

crash

Why it happened and what to do about it

real-world economics review, 2009

Introduction

Never has a financial crisis been so global as that of 2008. Yet the degree to which the financial sectors of globally integrated economies have contributed to and suffered from that crisis has varied enormously. Iceland's financial sector bankrupted its country, and those of the US and the UK narrowly escaped total meltdown. The advanced banking systems of China and Singapore, on the other hand, have reported no major casualties, and those of many European countries, although scathed, have escaped the debacles of their American and British counterparts. These differences are epistemologically significant. Since all nations forming the global economy, large and small, were subject to the same temptations and the same possibilities for errors of judgement and entrapment in ideological black holes, it follows that the levels of competence and incompetence characterizing bankers, regulators and economists advising them has between nations been hugely divergent.

The case of China is especially telling. China's chance of swallowing a lethal dose of America's toxic assets exceeded those of every other country. Each year its financial system faced the task of investing a significant percent of China's GNP in the US economy. But just as competent bus drivers drive their buses safely through dangerous traffic, China's bankers safely invested their country's trillions in 21st-century America. But why were they competent when their American and British counterparts most obviously were not? A short article in today's *Financial Times* gives us some clues.¹

Its author, Liu Mingkang, is the economist chairman of the China Banking Regulatory Commission. He lists what he regards as the five factors that "triggered the global financial crisis".

1. "the firewall between capital and banking markets was eroded by unsound financial innovations."
2. "macro-prudential regulation was neglected."
3. "financial institutions had too much leverage and were too opaque."
4. "incentives for staff at financial institutions were driven by short-term gains, rather than long-term benefits."
5. "the bail-out put the cart before the horse by pumping in capital and liquidity before cleaning up balance sheets."

It is highly significant that in offering his list of five causes Mingkang is **not** talking from hindsight. The first four of his five causes are merely the obverse of the policies advocated by Chinese economists and practiced by the Chinese banking system **prior to the crisis**. Mingkang tactfully explains Chinese economics for his *Financial Times* readers like this.

¹ Liu Mingkang, "Basic rules helped China sidestep bank crisis", *Financial Times*, 28 June 2009.

In an increasingly interconnected world, financial risks now spread like pandemics. One of the effective ways to prevent risk contagion is to set up firewalls between banking and capital markets.

Unfortunately, many people have forgotten this principle, or dispute it as “old-fashioned”. However, in China we have maintained such a firewall mechanism in our financial system reform. Only qualified commercial banks are allowed to participate in non-banking activities, and have strict firewalls separating them. We insist that the main funding source of banks should always come from deposits. On top of that, the China Banking Regulatory Commission (CBRC) is developing a regulation that would require firewalls to be established between commercial banks and their controlling shareholders and between commercial banks and their non-banking subsidiaries, in order to prevent risk contagion.

Sometimes the most effective way to address a complex issue is by using basic, simple but useful measures. Practice shows us that traditional tools work, especially considering that financial engineering can malfunction. In recent months we have noticed that many regulators in the rest of the world have also started to embrace this “back to basics” approach.

Today in many countries, especially the US and UK, the neoclassical-neoliberal mainstream is so institutionally entrenched that there exists the danger that its faithful, instead of working to disabuse themselves of the illusions that facilitated the global disaster, will put their efforts to shielding themselves from the guilt and shame that rightly they should bear. With few exceptions, several of whom are contributors to this book, economists, no less than men-in-the-street, remained silently oblivious to the approaching financial collapse and the human loss that follows. Even now the profession’s upper orders exhibit no inclination to subject the antecedents of the recent events to a rigorous and, most important, irreverent analysis. But only if we, like the Chinese, can find the intellectual courage to forgo the beatitudes of Economics 101, can we hope to approach the truth of why it happened and how it can be prevented from happening again.

This book offers 12 papers on the crisis by 10 economic thinkers who, like Mingkang, have that courage in abundance. Each paper has appeared in the *real-world economics review*. Notably, two of them, Ian Fletcher’s and Frédéric Lordon’s, appeared before the Crash. Other contributors, including Paul Davidson, Jacques Sapir and James Galbraith, have for years warned of the demise that awaited us if economic policy continued to be led by neoliberal economists. But no contributor to this collection, indeed no economist anywhere, has greater claim to foreseeing the Crash than Dean Baker. In a widely read paper², the first of several, published in August 2002 and three years before the foresight of the media’s current darling Nouriel Roubini, Baker detailed the dimensions of the US housing bubble and explained how its collapse would, if corrective policies were not undertaken, sink the economy. Alas, Baker and the others were ignored. Perhaps next time it will be different.

Edward Fullbrook
28 June, 2009

² Dean Baker, “The Run-Up in Home Prices: Is It Real or Is It Another Bubble?”
<http://www.cepr.net/index.php/publications/reports/the-run-up-in-home-prices-is-it-real-or-is-it-another-bubble/>