Financial Crisis

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The Financial Crisis Is Still Empowering Far-Right Populists

Why the Effects Haven't Faded[1]

By Manuel Funke, Moritz Schularick, and Christoph Trebesch - 20180913

The 2008 ***financial crisis*** [see below, page 12] was devastating to the world economy. Just how devastating is something economists still argue over. It is not easy to add up the costs of bank bailouts, a lost decade of economic growth, spiking public debt, ***grinding austerity*** [see below, page 50] , and surging

1 Source: https://www.foreignaffairs.com/articles/2018-09-13/financial-crisis-still-empowering-far-right-populists

inequality [see below, page 84]. But the biggest cost of the crisis might be not economic but political: the populist wave that has swept over the world in the last decade, upending political systems, empowering extremists, and making governance more difficult. Financial crises regularly lead to political polarization and populism, but the recent populist surge has lasted longer than those that followed earlier crises—and done more damage.

RISE OF THE RIGHT

The crash in 2008 and the subsequent eurozone sovereign debt crisis dealt a severe blow to political systems in the West. Crisis fighting became the new normal. Long-standing two-party systems in France and Spain were swept away. Populist far-right forces emerged from the fringes, sometimes achieving major electoral victories.

In 2015, we published a study that compiled data on nearly 100 financial crises and more than 800 national elections in 20 democracies since 1870. We found that far-right parties are the biggest beneficiaries of financial crashes. After a crisis, the share of the vote going to right-wing parties increases by more than 30 percent. We also found that government majorities tend to shrink and governing becomes difficult as more parties and antiestablishment groups get into legislatures. These effects turn up in the wake of financial crises but, crucially, not in normal economic downturns.

Why are financial crises so disruptive? To start with, they are manmade disasters. People blame elites for failing to prevent them. It’s often not hard to find policy failures and cronyism among the rich and powerful, so trust in the political system erodes. This opens the door to political entrepreneurs who try to set “the people” against the "ruling class.”

The tendency to blame elites after financial crises might suggest that far-left parties would benefit as much as far-right ones. But that doesn’t happen. Our research shows that the far left’s vote share stays about the same in the aftermath of a crisis. It seems that when social groups fear decline and a loss of wealth, they turn to right-wing parties that promise stability and law and order. In the 1930s, for example, it was the German petit-bourgeoisie that enabled Hitler’s rise to power. Similarly, the election of U.S. President Donald Trump was decided by the middle and working classes.

Right-wing populists are much more willing to exploit cultural cleavages and blame economic problems on foreigners and those who supposedly put the interests of a global elite above those of their fellow citizens. As British Prime Minister Theresa May put it last year, “If you believe you are a citizen of the world, you are a citizen of nowhere.” The left, by contrast, has traditionally taken an internationalist outlook and usually avoids crude rhetoric against foreigners and minorities. People want to attribute blame, and the right is willing to present scapegoats: immigrants, China, or the European Union. The names change but the playbook remains the same.

THIS TIME IS DIFFERENT

Our historical data show that most political upheavals after financial crises have been temporary. After five years, voting patterns usually return to their pre-crisis status quo, fractionalization within parliaments decreases, and the far right loses its momentum.

This time is different. Ten years on, fractionalization, polarization, and far-right voting are all alive and well. The established political system continues to stumble from one shock to another. Even countries that until recently had been immune to far-right politics have started to succumb.

Meanwhile in countries where right-wing populism was already strong, its vote share has increased further, allowing populist parties to enter government. In 2014, the nationalist Bharatiya Janata Party won elections in India. In 2015, the right-wing Law and Justice Party won in Poland. In 2016, Rodrigo Duterte won the Philippine presidential election and Trump won the U.S. presidential election. And this year, Recep Tayyip Erdogan won a second term as president of Turkey, Viktor Orban triumphed in Hungary for the third time running, the hard-right Freedom Party joined a governing coalition in Austria, and the right-wing populist Lega Nord did the same in Italy. Never before have so many populists been in power at the same time.

Why have politics not returned to normal? Part of the explanation might be that populists are learning. More than ever before, populism has become a tried and tested political strategy. Populist leaders teach one another how to use TV and social media to create polarization and divisions. This is crucial, since a polarized society is the fundamental prerequisite of populist success. They emphasize nationalism, giving a sense of identity to dissatisfied voters. And they use simple language that creates intimacy.

Populists have also become better at surviving in power. Many have been reelected multiple times. They cultivate their image as outsiders, even when they come to dominate the political and business worlds. They gradually erode checks and balances and move to take over the media, all in the name of “the people.”

They have started adopting more orthodox economic policies, as well. Unlike their free-spending predecessors, most populist leaders now choose business-friendly policies that foster growth and avoid bouts of hyperinflation that could endanger their survival (although there are notable exceptions, such as Venezuelan President Nicolás Maduro). In short, populists all around the world are following a similar playbook—and it is working.

The most important reason for populists' lasting success, however, is likely structural. The financial crisis of 2008 was a major shock, with more long-lasting effects than the average financial crisis. And the crash was just one of a series of disruptions over the past ten years. Politicians have seized on terrorist attacks and surging refugee flows to widen cultural splits. China and Russia now offer an authoritarian alternative to the Western model of open societies and free markets. Median incomes in the Western world are stagnant and inequality is rising. Lackluster economic performance in many countries has meant that the political trust the financial crisis destroyed has not recovered.

It’s hard to say how long the current political instability will last, in part because we don’t yet know enough about how populists perform in office, why they are often reelected, and what makes countries immune to populism.

But what is clear is that another financial crisis would do enormous damage. It would likely trigger yet another populist surge, bringing the far right to power in even more countries. Regulators, finance ministers and central bankers should take account of the political risks, not just the economic ones, when overseeing financial markets.

The Forgotten History of the Financial Crisis

What the World Should Have Learned in 2008[2]

By Adam Tooze - 20180813

September and October of 2008 was the worst financial crisis in global history, including the Great Depression." Ben Bernanke, then the chair of the U.S. Federal Reserve, made this remarkable claim in November 2009, just one year after the meltdown. Looking back today, a decade after the crisis, there is every reason

2 Source: https://www.foreignaffairs.com/articles/world/2018-08-13/forgotten-history-financial-crisis

to agree with Bernanke’s assessment: 2008 should serve as a warning of the scale and speed with which global financial crises can unfold in the twenty-first century.

