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The International Consequences of Financial Fragility

JONATHAN KIRSHNER

Nearly a decade after the catastrophic global financial crisis of 2007–8, economic challenges, international politics, and issues pertaining to global governance remain conditioned by its consequences. The considerable and in many quarters underappreciated danger of a new financial crisis lingers, while international economic relations are more brittle than before and complicated by the contrasting conclusions that different countries have drawn about the causes and outcomes of the upheaval.

The global meltdown ought to have served as a definitive reminder that finance is different, and distinctly susceptible to crisis. Capitalism is an indispensable engine of economic growth; it works its magic because most markets work well most of the time. But some markets don't. Even orthodox economists recognize spheres of economic activity that, left to themselves, would result in "market failure"—pathologies that can only be corrected by government intervention.

Unfettered financial markets fall into this category. Adam Smith, the founding father of laissez-faire economics, insisted in *The Wealth of Nations* that the "invisible hand" of market forces would bring about the best possible economic and social outcomes. But even Smith called for government regulation of the financial sector—specifically of interest rates, to prevent inefficient speculation.

A thriving financial sector is an essential feature of a healthy capitalist economy, but like a nuclear power plant it also generates extremely dangerous side effects. Laissez-faire does not work in finance because the uncoordinated behavior of individually rational actors fails to account for collective pathologies. Safe and solid banking is a public good. Letting the market rule in finance makes as much sense as letting the market decide how to handle and dispose of nuclear waste.

IRRATIONAL EXUBERANCE

One cause of the global financial crisis was that, by the middle of the 1990s, this enduring truth had fallen out of fashion. Alan Greenspan, then the revered chairman of the Federal Reserve Board, championed the new conventional wisdom that there was little need for government oversight, supervision, and (least of all) regulation of the financial sector. "Rising leverage appears to be the result of massive improvements in technology and infrastructure," he explained in 2007. "Increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago." Greenspan was only the most prominent voice in a crowded chorus. The view that finance, left alone, could govern itself was widely held (and remains so) in Washington, on Wall Street, and among economists.

By the 1990s mainstream macroeconomic thought had converged around the theory of rational expectations and its fellow traveler, the efficient markets hypothesis, which holds that current market prices accurately express the underlying value of an asset because they reflect the sum of a collective, rational calculus. The profession seemed little concerned that, when tested, real world outcomes were inconsistent with rational

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expectations, especially when applied to financial questions. More important, apparently, was faith in sophisticated and elegant models.

In the words of one critic, the efficient market hypothesis "justified, and indeed demanded, financial deregulation." Markets, however, did not deregulate themselves. The financial industry spent a fortune on lobbying Washington to grease the wheels of change. In the 1980s these efforts bankrolled Republican initiatives that were often rebuffed by congressional Democrats. But in the 1990s the money spigot opened even wider, and, crucially, the push became bipartisan. Bill Clinton's New Democrats, challenging the establishment of a party that had lost five of the past six presidential elections, moved the party toward the center. The shift included a full-on embrace of Wall Street.

Another nail in the coffin of regulatory prudence was the transition at the Fed's helm from the old-school conservative Paul Volcker to the libertarian Greenspan. In the 1980s, Volcker stoutly defended the Glass-Steagall Act, the Depression-era law that had reordered and compartmentalized the entire financial system. He thought it was "obvious that if you had a large investment bank aligned with a large [commercial] bank, the possibility of a systemic risk arising is evident." But Greenspan lobbied hard for its repeal.

The financial world remains a very dangerous place—more dangerous than it was even before the global crisis.

The Gramm-Leach-Bliley Act of 1999 gutted Glass-Steagall. The Commodity Futures Modernization Act of 2000 ensured that the government would not supervise or regulate booming new areas of the financial economy, including various forms of derivatives and other exotica (such as the credit-default swaps that would play a central role in the global financial crisis). They produced massive wealth, fueled rapid growth of the industry—and were inherent carriers of systemic risk. These trends accelerated during the George W. Bush administration. Finance became the biggest and fastest-growing sector in the US economy. As the value of derivatives trading rose into the tens and even hundreds of trillions, few paused to question the wisdom of an economy driven by such frenzied activity.

