Special issue: The financial crisis analysed

radical feminist green

Perspectives

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SCOTS

and most of the rest of the world

ON THE ROCKS?

HSBC

CREDIT CRUNCH

RECESSION

UNEMPLOYMENT

NEGATIVE EQUITY

MAGAZINE OF SCOTLAND'S DEMOCRATIC LEFT

Contents

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Tel: 01382 819641
e: s.fairweather703@btinternet.com
www.democraticleftscotland.org.uk

Editor: Sean Feeny
Depute editor: Davie Laing

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For further information on *Perspectives* (including advertising rates), or to submit articles or letters, please contact:

The Editor, *Perspectives,* Democratic Left Scotland, Number Ten, 10 Constitution Road, Dundee DD1 1LL
e: dlsperspectives@talk21.com

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EDITORIAL

THE CRISIS DISSECTED

Welcome to this special issue of *Perspectives* – the first one we have produced dedicated to a single theme. And what a theme!

Much of the daily news about the financial crisis makes grim reading. Here we are attempting to make sense of what is going on and to look at possible new developments and strategies that might lead us away from the underlying theme that lies at the base of so many of the world's current problems – neo-liberalism.

David Purdy sums up the ground covered by our contributors on page 3. Thanks are due to them and especially to David for commissioning and editing the pieces.

■ **Letters and contributions (which we may edit) are welcome and should be sent to the editor – contact details alongside.**

If *Perspectives* seems a little wordy this time don't be put off. The articles themselves are very clear and well worth the read.

New readers to this magazine (produced by Democratic Left Scotland) might like to note that although this issue concentrates largely on economic/financial issues, we explore our political ideas, in the broadest sense, in our usual (non-special) issues – number 18 is currently available and 20 will appear next month in time for the 250th Robert Burns anniversary (see below).

Subscriptions are available by completing the form on the back cover – £8 for four issues.

Sean Feeny
Editor

FINANCIAL CRISIS, GLOBAL RECESSION AND THE STATE WE'RE IN

David Purdy surveys the ground covered by contributors to this special issue of *Perspectives*.

Historic turning points are rarely foreseen in advance, though in retrospect they can come to seem inevitable. No one predicted the outbreak of the First World War or the collapse of communism, though in both cases the relevant antecedents were known to contemporaries. So it has been with the crash of 2008. Many commentators warned that the credit-fuelled boom of the past decade would not last, but no one could have known when it would end and few realised how serious the repercussions would be, not just for banks and financial institutions, but for the so-called real economy, and not just for the US, where the crisis originated, but for the world as a whole.

In this special issue of *Perspectives*, six invited contributors discuss various aspects of the crisis. Three of these focus on financial and economic issues. **David Cobham** explains how modern banking works and describes the development of asset-based securities. Intended to reduce the risks of financial investment, these devices helped to inflate housing prices, and when the bubble finally burst, turned toxic, causing the entire financial system to seize up. The roots of the crisis, he argues, lie in the liberalisation policies of the 1980s and the installation of a monetary policy regime which targets inflation in goods and services, but disregards movements of asset prices.

Many commentators warned that the credit-fuelled boom of the past decade would not last, but no one could have known when it would end and few realised how serious the repercussions would be.

John McLaren examines the impact of the crisis on the Scottish economy and reviews the options facing policymakers at both Westminster and Holyrood. While they have little room for manoeuvre in the short run, the time is ripe, he suggests, for a fundamental rethink about the long-term goals of economic policy. In affluent societies, it makes no sense to go on straining after economic growth and material goods when it is the quality of our lives – as persons, as citizens and as denizens of planet Earth – that needs to be improved.

Sheila Dow considers global financial institutions and revisits the idea, originally proposed by Keynes at Bretton Woods in 1944, for a world central bank, which would create and manage a stable, dependable and genuinely international currency. At the time, Keynes's plan was overruled by the US government, which proceeded to put the dollar at the heart of the post-war international monetary system, with damaging long-term consequences for global financial stability. Whether a revised and updated version of the plan will fare any better now that US power is in decline is hard to say, but politics and power are sure to play a key role in deciding which ideas for redesigning the world's financial architecture are accepted.

The remaining contributors focus on politics and policy. **Maggie Chapman** commends proposals for a Green New Deal, the contemporary counterpart, she notes, both in transforming ambition and in mobilising potential, of the programmes launched by the Roosevelt administration in response to the Great Depression of the 1930s. Certainly, Roosevelt's New Deal offered hope to beleaguered American workers and farmers, convincing them that for once the government was on their side. How far it succeeded in overcoming the Depression is another matter. Nevertheless, the Green New Deal offers the most promising basis yet produced for challenging conventional wisdom and building a progressive alternative to mainstream neo-liberalism.

In my own contribution I point out that on the Richter scale of economic history, the current recession does not (yet) begin to compare with the slump of 1929–33 and that (so far) governments have avoided the disastrous policy mistakes that were made then. The crash of 2008 has, to be sure, destroyed one of the pillars of the neo-liberal order – belief in light-touch financial regulation – but other pillars remain intact, not least the belief that owning, earning and spending are the highest expressions of human civilisation. The Wall Street Crash of 1929 marked the end of laissez-faire. But it took ten years of global economic carnage and six years of total war to effect the transition to a new regime.

Gerry Hassan and **Anthony Barnett** examine the fall-out from the crisis for UK and Scottish politics. In a scathing indictment of Britain's neo-liberal state, they argue that Gordon Brown's swift and timely resurrection of Keynes has (for now) saved his premiership (if not the world), discountenancing both David Cameron's Conservatives and Alex Salmond's SNP. Brown has not, however, offered any reflection on the policies that helped to produce the state we are in, and in the absence of any serious intellectual and political challenge, the chances are that neo-liberal ideas, suitably adapted, will continue to dominate economic policy on both sides of the border.

There's more to politics than parties

People and politics

In Scotland, as in the rest of Britain, there is widespread disillusionment with politics. The mainstream parties have lost touch with ordinary people and issues are trivialised and distorted by the media.

We are continually told that "there is no alternative" to global capitalism. Yet this is doing untold damage to our environment, our communities and the quality of our lives, while millions of people remain poor and powerless because the market dominates our society and we do too little to protect and empower them.

Democratic Left Scotland is a non-party political organisation that works for progressive social change through activity in civil society – in community groups, social movements and single-issue campaigns – seeking at all times to promote discussion and alliances across the lines of party, position and identity.

Political parties remain important, but they need to reconnect with the citizens they claim to represent, reject the copycat politics that stifles genuine debate and recognise that no single group or standpoint holds all the answers to the problems facing our society.

We are trying to develop a new kind of politics, one that starts from popular activity – in workplaces, localities and voluntary associations – and builds bridges to the world of parties and government, on the one hand, and the world of ideas and culture, on the other.

What does Democratic Left add?

Our approach to politics is radical, feminist and green.

Radical because we are concerned with the underlying, structural causes of problems such as poverty, inequality, violence and pollution and aspire towards an inclusive, more equal society in which everyone is supported and encouraged to play a full part, within a more just and sustainable world.

Feminist because we seek to abolish the unequal division of wealth, work and power between men and women and to promote a better understanding of the intimate connections between personal life and politics.

Green because we believe that our present system of economic organisation is socially and environmentally destructive, and that a more balanced relationship between human activity and nature will be better for us, for our descendants and for the other animal species with whom we share the planet.

Who can join Democratic Left Scotland?

Membership is open to anyone who shares our general outlook and commitments. Whilst many of our members are involved in a range of political parties, others are not.

Democratic Left Scotland
na Deamocrataich Chli an Alba

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BRITAIN'S NEO-LIBERAL STATE

Gerry Hassan and **Anthony Barnett** stake out the domestic political context to the global crisis.