The basic story of the financial crisis is familiar enough. The trouble began in 2007 with a downturn in U.S. and European real estate markets; as housing prices plunged from California to Ireland, homeowners fell behind on their mortgage payments, and lenders soon began to feel the heat. Thanks to the deep integration of global banking, securities, and funding markets, the contagion quickly spread to major financial institutions around the world. By late 2008, banks in Belgium, France, Germany, Ireland, Latvia, the Netherlands, Portugal, Russia, Spain, South Korea, the United Kingdom, and the United States were all facing existential crises. Many had already collapsed, and many others would before long.

The Great Depression of the 1930s is remembered as the worst economic disaster in modern history—one that resulted in large part from inept policy responses—but it was far less synchronized than the crash in 2008. Although more banks failed during the Depression, these failures were scattered between 1929 and 1933 and involved far smaller balance sheets. In 2008, both the scale and the speed of the implosion were breathtaking. According to data from the Bank for International Settlements, gross capital flows around the world plunged by 90 percent between 2007 and 2008.

As capital flows dried up, the crisis soon morphed into a crushing recession in the real economy. The "great trade collapse" of 2008 was the most severe synchronized contraction in international trade ever recorded. Within nine months of their pre-crisis peak, in April 2008, global exports were down by 22 percent. (During the Great Depression, it took nearly two years for trade to slump by a similar amount.) In the United States between late 2008 and early 2009, 800,000 people were losing their jobs every month. By 2015, over nine million American families would lose their homes to foreclosure—the largest forced population movement in the United States since the Dust Bowl. In Europe, meanwhile, failing banks and fragile public finances created a crisis that nearly split the eurozone.

Ten years later, there is little consensus about the meaning of 2008 and its aftermath. Partial narratives have emerged to highlight this or that aspect of the crisis, even as crucial elements of the story have been forgotten. In the United States, memories have centered on the government recklessness and private criminality that led up to the crash; in Europe, leaders have been content to blame everything on the Americans.

In fact, bankers on both sides of the Atlantic created the system that imploded in 2008. The collapse could easily have devastated both the U.S. and the European economies had it not been for improvisation on the part of U.S. officials at the Federal Reserve, who leveraged trans-atlantic connections they had inherited from the twentieth century to stop the global bank run. That this reality has been obscured speaks both to the contentious politics of managing global finances and to the growing distance between the United States and Europe. More important, it forces a question about the future of financial globalization: How will a multipolar world that has moved beyond the transatlantic structures of the last century cope with the next crisis?

TALL TALES

One of the more common tropes to emerge since 2008 is that no one predicted the crisis. This is an after-the-fact construction. In truth, there were many predictions of a crisis—just not of the crisis that ultimately arrived.

Macroeconomists around the world had long warned of global imbalances stemming from U.S. trade and budget deficits and China's accumulation of U.S. debt, which they feared could trigger a global dollar selloff. The economist Paul Krugman warned in 2006 of "a Wile E. Coyote moment," in which investors, recognizing the poor fundamentals of the U.S. economy, would suddenly flee dollar-denominated assets, crippling the world economy and sending interest rates sky-high.

But the best and the brightest were reading the wrong signs. When the crisis came, the Chinese did not sell off U.S. assets. Although they reduced their holdings in U.S.-government-sponsored enterprises such as the mortgage lenders Fannie Mae and Freddie Mac, they increased their purchases of U.S. Treasury bonds, refusing to join the Russians in a bear raid on the dollar. Rather than falling as predicted, the dollar actually rose in the fall of 2008. What U.S. authorities were facing was not a Sino-American meltdown but an implosion of the transatlantic banking system, a crisis of financial capitalism.

And the crisis was general, not just American, although the Europeans had a hard time believing it. When, over the weekend of September 13–14, 2008, U.S. Treasury Secretary Henry Paulson and other officials tried to arrange the sale of the failed investment bank Lehman Brothers to the British bank Barclays, the reaction of Alistair Darling, the British chancellor of the exchequer, was telling. He did not want, he told his American counterparts, to "import" the United States' "cancer"—this despite the fact that the United Kingdom's own banks were already tumbling around him.

The French and the Germans were no less emphatic. In September 2008, as the crisis was going global, the German finance minister, Peer Steinbrück, declared that it was "an American problem" that would cause the United States to "lose its status as the superpower of the world financial system."

French President Nicolas Sarkozy announced that U.S.-style “laissez faire” was “finished.” To Europeans, the idea of an American crisis made sense. The United States had allowed itself to be sucked into misguided wars of choice while refusing to pay for them. It was living far beyond its means, and the crisis was its comeuppance. But confident predictions that this was a U.S. problem were quickly overtaken by events. Not only were Europe’s banks deeply involved in the U.S. subprime crisis, but their business models left them desperately dependent on dollar funding. The result was to send the continent into an economic and political crisis from which it is only now recovering.

Even today, Americans and Europeans have very different memories of the financial crisis.

For many American commentators, it stands as a moment in a protracted arc of national decline and the prehistory of the radicalization of the Republican Party. In September 2008, the Republican-led House of Representatives voted against the Bush administration’s bailout plan to save the national economy from imminent implosion (although it passed a similar bill in early October); a few months later, after a lost election and at a time when 800,000 Americans were being thrown out of work every month, House Republicans voted nearly unanimously against President Barack Obama’s stimulus bill. The crisis ushered in a new era of absolute partisan antagonism that would rock American democracy to its foundations.

Europeans, meanwhile, remain content to let the United States shoulder the blame. France and Germany have no equivalent of The Big Short—the best-selling book (and later movie) that dramatized the events of 2008 as an all-American conflict between the forces of herd instinct and rugged individualism, embodied by the heterodox speculators who saw the crisis coming. Germans cannot ignore that Deutsche Bank was a major player in those events, but they can easily explain this away by claiming that the bank abandoned its German soul. And just as the Europeans have chosen to forget their own mistakes, so, too, have they forgotten what the crisis revealed about Europe's dependence on the United States—an inconvenient truth for European elites at a time when Brussels and Washington are drifting apart.

