeNavas-Walt, Proctor, and Smith 2007). Since average household size has declined, and the labour force participation of women has grown, income per person has shown modest growth for all groups, but the gap between the rich and the poor has never been wider.

The most notable area of income growth from the 1970s onwards was in the finance sector. By the early decades of the 21st century, financial corporations accounted for 25 per cent of revenues, up from around 5 per cent in 1983 (Auerbach 2006) and 40 per cent of corporate profits (Johnson 2009) in the United States. The multi-million dollar bonuses and other payments made to senior executives attracted considerable attention. More significantly, many thousands of professional employees earned salaries far in excess of average earnings, and competition from the financial sector drove increases in incomes for senior professionals and managers in a wide range of industries.
Inequality could also be observed in spatial terms. Wealth and power were increasingly concentrated in a handful of ‘global cities’ (New York, London, Tokyo and, to a lesser extent, Paris) characterised by a focus on finance and accounting services. (Sassen 1991).

Although empirical evidence on the relationship between inequality and economic growth remains ambiguous, it was widely claimed during the era of economic liberalism that the growth in top incomes was both a reflection of the increased importance contribution to the value of output of senior executives and highly skilled professionals, particularly in the financial sector, and a necessary condition for continued general prosperity.

The latter claim, though frequently derided as ‘trickle-down economics’, was an important justification for large reductions in top marginal tax rates and in taxes on capital income adopted by many governments over this period. The suggestion was that the benefits of innovative financial management would flow through to households in their capacity as direct and indirect investors in equity, and then to the economy as a whole.

The global financial crisis provides clear evidence on the relationship between inequality and economic performance, with no need for subtle statistical inference. The crisis was brought about by the mistaken decisions of financial enterprises which had, during the expansion, received a large share of corporate profits, as well as making exceptionally large payments to managers and high-level employees.

As a result of the decline in share prices in 2008, investors in equity have lost all the gains of the past three decades, relative to the low-risk alternative of investment in government bonds. By contrast, except for a handful of forfeited bonus payments (and their own exposure as holders of equity) the managers and employees have retained the massive salaries and other benefits paid to them out of profits that now appear to be illusory.
Furthermore, there is considerable evidence to suggest that the payment structures that contributed so much to the growth in inequality were directly responsible for the poor investment decisions. Decision-makers received huge payoffs for risky investments as long as they went well. However, their potential loss from poor investments was limited, in personal terms by the inability of firms to reclaim past payments, and in corporate terms by the fact that the soundness of financial enterprises was explicitly or implicitly backed by governments.

*Macroeconomic implications*

Until recently, macroeconomic evidence seemed to favour economic liberalism. Beginning in the mid-1980s, the macroeconomic performance of the United States improved substantially relative to the chaotic period that with the emergence of intractable inflation problems in the late 1960s. In particular, the average rate of inflation declined while the average rate of economic growth increased, and the volatility of both these variables declined markedly. Bernanke (2004) popularised the phrase ‘The Great Moderation’ to describe this period of improved performance.

The Great Moderation was not confined to the United States. Although Australia and the United Kingdom experienced severe economic crises around 1990, these were followed by nearly two decades of uninterrupted economic expansion. This success was commonly explained as the result of free-market economic policies and particularly of financial liberalisation.

More generally, economic liberals contrasted the supposed success of radical free-market reforms in English-speaking countries including New Zealand, Australia, the United Kingdom and the United States with the supposedly sclerotic performance of the European social democracies. Other exemplars of success included Argentina, which undertook an extensive program of privatisation in the early 1990s and Iceland, rated by the Heritage Foundation as having a higher level of economic freedom than any other European country.
The macroeconomic case for economic liberalism has collapsed with surprising rapidity, though in retrospect its unsustainability has been evident since the late 1990s. It is clear that the global economy is undergoing a severe recession, which will generate a substantial increase in the volatility of output. Meanwhile, the free-market ‘miracle economies’ have encountered catastrophes far more severe than those of the global economy as a whole. Iceland in particular has experienced a total economic collapse, with all its major banks declaring insolvency in a matter of weeks, foreign exchange convertibility abandoned, and imports restricted to essential items.

**Further implications**

The failure of the efficient markets hypothesis, the end of the great moderation and the breakdown of the standard justifications for growing inequality will obviously have a wide range of implications within and beyond economic theory. Some further implications are explored in Quiggin (2009a).

An obvious question is where the breakdown of so many dominant ideas will lead. One possibility is a restoration of something like the mainstream economics of the 1950s and 1960s, Keynesian in macroeconomics and with a focus on market failure and the scope for beneficial government intervention. Another is the development of new approaches in which the standard microeconomic framework based on rational optimisation is replaced by an alternative view of individual and group decision-making, drawing on developments such as the rise of behavioral economics, and the implications of asymmetric information. One such approach, centred on the idea of ‘animal spirits’ is proposed by Akerlof and Shiller (2009).

4. **The case for social democracy**

The resilience of social democratic institutions and values in the face of a concerted neoliberal attack has been striking. The time is now ripe for a shift from the defensive position of the last quarter-century, in which social democrats struggled mainly to protect the achievements of the past.
Governments of all political persuasions are being forced to deal with a sudden and drastic increase in risk and insecurity generated by the collapse of the global financial sector. But only a social-democratic analysis provides any coherent basis for a response.

Social democrats have long stressed the idea that we have the capacity to share and manage risks more effectively as a society than as individuals. The set of policies traditionally associated with social democracy may be regarded as responses to a range of risks facing individuals, from health risks to uncertain life chances.

Risk and inequality are closely linked. On the one hand, the greater the risks faced by individuals in the course of their life, including the risk associated with differences in initial opportunities, the more unequal society is likely to be. On the other hand, as the financial crisis has shown, radical inequality in outcomes, such as that associated with massive rewards to financial traders, encourages risky behavior and particularly encourages a search for opportunities to capture the benefits of risky actions while shifting the costs onto others, or onto society as a whole.

A social democratic response to the crisis must begin by reasserting the crucial role of the state in risk management. If individuals are to have security of employment, income and wealth, governments must act to establish and enforce the necessary legal and economic framework. The fact that government is the ultimate risk manager both justifies and necessitates action to mitigate the grotesque inequalities in both opportunities and outcomes that characterise unrestrained capitalism and were increasingly resurgent in the era of economic liberalism.

Quiggin (2009b) presents a social democratic agenda for reform in the light of the economic crisis. The key elements are:
* A reconstructed financial sector must be based on a tightly controlled system of ‘narrow banking’ providing essential financial services to households and business. Banking must be clearly separated from speculative financial activity. Speculative financial enterprises must bear the full risk associated with their activities, without any public guarantee or support.

* The inevitable contraction of the financial sector creates both the need and the opportunity for an expansion in the provision of non-financial human services, such as health and education.

* The financial crisis has undermined the case for the privatisation of public infrastructure and implies an end to ‘innovative’ financing methods such as public-private partnerships.

* The failure of economic liberalism does not imply a wholesale return to the ideas and policies of the postwar social democratic era. Social democrats must learn from the mistakes of that era and retain what was valuable in economic liberalism, including a commitment to sound fiscal policy and a rejection of protectionist restrictions on trade in goods and services.

**Concluding comments**

In a situation where seemingly safe institutions, and the assumptions they embody, are dissolving daily, it is impossible to present detailed blueprints for the future. Nevertheless, it is clear that the institutions and economic systems that dominated the late 20th century have failed. Space is now opening up for an effective social response.

The only plausible candidate for such a response is a revived and updated social democratic polity, framed around the ideas of collective risk management, social justice and the central role of public goods.

**References**


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