Big finance, big money, and ideological convergence led the US government to voluntarily abdicate its responsibilities for supervision and oversight. Regulatory agencies like the Securities and Exchange Commission failed to keep pace with financial innovations and paid too little attention to metastasizing shadow banking activity, in which nonbank financial institutions, such as hedge funds, engaged in undertakings once the purview of traditional banks. Highly leveraged risk taking, involving complex and novel financial instruments, took off. As the US Senate inquiry into the crisis noted in a report released in April 2011, "the multi-trillion-dollar US swaps markets operated with virtually no disclosure requirements, no restrictions, and no oversight by any federal agency." In fact, "federal regulators couldn't even ask US financial institutions to report on their swaps, trades, or holdings."

More to the point, it was not simply that regulators got lost in the tall weeds of financial complexity—as the Senate report observed, "no regulator was charged with identifying, preventing, or managing" systemic risk. Finance may have become the purview of physics PhDs, creating models incomprehensible to mere mortals, but the causes of the crisis were distressingly familiar. Former Fed Vice Chairman Alan Blinder summarized them succinctly: "It was shameful business practices, coupled with regulatory neglect, that got us into this mess."

STYMIED REFORM

By most accounts that mess was worse than the financial crisis that touched off the Great Depression. According to Ben Bernanke, who served as Fed chairman during the 2007–8 crisis, "out of . . . 13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two." Yet despite this, another Great Depression was avoided. Superior public policy, at least initially, saved the day by providing essentially unlimited liquidity and a massive bailout of the banks (as well as large-scale lending to foreign central banks by the Fed), combined with fiscal stimulus. Additionally, this time a much more robust social safety net helped stop the economy's nosedive by acting as an automatic fiscal stabilizer. Although the Great Recession was the worst economic downturn in the United States in 80 years, it could have easily been much worse.

During the Depression, policy makers in Washington and abroad made a bad situation worse. The do-nothing liquidationists in the Hoover administration and at the Fed allowed the economy to asphyxiate, the United States was tight-fisted with its international lending, and pre-Keynesian economic witch doctors prescribed austerity—the moral equivalent of treating anorexia with a starvation diet. But the Depression was so catastrophic that real reforms were politically possible, including (over the bitter opposition of Wall Street) the framework of oversight and restructuring of the financial sector that ushered in an unprecedented half-century of financial stability.

In the wake of the 2007–8 financial crisis, in contrast, the initial policy response was as good as could practically have been hoped for, but once the worst was avoided, despite the fact that the economy was still wounded and anemic, the momentum of good public policy dissipated. After the economy was pulled back from the abyss, normal politics returned. The guardians of the status quo regrouped and went on the offensive. In an open letter published in the *Wall Street Journal* in 2010, 23 conservative public figures warned the Federal Reserve that "quantitative easing" would "risk currency debasement and inflation." The five-plus years since then have disproved that rhetoric, but the effort reflected a successful attempt to reframe the debate away from needed action and reforms. The stimulus measures undertaken were modest and short-lived. By mid-2010, misguided austerity ruled the day. Even though the worst was avoided, the Great Recession was allowed to take hold, and linger.

Saving the economy from utter ruin took the wind out of the sails of fundamental financial reform. In the first nine months of 2009, the industry poured well over a million dollars a day into its lobbing efforts. The measures enacted ultimately tinkered at the margins but did not address fundamental problems. Consider, for example, the "too big to fail" problem: The six largest US financial institutions were over 35 percent larger in 2013 than they were in 2008. Measures like the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act have been rendered impotent by exceptions and obfuscating complexities. Dodd-Frank came to 848 pages, supplemented by 8,843 pages of rules. The "Volcker rule," a provision of Dodd-Frank intended to restrict banks' ability to engage in speculative trading, grew from a three-page memo to 298 pages of legislation. Because of these missed opportunities for reform, the US financial system today remains vulnerable to a major crisis.

Europe's Straitjacket

A similar story can be told for Europe, and the institutions of global governance more generally. In the words of former British Prime Minister Gordon Brown in a December 2013 *New York Times* op-ed piece, "Political expediency, a failure to think and act globally, and a lack of courage to take on vested interests are pushing us inexorably toward the next crash."

Europe's problems run deeper than that. Its public policy choices have been even more half-hearted than those of the United States. Worse, the global financial crisis exposed the flaws of the euro system. Economic integration greatly outpaced the process of political integration, and as a result, identity politics along a North-South divide led to policy paralysis. And by adopting a common currency, member states abdicated policy instruments essential for responding to economic distress. In some respects, the euro system recreated the pathologies of the disastrous interwar gold standard. The only policy tool left in the kit was naked, draconian austerity.