Eduardo Munoz / Reuters Lower Manhattan during a power outage, October 2012.

A FISTFUL OF DOLLARS

Europe’s persistent illusions were on full display in an August 9, 2017, press release from the European Commission. In it, the commission announced that the “crisis did not start in Europe” and that the underlying problem had been “exposure to sub-prime mortgage markets in the United States,” which triggered the deep European recession that followed. Brussels went on to take credit for mitigating that recession through the “strong political decisions” of EU institutions and member states.

The timing of the press release was significant. It came on the tenth anniversary of what most experts consider to be the true start of the global financial crisis—the moment on August 9, 2007, when the French bank BNP Paribas announced that it was freezing three of its investment funds due to volatility in asset-backed securities markets in the United States. This was the first indication that the downturn in housing prices, which had begun in early 2007, would have global ramifications. That same day, the European Central Bank (ECB) was sufficiently alarmed to inject $131 billion in liquidity into Europe's banking system.

The commission's analysis of what happened in 2007 was telling. Set aside, for a moment, the fact that problems at a French bank were the occasion of the anniversary, that there were massive homegrown real estate busts in Ireland and Spain, and that Greece and Italy had accumulated dangerous debt stocks of their own. What, exactly, did the implosion of U.S. subprime mortgage markets expose?

The United States' mortgage system was obviously broken. Some of the lending was criminal. And the design of mortgage-backed securities, many of which earned the highest bond ratings by bundling together bad mortgages, was flawed. But none of these problems explains why the downturn precipitated a global banking crisis. After all, investors lost more money when the dot-com bubble burst in 2000 and 2001, but that did not bring the global financial system to the brink of disaster.

What turned 2008 into the worst banking crisis in history was a new business model for banks. Traditionally, most banks had funded their operations through what is known as “retail” banking, in which consumers lend money to banks in the form of deposits, which banks use to make loans. Beginning in the 1980s, however, banks across the world increasingly moved toward “wholesale” banking, funding their operations through large, short-term loans from other financial institutions, such as other banks and money market funds. The motive for this shift was profit and competitive survival. Wholesale funding gave banks the ability to borrow much larger sums of money than they could in the retail market, allowing them to become more leveraged—and thus more exposed to risk—than ever before.

But the real threat to the global economy was not just that banks in the United States, Europe, and, to some extent, Russia and Asia were becoming overleveraged; it was also that much of these banks' short-term funding involved currency mismatches. In order to do business in the United States, non-U.S. banks needed dollars, which they obtained from wholesale markets through a variety of methods: borrowing unsecured cash from U.S. sources, issuing commercial paper (essentially short-term IOUs), and, crucially, using currency-swap markets to receive short-term dollar loans in exchange for their own local currencies, with a promise to "swap" the currencies back at the end of the loan term. In short, foreign banks were racking up sizable liabilities that had to be paid in dollars. If the money markets where they obtained these dollars ceased to function, many of the world's banks would immediately be at risk of failure.

And in fact, that is precisely what happened. The first big bank to fail spectacularly was the British lender Northern Rock, in August and September 2007. It had no exposure to American subprime mortgages, but its funding model relied overwhelmingly on wholesale borrowing from around the world. What cut off Northern Rock's access to funding was BNP Paribas' August 9 announcement. This sent a signal to wholesale lenders that more banks were holding bad assets than anyone had previously understood.

With the extent of the contagion unknown, wholesale lending ground to a halt. Five days later, Northern Rock informed British regulators that it would need assistance.

The shutdown in bank funding quickly rippled across the global financial system, even reaching Russia and South Korea, countries remote from the subprime debacle but whose banks relied on the same wholesale markets now under stress. The world was witnessing a trillion-dollar, transnational bank run.

People tend to think of globalization as involving the rise of emerging markets such as China and India, and in manufacturing and commodities, these countries have indeed been the engines of growth. But in the early twenty-first century, financial globalization still revolved around the transatlantic axis, and it was between the United States and Europe that the real disaster threatened. The Bank for International Settlements estimated that all told, by the end of 2007, European banks would have needed to raise somewhere between $1 trillion and $1.2 trillion in order to cover the gaps on their balance sheets between dollar assets and dollar funding. In the good times, these banks had easily obtained funding through currency swaps and wholesale markets. Now, with interbank markets drying up, they were desperate for dollars.

By the fall of 2007, officials in the United States had begun to fear that European banks, in a frantic bid to earn dollars to pay their bills, would liquidate their dollar portfolios in a giant fire sale. And because these banks owned 29 percent of all nonconforming, high-risk mortgage-backed securities in the United States, this was not just a European problem. The nightmare scenario for the Americans was that European banks would dump their dollar holdings, driving the prices of mortgage-backed securities to rock bottom and forcing U.S. banks, which held even larger quantities of those securities, to recognize huge losses, thus triggering a bank run that would have overwhelmed the furious efforts of the U.S. authorities to restore stability. It was this risk of simultaneous implosion on both sides of the Atlantic that made 2008 the most dangerous crisis ever witnessed.

CALLING THE FEDS

With disaster threatening, the question became how to respond. In the fall of 2008, governments across the West rushed to bail out their ailing financial institutions. In the United States, Washington came to the aid of the investment bank Bear Stearns, Fannie Mae and Freddie Mac, and the insurance giant AIG. The United Kingdom effectively nationalized HBOS, Lloyds, and the Royal Bank of Scotland. Belgium, France, Germany, Ireland, and Switzerland all took emergency measures to rescue their own banking sectors.

As the trouble spread, crisis diplomacy kicked in. The inaugural G-20 leadership summit convened in November 2008, bringing together heads of state from developing countries such as Brazil, China, and India, in addition to those from the developed world. The birth of the G-20 reflected a multipolar world economy in which emerging markets had new weight. But it also made recourse to institutions such as the International Monetary Fund, which many developing countries viewed with hostility, all the more sensitive. No one in Washington wanted a repeat of the controversies of the Asian financial crisis in the late 1990s, when the IMF's draconian loans came to be seen by their recipients as violations of national sovereignty.

