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1

From Boom to Bust

The long economic upswing that culminated in the financial crash of 2008 began in the 1980s in the United States and in the United Kingdom, and was underpinned by a new growth model, which had the financial markets at its core, and the ambition to make every citizen an independent financial subject. This model pinpointed the route out of the stagflation of the 1970s, which eventually was to give rise to a new prosperity and renew the economic ascendancy of the United States. It accompanied and helped make possible a major restructuring of the global economy, involving a shift in many of the leading economies from manufacturing to services, an acceleration of the trends towards globalization, the introduction of new information technologies, the adoption of neo-liberal ideas across the whole field of public policy and a reorganization of the state.

The early signs, however, were not propitious. The major crisis of the 1970s had created deep problems of stagflation, which persisted long into the 1980s. Inflation rose again to over 20 per cent in the UK in 1980 and 13 per cent in the US, and unemployment climbed sharply. In the UK it reached 11 per cent or 3 million by 1982 and stayed there until 1986. In the US it reached 9.7 per cent in 1982. But relief was at hand. The first major upswing of the new era got under way in the second half of the 1980s, particularly after 1986, and both unemployment and inflation fell. This first upswing was to be cut short by the recession of the early 1990s, but although painful this was relatively short-lived, and after 1992 growth resumed in earnest. The boom was under way.

One of the significant changes given credit for laying the foundations of the boom and the financial growth model at its heart were the new doctrines of monetarism and supply-side economics that came to prominence in the 1970s and 1980s, particularly in Anglo-America, and the institutional and policy changes which they helped inspire and for which they provided the rationale. Rebuilding the foundations of sound money after the turmoil of the 1970s was a priority for the Thatcher Government, elected in 1979, and also for the Reagan Administration, elected in 1980. The Thatcher Government pursued a tough monetary and fiscal policy in

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its early years, which brought down inflation but at the cost of a doubling of unemployment. The political purpose of the government was not just to create monetary stability but also to defeat the special interests in the shape of public sector trade unions and local governments, which constantly threatened to undermine it. A bruising series of conflicts ensued, which eventually created the political conditions in Britain for the introduction of the new supply-side economics. In the US there was a sharp recession at the beginning of the 1980s, as a result of a severe monetary squeeze by the Federal Reserve, but then followed an experiment with supply-side economics, in a bid to return the economy to growth. Some of this was inadvertent. The government slashed taxes but could not get Congressional approval for its spending cuts. It went ahead with the tax cuts anyway and in some areas, particularly the military budget, spending increased. The result was a ballooning deficit, leading to the $3 trillion debt made famous by Ross Perot in his campaign for a balanced budget in the 1992 presidential race. This was only the beginning. By 2007 the US national debt had reached $5 trillion (see Figure 1.1).

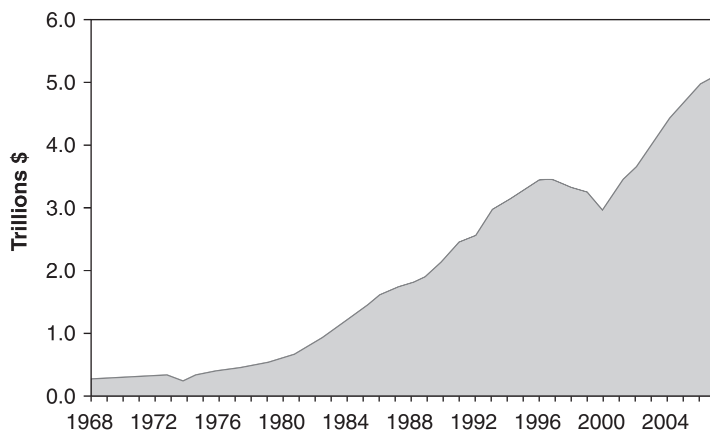

Figure 1.1 The US national debt, 1968–2007

Source: data from US Department of the Treasury, www.treasurydirect.gov

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Officially both the Reagan and the Thatcher governments were monetarist. But this did not mean that they sought to go back to a pre-Keynesian era in political economy. In one sense both remained fundamentally Keynesian in their policy stance, This was partly because monetarism in the strict technical sense could not be made to work, as the Thatcher Government discovered. Every measure of control of money was quickly subverted by the markets. But it was also because when it came to it there was little political appetite for trying to restore sound money by making the state truly limited, and giving up all the direct and indirect levers that had been developed for influencing the economy. The rhetoric was often anti-Keynesian, but much of the practice fitted neatly within a Keynesian framework. But this was Keynesianism with a difference. It was what Colin Crouch has aptly called 'privatized Keynesianism'. This new financial growth model used tax cuts to stimulate the economy, and it promoted privatization of public assets and deregulation of the private sector, particularly the financial sector. It sought to expand credit, not restrict it, and to enlist the financial sector as the most important driver of growth and competition in the economy. It led to the rise of the investment banks and the rating agencies to their commanding position in the global economy at the beginning of the twenty-first century, and the proliferation of new financial vehicles and instruments, a readiness to 'leverage' every asset whether in the public or private sector, and to make all citizens and organizations 'financial subjects'. Leveraging meant simply using existing assets and income to borrow in order to invest in other assets which promised a higher return. Applied to individuals and companies this meant taking on ever larger burdens of debt, in relation to what they already owned or earned, to be redeemed against future earnings or, in the case of government organizations, taxes. The ingenuity of the financial sector was set to work to create new ways of spreading risks, new ways of expanding credit, new ways to encourage individuals, companies and governments to borrow, employing new devices such as financial derivatives and credit default swaps, and in this way to keep spending, asset prices and jobs continually rising. The credit rating which individuals, companies and governments received became very important in determining the amount of credit they could obtain, and great ingenuity went into devising ways in which high credit ratings could be given to those who would once have been judged to be poor credit risks. In this way credit could continue to expand, drawing in more and more citizens and companies. If it worked everyone could become rich painlessly. As one advertising slogan suggested, it took the waiting out of wanting.