As he became prime minister in June 2007, Gordon Brown looked back across a decade of power with pride and satisfaction. Speaking to the Lord Mayor's banquet, an annual white-tie report to the City itself, he declared:

"Over the ten years that I have had the privilege of addressing you as Chancellor, I have been able, year by year, to record how the City of London has risen by your efforts, ingenuity and creativity to become a new world leader … Now today over 40 per cent of the world's foreign equities are traded here, more than New York … 80 per cent of our business is international …

"So I congratulate you, Lord Mayor and the City of London, on these remarkable achievements, an era that history will record as the beginning of a new golden age for the City of London …

"And I believe it will be said of this age, the first decades of the 21st century, that out of the greatest restructuring of the global economy, perhaps even greater than the industrial revolution, a new world order was created …"

Fourteen months later, the baseless fabric of this vision had dissolved. Alan Greenspan was left spluttering before Congress, John Maynard Keynes was resurrected from the lower circles of hell, and Labour ministers once more bombarded Will Hutton with invitations to be their Virgil and interpret the great sage's insights on finance capitalism and the economic cycle.

THE WESTMINSTER SWITCHBACK

Initially, there was a near-complete consensus amongst the political classes and the media that Gordon Brown and Alistair Darling, his Chancellor, managed the crisis in a masterful fashion. Their improvised rescue plan, culminating in the part-nationalisation of the Royal Bank of Scotland and HBOS, won plaudits across the political spectrum. Certainly, Numbers 10 and 11 Downing Street acted with lightning speed, with little protest over the lack of scrutiny, oversight or democratic debate, and the absence of public forums where people can vent their anger and dismay at those who got us into this mess.

It was different in the US where Treasury Secretary Hank Paulson had to fight tooth and nail to get his bailout plan through Congress. Part of this was due to the death pains of the Bush administration, as politicians sought to persuade voters that they had nothing to do it, but it also reflected the resurgence of American democracy, after years of being overridden and humiliated by Bush and company.

In Britain, Alistair Darling's pre-budget report revealed the scale of indebtedness the country is likely to incur. To reassure the financial markets, he was forced to set out a commitment to raise taxes as soon as the recession ends, on a projected timescale that seems highly optimistic. There are interesting differences between the two major parties, but what has really changed? Near total scorn for the state has given way to delight in the decisiveness of government

Numbers 10 and 11 Downing Street acted with lightning speed, with little protest over the lack of scrutiny, oversight or democratic debate.

Since the financial crisis broke, Salmond has veered all over the place, from slamming "spivs and speculators" in order to win brownie points in the Scottish Parliament, to calling on the existing RBS bosses to stay.

bailouts. In both cases, it was said, "There is no alternative." Ideologically, neo-liberalism derided government. But it traded on the covert support of state power, nationally and globally. Hence the ease with which it could embrace its "necessity".

The opposition parties at Westminster have had mixed fortunes. The Liberal Democrats – that is to say Vince Cable, Treasury spokesman – have had a good crisis. But Nick Clegg, their new leader, has moved the party rightwards calling for a "smaller state", lower tax and more competition, while backing away from wholehearted campaigning in support of Europe. As so often over the past twenty years, one can say that the Lib-Dems "have not done badly". This seems to satisfy them. But it also confines them to the traditional mores of Westminster and local politics when there is a profound need for something genuinely different that they could have provided.

Over the past three years David Cameron's Conservatives have sought to square the circles of their inheritance. The new leader aims to put the in-fighting and dogma of Thatcherism behind him and to create an inclusive Conservatism, at ease with contemporary Britain. At a time when Cameron's weaknesses are being revealed, it is important to stress the positives as well as the limitations of his vision. He successfully dumped Thatcher's social divisiveness and moderated her hostility to government and the welfare state. Emphasising "well being" and social responsibility, he declared that the party's mission was "to revive our society just as Margaret Thatcher revived our economy; to reverse Britain's social breakdown, just as she reversed our economic breakdown."[1] In the process, Cameron made the Tories re-electable.

His aim was to become the true "heir to Blair" (in contrast to the more dour Brown). But Blair was the heir to Thatcher and the neo-liberal settlement that Cameron was also seeking to break away from. It must have seemed like a perfect steal, to snatch back the inheritance. Instead it has become a poisoned chalice, and not just because Cameron's "new Conservatism", with its plutocratic opportunism, is in some ways even more neo-liberal than New Labour.

The decisive vector of British politics is not who will inherit Tony Blair's mantle, but who is furthest away from being identified with the epoch of Blair (and Bush). For his first three months as PM this seemed to be Brown, as he governed with a very different style and with seeming integrity. His ratings soared above those of both Cameron and his predecessor. Then Brown failed to deliver on his promise of a democracy voters could trust: he declined to call an autumn election for which he had blatantly prepared while denying he had looked at polls – a spinner, after all, just like his predecessor, but without his flair. Brown became the unpresentable face of Blairism. His popularity crashed and Cameron's time seemed to have arrived.

In the big-dipper of UK politics, the financial crisis suddenly re-reversed these terms. Gordon Brown excavated a belief in Keynesian solutions from his social democratic past and a solidity of purpose that was lacking from Blair's lightness of being. Meanwhile Cameron and his shadow Chancellor George Osborne look more like the old prime minister. In an exceptionally fast-moving situation, the Tories' clothes are exposed as, literally, yesterday's fashion. With newspaper supplements asking what will be "the hemlines of recession" and the sale of sewing machines on the rise, the classless consumerism of the Cameron Conservatives seems all too close to the shopping mall "social-ism" of Tony Blair.

ALEX SALMOND'S HONEYMOON COMES TO AN END

Besides the Westminster parties, there is another shaper of UK politics, the Scottish National Party. Most political commentaries neglect to mention that the UK has two first ministers and two political dynamics. The Tories are a major force in only one of them.

Recent events have proven just as troublesome for Alex Salmond's SNP. Although the "broad tent" alliance of social democracy and good business sense in a populist, national project is progressive for Scotland as a country, it also turns out to be building Scotland's variant of the neo-liberal state. Salmond, a former economist at RBS, was happy to be a friend and ally of the Scottish financial sector, RBS and HBOS in particular, relying on the strength and reputation of these venerable institutions to support the case for independence just as they were heading for bankruptcy.

Since the financial crisis broke, Salmond has veered all over the place, from slamming "spivs and speculators" in order to win brownie points in the Scottish Parliament, to calling on the existing RBS bosses to stay (the day before Brown and Darling part-nationalised RBS and forced Fred Goodwin, its chief executive to resign), saying, "let the people in charge guide the institutions into safer times."[2] The next day, confronted with these comments, he appeared lost for words. Invited to condemn RBS or bankers in general, Salmond refused to do either, commenting that there should be "no scapegoats".[3] The circle was then completed at the SNP annual conference when in a downbeat, sombre speech, he again tore into nameless "spivs and speculators", but gained little credit for a platitudinous populist speech that failed to rise to the occasion.[4]

Why is the SNP in difficulties? Mainly because it is a catch-all political party, but Salmond's recent remarks about Thatcherism are also revealing: "We didn't mind the economic side so much," he claimed, "but we didn't like the social side at all" – a striking echo of Cameron's similar distinction.[5]

While Salmond's formidable achievement in giving Scotland a government it can respect should not be gainsaid, the nationalist case for Scottish independence will have to change dramatically and become much more ambitious and radical. The narrow, technocratic, economic case for independence – for the building of a "Scotland plc" and a "new Celtic Tiger" – now seems much less plausible. Pre-crisis, this made some sense. It could be called the SNP "bank manager" case, personified by John Swinney and Jim Mather, now both ministers in the nationalist administration, as they mounted a "cocktail offensive" around the boardrooms of Scotland.

Their argument moved independence away from emotion and romance. Instead, Scottish independence was presented as a tight, light, corporate-friendly national project in which business would be better supported than in the remote and over-centralist UK. Arguably, this repositioning was a stage the SNP had to go through on the way to becoming a serious, modern political party. The downside was that it took the emotional resonance of independence for granted and anchored the party to the ruling economic orthodoxy.

