Painful death of the American economic dream

This crisis has been a long time in coming, and history suggests that the period of upheaval will be long and painful, just as it was between 1914 and 1945

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- - Larry Elliott
  - guardian.co.uk, Monday 2 November 2009
  - Article history

It wasn't really supposed to end up like this. When the Berlin Wall came crashing down 20 years ago, the cold war ended with triumph for the west. Instead of two superpowers, there was one. Instead of competing ideologies, there was capitalism, and a particularly brash form of capitalism at that.

The elder George Bush said the world should learn how to do things the American way. "We know what works," he said. "Free markets work."

The reach of the market grew longer for two decades, encompassing China and India as well as the former Soviet Union and its satellites. Rapid growth brought impressive poverty reduction in China and India; there are few Poles or Czechs who hanker after the days when Moscow pulled the strings.

But it was always inevitable that, sooner or later, globalisation would run into a crisis, and what we have seen in the past two years is just the start of it. Don't be fooled by the sucker's rally of the past six months – Americans are once again running down savings to consume goods they can't afford; China's exports are booming.

The global imbalances are back. A combination of political change and technological revolution has always produced upheaval. That was true when the spinning jenny met the Enlightenment, and it was true when a second wave of inventions – cinema, electric light, the automobile, aircraft – coincided with a crumbling of the 19th century balance of power.

Digital technology and bioscience will drive the third industrial revolution, but these changes take place at a time when the spread of the market has vastly increased the reserve army of labour. America's hegemony is being threatened by the rise of China.

These, then, are combustible times. This crisis has been a long time in coming, and history suggests that the period of upheaval will be long and painful, just as it was between 1914 and 1945.

It didn't take long for the first cracks in the new global order to appear. The golden age lasted for barely half a decade – the period between the lifting of the iron curtain and the creation of the World Trade Organisation in 1994. Even during that half-decade there were signs of trouble, not least the impact of the shock treatment on the Russian economy in the early 1990s.

But it was the succession of financial crises that began on the periphery of the global economy and gradually worked their way towards the core that gave the lie to the notion that there would be a smooth and steady transition to market nirvana. The warnings from Mexico, Thailand and South Korea, from the collapse of the hedge fund Long Term Capital Management and from the dotcom bubble were ignored.

Policymakers found it easy to dismiss these flashpoints as teething troubles. Growth was strong and inflation was low. The early 1990s to the mid-2000s were what Mervyn King, the governor of the Bank of England, once described as the NICE decade – the years of noninflationary continual expansion.

Debt, of course, was the key. The loss of bargaining and spending power of workers in the west was compensated by raging asset price booms which allowed consumers to borrow against the rising price of their homes.

This was not just true of developed economies such as the US and Britain. The annual transition report by the European Bank for Reconstruction and Development, released today, says that large-scale capital inflows into eastern European countries had "contributed to credit booms and foreign currency lending. These, in turn, made the crisis deeper and complicated its management."

Just as in Britain and the US, the easy availability of credit meant excessive levels of debt when the global economy turned down and demanded concerted international action to prevent an Iceland-style banking meltdown.

Understandably, policymakers have been left bemused by the first systemic crisis of the global age. Up until 2007 they thought their job was to tinker with market economies; instead they face an existential challenge: where do we go from here?

Option one is the Schumpeterian one: this is an era of creative destruction, so we may as well grin and bear it. The problem of the financial system is that the market has not been allowed to function properly: badly run banks need to be allowed to fail so that good banks can thrive. The second option is business as usual, which, predictably enough, is the one favoured by the City and Wall Street. Given the size of their welfare cheques from the taxpayer, big finance can hardly demur at the prospect of tougher regulation, but it is lobbying hard against more radical change. There is plenty of talk of throwing the baby out with the bathwater and killing the goose that lays the golden eggs.

The Conservatives are in this camp, not just because David Cameron bizarrely thinks the crisis was caused by too much government rather than too little but because Boris Johnson is actively lobbying on behalf of City hedge funds and private equity firms to block tougher European regulation.

Option three is business as usual plus extras. This recognises that there has been a systemic problem in the financial sector but sees the answer as tighter supervision, better surveillance of the global economy from the International Monetary Fund, changes to capital adequacy rules to ensure that banks can't lend as freely during booms, and new incentive structures for financiers that will favour long-term growth of the business over short-term speculative activity. This, no prizes for guessing, is where you would find Gordon Brown and Barack Obama.

But there is a motley band of discontents for whom business as usual, in whatever form, means that another crisis will erupt before too long. They argue that the exiguous nature of current reform proposals is explained by the institutional capture of governments by the investment banks, the world's most powerful lobbying groups.

King's ideas for splitting up the banks into retail and investment arms puts him in the option four group, as does Adair Turner's support for financial transaction taxes. Others would go further. A recent report by the United Nations committee on trade and development (Unctad) urged a rethink of the "conventional wisdom that dismantling all obstacles to cross-border private capital flows is the best recipe for countries to advance their economic development. Those who support a green new deal – expansionary monetary and fiscal policies designed to boost renewable energy and support firms developing environmental technologies – say that quantitative easing should have been used to support sustainable, productive investment rather than to re-inflate asset prices. If the root cause of the financial crisis was the imbalances in the global economy prompted by the search for higher profits, real reform will require higher real wages in the west, so that consumers are less dependent on debt. That means a shift in the balance of power between labour and capital; it also means a rethink of the shareholder model of capitalism.

Finally, there are those who believe that any conventional reform is doomed because any growth-based model is at odds with the viability of the planet.

Where is the political centre of gravity now? Somewhere between option two and three. That represents not just a missed opportunity but a profound lack of judgment.

The seeds of the next crisis are being sown. Right here, right now.

larry.elliott@guardian.co.uk

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