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One of the most important conditions for this new financial growth model to become fully established was the deregulation of the financial markets. This had been proceeding steadily for some time, but in the 1980s it was given a major boost. In the UK, the so-called 'Big Bang' of 1986 swept away many of the restrictions, which had determined the kind of banks which could locate in London and how they traded. The City of London had once been the preserve of a relatively small and cohesive financial elite, whose businesses were founded on close personal connections and trust. In throwing open the City to competition, the Thatcher Government was pursuing what it believed to be the right policy for all parts of the economy. Exposure to international competition with no guarantees from the government was tough medicine but considered the best way the City could sustain and develop its international role.

The financial revolution in London and New York in the 1980s was to have profound consequences. The main driver was the US financial sector, and the re-establishment of its global dominance. An important part of its global reach was being able to create a network of other financial centres around the world in which American banks and their subsidiaries could operate freely. This network included Hong Kong, Tokyo, Singapore and London. The traditional willingness of the British to treat the City of London as an 'offshore island' with more freedom to operate independently than most other national financial centres, made London the ideal partner for Wall Street. Within twenty years the financial sector in London had become one of the UK's largest employers and export earners, and in comparative terms was large in relation to the rest of the economy. Some smaller economies, like Iceland and Switzerland, went even further, but among the large economies, none rivalled Britain for the relative size of its financial sector. It accounted for 5 per cent of gross domestic product (GDP) and over a million employees, and gave Britain the largest trade surplus in financial services in the world. (In 2003 it totalled $25.3 billion, more than twice as much again as the next largest surplus, that of Switzerland.) The British government actively encouraged the growth of the financial sector and the service sector more generally to replace the gap left by the decline of manufacturing and the older industrial towns and cities.

Susan Strange called this new financial growth model 'casino capitalism'. It created a rapidly expanding financial sector, which was increasingly separate from the rest of the economy, intensely competitive, fast moving, nimble and innovative, brilliant at calculating margins and exploiting opportunities. Its business was trading in financial claims, and

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as the boom developed speculation became an ever more important part of its activities. As Keynes remarked in *The General Theory of Employment, Interest and Money*, published in 1936:

> Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done. (Keynes, 1973, p. 159)

Casino capitalism was to flourish, particularly in what later became known as the Anglosphere economies, consisting of the United States, Canada, Britain, Ireland, Australia and New Zealand, and particularly in the heart of the Anglosphere – the United States and Britain, or Anglo-America. These countries not only shared a common language, but common political and legal traditions, and a form of capitalism noted for its emphasis on flexible labour markets, shareholder value and highly developed financial sectors.

The alternative to casino capitalism in the 1980s was the model of capitalism represented by Germany and Japan, with its emphasis on long-term investment in capacity and skills, the nurturing of successful businesses, life-long relationships with employees and the subordination of finance to those ends. The short-termism in the Anglosphere economies induced by the increasing dependence of companies on the financial markets and by their need to focus relentlessly on increasing shareholder value appeared for a time during the 1980s to make the financial growth model look distinctly inferior to the investment growth model. Japan and Germany were regarded by many as having devised a much more effective and sustainable form of capitalism, which would finally consign the Anglosphere model to the scrapheap, and oblige them to adopt German and Japanese institutions.

That is not what happened. The Japanese economy stalled at the beginning of the 1990s because of the bursting of its own local financial bubble that had been allowed to form in property prices. The uncertain response by the Japanese authorities to this crisis pushed Japan into a deflationary spiral from which it did not properly emerge for ten years. It retained its position as the world's second largest economy, but its growth rate declined sharply, and it no longer looked like an economy that was about to overtake the United States, or that could offer a successful model to the

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rest of the world. Germany was preoccupied in the 1990s with the absorption of the East German economy following reunification, which proved much more protracted and complex than had been envisaged. German growth slowed, and its attraction as an alternative model sharply decreased. After the end of the recession at the beginning of the 1990s and the extraction of sterling from the European Exchange Rate Mechanism in 1992, the financial growth model of the Anglo-Saxons began to sweep all before it. The European and the Japanese banks became deeply integrated into the complex financial web which was spun in the 1990s. There was still resistance in many countries to accepting the full Anglo-American medicine of flexibility, deregulation, tax cuts and privatization, but the hegemony of Anglo-American finance was not contested. Everyone queued up to join this particular part of the feast.

A second major factor which made the boom possible was the emergence of China, India, Brazil and other rising economic powers in the 1990s. The dramatic leap, in particular, of Chinese economic growth in the 1990s, propelled by the movement of rural workers into the cities on the eastern coastal strip, made possible a supply of cheap manufactured goods which kept inflation low in the rich countries. The high savings ratio in China created large surpluses, which were lent to western governments and western banks, and helped create the credit to allow consumers to continue buying the goods China was producing. The bringing into play of such vast populations in both world production and world trade was a transformative event for the global economy, and helped create the conditions in which the financial growth model could succeed for such a long time, despite the numerous bubbles and instabilities, and the huge imbalances in surpluses and deficits which piled up inexorably. The low inflation and the seemingly endless expansion of credit brought a mood of euphoria to the markets, which after a time seemed to infect the regulators as well.