While this glided them to a stunning by-election victory in Glasgow East, the underlying weakness was revealed in the more recent, post-crash by-election in Glenrothes. Labour voters who up until a month previously would have sat on their hands, turned out in large numbers to deliver a convincing victory for the prime minister.[6] It is striking that a week before, thanks to Salmond's intervention, Donald Trump was given permission to go ahead and build a billion-dollar golf course in the north-east of Scotland, overriding the local planning procedures. Although there is no evidence of any direct influence on the voters of Glenrothes, this decision imposed the interests of the global marketplace and Trump's clientele over Scotland's environment. The smallholder who still refuses to sell out to the American casino owner was disgusted. The *Guardian* reported that he was once a Scottish National Party voter but would never be one again. "I used to be proud to be a Scotsman, but I'm going to take both of my kilts out and burn them after this."[7]

In a fascinating coincidence, just as the advent of Trumpland was announced days before Glenrothes, so shortly after Labour's surprising victory, the UK government published its 126-page submission to the Calman commission, set up by the Scottish Parliament to consider the case for deeper devolution.[8] At great length, the UK government delivered its opinion that there was no need to devolve major new powers – indeed, there was room for taking some back – citing international admiration for the Scotland Act 1998 – shades here of the Westminster belief in the eternal perfection of the British constitution. This matters because even after the cause of independence received a major setback, the UK government continues to pose the constitutional debate north of the border as simply one of independence versus the status quo, a framing of the issues that allows no constructive way forward.

Thus, neither the SNP nor the Conservatives are coping well with the crisis. Their respective leaders have both been exposed as prisoners of the neo-liberal order whose logic was previously embraced as offering voters freedom and greater autonomy.

So far – and these two words must be emphasised in a swiftly moving context – Gordon Brown has shown himself to be more capable than both his main opponents. It is ironic in view of his central role in creating the neo-liberal state for over a decade, but more than any other party leader he has found a coherent response to the crisis. It has played to his strengths: his seriousness of purpose, his eye for the big picture, his knowledge of finance and his experience on the international stage. But the hints of democratic republicanism that could be discerned in his initial green paper have vanished. Instead, the signs are that, in coalition with the arch neo-liberal and co-founder of the New Labour "project" Peter Mandelson, Brown wants to set about an even more complete fusion of the 1997 combination of Whitehall and corporate power.

So far …Gordon Brown has shown himself to be more capable than both his main opponents.

GUILTY MEN IN THE AGE OF THE BLOVIATORS

Theodor Adorno once said, "The world wants to be deceived."[9] The glorification of globalisation appears to vindicate his perception. But there is now a desire for public truthfulness from politicians – not disingenuous flannel from the fellow-travellers of securitisation who, as credit-default swaps were transformed into yachts, intoned that they had seen the future and it worked. A political system that once prided itself for its honour and decency has been humiliated. Public life and standards have been debased, from the rise of "sofa government" to the Iraq war through the "cash for honours" scandal, and now Corfu, where unsavoury Russian oligarchs like Oleg Deripaska mix with Mandelson, Osborne, Nathan Rothschild and two generations of Murdochs.

During the last twenty years a new class of apologists for the economic, social and political order has taken shape. This elite has its own language, words and phrases which are shaped by a torrent of buzzwords and jargon emanating from management and consultancy mumbo-jumbo. Its leaders have filled the air with talk of "the knowledge economy", "living on thin air", "the rise of the creative class" and "step change", and have encouraged the emergence of a shameless group of self-promoting bloviators: Richard Florida and Malcolm Gladwell in the US, Anthony Giddens (in his "third way" phase) and Charlie Leadbeater in the UK, being four of the most obvious examples.

Across British public life, in public institutions and discourse, the New Labour decade has been characterised by the bowdlerising and debasement of values and meaning. To talk about the future of our society we have been obliged to pass through a linguistic supermarket where sterile, vacuum-packed in-words are provided by the supply-lines of the new elite. There have been many casualties. Government white papers and documents once renowned for their plain English have become inflated by gobbledegook.

The future of politics across the UK may not be shaped by the political parties as we currently know them.

Economic development agencies have abandoned political economy. Think-tanks have stopped thinking. University departments scrambling for research funds peer-review each other's publications in barely-read journals. Cities and regions aspiring to "world-class" status base their growth forecasts on shopping and tourism, discarding the solid revenues of manufacturing provincialism. In all parts of the UK, from London to Liverpool, Glasgow to Gateshead, this has been an age of gloss and superficiality, floating on finance from "neverland".

Can Gordon Brown lead Britain out of the crash? The question prompts further questions about the transformation of our political classes over the last thirty years, of which Brown is a leading example. There was the "Red Brown" of 1970s socialism, the pale-pink Brown of Kinnockite supply-side socialism, and the Union Jack Brown of New Labour, New Britishness.[10] Will a new Brown now emerge to seize the moment? Without indulging in too much remorse and recrimination, there has to be some self-reflection on the policies that got us to where we are. This seems unlikely to happen as long as Brown continues to present himself as the saviour of the world economic order in the same language of triumphalism and self-delusion that marked the high period of Thatcherism and Blairism.

In which case, the future of politics across the UK may not be shaped by the political parties as we currently know them. In his new book *Britain Since 1918*, David Marquand calls for a democratic republican politics that honestly embraces the territorial issues of the Union and frees the English question from its integument.[11] This is hardly a plausible programme for Brown or Cameron – while Clegg calls for the reinvention of politics, but from within the Westminster fastness. A new approach is needed to the problems of Britain's neo-liberal state, which will end the fusion of money and politics.

■ *Gerry Hassan is a writer and commentator whose books include* After Blair: Politics after the New Labour Decade. *Anthony Barnett was the founder and director of Charter 88 and is managing editor of Open Democracy.*

[This is an edited version of an essay posted on the Open Democracy network: as part of its "Our Kingdom" conversation on the future of the United Kingdom. Open Democracy offers in-depth news analysis and commentary from a pro-democracy and pro-human rights perspective. Everything on it is free to read and free to share.]

NOTES

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THE **GLOBAL FINANCIAL CRISIS**: THE STORY SO FAR

The origins of the current crisis go back to the liberalisation policies of the 1980s. **David Cobham** explains how banking works … and how it has all gone wrong.

The financial crisis that has struck the world since 2007 is the largest since the 1930s, and will have deep and lasting effects. In this article I first discuss why banks are prone to crisis – as the pharmaceutical industry, for example, is not – and why banks are usually regulated in special ways. Next I present an outline of the development of the crisis. I end with some comments on the wider international effects, including those on developing or emerging countries, and on the short- and medium-term prospects.

BANKS AND BANK RUNS

The core business of banks is to take in deposits and make loans. Banks hold assets other than loans: notably, reserves of cash and their own deposits at the central bank, which are essential to the operation of the payments system. They also obtain funds from sources other than deposits, as we shall see shortly. But the core business is deposits on the liability side of their balance sheets and loans (claims on borrowers) on the assets side.

Economists analyse banks in two main ways. On the one hand, focusing on banks' assets, they argue that many individuals and firms cannot access the capital markets to get "direct" finance, because they are not known to the markets and too small to make it worthwhile to get themselves known. Such borrowers rely instead on the banks. However, potential borrowers tend to know more about their own investment projects than potential lenders – what economists call asymmetric information – so banks must do what they can to offset this. Banks are therefore institutions that specialise in collecting information on potential borrowers, lending – in what is called "indirect finance" – to those they think are reliable, and monitoring and "enforcing" loans.

Banks' realisable assets are typically well below their short term liabilities, which means that there is always a possibility of an illiquidity or cash-flow problem for the banks.

On the other hand, focusing on the liability side, economists emphasise the mismatch between depositors' and borrowers' preferences. Depositors typically want their deposits to be secure, with some return if possible, but to be able to get the money back if and when they need it. Borrowers, however, typically want to borrow to finance long term investment projects. The banks enable these contrasting preferences to fit together. They offer a return of some sort – it may take the form of services of different kinds – to depositors, with a guarantee that they can withdraw whenever they wish. They then estimate the likely amount of withdrawals by depositors in any period, keep enough reserves to cover that, and lend the rest to borrowers at longer term. The effect is that banks' realisable assets are typically well below their short term liabilities, which means that there is always a possibility of an illiquidity or cash-flow problem for the banks, even if a bank is solvent in the sense that the value of its assets exceeds the value of its liabilities.