Behind the scenes, U.S. officials were putting an alternative rescue mechanism in place. The central problem was that the world’s banks needed dollar funding. And the only institution that could fill that need was the Federal Reserve.

Officials at the Fed had already started to worry about European banks’ funding gaps toward the end of 2007. By December of that year, Bernanke and Timothy Geithner, then the president of the New York Federal Reserve Bank, had begun offering special liquidity programs to Wall Street, giving U.S. financial institutions access to cheap cash in the hopes of stabilizing their balance sheets and avoiding a ruinous selloff of mortgage-backed securities. Immediately, European banks started dipping into these funds. The Europeans took more than half of the $3.3 trillion offered through the Fed’s Term Auction Facility, which auctioned off low-interest short-term loans, and 72 percent of the deals provided through the Single-Tranche Open Market Operation, a little-publicized

Fed liquidity program that ran from March to December of 2008. (Credit Suisse alone took one-quarter of that program's funds.)

For the Fed to be acting as lender of last resort to foreign banks was no doubt unusual, but these were desperate times, and it needed to avoid a European fire sale of U.S. assets at all costs. As the crisis intensified, however, the Fed's leaders found that simply providing the European banks with access to the Wall Street liquidity programs would not be enough. Their funding needs were too great, and they lacked sufficient high-quality collateral in New York. So Geithner and the New York Federal Reserve resorted to an indirect mechanism for providing them with dollars, repurposing a long-forgotten instrument known as a "liquidity swap line."

Liquidity swap lines are contracts between two central banks, in this case, the Fed and a foreign central bank, to temporarily exchange currencies: the Fed provides its counterpart with a fixed amount of dollars and in return receives an equivalent amount of that bank's local currency. (The foreign central bank also pays a margin of interest to the Fed.) Liquidity swap lines had been used extensively in the 1960s to deal with tensions in the Bretton Woods system—which, by compelling countries to back their money with gold, led to frequent currency imbalances—but had since been confined to emergencies, as when they were used to help the Bank of Mexico during the peso crisis of 1994–95. The revival of liquidity swap lines in 2007–8 ensured that there would be no dangerous spikes in the funding costs of key Asian, European, and Latin American banks. If interbank funding got too tight, the global financial system would receive dollars directly from the Fed.

The major beneficiaries of the swap lines were the central banks of Japan, Europe, and the major emerging-market countries, which could now take dollars from the Fed to pass on to their own struggling banks. The Fed introduced the liquidity swap lines in December 2007, and they were rapidly increased to a permissible limit of $620 billion. On October 13, 2008, they were uncapped, giving the major foreign central banks unlimited dollar drawing rights. By December 2008, the swap lines were the single largest outstanding item on the Fed's balance sheet. The swap lines operated over various terms, ranging from overnight to three months. But if, for accounting purposes, they were standardized to a 28-day term, between December 2007 and August 2010, the Fed provided its Asian, European, and Latin American counterparts with just shy of $4.5 trillion in liquidity, of which the ECB alone took $2.5 trillion. That the European banks' giant funding gap did not escalate into a full-blown transatlantic financial crisis is thanks in large part to these swap lines.

Although the swap lines could be dismissed as technical in-house arrangements between central banks, they represented a fundamental transformation of the global financial system. The world's central banks effectively became offshore divisions of the Fed, conduits for whatever dollar liquidity the financial system required. The Fed, that is, made itself into a global lender of last resort. Whereas before 2008 many had expected an imminent dollar selloff, the crisis ended up confirming the centrality of the Fed to the global financial system. And by successfully managing the crisis, the Fed reinforced the dollar's attractiveness as the world's commercial currency.

But in establishing the swap-line system, the Fed also confirmed a hierarchy of central banks. The system included the obvious European central banks, such as the ECB, the Bank of England, and the Swiss National Bank, and those of Canada and Japan. But it also included the central banks of major emerging-market financial centers, such as

Brazil, Mexico, Singapore, and South Korea. They were in; the likes of China, India, and Russia were not. Veterans of the swap-line program at the Fed, who spoke to me on the condition of anonymity, admitted that they knew that by rolling it out they were straying into geopolitical terrain. They carefully compiled a list of the 14 central banks that were to participate in the program, all of which had to be approved by the U.S. Treasury Department and the State Department. The Fed's minutes from the meeting of the Federal Open Market Committee on October 29, 2008, record that at least two applicants were rejected, but their names were redacted. Not everyone was sufficiently important—or sufficiently politically and economically aligned with the United States—to qualify.

The swap-line system wasn't secret, but it wasn't trumpeted, either. This was no Marshall Plan moment, and U.S. officials had no desire to publicize the fact that they were coming to the world's rescue. The inability of Europe's megabanks to come up with the trillions of dollars they owed posed such a risk to the U.S. economy that doing nothing was simply not an option. So discreetly, the Fed offered the Europeans a helping hand.

The liquidity swap lines wound down rapidly in 2009, as private credit markets began to recover. The full details of the liquidity programs were not disclosed until 2011, when the U.S. Supreme Court ordered the Fed to release the data to reporters from Bloomberg.

There was good reason for secrecy: central banks do not wish to stigmatize borrowers that avail themselves of support when they need it, and announcing that the world's most important central banks were desperate for dollar funding could have frightened international markets. The result, however, is that the Fed's actions to save the global financial system have largely been forgotten. An unprecedented intervention effectively disappeared down a memory hole.

THE FIRE NEXT TIME

Today, the swap lines are an obscure part of the narrative in the United States; in Europe, they have been forgotten altogether. The European Commission is free to peddle its story that it was prompt action by the

European authorities that saved Europe from a crisis made in the United States. European banks such as Barclays and Deutsche Bank can proudly proclaim that, unlike their American counterparts, they came through the crisis without state assistance, despite the fact that they took hundreds of billions of dollars in liquidity from the Fed. Although such depictions are profoundly misleading, they speak volumes about the state of transatlantic relations in the early twenty-first century. The United States and Europe remain massively interdependent, but they lack a common story to glue the relationship together.