As the boom developed there were numerous fears expressed that it was unsustainable, and that the build-up of consumer debt and current account deficits, particularly in the United States and the United Kingdom, and the vast surpluses elsewhere which were being used to finance them, would at some stage require a correction. By 2008 there were $3 trillion held in the Sovereign Wealth Funds of China, Saudi Arabia and Russia, a sum higher than the GDP of the United Kingdom, the world's fifth largest economy. Consumer debt in the UK reached £1.44 billion in June 2008, higher than total UK output. Household, banking and corporate debt combined

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reached 350 per cent of US GDP and 300 per cent of UK GDP. With remarkable prescience, the Pope had declared in 1985 that the foundations of the world economy were unstable and would lead at some point to a collapse. Unfortunately, the warning was rather too general to be of immediate use in the financial markets, and the heavens did not fall. Some academics and some financial journalists warned that the boom could not continue indefinitely, but their advice was not heeded. This was partly because those with very real knowledge and concern about the risks that were being run could always be accused of crying 'wolf' when the crisis did not then materialize, or did not spread. The more knowledgeable critics suffered too from being lumped together with some of those offering 'independent' financial advice. There were a series of financial newsletters in the years running up to the crash with doom-laden predictions of 'Apocalypse Now'. Sooner or later one of them had to be right. Whenever one of the bubbles burst, or was deliberately collapsed, there was an outpouring of dire warnings that this time the end really was nigh. But the markets steadied themselves and growth resumed. Everyone involved in the markets and in regulating the markets had a sense that it was too good to last. But, while it lasted, no-one was inclined to act the sheriff. No-one wanted to turn off the fuel that was powering the boom. No-one wanted to think about the crash.

The Credit Crunch

The boom was powered from many different sources, and there was not one bubble but several. Once the financial growth model got into its stride, it spewed out bubbles. There were bubbles in different kinds of financial assets and in commodities. But the most important bubbles were in dot.com shares, which burst in 2000, and subsequently in housing (see Figure 1.2).

It was the bursting of the housing bubble that brought the whole global financial structure crashing down in 2008 and plunged the world into recession in 2009. The problem began in the US housing market. The federal authorities raised interest rates from 1 per cent in 2004 to 5.35 per cent in 2006, and they went on climbing, peaking at 6 per cent in 2007. This was a steep rise but not unusual. It represented the kind of active monetary policy which all central banks had become used to conducting, aiming to stabilize their economies and keep them growing. The Federal

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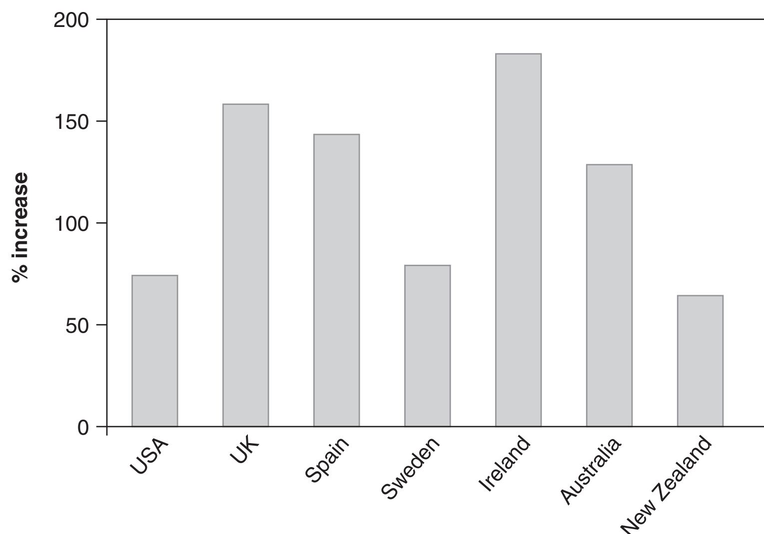

Figure 1.2 Average percentage increases in house prices, 1997–2005 (selected countries)

Source: data from Blyth (2008) from original source Wyss (2007).

Reserve judged that credit conditions were too lax now that the economy had recovered from the mini recession it had suffered in 2001–2, after the bursting of the dot.com bubble, and that credit should become tighter to reduce the risk of inflation. This meant restricting the flow of credit in key areas like housing. This was a normal operation, which had been performed many times before. It had the desired result. The squeeze on credit made house prices start to fall, as the supply of new mortgages dried up and some of those with mortgages were forced to default. This too had happened many times before and in itself was no cause for alarm. It was part of the normal housing cycle. A period of greater tightness in the market, and a downward adjustment of prices would be followed by the return of buyers to the market, as credit became more freely available again, and prices would resume their upward march.

This time was different. The number of homeowners defaulting rose to record levels in 2006 and 2007 in the US. Those defaulting most heavily were those who had sub-prime loans. The term 'sub-prime' is one of those masterly circumlocutions which litter the English language. Calling loans

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'sub-prime' is like calling execution 'termination with extreme prejudice'. Sub-prime loans were developed by the financial services industry to keep the housing boom going. They involved making high-risk loans to applicants with poor or non-existent credit histories, people who would be classed as very poor risks in normal circumstances and shut out of the market. There was something egalitarian and inclusive about sub-prime loans. Their origins lay in the 1970s, in the Community Reinvestment Act passed in 1977 under the Carter administration. It imposed an obligation on banks to provide mortgages to low-income families, and listed a number of criteria and a number of compliance measures. It had some powerful political supporters in Congress, because it was seen as a way of at last reaching into the ghettos and extending homeownership to that minority of the population that had never previously enjoyed it. The legislation worked well, but in 1997 there was a significant change. Bear Stearns, the investment bank, created the first securitization of Community Reinvestment Act loans, which were guaranteed by Freddie Mac, one of the leading US mortgage lenders, and given the top triple A credit rating. These securities were soon many times oversubscribed. The mistake, however, was not the policy of trying to get low-income families on the housing ladder, but putting investment banks in charge of delivering it. They came up with an ingenious solution which achieved a key public policy goal at minimal cost to the public purse, by distributing the costs elsewhere. The consequences were largely unforeseen.