If all goes well – in what economists call a "good equilibrium" – the deposits in a bank remain at the level estimated by the bank, borrowers get loans, the bank makes profits and everybody is content. But there is also a "bad equilibrium" where depositors lose confidence in the bank and try to withdraw their funds at a rate above that foreseen by the bank, which may then become illiquid and collapse even if it is solvent. Since withdrawals from the bank are on a first-come-first-served basis, depositors try to withdraw their deposits fast before the bank runs out of cash. This is known as a bank "run".

So it's all about confidence, and confidence can change as a result of rumours or news about other banks (a process called "contagion") because information is always imperfect – even the bank itself does not know completely how good its loan book is (exactly how many defaults are likely), and anyone outside the bank has even less knowledge.

MONEY MARKETS, REGULATION AND ASSET-BACKED SECURITIES

The vulnerability of banks to runs has been increased in recent years by the development of money markets, especially the inter-bank market, now the most important. These are markets where banks with short-term surpluses lend to banks with short-term deficits. This is unsecured lending, with no collateral, and for that reason it is open only to recognised banks and financial institutions.

The use of money markets enables a bank to get additional funds without raising the interest rate on all its deposits. The growth of these markets led to a key shift in the 1970s from "asset management", where banks adjust their loans to the amount of deposits they have taken in, to "liability management", where banks use the money markets to obtain the funds necessary to finance the loans they want to make.

In the UK, major reforms in the mid-1980s allowed building societies also to get access to money markets, and then to convert from what were then seen as staid "mutuals" (i.e. owned by investors/borrowers) to dynamic (i.e. risk-taking) plcs, which means in effect banks.

However, the use of money markets as a source of funds creates a further "vulnerability" for banks: instead of the risk of retail depositors withdrawing, there is now the risk that other banks lose confidence and cease to lend, in which case, a bank suddenly can't get the wholesale deposits – which typically have a shorter term than its loans – on which it has been relying. Because this lending is unsecured, the bank can't just offer a higher premium on the loans it takes and risks the complete disappearance of available funds.

The vulnerability of banks to runs and crises, plus their role in the payments system, explains the conventional view that banks are "special" and should be treated differently, to encourage good behaviour and maintain confidence. Typically banks are regulated in a variety of ways, including:

- reserve requirements (which oblige them to hold minimum amounts of liquid reserves);
- capital requirements (which require banks' shareholders to put up minimum amounts of capital to absorb likely losses without those losses affecting depositors);
- prudential supervision (where the supervisory agency scrutinises a bank's books on a regular basis);
- deposit insurance (where bank deposits are – usually in part only – insured against collapse);
- lender of last resort (where the central bank lends directly to a bank in difficulty which cannot borrow elsewhere but is thought to be basically sound).

However, some of these arrangements involve the danger of "moral hazard": if banks assume they will be bailed out, managers don't feel they need to behave responsibly; and if customers know they are insured they will have no incentive to consider the riskiness of a bank (as well as the return it offers) when they choose where to deposit their funds.

Because these mortgages had been packaged into securities and sold on – to European as well as US banks – no bank, or anybody else, knew the full extent of the losses implied.

Finally, one other crucial financial innovation of the last few decades needs to be mentioned. This is the practice by which loans of different kinds – for example car loans, mortgages – came to be bundled together into larger-sized "asset-backed" securities (ABSs), which could then be sold on to other financial institutions. This practice supposedly enabled securities to be created which included good as well as not-so- good loans, and in average terms were therefore above some minimum threshold; in addition, they were typically insured against default. It therefore enabled banks to make loans, notably mortgages, to people whose individual credit ratings were so low that they would not previously have been offered loans. However, the separation between the agent or institution which awarded the loan and the institution which subsequently held the security meant that the former had little incentive to avoid excessively risky borrowers and the latter did not know the riskiness of the ABSs they were buying.

THE BASIC STORY

While it is always possible to find causes further and further back in time, it seems sensible to identify the more proximate causes of the current crises in two developments. First, in the US, the UK and many other countries there had been a long period of financial liberalisation, in some cases from the 1980s, in others from the 1990s. (In the UK's case, it goes back to the 1980s and in some areas before that. The Labour government is open to the charge that it did nothing to restrain the existing tendencies, rather than that it introduced significant further liberalisation.)

Second, monetary policy in the US and the UK, though to a lesser extent in the Eurozone, was focused on inflation in goods and services, and typically rejected the suggestion that policy should aim to prevent the emergence of bubbles – large rises not justified by the "fundamentals" which are likely to be reversed sharply when the bubble bursts – in the prices of assets such as houses, stocks and possibly foreign currency, or even that it should "lean against the wind" of asset prices. The combination of these two factors lies at the root of an acceleration of house prices from the early 2000s, which then facilitated further lending, particularly "sub-prime" lending to low-income households in the US whose chances of paying off a mortgage depended heavily on a continuation of the rise in house prices. As was subsequently revealed, much of this lending was based on over-optimistic assumptions about house prices and/or exaggerated or fraudulent assumptions – by mortgage brokers or banks as well as individual borrowers – about individuals' own incomes.

Defaults on US sub-prime mortgages began to rise in 2006, and by 2007 led to widening spreads on mortgage-backed securities. Lending fell back, and US house prices began to fall. That in turn meant that many more sub-prime borrowers began to default, since they could no longer remortgage on the basis of a higher house price. But a key problem was that, because these mortgages had been packaged into securities and sold on – to European as well as US banks – no bank, or anybody else, knew the full extent of the losses implied. Banks began to lose confidence in each other. By July 2007 the Federal Reserve was estimating potential loses for banks on sub-prime mortgages of $50–100 billion. Central banks in the US, the UK and Europe reacted by cutting interest rates and lending more to the banks themselves through a variety of channels, in increasingly desperate attempts to keep the banking system functioning. However, this proved harder than expected, and the Fed's estimate was soon dwarfed by much larger estimates, culminating – so far – in the IMF's October 2008 figure of $1.4 trillion.

In the UK the effect of the uncertainty about the size and distribution of losses in the US subprime market was that banks became increasingly unwilling to lend to each other in the interbank market. Northern Rock, a former building society which had converted into a plc bank and expanded its balance sheet rapidly on the basis of large recourse to wholesale funding, became unable to borrow in September 2007, and had to be supported and later nationalised by the UK government. Subsequently other banks which had been using the same business model – heavy use of wholesale funding, mostly relatively short term, to finance medium-to-long-term mortgage lending – suffered similar fates: HBOS was pushed into a merger with Lloyds-TSB in September 2008, while Bradford & Bingley was nationalised.

Meanwhile, in the US the investment bank Bear Stearns was taken over by JP Morgan Chase (with help from the Federal Reserve) in March 2008. Fannie Mae and Freddy Mac – two government-sponsored, but privately owned institutions which guaranteed mortgages – were given large-scale support by the US Treasury in July and then taken into "conservatorship" (effectively nationalised) in early September. On the other hand, the investment bank Lehman Brothers was allowed by the US authorities to file for bankruptcy in mid-September 2008, apparently on the basis that a line had to be drawn somewhere and some banks should be allowed to fail in order to encourage the others and avoid moral hazard. That decision is now widely understood to have precipitated an even larger fall in confidence in different areas of the banking system, and above all to have led to the almost complete drying up of the inter-bank market, with drastic consequences.

By late September, the insurance giant AIG, which had been insuring a wider range of ABS and ABS-related securities, had to be all but nationalised. Two major commercial banks, Washington Mutual and Wachovia, needed support from other banks. Two large investment banks, Goldman Sachs and Morgan Stanley, were transformed into bank holding companies so that they could be supported by the Fed, while another, Merrill Lynch, was taken over by Bank of America, a commercial bank. Hank Paulson, the US Secretary of the Treasury (minister of finance), put forward to Congress a proposal under which he could buy more or less any asset he liked from more or less any financial institution with the aim of taking the bad assets out of the system and restoring its stability.

