

## Teddy Brett: Failed Markets, Failed States and the Global Recession: Responding to the Financial Crisis



Prof Teddy Brett

“... the world economy has rarely been in better shape than it is today. [We have] yet again revised upwards expectations for global growth . . . growth in the United States remains rapid . . . there are signs of an upturn in those parts of Western Europe ... where growth has been sluggish ... The global economy appears to be more resilient ... than it was even a short time ago.” (*Anne Krueger, First Deputy Managing Director of the IMF 2006*)

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“Recent developments have broadly confirmed [our] prognosis [that] the *current economic situation is in many ways better than what we have experienced in years . . . Our central forecast remains quite benign . . . [we expect the OECD to show] strong job creation and falling unemployment.*” (*Jean-Philippe Cotis, Chief Economist OECD May 2007*)

“The consensus forecast for the global economy ... anticipates that recent high levels of growth will continue, that global inflation will stay quite subdued, and that global current account imbalances will gradually moderate. ... Evidently, and appropriately [it] implicitly assumes that there will be no major geopolitical disruptions and no disturbances in the financial sector significant enough to affect the real economy.” (*Bank for International Settlements, Annual Report, 2006-7: 140*)


### The Logic of Deregulated Markets

Continuous financial deregulation since the 1970s has been justified by Alan Greenspan’s claim that

“Unfettered markets [must] create a degree of wealth that fosters a more civilized existence’, because market capitalism based on the principle of creative destruction,’ would replace ‘less-productive capital ... with innovative cutting-edge technologies’, and, while this could produce ‘societal costs’ and ‘distress’ and a demand for ‘government intervention to control risk-taking’, he saw the problem as ‘a trade-off between economic growth with its associated potential instability and a more civil but less stressful way of life with a lower standard of living.” (2002)

The equation of competition and stable growth depends on neo-classical models that assume that competition must produce self-adjusting mechanisms that enable losers to find more productive jobs in new firms, and punish inefficient or irresponsible ones without generating systemic problems. This was also expected to apply in the financial sector where large diversified banks, globalised markets and new instruments for sharing, hedging and insuring against risk were expected to prevent systemic failures. Deregulation after the 1970s produced massive increases in lending, and profits and bonuses for banks and bankers that seemed to validate these claims despite the financial crises in the 1980s and 1990s, encouraging widespread optimism in the orthodox policy community expressed in the quotations at the head of this paper.

### Deregulated Markets, Financial Sector Instability and Global Crises

However, the failure to anticipate and address the weaknesses that produced the 2007-8 crash because of an inability to understand both lessons from history and the problems of market failure identified by heterodox economists. Tight banking regulations and redistributive policies  virtually

eliminated financial and banking crises between the 1930s and 1970s, but deregulation has produced chronic instability and generalised economic crises:

- Liberalization in the 1920s produced multiple bank failures in the early 1930s, partly driven by the collapse of the over-leveraged stock and property market in the USA and a run on the banks.
- The Eurocurrency market in the 1970s allowed banks to evade national regulations and take on risky levels of public debt that produced the sovereign debt crisis in 1981/2 when raw material prices fell and interest rates increased.
- Over-borrowing, bad governance and falling raw material prices produced the African Debt Crisis in the early 1990s linked to liberal structural Adjustment Programmes.
- Opportunism; malfeasance; rigidities; and herd behaviour produced the East Asian financial crisis in 1997.
- Unregulated lending, magnified by securitisation and hedging produced unsustainable property bubbles and sovereign debt problems that bankrupted major banks in 2007-8.

### **Market Failures and Financial Crises: the Theory**

These crises were also caused by bad governance and inappropriate policies, but also because markets only succeed in the presence of multiple agents with the information they need to protect themselves against malfeasance and excessive risk; where firms can fail without threatening the stability of the whole system, and where competition generates investment opportunities for weaker as well as stronger producers and states. These assumptions are especially problematic in the financial sector for three reasons:

- bounded rationality, opportunism and malfeasance;
- scale economies and systemic risk;
- and the destabilizing and deflationary consequences of uneven development and sovereign risk.

#### **Bounded Rationality, Opportunism & Malfeasance (Williamson, 1985)**

Banks borrow short and lend long, and thus depend on reliable information about future prices and the stability and honesty of the individuals, firms or states to which they lend. However, unforeseen changes lead to maturity transformation problems, crises of confidence and runs on banks. Intense competition and perverse incentives generated by over-leveraged loan positions based on new financial instruments like sub-prime mortgages, derivatives and hedge-funds increase rather than spread risk by concealing information and increase opportunism and malfeasance.

#### **Centralisation, Concentration and Systemic Risk**

Scale economies concentrated resources in a few banks that provide public goods by protecting savings and supplying credit. This does not protect them from competitive pressures, but does make them too big and too indispensable to fail, thus protecting them from market discipline. Inter-bank lending, amplified by the expansion of new financial instruments, concentrate and conceal rather than dispersing risk, so the failure of any significant bank threatens the system as a whole.

#### **Uneven Development, Exclusion, and Weak Investment Opportunities**

*(Marx/Schumpeter)*

Firm and regional level scale economies produce the 'creative destruction' that did not just produce 'distress', but increased global inequality, destroyed weak firms and jobs, and marginalised weak states, as well as creating bad loans and financial and economic crises. They also constrained investment opportunities in productive enterprises, and fueled investment in non-productive assets like property and sovereign debt in weak states, producing unsustainable bubbles regularly produce generalised defaults and systemic crises.



## Conclusion

Thus the consequence of unmanaged creative destruction has not been a limited amount of 'distress' and 'social costs', but regular systemic crises that have threatened the viability of the economic system, and indeed, of civilized life itself, and led to demands from the corporate sector itself rather than the left for the state to rescue the financial sector from the destructive consequences of unregulated markets, as Polanyi argued.

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