The problem with sub-prime loans was that the people taking out these loans were in no position to afford them once interest rates rose sharply as they did after 2004, as part of a general monetary correction, and there were no arrangements in place to cushion them against such changes. In ordinary times this would have had serious consequences for a large number of borrowers who could no longer meet the repayments on their loans. But it would not have had wider implications for the whole financial system. The reason that it did in 2007 was the inverted pyramid which the financial services industry had created on the back of sub-prime lending. On the strength of the new assets they had acquired the banks proved ingenious at bundling together the loans and securitizing them, turning them into investment bonds which were sold on to other financial interests. In many instances these bonds were triple A rated by the rating agencies of Wall Street, the guardians of financial probity. A triple A rating was conferred on those companies, countries and investment products where the investors could have strong confidence in the soundness of the bonds.

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In this case, however, far from being sound the bonds were hollow. There were no secure income streams behind them, and once many mortgagees started to default on their loans, the precariousness of the imposing financial structure, which the financial services industry had created, was exposed. It had been erected on the supposition that sub-prime loans were just, in fact, like any other housing loan. In their search for ever more lucrative income-bearing assets, banks and other financial institutions had invested in the sub-prime market by buying the securitized investment products the financial services had developed. So global and interdependent had the financial system become that banks all around the world had bought these products, boosted their balance sheets and used them as justification for increasing their own lending. One of the most extraordinary features of the credit crunch as it unfolded was the light it threw on the lending practices of banks, and the extent of financial globalization, the way in which banks in Iceland and throughout the European Union had become responsible for sub-prime loans issued in local housing markets in the United States. What became clear was that the banks had no way of independently assessing the value of many of the assets they so freely added to their balance sheets, and which they used to increase their lending. They relied on the judgements of the rating agencies. What the rating agencies were basing their judgements on was unclear.

During the second half of 2007 events began to move at a quickening pace. The chronology of some of the main events through 2007 and 2008 is set out in Table 1.1. Signs that all was not well in the sub-prime market began to multiply in 2007. An American bank, New Century Financial, which specialized in sub-prime mortgages, filed for bankruptcy in April 2007 and reduced its workforce by half. Many of its debts had been taken on by other banks, so the collapse of New Century Financial sent ripples throughout the financial markets. Many other financial institutions were forced to realize that they might have to write off that part of their assets based on sub-prime loans. There were many variations in the way different banks were affected, but those that were most exposed, those that had chosen to make involvement in the sub-prime loan market a major part of their business suddenly found themselves in great peril. The first major name to get in trouble was Bear Stearns, the investment bank, which in July 2007 had to announce a total loss in two of its hedge funds. Those who had invested in them stood to lose all their investment. Bear Stearns had tried hard to avert this outcome, and had tried to raise money from other banks to tide it over. But it failed to persuade other banks to lend to

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Table 1.1 Chronology of the crisis, July 2007–February 2009

2007	
July	Bear Stearns announces major losses on hedge funds
August	Severe tightening in wholesale money markets
	Federal Reserve cuts lending rate to 4.75%
September	Run on Northern Rock
Sept–Dec	Federal Reserve cuts lending rate to 4.25%
	Major international banks announce losses
	Credit ratings of bond insurers reduced
December	Federal Reserve announces major loan package to banks
2008	
January	Major falls in stock markets
	House prices start to fall
February	Federal Reserve cuts lending rate to 3%
March	Northern Rock nationalized
April	Bear Stearns taken over by JP Morgan Chase
July	IMF predicts financial losses will be $1 trillion
September	Collapse of IndyMac
	Bail out for Freddie Mac and Fannie Mae
	Collapse of Lehman Brothers
	Merrill Lynch taken over by Bank of America
	HBOS taken over by Lloyds TSB
	Numerous bank rescues, bailouts, nationalizations
	$700 billion bailout rejected by US Congress
October	Wall Street collapse
	Further falls in stock markets
	Further bailouts and rescue packages
	Further reductions in interest rates
	G7 proposes five-point action plan
November	Steve Forbes declares the worst is over
December	European Central Bank reduces lending rate to 3.25%
	IMF announces rescue package for Iceland
	Federal Reserve reduces lending rate to 0–0.25%
	US announces rescue package for Ford, GM and Chrysler
2009	
January	IMF predicts worst recession for advanced economies since 1945
February	Bank of England reduces lending rate to 1%
March	Bank of England reduces interest rate to 0.5%
April	G20 Summit in London

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it or to guarantee its sub-prime investments, because by this time other banks had become seriously alarmed by their own exposure to bad debts arising from sub-prime. This was the new element which was to become such an important feature of the next eighteen months. The confidence of banks in one another, and their willingness therefore to lend to one another, and to take over bad debts, had begun to weaken. At the height of the crisis it was to disappear altogether. At the beginning of 2009 it had still not returned.

During July and August 2007, the financial markets became aware that the sub-prime loans which had been such an important source of new income in the previous decade were no longer secure, and that the banks across the world faced major losses. Central banks began to intervene at this point, injecting extra liquidity in a bid to persuade banks to keep lending to one another and to tide the markets over the worst effects of the collapse of the sub-prime market. Ben Bernanke, chairman of the Federal Reserve, warned that the losses involved could run to $100 billion. Compared to what was to come that was to seem a modest sum. It was at this time that the term 'credit crunch' began to be used, to refer both to the increasing difficulties some borrowers were having in securing loans, and to the growing unwillingness of banks to lend to one another, when the reason for the loan was to shore up bad debts. The financial authorities were sufficiently concerned to make the first moves in bringing down interest rates and expanding liquidity. On 17 August, the Fed made the first cut in its lending rate, by 0.5 per cent to 4.75 per cent.