It is difficult to believe that the recessions on which most advanced countries are now embarked will be shallow or short-lived.

In early October the Icelandic banking system collapsed. The UK government announced its plan to recapitalise UK banks, i.e. provide additional capital to absorb losses and/or replace the private shareholder capital which had been largely wiped out by the bad debts revealed so far. The US began to use some of the $700 billion package agreed by Congress in the same way. Further cuts in interest rates were made and/or were on the way. By November attention was shifting to the likelihood of a deep and lasting recession, and governments began to talk about large programmes of fiscal stimulus to try to reduce the severity of the recession.

THE PROSPECTS

At the time of writing (end-November) banks in the UK and elsewhere remain unwilling to lend to each other or to their customers, and it is unclear whether and when the extraordinary panoply of measures announced by governments are going to restore the financial system to anything approaching basic health. It is also difficult to believe that the recessions on which most advanced countries are now embarked will be shallow or short-lived (though they may be less drastic than if no fiscal stimulus was applied).

What we have been witnessing is not only the largest financial crisis since the early 1930s; it is also an upheaval that will affect the world economy for at least the next decade. At an earlier stage some observers believed that the crisis might be confined to the advanced economies and that the "emerging" economies of China and India might both "decouple" from the west and provide some underlying support to world demand. But it is now clear that the latter, and developing countries more generally, will also be severely affected by the gathering recession.

At the same time, we can expect a significant restructuring of the UK and other economies over the next decade in response to these events, with a reduction in the relative, and maybe absolute, size of the financial services sector. In the UK's case, in particular, that sector has grown enormously over recent decades but particularly since the mid-1990s, and in doing so it offset the pronounced decline over the period in the relative size of manufacturing and industry. Since 1996 much of the latter decline has been associated with a sharp appreciation and then sustained overvaluation of sterling, which has only now been unwound. But that unwinding offers some hope that the economy has a reasonable chance of returning within the not too distant future to what many would consider a more balanced structure.

This restructuring will be accompanied by a move away from the "neo-liberal" policies and thinking of the last two to three decades and a renewed emphasis on the role of government in combating "market failure" and providing the essential infrastructure for the market economy. That in turn raises the possibility, but of course no guarantee, of some movement in a progressive direction in terms of income distribution and the social safety net.

■ *David Cobham is a Professor in the Department of Economics at Heriot Watt University.*

THE CRISIS AND SCOTLAND

The current financial problems are manifestly global … but what is the outlook for Scotland? **John McLaren** examines the domestic implications of the crisis.

In the midst of the current global carnage, where stands Scotland? To answer this question we need to look at a variety of issues. How far are the current global problems shared by Scotland? What can the devolved government do and what might a more autonomous or independent Scottish government be able to do? How strong is the underlying Scottish economy? What should we be doing in Scotland given the tentative answers to these questions?

By and large Scotland shares the strengths and weaknesses of other mature capitalist economies.

SCOTLAND IN THE GLOBAL ECONOMY

As an integral part of the UK, Scotland is a leading player in the existing global economic order. Through policies associated with Thatcherism and New Labour the UK could be said to have helped lead the way in fashioning the current system. And where the UK government has led, Scottish firms have willingly followed. They have adapted to global markets and industries like financial services have joined others in pushing the opportunities opened up by deregulation to the limits.

Would things have been different if Scotland had pursued policies as an independent state? Possibly, but the examples of countries like Ireland and Iceland do not suggest that these policies would have gone against the grain of the existing Anglo-American economic orthodoxy.

By and large Scotland shares the strengths and weaknesses of other mature capitalist economies. One of the strengths is a system that encourages and rewards innovation. Innovation is what capitalism does best. It promotes technical change, develops new products and fosters economic growth. In this respect, the financial sector is no different from any other, with innovation tending to reduce costs and risk, to improve the quality and variety of products and to create new jobs.

Sometimes, however, new financial products and practices are unsound or spread too fast, and when this happens, instability may ensue, with excessive credit creation, speculation, asset overvaluation, herd behaviour and momentum investing. At such times of "irrational exuberance" a correction is ultimately needed to return to "fundamentals". This kind of thing has happened many times before, most recently in the Nordic countries (1989–1994) and in Japan (1991–?). What's different about the current crisis is its global scale.

Speculative bubbles have common sources: financial deregulation, lax lending standards, overly complex products, excessive lending and borrowing, poor risk assessment by investors and the conviction among market participants that there has been a "paradigm shift" – a radical change in basic assumptions about how the world works. They also have common endings: bad debtors default, lenders flee to safety, asset values crash and the bubble bursts.

RECENT EVENTS

So what caused the latest "boom and bust" cycle? After the dotcom boom came to an end in 2001, the US Federal Reserve deliberately kept interest rates low, assisted by a vast influx of funds from China and OPEC countries. Meanwhile, banks had been moving from retail markets (traditional savers) to wholesale markets (inter-banking) to finance much of their activity. And the emergence of new financial tools such as collateralised debt obligations (CDOs) and credit-default swaps (CDSs) served to disguise the risk involved in making loans, distorting the trade-off between prospective returns and the risk of default and inflating the bubble instead of helping to prevent it, as their designers intended.

It is, however, important to remember that the experience of every country has been different. In the USA, which pioneered sub-prime lending and new financial tools, house prices soared and then tumbled. In Germany, house prices have been relatively stable, but banks still behaved imprudently and had to be bailed out. Iceland's banks, which offered high returns to depositors and invested in correspondingly high-risk assets, became insolvent. Spain had better bank controls, but still experienced a housing bubble. Scotland's record is no different from the rest of the UK. The practices of its financial sector have been just as questionable as elsewhere, possibly worse.

POLICY RESPONSES

Great uncertainty remains about what has happened, where we now stand, what needs to be done and how successful any policies might be. The length of the downturn is *very* uncertain. It could be two, five or ten years. Certainly, the policy horizon needs to extend well beyond 2009–10. The Swedish recession of the early 1990s lasted three years, whereas Japan's financial collapse was followed by a whole decade of economic stagnation. At the end of 1989, the Nikkei-225 share index stood close to 40,000 and even now is only around 8,000.

From an international perspective the most important objective is to stabilise financial markets. This will be difficult. The list of desirable changes is long: tighten lending standards; make products more transparent; increase capital adequacy ratios; strengthen long-term, as against short-term, incentives; reduce executive bonuses; remove incentives for asset managers to engage in "churning"; overhaul methods of valuing assets and rating institutions; split banks between "utilities" (low-return, low-risk, protected) and "investments" (high-return, high-risk, unprotected); protect pensions; smooth cycles and associated gains/losses by avoiding short-term, herding/momentum behaviour and the pursuit of yield over stability. None of these changes will be easy to achieve. The last is hardest of all: how are we to shift the financial system away from the short-term hunt for yield that so many institutions have bought into and which is at the root of our current problems?

Leaving that conundrum to one side, the next question is how do we boost our economy and prevent recession turning into depression. Interest rates have already been slashed and the reflationary package announced in November's Pre-Budget Report featured a temporary cut in VAT along with higher public spending. UK public borrowing, already running at double the level forecast in the last budget, is set to rise substantially in the next two years, peaking at 8 per cent of GDP in 2009–10 and not returning to what the Chancellor defines as a prudent level until 2015–6. Whether the government will be able to sustain borrowing on this scale without adverse side effects remains to be seen, while the plan for returning to fiscal balance involves raising tax rates and restraining the growth of public spending, which is unlikely to be popular with voters.

How do we boost our economy and prevent recession turning into depression?