The year 2008 can thus be seen as a moment of transition. On the one hand, it marked a twenty-first-century global crisis. On the other hand, the management of that crisis relied on networks of interdependence shaped by the twentieth-century history of the transatlantic relationship—networks that were deep but that leaders on both sides of the divide now seem eager to leave behind.

What are the implications for the future? Many predicted that in the aftermath of the crisis, the dollar would lose its status as the world's leading currency, but the opposite has happened. According to figures compiled by the economists Ethan Ilzetzki, Carmen Reinhart, and Kenneth Rogoff, today the dollar is the anchor currency—the standard against which other currencies are pegged—for countries representing around 70 percent of global GDP, up from closer to 60 percent at the turn of the millennium. It was European, not American, finance that retreated. The events of 2008 left the European banks in a weakened position, and since then, they have repeatedly looked to Washington for support. When the eurozone crisis was at its most acute, in 2010, the Fed reopened its swap lines, and in November 2013, they were made permanent.

At the same time as the Fed tided the European banks over during the crisis, U.S. regulators began to take an increasingly dim view of their stability. During negotiations in the Basel Committee on Banking Supervision throughout 2010, U.S. and European officials clashed over tightening banking rules and capital requirements. And after Obama signed the Dodd-Frank financial regulations into law in July of that year, U.S. regulators began using the law's provisions to force European banks in the United States to either comply with the tougher standards or exit the U.S. market.

The ultimate outcome of the crisis was thus an unwinding of the extraordinarily tight connection between U.S. and European finance that had characterized the 1990s and early years of this century. Between 2009 and 2017, the foreign claims of banks as a share of global GDP—a rough proxy for financial globalization—fell by roughly 22 percentage points, or around $9.5 trillion. The entirety of that reduction was attributable to European banks, with much of it coming in 2009 through a collapse of European claims on the United States. Deutsche Bank’s April 2018 decision to reduce its presence on Wall Street was a belated example of this broader European retreat.

At the same time as European finance has deglobalized, emerging markets have taken center stage. Cheap dollar finance enabled by the Fed's policy of low interest rates has sucked emerging markets into a deep entanglement with the U.S.-dominated financial system. By 2015, China's businesses had borrowed over $1.7 trillion in foreign currency, the largest part of that in dollars, to feed their rampant need for investment finance. This is profitable for everyone involved and widely seen as a harbinger of China's integration into international finance; yet with this new development come new dangers. The actions taken by the Fed to manage the 2008 crisis were underpinned by the remnants of a transatlantic relationship dating back to the end of World War II; given today's fraying transatlantic ties, it is an open question whether it will be able to repeat its efforts on a truly global scale when the next crisis arrives.

Nor is it clear that the Fed will have as much political leeway as it did in 2008. When asked about the politics of the swap lines back then, one Fed veteran who spoke to me on the condition of anonymity remarked that it had been as though the world's central bankers had a guardian angel watching over them on Capitol Hill. Some legislators clearly understood what was going on, but no unhelpful and potentially inflammatory questions were asked, such as whom the billions of dollars flushing through the swap lines would ultimately benefit. The Fed had carte blanche to do what was necessary. Given what has since emerged about the scale of its actions, the shift in the political climate in the United States, and the likelihood that the next crisis will be in the emerging markets, and quite possibly in China, it may take more than a guardian angel to save the global economy next time.

Capitalism in Crisis

What Went Wrong and What Comes Next[3]

By Mark Blyth, July/August 2016

Ever since the emergence of mass democracy after World War II, an inherent tension has existed between capitalism and democratic politics; capitalism allocates resources through markets, whereas democracy allocates power through votes. Economists, in particular, have been slow to accept that this tension exists. Instead, they have tended to

3 Source: https://www.foreignaffairs.com/reviews/review-essay/2016-06-13/capitalism-crisis

view markets as a realm beyond the political sphere and to see politics as something that gets in the way of an otherwise self-adjusting system. Yet how democratic politics and capitalism fit together determines today's world. Politics is not a mistake that gets in the way of markets.

The conflict between capitalism and democracy, and the compromises the two systems have struck with each other over time, has shaped our contemporary political and economic world. In the three decades that followed World War II, democracy set the rules, taming markets with the establishment of protective labor laws, restrictive financial regulations, and expanded welfare systems. But in the 1970s, a globalized, deregulated capitalism, unconstrained by national borders, began to push back. Today, capital markets and capitalists set the rules that democratic governments must follow.

But the dominance of capital has now provoked a backlash. As inequality has widened and real wages for the majority of people have stagnated—all while governments have bailed out wealthy institutions at the first sign of trouble—populations have become less willing to accept the so-called costs of adjustment as their lot. A "double movement," in the words of the Hungarian historian Karl Polanyi, occurs in such moments as these, when those who feel most victimized by markets reclaim the powers of the state to protect them. The rise of Bernie Sanders and Donald Trump in the United

States is a product of this reaction, as is the strengthening of populist parties in Europe.

Three recent books shed light on this continuing tension between the imperatives of the market and the desires of the people. Together, they offer a biography of capitalism : where it came from, what went wrong, and where it may be going in a world of stagnant living standards, *widening inequality* [see below, page 84] and rising carbon emissions. And the picture they paint is a bleak one.

THE RISE OF CAPITALISM

Capitalism: A Short History, by the German historian Jürgen Kocka, is aptly named. In just 169 pages, it tells the story of capitalism from its origins in the ancient long-distance trade routes of Mesopotamia to the 2008 financial crisis. This is no mean feat. Yet such brevity requires some simplification, which comes at a cost.

The dominance of capital has now provoked a backlash.

For Kocka, capitalism is “an essential concept for understanding modernity.” More important, it is a set of institutions that enshrine property rights, promote the use of markets to allocate resources, and protect capital. And it is also an ethos, he claims, a set of principles and ideas. Defining capitalism so expansively allows Kocka to see its earliest forms developing among traders in Mesopotamia, in the eastern Mediterranean, and along Asia’s Silk Road, until, by the eleventh century, the beginnings of a merchant capitalist bourgeoisie had emerged on the Arabian Peninsula and in China.