The problems in the banking sector continued to worsen, however, during August 2007, with several other banks which were heavily involved in the sub-prime market in the US or who had engaged in lending to borrowers who were high credit risks within their own national economy getting into difficulties and being forced to default. Sachsen Landesbank, a German regional bank, got into trouble and was taken over by another Landesbank. Across Europe a number of financial institutions began reporting losses from their investments in the US sub-prime market, while in Britain, where sub-prime lending had also flourished, although not to the same extent, and under a different name, banks began cutting back on the loans they were prepared to make.

At this point the situation looked serious but still manageable. What gave the authorities greatest cause for concern in the two leading financial centres, Britain and the United States, was the growing divergence between the interest rate at which the Bank of England and the Federal

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Reserve was prepared to lend to the banks and the interest rate at which banks were prepared to lend to one another. In London the key rate was the London Interbank Offered Rate (LIBOR), which had come into existence in 1984 to provide some uniformity to the different interest rates at which banks could borrow unsecured funds from other banks on the London wholesale money markets. Since then these two rates had normally been very close, but in August 2007 they began to diverge markedly. LIBOR rose to 6.79 per cent, while Bank Rate was 5.75 per cent. This was to become one of the hallmarks of the financial crisis. The divergence reflected a breakdown in trust between the banks themselves. They had begun to lose confidence in the ability of other banks to pay back money that was advanced to them, and they wanted to be sure of having the money available for their own needs, so began to demand a premium for making any such payments. This made it much more difficult for banks that got into trouble to borrow from their fellow banks to tide them over. This drying up of liquidity became one of the most visible signs of the growing credit crunch, as banks began to take a hard look at what was on their balance sheets, and which assets were backed by solid income streams. The more they probed, the more they realized that they did not know the full extent of their potential liabilities, and therefore could not estimate the full extent of their exposure to bad debts within the global financial system. The result of thousands of bankers all making individual decisions about their own businesses led cumulatively to a sharp contraction of credit and a collapse in confidence and trust. It created a downward spiral, with assets having to be regularly marked down and value destroyed. The disappearance of so much wealth into a black hole caused perturbation. What the banks had created they were now forced to destroy. The anguished cry from media presenters, ‘Where has all the money gone?’, suggested that someone must have stolen it. The truth was even more shocking. The values which had been posted as the bubbles inflated had always contained a large element that was fictitious, as market insiders knew only too well. The trick was always to sell up before the market turned. Some called it swimming naked in the ocean. No-one could tell who was naked until the tide went out.

In September 2007 the growing tightness in the financial markets produced a run on a bank, Northern Rock. This was one of the new UK banks which had emerged from the demutualization of the building societies in the 1990s, which had enjoyed great success with its aggressive lending policies, offering some of the best deals on the market. During

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2007 it was offering mortgage deals to some clients that were worth six times their annual income. Some of its combined mortgage and personal loan deals were worth 125 per cent of the value of homes. Its ability to offer such attractive terms was dependent on raising a large proportion of its funds from the money markets rather than from depositors. This worked fine when the markets were rising, and confidence was strong. Once the check occurred and the supply of credit dried up, Northern Rock found itself in desperate straits. It could no longer borrow enough to honour the obligations it had undertaken at rates it could afford, so was forced to apply to the Bank of England for emergency financial support. This caused a collapse of confidence in Northern Rock among its depositors, who feared that their money was no longer safe. So began the first bank run in Britain for more than one hundred years. The queues of depositors desperate to get their savings out of the bank which began to form outside Northern Rock branches all over the UK were a harbinger of much worse to come. It shocked the financial establishment and forced the British Government to announce that it would guarantee all the savings in the bank. This was a drastic solution but the alternative was worse, to risk Northern Rock actually becoming bankrupt and the contagion spreading through the UK financial system, with further runs on banks, and huge potential damage to the reputation of UK banking. The actions of the UK authorities were the minimum necessary to stop the financial panic which was engulfing Northern Rock, but at the same time they were trying to intervene as little as possible in the deregulated financial markets, in the hope that the markets would right themselves, and Northern Rock could be kept as an isolated incident.

In the autumn of 2007 the Federal Reserve's strategy for dealing with what was now being called everywhere the 'credit crunch' was an aggressive use of monetary policy, to reduce the price of credit and to inject more funds into the market (see Figure 1.3).

Its main interest rate was cut in September by half a percentage point to 4.75 per cent, and then by quarter percentage rate cuts in October and December 2007 to 4.25 per cent. Even more dramatic cuts were to follow in 2008, starting with two cuts at the end of January 2008, which brought the rate down to 3 per cent. Further reductions followed in March and April bringing the rate down to 2 per cent. Two cuts in October brought it down to 1 per cent, and then in December, a further three quarters percentage rate cut saw the rate hit zero to 0.25 per cent. There was nowhere further to go. This was uncharted territory for the Federal Reserve. The Bank of Japan

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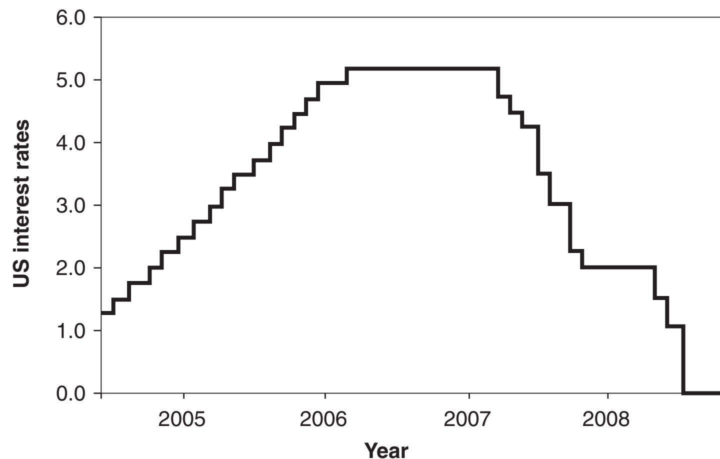

Figure 1.3 US Federal Reserve interest rates, 2005–8

Source: data from Federal Reserve.

had cut rates in the 1990s and eventually reached zero, but by that time the Japanese economy was caught in a downward spiral of deflationary expectations, which even zero interest rates did not break. The steepness of the decline in US rates from 6 per cent in 2007 to 0 per cent by the end of 2008 was remarkable and suggested how worried the authorities were about the consequences if liquidity in the market were to dry up.