In principle, Scotland too can cut tax rates, via the tax-varying power (up to 3 pence in the pound) that applies to the basic rate of income tax. But under the current funding system, the resulting fall in revenue raised in Scotland would lead to an equivalent cut in the block grant the Scottish Government receives from Westminster. The negative impact of a reduced budget is likely to offset any stimulus from a tax cut.

The Scottish Government has no borrowing powers at present. And even if it were to acquire such powers, since Scotland is already running a hefty deficit as part of the UK, great care would have to be taken in going beyond existing UK borrowing levels. As the Scottish Budget is fixed and "End Year Flexibility" at HM Treasury has mostly been drawn down already, the only remaining option is to re-profile existing budgets, which is unlikely to have a strong impact.

Would Scotland be any better off under fiscal autonomy or independence? No definitive answer is possible, but what can be said is that more revenue would only have been available with high oil prices. At $150 a barrel, prospects might have looked good; at $50 a barrel, they look much less rosy. Certainly, the idea of balancing the existing Scottish Budget under independence and at the same time creating an oil-related Futures Fund has a big question mark hanging over it.

This may well be a good time to rethink the future, something that is too often not possible when things are going well. A good example might be affordable housing. How should housing provision be reorganised to meet the needs of those who are ill-served by the current system? What will future housing needs be, after falling house prices and the changes in the buy-to-let market work their way through the system? What ownership pattern do we want? Other areas of long-term concern where tough decisions will soon be needed include provision for an ageing society and future energy needs. One of the potential benefits of the current situation is the ability to take decisions that put in place good practice for the upturn. The Irish government, it is worth noting, insists that this is no time for soft options and is reducing its deficit by cutting spending and raising taxes!

HOW STRONG IS THE SCOTTISH ECONOMY?

This is a difficult question to answer. In the past, Scotland's growth rate (GDP) has been relatively poor, but its growth in living standards (GDP per person) has been more middling, neither exceptionally good nor bad. However, growth rate calculations need to be treated with caution, as the quality of the data on which they are based, especially over the longer term, is uncertain. Even current data can be hard to fathom. For example, Hotels and Catering, according to official statistics, has not grown at all over the past decade, despite what seems like an obvious boom of bars and restaurants on Scottish high streets. And what is going on in financial services? The figures for employment in this sector are hard to credit, and its output appears to have grown faster in Scotland than in London, yet it recently posted a 10 per cent fall in output in a single quarter (prior to the troubles at RBS/HBOS).

Communications too shows very strong growth, but it is not clear where this stems from.

Why do dubious statistics matter? Until recently most observers might have assumed that tourism and financial services were the sectors in which Scotland had a clear competitive advantage. But the fact is we don't understand them. And if we don't understand them, then it is very difficult to craft policies to promote their growth. For example, the sector most likely to benefit from tourism is hotels and catering. Yet according to official data, it has not grown in the last decade. So either it is one of our weakest sectors or the data are wrong.

The bottom line is that we don't know how well our economy is performing and we don't understand its strengths and weaknesses. This is a disappointing position to be in for a small country that should be able to follow the ups and downs of its major industries.

So what is to be done? Here is my checklist:

1. Think long term (Planning, Energy, Housing).
2. Understand how our economy works better.
3. Liaise with the key decision-makers at the Bank of England, UK Treasury and the European Union.
4. In the public sector, follow Ireland's example. In particular:
   - improve public sector efficiency and cut non-essential spending (e.g. on advertising, consultancy etc);
   - introduce a public sector pay settlement that protects jobs over pay increases;
   - rethink universal versus targeted benefits: e.g. prescription charges and free pensioner travel;
   - enhance private contributions: e.g. to Higher Education.
5. Revisit the Howat Report, where the most difficult decisions were avoided: for example drugs bill savings, dental service charges, fixed three-year degrees at FE and HE, Scottish Water mutualisation etc. Some changes could have immediate benefits, others may take longer to accrue, but either way, the point is to focus on the long term.

The bottom line is that we don't know how well our economy is performing and we don't understand its strengths and weaknesses.

AN ALTERNATIVE WAY FORWARD?

What has been described above is a fairly orthodox view of what policies might be followed at the present time. But what if we want to move away from the sort of system that has repeatedly brought about these boom and bust cycles, of which this is just the latest and most extreme?

When we look around the modern world, credible alternatives are hard to find. Since the collapse of communism, most countries have embraced some form of constrained capitalism. China and other Asian economies retain distinctive institutional features, but they have become more committed to a narrowly defined, materialistic conception of the good life, which some would argue is part of the problem.

One way for Scotland to move forward, but with a different emphasis, is to adopt a wider definition of success and development. Instead of being fixated by growth in output (GDP) and material living standards, we might think more in terms of improvements in the quality of life, focusing on (healthy) life expectancy, education, equality of opportunity, environmental standards and social cohesion. It would not be difficult to build these factors into a new index of social progress, which could be used to evaluate economic performance and policy. Governments might then, for example, pay less attention to promoting economic growth and more to improving Scotland's poor mortality record.

Such a change in emphasis, a broadening of the scope of what counts as success, would still work within whatever global system dominated. However, it would look more to the long term for success and be less driven by short-term financial gains. And its priorities would be social and cultural, rather than narrowly materialistic, focusing on our collective way of life and our shared sense of social membership as Scottish citizens.

One of the big question marks over such a move would be whether it could sustain or even enhance the innovatory processes inherent within the current system? Does innovation depend on high financial rewards or could a widening of opportunity actually lead to more innovation as more people acquire the requisite abilities and enthusiasm? If we begin to move towards a post-materialistic way of life, perhaps the focus of innovation will change, leading to a renaissance in the creative arts, the design of cities, transportation systems and the organisation of public services.

The mainstream response to the financial crisis seems to be: "Let's fix it as best we can and get back as soon as possible to where we were before". However, the worse things get, the greater must be the likelihood that this goal is neither achievable nor desirable. At this point a more fundamental rethink will be needed over what should be our goals in the age of opulence, which, despite the recession, we still enjoy.

■ *John McLaren is an economist working at the Centre for Public Policy for Regions. The views expressed here are entirely his own.*

REDESIGNING GLOBAL FINANCIAL **INSTITUTIONS**

Sheila Dow argues that the time is ripe for a major restructuring of international monetary policy and institutions.

The international financial system is once again in crisis and once again there is talk of redesigning its architecture. The problems with the International Monetary Fund (IMF) and World Bank have been well rehearsed over the years, but the wheels of governance of these institutions move so slowly that there has been little fundamental change. Is this crisis different? Is there a will finally to address the issues? Fundamental questions about the role of central banks and the nature of money spill over into the international arena, given the global scale of the crisis. The need for an international central bank to underpin international money has never been so clear. The interconnectedness of money, finance and the real economy is also now more widely recognised and questions of international finance need to be considered within a framework that extends to macroeconomic management, international trade, economic development and global inequality.

CRISIS OF CONFIDENCE: THE INTERNATIONAL DIMENSION

While domestic central banks were given the task of controlling inflation, governments liberalised financial markets (encouraged by international institutions), giving them increased latitude to determine credit creation in global markets. Prudential control at the national and international levels rested on capital adequacy ratios, and it was attempts to avoid these by creating asset-backed securities and other new financial products that gave rise to the latest crisis. Since confidence in bank deposits and thus the payments system was threatened, the economic system itself was vulnerable to collapse. So central banks returned after many decades to performing their primary role – which is to promote confidence in money – and duly provided the liquidity needed to keep banks afloat, though delays and confusion in crisis management further damaged confidence in nervous markets: a liquidity problem for the banks became a potential insolvency problem.

At the national level, it is clear that central banking should ensure that confidence in money should not be so threatened in the first place. Procedures should be in place to obviate the need for the kind of ad hoc, confidence-sapping, responses which have worsened the current situation. The same argument applies at the international level. Rather than intermittent international consultations, is there scope for creating a world central bank out of the existing international institutions? What is needed is a bank which generates an international money with stable value, which is responsible for maintaining confidence in this money (including oversight of the private sector financial system), and which seeks to avoid or correct international imbalances.