Capitalism developed later in Europe, boosted by long-distance trade with Asia and the Arab world, between the twelfth and fifteenth centuries. Merchants formed cooperative institutions that led to greater risk sharing, which encouraged the accumulation of capital. This development, Kocka writes, led to “the formation of enterprises with legal personalities of their own,” rudimentary capital markets, and, finally, banks whose fortunes became intimately connected with the rise of modern states through the management of their debts.

This alliance between merchant capitalism and the emergent state helped usher in the age of colonialism. Merchants, entrepreneurs, and conquistadors, with increasingly powerful states backing them, propelled European expansion. Critical to this expansion was the triangular trade, in which European merchants brought finished goods to Africa, traded them for slaves, and then exchanged those slaves in the New World for sugar and cotton that went back to Europe. This process helped embed capitalism deeper in Europe than in the Middle East and China: the scale of investment that such ventures required led to the rise of what would become known as "joint-stock companies" and the beginnings of what economic historians call "finance capitalism"—stock exchanges opened in Antwerp in 1531 and Amsterdam in 1611.

Much of the profits that early European capitalists enjoyed came from these profoundly illiberal activities. As Kocka points out, “capitalism . . . contains little in the way of resistance against inhumane practices.” Yet in the long run, capitalism laid the groundwork for democracy, because the wealth it generated, and the possibilities that came with its new institutions, disrupted the guilds, helped cities expand, and allowed nineteenth-century industrialization to evolve into twentieth-century managerial capitalism.

People wait in line to enter the NYCHires Job Fair in New York, February 2010.

In Kocka’s narrative, each stage of capitalism begets the next, in an almost natural progression. Capitalism simply marches onward, for the most part benevolently—at least once the reformers abolished slavery and colonialism. But beginning around 1980, he writes, something started to go wrong. Firms started to derive a larger share of their profits from the financial sector than they did from real investments, a process economists call “financialization.” This process, according to Kocka, “imparted a new quality to the system.”

Modern finance, in contrast to the earlier, “productive” forms of finance that Kocka admires, seems to mainly consist of unproductive “locust” hedge funds that “cannibalize” good firms, contributing nothing to production in the wider economy. Meanwhile, Kocka insists, since the 1980s, governments have failed to exercise self-restraint, and publics have lived beyond their means. Massive growth in public and private debt in the developed world has been the result, which represents “a lasting source of destabilization for capitalism.”

But this trenchant critique of modern finance sits oddly alongside the rest of the book. For Kocka, the system was doing just fine until the rot of modern finance set in. He insists that financialization represents a break in the evolution of capitalism. But he fails to explain where it came from, if it didn’t emerge directly from those earlier forms of capitalism.

After all, the modern finance that Kocka condemns is not so different from the earlier, "productive" finance that he lauds. The financiers that got Germany into trouble in 2007 through their exposure to U.S. subprime mortgages were not "locust" hedge funds but traditional German development banks. And one of the world's largest derivatives traders at the time of the crisis was Deutsche Bank—hardly a new institution on the financial scene. In short, the idea that financialization may be not a perversion of capitalism but the next stage in its evolution seems to be a little too uncomfortable for Kocka to fully consider.

IN THE RED

The German sociologist Wolfgang Streeck also sees modern capitalism as flawed. Yet its current plight is not an aberration, he argues in *Buying Time*, but a direct consequence of the unraveling of the postwar marriage of capitalism and democracy.

Streeck's account focuses on Michal Kalecki, a Polish economist who came to prominence in the interwar period. Kalecki published a remarkable article in 1943 that predicted the economic turmoil of the 1970s. Kalecki argued that if full employment ever became the norm, workers would be able to move freely from job to job. Not only would this undermine traditional authority relationships within firms; it would also push wages up regardless of productivity levels, since workers would have more leverage to demand higher wages.

As governments began to rely more and more on debt, the tax-based states of the postwar era became the debt-based states of the contemporary neoliberal era.

In response, firms would have to raise prices, creating a spiral of inflation that would eat into profits and lower real wages, which would, in turn, promote greater labor unrest. Kalecki argued that to restore profits, capitalists would rebel against the system that promoted full employment. In its place, they would seek to create a regime in which market discipline, with a focus on price stability rather than full employment, would be the primary goal of policy. Welfare protections would be rolled back, and the discipline that unemployment provides would be restored.

Kalecki's predictions proved astonishingly accurate. By the 1970s, as Kalecki had foreseen, inflation had risen dramatically, profits had fallen, and capital began its rebellion. Organizations as diverse as the Swedish Employers' Confederation and the Business Roundtable in the United States pressured governments to reduce taxes, especially on high earners. But cutting taxes in the recessionary early 1980s meant that revenues fell, deficits widened, and real interest rates rose as those deficits became harder to finance. At the same time, conservative governments, especially in the United Kingdom and the United States, set out to weaken labor and shrink the role of the state as they dismantled the regulations that had reined in the excesses of finance since the 1940s.

The financial industry could now grow unchecked, and as it expanded, investors sought safe assets that were highly liquid and provided good returns: the debt of developed countries. This allowed governments to plug their deficits and spend more, all without raising taxes. But the shift to financing the state through debt came at a cost. Since World War II, taxes on labor and capital had provided the foundation of postwar state spending. Now, as governments began to rely more and more on debt, the tax-based states of the postwar era became the debt-based states of the contemporary neoliberal era.

This transformation has had profound political consequences. The increase in government debt has allowed transnational capitalists to override the preferences of domestic citizens everywhere: bond-market investors can now exercise an effective veto on policies they don't like by demanding higher interest rates when they replace old debt with new debt. In the most extreme cases, investors can use courts to override the ability of states to default on their debts, as happened recently in Argentina, or they can shut down an entire

Greek riot policemen rest in front of graffiti written on the wall of a bank during violent demonstrations over austerity measures in Athens, May 2010.

country’s payment system if that country votes against the interests of creditors, as happened in Greece in 2015. The financial industry has become, Streeck writes, “the second constituency of the modern state,” one more powerful than the people.