Many other central banks followed the example of the Federal Reserve, if much more cautiously, and brought their own rates down. Even the Bank of England, notoriously conservative about interest rates, and throughout most of its history the guardian of a relatively high rate in order to protect the currency, began to aggressively cut rates in 2007, and by the end of 2008 rates had come down to 1.5 per cent; in February 2009 they went to 1 per cent, the lowest ever, and in March 2009 lower still, to 0.5 per cent. There were many critics who regarded this policy as too hasty and too drastic. Given the time lags involved between a rate cut and its impact on spending and saving in the economy, the cuts followed much too quickly to allow an assessment of whether the previous cuts were having any effect. But the authorities brushed this objection aside. They were concerned chiefly with maintaining liquidity in the system, preventing a financial collapse, and making the inevitable recession as shallow and short-lived as possible. In

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the fog of the markets it was impossible to say who was right. It depended on judgements about the nature of this financial crisis, its causes and its seriousness. Some of the people in charge of the central banks, notably Ben Bernanke at the Federal Reserve, had studied the Great Depression and were adamant the same mistakes would not be made again, when the Fed had actually reduced liquidity and contracted the money supply, in the face of the slump. The result had been a serious price deflation, which had helped make the downturn into a depression that took a decade to overcome. But if the threat of deflation was exaggerated, then reducing interest rates to zero and flooding the markets with money, through the technique known as 'quantitative easing', made the risk of reintroducing inflation at some point in the future a strong possibility. It was a risk that governments were increasingly prepared to face. Ben Bernanke had developed the Bernanke doctrine, based on close study of the 1930s Great Depression. The Bernanke doctrine provided rules for monetary policy to prevent deflation. In a speech in 2002, Bernanke argued that the sources of deflation were not a mystery. Deflation was almost always a side effect of a collapse of aggregate demand. Producers, in response to such a sharp drop in spending, had to cut their prices and then cut them again in order to find buyers. The economic effects of such behaviour would be recession, bankruptcies, rising unemployment and financial stress.

The measures he suggested to combat it included increasing the money supply, ensuring that it resulted in increased liquidity, cutting interest rates – to zero if necessary – depreciating the US dollar and using the power of the Federal Reserve to print money to acquire equity stakes in banks and financial institutions. By 2009 all these policy measures had been adopted, but none of them proved a quick fix.

Cynics noted that resorting to inflation might be the only way governments could possibly alleviate the huge debt burden they had incurred in trying to shore up the financial system. But this itself carried risks. A policy of depreciating both the value of the currency and the value of public debt would undermine the reputation and credibility of governments and financial centres in the advanced economies. If the confidence of key foreign investors and states fell away, the private debt crisis could be replaced by a public debt crisis. Governments and central banks could find it very hard to fund their borrowings, as Iceland found in 2008. Judging where the line lay was far from easy, because no-one had been in this exact place before. Levels of public debt were already high for many countries at the start of the crisis (see Table 1.2).

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Table 1.2 Public debt as a percentage of GDP, 2008 (selected countries)

Country	
Japan	170
Italy	104
France	64
Germany	63
United States	61
United Kingdom	47
China	16
Russia	7

Source: data from CIA, *The World Factbook 2008*.

This dilemma of funding borrowing took some time to emerge. In the early stages of the crash in 2007 and early 2008 the Federal Reserve and the other major central banks did not imagine that they would have to contemplate implementing the Bernanke doctrine in full. Despite the shocks of the failure of Northern Rock and the huge losses being announced by banks like Citigroup and the Swiss Bank UBS (Citigroup alone was to post losses of $40 billion), it was still hoped that modest rate cuts and the announcement by the central banks, orchestrated by the Federal Reserve, in December 2007 of a major loan package to banks, would prove enough. At this stage the Bank of England was still looking for a private sector buyer for Northern Rock, and its interest rate was still at 5.5 per cent (the Fed's rate was 4.25). Governments in several countries were devising packages to help mortgage holders faced with repossession of their homes, but the uncertainty of the outlook was underlined just before Christmas 2007 by Standard and Poor's, one of the world's leading rating agencies, downgrading the credit rating of several insurers of bonds, making it harder for the insurers to repay the loans if the issuer to the bonds defaulted. As so often in this crisis, the problem was not so much the effect on the insurers themselves as the wider effect on the financial markets. It was the realization by the banks that if the insurers were judged no longer able to pay out if the issuers of bonds failed, then another layer of bad debts was potentially uncovered. The longer the crisis went on the more it was like an archaeological dig uncovering layer after layer of bad debts, which no-one had previously suspected, partly because so long as the economy was doing well, there was no reason to regard them as bad debts. Once the market dived, assets that had been considered financially sound suddenly became toxic.