What is needed is a [world central] bank which generates an international money with stable value, which is responsible for maintaining confidence in this money (including oversight of the private sector financial system), and which seeks to avoid or correct international imbalances.

As market valuations with respect to national economies have shifted, exchange rate volatility has added to other destabilising forces. Interestingly, while the US dollar had been falling in value, indicating that it might no longer be the key international currency, its value rose again as the crisis unfolded and it regained this role. Meanwhile, developing economies are hit by deteriorating credit conditions and weakening world demand, even though they were not part of the cause of the crisis – so much for the much-vaunted "decoupling" thesis. All these factors are likely to hamper world trade. Indeed, there is a danger that the rise in the US dollar may push the US towards protectionism, though the G20 agreement may succeed in averting that. There is also growing concern that developing economy governments will not be able to lend to their banks on the same scale as developed country governments. This too is an international problem, with potentially more serious consequences for people's livelihoods.

FROM BRETTON WOODS TO WASHINGTON CONSENSUS

In considering what might be possible within existing international institutions, we need to consider how the present system started. The IMF and the International Bank for Reconstruction and Development (IBRD) were formed in 1944 in response to the twin needs for an international payments system and for post-war economic reconstruction in Europe. The IMF continued to promote international monetary cooperation, though its views about what this entails have sometimes been in conflict with development goals. The IBRD evolved to promote economic development more widely; along with the International Development Association (IDA) it forms the World Bank.

The IMF set up a fixed exchange rate system, supported by loans to assist countries in handling temporary balance of payments difficulties, but with provision for changes in the peg when there was "fundamental disequilibrium". The major problem with the design of this system – apart from the disruptions associated with changes in pegs – was the central role assigned to the dollar as the world reserve currency. Foreign holdings of dollar reserves could only grow to the extent that the US ran a current account deficit, which other things being equal would have triggered a fall in the dollar, eroding its attraction as a reserve currency. This contradiction at the heart of the system led to its replacement by a "non-system" of generalised (managed) floating from the early 1970s, which has contributed ever since to a marked increase in instability in international financial markets.

The experience of floating has not been good, with exchange rates being managed at levels which accord with conventional market judgement as to the appropriate rate, and subject to marked instability as that market judgement changes. Developing countries have experienced particular problems with floating exchange rates, on top of having to cope with deteriorating terms of trade, high credit costs and capital flight. National currencies with changing values do not satisfy the requirements for international money – a stable store of value to act as a dependable unit of account – but national currencies are all we have. Floating rates have thus exacerbated the earlier problems with having the US dollar as the international currency.

The demise of fixed exchange rates temporarily left the IMF without a role, for national payments imbalances, which arose because floating was rarely free, could now be managed by markets without recourse to the IMF. The removal of controls over foreign exchange markets and international capital movements meant that whereas previously all international transactions had to go through central banks, now they mainly went through private sector financial institutions: notably in the euro-currency market, which operates in non-domestic currencies beyond national regulatory controls. But the 1980s debt crisis revealed that these institutions had badly mismanaged their lending, underestimating both borrower-specific and systemic risk. With its good knowledge of individual countries and its ability to impose conditions on borrowing governments, the IMF found a new role. Banks now only had confidence in continuing to lend if the borrowers first submitted to IMF scrutiny.

It was in this period that the IMF and World Bank came to be known for the controversial Washington Consensus. Neo-liberal structural adjustment packages, which were the conditions for borrowing, formed the standard prescription pushed by both institutions for tackling balance of payments problems and promoting economic development. The failure of this approach, not least as manifest in the consequences of financial market liberalisation in South-East Asia in the 1990s – and more generally as a blueprint for economic development – shifted the attention of policymakers to issues of national governance. Arguably, it was the behaviour of global finance that had created systemic risk. But just as the Washington institutions had blamed the earlier debt crisis on borrowing nations, so they attributed the crisis of the 1990s to South-East Asia itself.

Yet the same pattern of huge credit expansion, facilitated by ever more sophisticated – and correspondingly less transparent – instruments and markets, has repeated itself in the build-up to the current crisis. This time, however, the borrowing was predominantly in Western economies: most notably the sub-prime mortgage market in the US, but more generally in a range of countries, including the UK. Now the focus of policy debate has switched to the regulation and monitoring of financial institutions in Western economies, the presumption being that improved governance will prevent future crises.

The focus of policy debate has switched to the regulation and monitoring of financial institutions in Western economies, the presumption being that improved governance will prevent future crises.

But crises have evidently been a recurring feature of market economies where, contrary to the impression given by financial institutions, risk cannot be measured objectively and is thus subject to waves of optimism as well as pessimism; where profit-seeking financial institutions are highly innovative; and where, when asset prices prove disappointing, liquidity problems can turn into insolvency problems. Because producers and workers are affected by shortage of credit, falling asset prices and failing cash flow, a financial crisis becomes a crisis in the real economy.

A WORLD CENTRAL BANK

Recent months have brought a sea-change in thinking about the role of the state, with renewed recognition that only the state can address problems – particularly macroeconomic problems – which markets do not address and which, indeed, markets create. When economies are operating successfully – at least for the main players – this role tends to be forgotten, even though, as the American economist Hyman Minsky points out, crises may be brewing as leverage builds up. But perhaps, as at Bretton Woods in 1944 with the memory of the Depression, governments may now be willing to contemplate an enhanced role for the state at the international level.

In fact, the Keynes Plan for the IMF, which was overruled, envisaged an institution which resembled more closely an international central bank, an International Clearing Union (ICU), than the White Plan which prevailed. Keynes argued that the ICU should issue its own liability, bancor, whose value would not, like the dollar, be caught in the contradiction noted above. In other words, bancor would satisfy the requirements for money to be a safe asset of stable value in which confidence was maintained, particularly in times of high uncertainty, independent of the conditions in any one economy. Keynes anticipated national exchange rates being fixed individually in relation to bancor, with scope for managed par value changes. Experience with the original IMF fixed exchange rate system suggests that a more workable model might be currency blocs, with exchange rates fixed within blocs and value changes negotiated for blocs rather than individual countries.

All international payments between national central banks would be settled in bancor, through the accounts of the IMF. As lender-of-last-resort, the IMF would lend to countries with net payments deficits, at interest, but would also charge interest on surplus balances. Indeed, continually unused surplus balances would be forfeit, in order to shore up aggregate demand and restore balance between surplus and deficit economies. This feature of Keynes's plan recognised that, since deficits and surpluses are the accounting image of each other, the burden of adjustment should be spread equally. A "scarce currency" clause was in fact agreed for the IMF for this purpose, but has never been invoked. Countries unable to finance deficits with capital inflows have thus been forced to adjust by deflating demand, thereby helping to cure other countries' surpluses. The result has been a deflationary bias for the world economy.

Keynes also wanted financial stability to be promoted by controls on short-term capital flows. (James Tobin subsequently argued for a tax on foreign exchange transactions to discourage speculation.) But this was not accepted for the IMF. Indeed, the dominant school of thought within the IMF favoured freeing up international financial flows, an approach that culminated in the Washington Consensus structural adjustment packages. Prudential regulation of financial markets fell, by default, to the Bank for International Settlements (BIS), another international institution set up after World War II, looking for a new role. The BIS made a major contribution by compiling data on international capital flows, and in its analysis of trends. But it has no authority other than moral suasion.

A world central bank would need to be given, by its members, authority over banking system regulation, just as the European Central Bank is taking an increasing role in bank regulation within Europe. Further, unlike the modern fashion for separating financial supervision from central banking, the world central bank should be actively engaged with the commercial banking system; there needs to be good in-house knowledge, given the speed – and often opaqueness – with which financial developments occur. Finally, if the IMF were more substantially resourced, it could be more pro-active as a lender-of-last-resort to supply liquidity swiftly to national central banks if a crisis does emerge. But in any case, the IMF could exert leverage on the funds it has by extending guarantees on developing country debt, thus increasing their access to capital markets.