This shift from taxes to debt initially bought time for capitalism: it restored profits, destroyed labor’s ability to demand wage increases, tamed inflation to the point of deflation (which increases the real value of debt), and even seemed to provide prosperity for all after the crisis of the 1970s. Mortgages and credit cards allowed private citizens to rack up deficits of their own—a process the sociologist Colin Crouch has described as “privatized Keynesianism.” But it was all an illusion. Credit sustained the appearance of prosperity for the lower classes. In reality, the rich captured most of the newly created wealth. In the United States, for example, the top one percent more than doubled their share of the national income over the last three decades, as wages for the bottom 60 percent stood still.

In 2008, the financial crisis shattered this illusion. Governments bailed out the banks and transferred the costs of doing so to public budgets. Public debt exploded as governments bailed out the rich, and austerity measures, intended to reduce this new debt, have only compounded the losses of the majority of citizens. Capital continues to dominate democracy, especially in the EU: in Greece and Italy in 2011, technocrats replaced democratically elected governments, and in

2015, the so-called troika—the European Central Bank, the European Commission, and the International Monetary Fund—bulldozed Greek democracy.

So where Kocka blames profligate governments and debt-laden citizens for the current crisis, Streeck instead sees them as the victims. It's not lavish public spending, he shows, but rather falling tax revenues and financial bailouts that have created so much government debt and empowered capital. If states are spending extravagantly on voters, as Kocka and those who fetishize austerity maintain, there is precious little to show for it. "Had the rise in public debt been due to the rising power of mass democracy," Streeck writes, "it would be impossible to explain how prosperity . . . could have been so radically redistributed from the bottom to the top of society."

Streeck foresees a prolonged period of low growth and political turmoil ahead, in which states commanded by creditors, allied with transnational investors, struggle to get resisting debtor states into line: think of Germany and Greece. "The clock is ticking for democracy," Streeck writes, but "it must remain an open question . . . whether the clock is also ticking for capitalism."

"NEOLIBERALISM IS BROKEN"

For the British journalist Paul Mason, that question is closed: capitalism's current condition is terminal. In *Postcapitalism*, Mason writes that capitalism is "a complex, adaptive system which has reached the limits of its capacity to adapt.” The roots of capitalism’s demise, Mason argues, lie in the 1980s (also when Kocka saw problems arise), when capitalism was taken over by neoliberalism: an ideology and a set of policies that recognize no limits to the commodification of the world. Unfortunately for capitalism, “neoliberalism is broken.” To explain why, Mason turns to the work of Nikolai Kondratieff, a brilliant Soviet economist whom Stalin had murdered in 1938.

According to Kondratieff, capitalism goes up and down in 50-year cycles. At the bottom of a cycle, old technologies and business models cease to function. In response, entrepreneurs, both public and private, roll out new technologies to open up untapped markets, and an upswing begins. This leads to a loosening of credit, which accelerates the upswing. These cycles bring to mind the concept of “creative destruction” popularized in the 1940s by the economist Joseph Schumpeter. But Mason downplays the importance of the entrepreneur, whom Schumpeter cast in a central role, and focuses instead on the effect of class-based politics on productivity.

Mason’s first cycle runs from 1790 to 1848. The upswing began when British entrepreneurs first harnessed steam power to run their factories, and it ended with the depression of the 1820s. The subsequent downswing produced the revolutions of 1848, when the emergent bourgeois classes of Europe burst onto the historical stage.

Mason’s second cycle runs from 1848 to the mid-1890s. The spread of railways, the telegraph, and shipping drove growth until the depression of the 1870s. In the decades that followed, strong labor movements gained momentum all over the world, and capital, in response, became more concentrated. Electricity and mass production then powered a third upswing that crashed in the Great Depression and the massive capital destruction of World War II. After the war, a fourth cycle began with innovations in electronics and synthetics, improvements in the organization of production, and labor’s relative victory over capital in the institutions of the welfare state. That cycle’s upswing peaked in the mid-1970s, but this time, there was no major depression. The fourth cycle stalled.

THE END OF CAPITALISM

Mason's argument about why a major depression has not arrived during the past 40 years, the Great Recession notwithstanding, is partly conventional and partly surprising. The conventional explanation has four components. First, after U.S. President Richard Nixon took the dollar off the gold standard in 1971, the United States moved to a paper standard, which eliminated the constraints on deficit financing that the gold standard entailed. Second, the financialization of the developed economies masked the reality of stagnant incomes by substituting credit for wage increases. Third, the emergence of global imbalances in finance and trade allowed the United States to keep consuming as Asian countries stepped in as producers. Finally, advances in information technology empowered capital and weakened labor, and helped spread neoliberal practices across the globe.

That is a fairly familiar analysis. The unconventional part of Mason's answer harks back to Marx and Kalecki and stresses how neoliberalism managed to prevent profits from falling more effectively than any previous economic system. Mason borrows from Marx and Kalecki the idea that average profits in any market will fall due to both competition and the flood of capital into a new market, which reduce returns on investment. As a result, capitalists will always try to replace human labor with machines to protect their share of profits. During a downswing, as profits shrink, capitalists will do everything they can to boost their share of profits at the expense of labor: they will force employees to work intensively and will accelerate their attempts to replace workers with machines.

In the past, such attempts to restore profits simply by crushing labor failed. In each of the first three waves, one way or another, workers managed to resist. The best examples of such resistance were the postwar constraints on capitalism: strong unions, rigorous regulations, and generous welfare systems. When workers defy capitalists’ attempts to squeeze profits from them by building such institutions, firms have to adapt. Rather than fight labor over the fixed distribution of income, they are forced to invest in improving workers' productivity, to the benefit of both parties: this was the post–World War II growth story.

But under neoliberalism, capitalists have managed to squeeze labor in an entirely new way. Globalization obliterated the power of workers to resist, because if they did, capital—and jobs—could easily flow elsewhere. This explains why the number of labor strikes has declined so steeply all over the world. As Mason writes, "The fourth long cycle was prolonged, distorted and ultimately

A protester holds a sign reading "Give Us Our $$$ $$ Back" as U.S. Treasury Secretary Timothy Geithner speaks in Washington, April 2009.

broken by factors that have not occurred before in the history of capitalism: the defeat . . . of organized labour, the rise of information technology and the discovery that once an unchallenged superpower exists, it can create money out of nothing for a long time."