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The steady drip of bad news since the summer of 2007 had had a generally lowering effect on stock markets across the world. In January 2008 came the first really steep falls, across all the major markets. The falls were the largest since the aftermath of the 9/11 attacks. It prompted one of the Fed's major rate reductions, which temporarily steadied the markets. But no-one thought the worst was over. It was clear that it was only just beginning. The announcement of major losses, running into billions, by major insurers and banks and other financial institutions, became almost a weekly occurrence, adding to the gloom in the markets, and making everyone more cautious and risk-averse. Everyone, that is, except for governments and central banks, which were now beginning to abandon caution in a desperate bid to restart lending and stop the delicate mechanism of the financial markets, once considered so robust, from stalling.

The casualties kept coming. In February 2008 the British Government announced that Northern Rock would be nationalized. A private buyer had not materialized. The government stressed that Northern Rock would only be in government hands for a temporary period and that, although the government was now directly underwriting all Northern Rock's loans, the exposure of the taxpayer would be limited. But an important precedent had been set. The government had shown it was ready not just to broker a private sector rescue, but to take control itself in certain circumstances. Many questioned why it had taken the government so long, and why this decision could not have been announced the previous September, when Northern Rock first got into difficulties. The answer again turned on judgement. Many government ministers and senior people in the Bank of England had not expected that the crisis was going to worsen in the way it did, and they still could not believe that the engine of the growth model of the last thirty years, the financial services industry, which had been held in such awe for so long, could not be restarted. They kept waiting for it to spring back into life.

The nationalization of Northern Rock in the UK seemed rather minor when, in March, the fifth largest bank on Wall Street, Bear Stearns, was suddenly acquired by JP Morgan Chase. Morgan Chase paid $240 million for a bank which had been valued at $18 billion just one year earlier. If it had waited a few more months it could have had it for even less. This was the speed of the financial collapse which was now beginning to affect some of the best-known names and established businesses on Wall Street and in the City of London. In April, the IMF predicted that losses as a result of the financial crisis could be $1 trillion, and might go higher. It suggested

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that the losses were now spreading from sub-prime mortgage assets to other sectors, including commercial property, consumer credit and company debt.

No player in the market was immune from this contagion. Even the biggest and most established names began to experience difficulties. A series of rights issues were announced between April and July by major banks to increase the funds available to them; in April the Royal Bank of Scotland announced a £12 billion rights issue, at the same writing £5.9 billion off the value of its investments, the largest ever write-off for a British bank; in May the Swiss Bank UBS announced a $15.5 billion rights issue; and in July Barclays unveiled a £4.5 billion rights issue. The Bank of England and the other central banks, including the ECB, were by now intervening actively in the markets, putting together loan packages, and offering to buy the toxic debt of the banks, later known as TARP (Troubled Assets Relief Programme). But everything was beginning to point down. House prices had begun to slide, along with shares. Banks everywhere were announcing big reductions in their profits and a big increase in their bad debts.

In July the crisis worsened significantly in the US with the collapse first of IndyMac, one of the leading US mortgage lenders, followed the next day by intervention by the authorities to prevent the collapse of Fannie Mae and Freddie Mac, the two mortgage lenders which were the backbone of the US housing market. Several British banks and mortgage lenders looked to be in serious trouble, with attention focused on two former building societies which had been allowed to demutualize and become banks in the 1990s, Bradford and Bingley, and Alliance and Leicester. The authorities appeared to brace themselves for worse news, with warnings being issued by several political leaders and by the OECD about the gloomy economic prospects.

No-one, however, can quite have expected the dramatic events of September 2008. This was an extraordinary month for the global economy. The decisive events again took place in the US. First, on 7 September, Fannie Mae and Freddie Mac had to be bailed out by the Federal authorities, with Hank Paulson, the US Treasury Secretary, declaring that the bad debts which the two mortgage lenders had accumulated posed a systemic risk to the stability of the whole financial system. Then, on 10 September, came the news that Lehman Brothers, one of the world's leading investment banks, had posted a loss of $3.9 billion for the three months to August. It began a desperate search for a buyer, but, on 15 September, was

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forced to file for bankruptcy. This was the first major bank to go under since the financial crisis began, but the authorities stood back and refused to rescue it. Alan Greenspan called it 'probably a once in a century type of event'. A few more such events were to follow. There was still at this point a strong aversion to a rescue of private sector financial institutions by the government, partly because neo-liberal doctrine held that government had no business in getting involved and would only make things worse, and partly for fear of the signal this would send to the markets. Without the financial discipline of failure and collapse the market could not function as it was intended. This was an ancient problem well known to Adam Smith, which had come to have a new name: moral hazard. If the state was seen to protect against failure, the incentive for market agents to act responsibly would be removed.

The failure of Lehman Brothers seemed to open the floodgates. In quick succession another of the big investment banks, Merrill Lynch, was taken over by Bank of America for $50 billion; the federal authorities stepped in with a $85 billion rescue package for AIG, the biggest insurance company in the US; Wachovia, the fourth largest US bank, was bought by Citigroup, absorbing $42 billion of bad debts. In the UK, HBOS, the country's largest mortgage lender, was taken over by Lloyds TSB, with the encouragement of the government and a promise to waive competition rules, potentially creating a bank which would control one third of the mortgage and saving market; Bradford and Bingley was nationalized; elsewhere in Europe bailouts and partial nationalizations had to be announced for Fortis, Glitnir and Dexia.

Against this background, governments around the world sought to stabilize the situation by agreeing even larger bailouts for their stricken financial systems. The US took the lead in setting out a bipartisan plan to permit the Treasury to spend up to $700 billion buying up the toxic debts on the banks' balance sheets. On 29 September, however, despite frantic last-minute negotiations between the White House and Congressional leaders, the House of Representatives rejected the package. Stock markets promptly collapsed, with Wall Street suffering its largest ever one-day fall; the Dow Jones index was off 770 points or 7 per cent. European governments were forced into competitive declarations of support for the banks, and their depositors, with the Irish Government leading the way in promising it would guarantee all deposits in the country's main banks for two years. The risk of a general collapse in the financial system, with incalculable consequences for the global economy, for a few days appeared very

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real. George Bush put it bluntly if inelegantly to intransigent Republicans who were refusing to approve the bailout: 'This sucker could go down.' The Senate passed the bailout plan, and then, after the plan had been significantly amended – expanded from twenty to 400 pages – the House of Representatives passed it on 3 October. Other governments around the world followed suit with their own bailouts.