The European commitment to the primacy of fighting inflation, despite an economy flirting with deflation, resulted in cautious fiscal policies and even less ambitious efforts at economic stimulus than in the United States, along with a more abrupt shift from stimulus to austerity. The commitment to austerity smothered nascent growth and produced much greater distress in Southern European economies than its proponents anticipated. The consequences of these policies are not just economic: They threaten to inspire the radicalization of politics and undermine stability on the Continent.

The travails of the euro system are informative—and newly relevant—because they lay bare the bitter distributional politics that boil beneath the surface of any monetary order. Europe's problems offer a microcosm of the inevitable fights over the burdens of adjustment generated by the normal functioning of international macroeconomic processes. Macroeconomic adjustment is nothing new—the British philosopher David Hume wrote about it in the eighteenth century.

In the mid-twentieth century, the British economist John Maynard Keynes plainly articulated these fundamental problems in passages that well describe the dilemmas of contemporary Europe. Arrangements like the gold standard, he wrote, impose a process of adjustment that "is *compulsory* for the debtor and *voluntary* for the creditor," and thus "throw the burden on the countries least able to support it, making the poor poorer." Besides being unjust and inefficient, Keynes noted, such systems can also be "disruptive of the social order."

Fool me twice

The United States is unrepaired and still vulnerable; Europe is hobbled and encumbered by the patchwork straitjacket of its political economy. The rest of the world, less directly affected by the crisis, is actively searching for something different. The global financial crisis was a watershed event—both alarming and astonishing—because the United States was at its epicenter. For over 75 years, America had been uniquely invulnerable to financial crises, which happened regularly everywhere else. What the crisis of 2007–8 revealed was that even the United States was not immune to the inherent dangers of unbridled finance. It upended the widespread assumption that the American model was the only way, or even that it was the right way.

In China, the crisis led to buyer's remorse about the state's massive dollar holdings, part of an economic strategy that bound the Chinese economy closely to America's. It also redoubled the already robust wariness of Chinese elites about the risk of exposure to the global financial economy, and delegitimized the American model that China had been cautiously tacking toward.

It is too easily forgotten that the United States did not stop at unleashing its own financial sector; it pursued, through aggressive diplomatic efforts by both the Clinton and Bush administrations, a policy of pressuring countries around the world to embrace financial liberalization as well. On the eve of the crisis, Treasury Secretary Henry Paulson lectured that "the risks for China are greater in moving too slowly than in moving too quickly" with financial liberalization.

Indeed for much of the world—Latin America, Russia, East Asia, and elsewhere—the global financial crisis was a "fool me twice" moment. It came within ten years of the Asian financial crisis of 1997–98, which exposed a deep ideological rift. In Asia and elsewhere, that regional episode was understood, correctly, as a garden-variety international financial crisis made more likely by deregulation and footloose capital. (This was the view in China and Japan, which were largely unaffected by the crisis; as one Japanese official noted, it revealed the "inherent instability of liberalized international capital markets.")

But in Washington and on Wall Street, a different narrative held sway. The International Monetary Fund (IMF), for one, "emphatically rejected the view" that capital liberalization was to blame. Both the United States and the IMF imposed draconian conditions on the emergency assistance provided to Asian countries at the time, an approach that produced bitter, lingering resentment. With the colossal US economy still shining and the American model the only one left standing, those gritted teeth mattered little. But the experience informed how many outside the West would interpret the next crisis when it inevitably arrived.

Chinese disenchantment

In China and beyond, the 2007–8 crisis has caused disenchantment with the stewardship of the international economy by Washington and institutions like the IMF. Chinese elites are dissatisfied with America's management of its economy, the dominance of the dollar as the world's money, and Beijing's undersized voice in existing international institutions. They have long expressed a preference for more multipolar international economic arrangements and are now acting on that preference.

China has its own daunting problems, including the risk of domestic financial instability, labor and environmental bottlenecks, and a panoply of economic and political management issues—all taking place in the context of a politically sensitive deceleration of its economic growth rate. Nevertheless, three observations still hold. First, as the world's second-largest economy and second-largest importer, China is now a pillar of the international economy. From an economic perspective, China is not rising—it has risen. Second, despite its problems and growth deceleration, the most likely trajectory is that it will still grow, and at a rate higher than will be seen in the West. Finally, and most important for world politics, China has acted on its disenchantments in the wake of the global financial crisis, seeking a larger role on the world stage, promoting wider use of its currency, and seeking leadership opportunities.