Still, Mason believes that these factors have only delayed capitalism's inevitable collapse. Where Marx thought that organized labor would rise up and overthrow the system, Mason bets that information technology will destroy it from within. Digital goods, such as music files and software, create a real problem for markets: they destroy the role of price in balancing supply and demand. People can copy digital goods freely forever: they have zero marginal cost and are nonrival in consumption. When one person downloads a music file or a piece of code from the Internet, for example, she makes it no harder for anyone else to do the same. So the only way that firms can maintain their profits is by enforcing monopoly property rights: consider Apple and Samsung suing each other for the right to profit from patents or the need for major pharmaceutical companies to keep drugs prohibitively expensive.

Climate change may be the one bullet that capitalism cannot dodge.

Mason is optimistic about what will replace the profit motive. He points to decentralized networks such as Wikipedia, the “biggest information product in the world . . . made by 27,000 volunteers, for free,” and the rise of the so-called sharing economy: nonmarket peer production systems, where work has value but cannot be priced in a traditional manner. The result is a “contradiction in modern capitalism . . . between the possibility of free, abundant socially produced goods, and a system of monopolies, banks and governments struggling to maintain control over power and information.” In such a world, the central battle will be between those who want to preserve property rights and those who wish to destroy them in the name of democracy. The stakes, Mason argues, could not be higher. Without the revolution he calls for, the world will be vulnerable to a much greater threat: catastrophic climate change.

WHAT COMES NEXT?

Mason’s chapter “The Rational Case for Panic” confronts what most economists and politicians tend to shy away from: the idea that capitalism in its current form is going to kill everyone. Of course, people have predicted an environmental apocalypse before. A group of experts called the Club of Rome famously published *The Limits to Growth* in the 1970s, forecasting economic and environmental crises—and those predictions have failed to come to pass. But this time may be different.

The science behind climate change is better this time around, and it's conclusive. The world is in trouble. As Mason notes, in 2012, the International Energy Agency predicted that even if world leaders implemented all the announced emissions-reduction plans, carbon dioxide emissions would rise by another 20 percent by 2035. The world cannot burn 60 to

80 percent of remaining known carbon fuel stocks without causing catastrophic warming. But under capitalism, this is exactly what the world will do. Carbon taxes will do little to change this reality.

Add to this mix an aging developed world with huge pension liabilities and a climate-shocked developing world of young people who have nowhere to go, and it's little wonder that the Organization for Economic Cooperation and Development has forecast stagnant growth for the global economy for the next 50 years and an almost 40 percent rise in inequality in the world's rich countries. But despite this stark warning, Mason emphasizes an aspect of capitalism that both Kocka and Streeck underplay: its adaptive potential.

It is highly likely, for instance, that statistics such as GDP underestimate the impact of new information-based technologies. Hal Varian, Google's chief economist, might be exaggerating when he claims that the free search engine is worth $150 billion to users in the United States every year, but there is no doubt that Google has transformed the economics of finding information. Google saves everyone time and money—but that doesn't show up in GDP. Although capitalism may be reaching its adaptive limits, it has been more robust than most doomsayers realize.

Nonetheless, Mason thinks that climate change may be the one bullet that capitalism cannot dodge. Neoliberals often naively assert that capitalism will generate a miracle technology at just the right moment to stave off catastrophe. But Mason argues that previous Hail Mary passes, such as geoengineering and carbon capture, have failed to pay off. What gives him hope is that large-scale technological innovations may not be as important as micro-level changes in the structure of property rights themselves.

Whether or not such a restructuring will be enough to save the world remains unclear. But Mason is right to hold out hope. Capitalism, in its current form, has reached a dead end. If ever there were a time for pessimism of the intellect and optimism of the will, it is now.

Inequality

What's Inside[4]

By Gideon Rose – Jan./Feb. 2016

Back in 1980, Irving Kristol, the “godfather of neoconservatism,” wrote an essay mocking the left’s obsession with income inequality: “The intensity with which economists work out their Gini coefficients, and the subtlety with which they measure income trends in the quintiles or deciles of the population, is matched—so far as I can see—by the utter lack of interest of the average American in

4 https://www.foreignaffairs.com/articles/world/2015-12-08/inequality

their findings." Having been impressed at the time by what seemed his cool logic, I checked back recently to see how the piece held up in the Age of Piketty. In retrospect, what was most striking was the setup: "It is my understanding, from surveying various studies of trends in income distribution in the United States over the past three decades, that economists have found very little significant change to have taken place." That was then; this is now. Were Irving still around to chime in, he would probably continue to mock. But ever the empiricist, he would have to concede that the objective realities of the situation had changed dramatically. Over the intervening years, real incomes and wealth have stagnated for the vast majority of Americans, even as they have skyrocketed for those at the very top. With some national variations, moreover, something similar has happened across the developed world. These trends are starting to define our era. But what is driving them? What is the significance of the economic inequality that has resulted? And what can or should be done about it? These are the questions this issue's lead package tackles. Ronald Inglehart explains both the fall and the rise of inequality over the last century as the product of the shifting balance of power between elites and masses, which has in turn been driven by the process of modernization. François Bourguignon points out that rising inequality within countries has been matched and probably exceeded by lowered inequality among countries, thanks mostly to sustained growth in China and India. Pierre

Rosanvallon and Danielle Allen note that economic inequality cannot be separated from social and political inequality—and that what a healthy democracy requires is not simply the lessening of extreme material differences but also the nurturing of a community in which all citizens share opportunity and dignity. Anthony Atkinson and Jonathan Tepperman, finally, address possible remedies, the former reviewing options for egalitarian policies in the developed world and the latter telling the story of Brazil's successful antipoverty program Bolsa Família. The old saw about frogs and boiling water is not true, of course: they will jump out of the pot if they can as the temperature rises. Democratic publics, increasingly feeling the heat, are unlikely to behave differently.

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