The full extent of what had happened took some time to be recognized. The great boom of the 1990s, powered by the inexorable rise of the deregulated financial markets, had ended with the nationalization of the banks. Governments had been forced to intervene to prevent a complete collapse. The markets had been unable to save or regulate themselves. The Iceland Government took control of Landsbanki, the country's second largest bank, Germany injected €50 billion into its banks, the UK announced its own rescue package of £50 billion on 8 October to recapitalize the banks, and a further £200 billion in short-term loans. There were similar rescue packages announced by Sweden, the Netherlands and France. Interest rates were slashed again in Washington, London and also in India. China too became concerned about the backwash of the financial crash on its economy and announced a major fiscal stimulus.

Despite these unprecedented moves, or perhaps because of them, the markets continued to slide. Expectations of a deep depression were now almost universal and the action by the central banks in cutting interest rates to such low levels, despite the relatively high rates of inflation, convinced the markets that the authorities themselves were now anticipating a sharp downturn in economic activity and were desperately trying to mitigate its effects and prevent it from turning into a major deflation, with the serious consequences for all economies that would bring. Figures on employment, prices and consumer confidence were enough to trigger further falls in stock market prices. On 15 October, the Dow Jones index fell 733 points, 7.8 per cent, even outdoing the fall in September.

International diplomacy was also now in full swing. A meeting of G7 finance ministers in Washington on 11 October issued a five-point plan of action to unfreeze the credit markets, and there was agreement that every country should do all in its power to reduce interest rates, recapitalize the banks and provide a fiscal stimulus to keep economic activity from plunging. This was followed up by the US Government announcing a $250 billion package to purchase stakes in US banks, and the UK Government agreeing deals with three of the largest British banks – Royal Bank of Scotland, Lloyds TSB, and HBOS – to receive £37 billion.

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Action to sustain liquidity and shore up the banks was increasingly accompanied by fiscal boosts to maintain the level of demand and prevent a descent into slump. China's announcement, on 9 November, that it would provide $568 billion over two years was particularly significant. It reflected widespread awareness of the perils that were now facing the global economy. Even the European Central Bank, which had been noticeably more cautious in responding to the crisis, was steadily reducing its interest rates, down to 3.25 per cent on 6 November. The eurozone economy had already entered recession, and everyone recognized it was only a matter of time before the US and UK economies did too.

Right up to the end of 2008 more news of bank rescues and fiscal packages kept coming. The IMF announced a major rescue for Iceland following the earlier collapse of the Icelandic banking system, and a few weeks later for Pakistan. Citigroup was rescued by the US Government after its share price collapsed, and the UK Government, in its pre-Budget Report in November, predicted that the effects of the bank bailouts and fiscal stimulus would require record borrowing. VAT was reduced by 2.5 per cent, a £12 billion injection. The government promised that the record borrowing would be temporary, designed to ward off the recession, and that as soon as the worst was over, taxes would have to rise and public spending be cut, in order to rebuild the public finances. These assurances were necessary because, with flexible exchange rates, those countries like Iceland and the UK which had very large financial sectors in relation to the rest of their economy were highly vulnerable to speculators losing confidence in the currency. Both the dollar and the eurozone were relatively insulated, the dollar because of its status as the reserve currency of the global economy. But the pound was highly exposed and, at the end of 2008, began to fall sharply against the euro and the yen, and to a lesser extent against the dollar.

Even countries that had seemed unaffected began to be caught up in the general problems. Australia had looked as though it would escape the worst of the crash and the downturn. Mineral exports had remained buoyant, and Australian banks had not been heavily involved in the international credit boom, and were not exposed to huge losses when the sub-prime market turned down. Australia had, however, seen very large rises in house prices, and it was dependent on the inflow of funds from foreign banks. When the international financial system crashed, overseas banks began to repatriate funds and, at the end of 2008, Australia suddenly faced a slowing economy, a stock market crash and anxieties about how it

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was going to fund the shortfall in its banking system. Australia was one of the first victims of the new phenomenon of financial protectionism, the unwillingness of banks to lend outside their own economies. The Australian Government responded with a package of measures, including an AS$4 billion business investment partnership, to plug the hole in the banks' accounts created by the withdrawal of foreign bank funds. In this way it was hoped Australia could insulate itself from the worst of the recession and the banking crisis in the rest of the world.

2008 ended with more dramatic decisions in the United States. The Federal Reserve brought interest rates down to zero and the US Government moved to bail out its loss-making car industry, Ford, GM and Chrysler, and save them from bankruptcy. There was clearly much more to come, but at the end of 2008 it did at least appear that swift and decisive action by governments had staved off the complete collapse of the financial system, but with unknown consequences for the rest of the economy. Governments had been forced to address problems which were unprecedented, and for which there were, therefore, no exact or reliable guides from the past. Steve Forbes, proprietor of *Forbes Magazine*, flamboyant financier, prominent neo-conservative and supply-sider, economic policy adviser to John McCain, having run for the Presidency twice himself, declared on 28 October that 'the worst was over', and that the US economy would quickly bounce back. But no-one could be sure. In the Great Crash, Herbert Hoover had been much mocked for announcing that 'prosperity was just round the corner'. It was, but it turned out to be a very long corner.

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