There are formidable barriers to the emergence of the renminbi, or yuan, as a widely used international currency, and care must be taken not to exaggerate the stakes on the table. Although the renminbi is increasing its international role, it is extremely unlikely to eclipse the dollar. But even well short of becoming number one, the renminbi's encroachments on the dollar (and on the American order) will matter. Chinese leaders have clearly decided to step up the pace of renminbi internationalization, promote regional monetary cooperation, and encourage reform of global monetary management.

It is early in this process, and the renminbi is still a relatively marginal presence as a global reserve currency. But measures taken by Beijing are consistent with the prepositioning of an apparatus that would support the emergence of the renminbi as an important international currency. And, crucially, this is not simply a story about China—it reflects a new global dynamic. Beijing's willingness to increase the supply of international monetary options has coincided, because of similar motivations, with greater demand for alternatives to the dollar and also to the ideology of unbridled financial globalization. Clearly, many other countries share China's preferences for a more pluralized international economic order.

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One manifestation of both disenchantment with the American way and a desire for greater voice is China's sponsorship of the Asian Infrastructure Investment Bank (AIIB). Another is the headlong eagerness of other countries to sign on. Again, it is important not to let underlying trends run ahead of the facts on the ground. There is no need to share former Treasury Secretary Lawrence Summers' hyperbolic reaction to the AIIB (its founding, he warned, "may be remembered as the moment the United States lost its role as the underwriter of the global economic system"). But a sober assessment suggests that the AIIB (and other initiatives) will enhance China's influence at the expense of the United States and international institutions that Washington and its allies currently dominate. And whatever the stakes, it is notable that the Obama administration tried and failed to undercut the AIIB's emergence.

DIVERGENCE AND DISCORD

The coming years are likely to be characterized by greater discord and contestation among countries over questions of international money and finance. Compared with the period before the crisis, when the American model of uninhibited financial deregulation was widely perceived as singularly correct, there is now a new heterogeneity of thinking about how to best govern finance. It favors varied experimentation rather than a unique alternative model.

In contrast to the experience of many other nations with regard to finance, laissez-faire economic ideology has persisted in the United States, along with the enormous power and influence of Wall Street and its enmeshment with Washington power brokers. These entrenched interests, combined with the fact that the 2007–8 upheaval was the first catastrophic meltdown in collective American memory, made framing the crisis as a freak event—one impossible to predict and about which little could be done—plausible and sellable. As a result, we will see old thinking in the United States and a variety of new thinking abroad.

Divergent beliefs about the global financial order will shape both national choices and international politics, reduce US influence (given new preferences for a multiplicity of governance options), and render cooperation over money and finance more problematic. This will matter, because the financial world remains a very dangerous place—more dangerous than it was even before the global financial crisis.

The largely unreformed American financial system remains a tinderbox for the simple reason that, as history plainly shows, that is what unregulated financial systems are. The US economy is characterized by a small number of gargantuan, intricately enmeshed financial institutions, most of which are run by titans who seem baffled or aggrieved by suggestions that their activities are anything but benign, brilliant, and essential. During the Great Depression, America engaged in a basic assessment of what a healthy financial system might look like; after the latest crisis such discussions were quickly snuffed out, and the country soon resumed business as usual.

The next financial crisis will not be as well contained as the last one. The 2007–8 crisis took place in a relatively benign international political environment and a well-performing global economy. Now, security dilemmas are more intense in Europe, Asia, and the Middle East. Years of European austerity, coupled with China's anxiety about its decelerating growth, have left a much shallower—if not arid—reservoir of good will for countries to draw on when coordinating their responses. And with Washington no longer simply calling the shots, disputes over how to distribute inevitable burdens of macroeconomic adjustment are likely to become more common, and sharper. (During the Cold War, the United States often imposed those burdens on its political allies and military dependencies.) Chronic tussling over issues like the devaluation of the renminbi (actually an issue of modest economic consequence) will be symptomatic of a more conflicted environment.

Finally, it is not only international politics that are brittle: American politics have calcified. Although the initial policy responses to the 2007–8 crisis were wise and essential, they were applied half-heartedly and incompletely. Such measures are now saddled with the baggage of their presumed failure—not to mention with the (more accurate) perception that the bailouts protected those most responsible for the crisis, and neglected those who suffered from the economic distress it produced. The political will that is going to be necessary for the emergency measures demanded by the next big crisis has likely been exhausted. ■