In 1999, recognition of the global dimension of financial stability issues following the 1997-98 crisis led to the setting up of the Financial Stability Forum (FSF) "to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance." The IMF, along with the IBRD and BIS, as well as national governments, is one of the members of the FSF, and has reiterated the importance of monitoring the international financial system and enforcing the regulations agreed by the FSF. But the fact that we are again in crisis in spite of this development demonstrates how inadequate the current framework is. The crisis may have been anticipated up to a point, but international agencies were unable to prevent it. The IMF currently exercises effective authority only over those members who borrow from it. Thus, beyond issuing policy pronouncements, there is little it can do to tackle the current crisis.

A world central bank would need to be given, by its members, authority over banking system regulation.

POLITICS AND POWER

Applying the same principles as we do to domestic central banks, a world central bank should be given the role – and thus the tools – to promote monetary and financial stability in the interests of the global economy. But we have been here before. The elephant in the room is power. This determines which policy proposals succeed. Within the IMF and World Bank themselves, power has always been a central factor, embodied in the voting structure itself. The power of the US, which determined the original design in 1944, has re-emerged as the US dollar has reasserted its role as international currency, with the benefits this confers of assured capital inflows from reserve holders. But power is shifting, to the G20 from the G8, and particularly to the Far East with its sovereign funds, which will influence how negotiations on a new international financial architecture proceed.

Karl Niebyl wrote in the 1940s about the history of monetary economics and monetary policy. He argued that ideas, events and institutional arrangements all operate separately and are often out of phase with each other. Events prompt ideas which, when filtered through power relations, encourage particular policy stances. The ideas also become embedded in institutional arrangements which cement particular power relations, accommodating only certain policy stances. New events may generate new ideas, but it takes time for these to change institutional arrangements and policy, by which time neither may be appropriate to contemporary events. But if any time is ripe for a change in ideas, policies and institutional arrangements, this may be it.

■ *Sheila Dow is a Professor in the Department of Economics at Stirling University.*

CAN A **GREEN NEW DEAL** TRANSFORM UK POLITICS?

Green politics have been perceived as stressing the environment above the economy but, **Maggie Chapman** argues, that may all be about to change.

A distinctive green voice has faded when social concerns are to the fore.

Since it emerged as an electoral force in the 1980s, Green politics has generally been seen as an altruistic politics. A Green vote is a vote for someone else, not for oneself. This perception reflects the global reach and optimistic outlook of much early Green politics, which reached its high point in 1989 when the UK Green Party won 15 per cent of the votes cast at the elections for the European parliament. However, as the economic boom of the late 1980s came to end, electoral support for the UK Greens fell away. The decline was partly due to organisational weaknesses: it had taken ten years' work to achieve the 1989 results. But it was also because mainstream parties began to respond to environmental concerns.

In the 1980s, Greens focused on the real and pressing problems of pollution, damage to the ozone layer and extinction of species: economic and social issues took second place. By the late 1990s, they were given even less attention by Greens thanks to the apparent success of global capitalism. The Greens, it seemed, were there to voice the environmental concerns of the day: first pollution, then genetic modification and latterly climate change. Of course, all these issues have social and economic aspects, but the dominant narrative has always been eco-centric. A distinctive green voice has faded when social concerns are to the fore.

Green politics does, however, have a serious analysis of economy and society that will become more relevant as recession continues. Where the mainstream Scottish and UK parties see economic growth as the high road to social progress, Greens have rejected it as a productivist dead end. Both the current Scottish Government and the Scottish Executive that preceded it have set out to "grow the Scottish economy" in order to "deliver social justice". This is little more than a lick of red paint on Thatcherism. In signing up to a trickle-down analysis of prosperity, the SNP, Labour and Lib-Dems are endorsing a neo-liberal view of the world.

Greens, by contrast, have argued that the aim of any Scottish administration should be to improve human well-being and the quality of life. Policies and decisions should take proper account of the social and environmental conditions that sustain economic activity. On this view, it is worthwhile increasing the production of goods and services only up to the point where the resultant gain in human well-being compensates for the costs incurred. From the standpoint of society as a whole, three kinds of costs should be counted: the means of production such as machines, tools, energy and materials which are used up in the process of production; the work performed (in so far as the workers concerned find it burdensome rather than satisfying); and any damage inflicted on the environment or the fabric of society. In poor countries, the overall benefits of economic growth normally outweigh these costs. But the more affluent the society, the more the balance tips the other way.

So why is the Green approach to economic policy so little understood and accepted? One reason is that it is counter-hegemonic: it is very difficult to argue for fundamental changes to a system to which there appears to be no alternative. More fundamental, though, has been the persistent reluctance of Greens to root their political activities in a social and economic critique of late capitalism.

IN THE STEPS OF ROOSEVELT AND KEYNES

The Green New Deal is the first attempt to bring together ideas about how a Green economic strategy might work.[1] Its title makes knowing reference to the various programmes launched by the Roosevelt administration in response to the Great Depression of the 1930s. The current crisis involves the entire financial system and poses major problems for the neo-liberal paradigm that has dominated economic policy for the past three decades. On both counts, it is more serious than the counter-inflationary recession of the early 1990s. A structural approach is, therefore, both appropriate and necessary.

Parallels with the 1930s are not confined to the financial system. They extend to the ecological underpinnings of economy and society. Of course, climate change poses a more fundamental challenge to our lives and futures than did the Oklahoma dust bowl. Nevertheless, thanks to the work of Nicholas Stern and the Inter-Governmental Panel on Climate Change (IPCC), it is now widely recognised that greenhouse gas emissions will impose heavy costs on future generations unless they are halted and reversed. Thus, the tasks of restructuring the global economy and combating climate change are inseparably intertwined.

In the years after the Second World War, the can-do spirit of Roosevelt's New Deal was coupled with the principles of Keynesian economics to produce the Marshall Plan, a large-scale aid programme designed to resuscitate war-torn Europe. In a similar way, the Green New Deal proposes a series of measures to ensure that development in the Global South is a priority for any

The aim is to put an end to the speculative excesses that have led to boom and bust, while at the same time strengthening the capacity of local economies.

change to the global economy. Where the G8 can now be seen to have failed comprehensively in its attempts to deliver a new future for Africa, and the UN is struggling to come close to achieving the Millennium Development Goals, the Green New Deal offers a new and fairer structure for the world economy.

Two sets of recommendations are proposed. One concerns the direction of economic activity and involves moving away from conspicuous consumption in order to invest in renewable energy sources and develop a more localised, low-carbon economy. The necessary funding could be raised through higher taxes on energy companies and on the rich. The second set of recommendations concerns the regulation and development of the global financial system. Here the aim is to put an end to the speculative excesses that have led to boom and bust, while at the same time strengthening the capacity of local economies.

Already the political implications of the Green New Deal are being felt, through Al Gore's call for the US to become energy-independent within ten years. This will be impossible without a major expansion in renewable energy designed to meet energy needs from low-impact sources. It will also open up a whole new field of employment, paralleling the infrastructure projects of the first New Deal, and should endow the US with an ability to generate clean power into the future. There are signs that the incoming Obama administration will embrace Gore's call, and set an agenda that will be followed around the world. The combination of political leadership and cheaper unit costs for renewables makes this eminently achievable.

Alongside investment in renewables, we need a sustained drive to insulate buildings so as to put end to fuel poverty while simultaneously creating jobs in the construction and manufacturing industries, and reviving many of the skills that our de-industrialised and finance-driven economy has ignored. If Scandinavians can build houses that gather all their heat from the sun, there is no reason why Scotland and the UK cannot do likewise. The payback time is short, and a recession is precisely the time to invest in infrastructure, both by retro-fitting existing buildings and by introducing a more effective regulatory regime for new ones.

THE POLITICS OF THE GREEN NEW DEAL

The Green New Deal is substantially different from previous interventions by Greens into economic policy debates. It focuses on the overall direction of the economy rather than attempting to achieve more and better regulation. In doing so, it moves away from the Green (and indeed green) predilection for targets. This is important because it rejects any notion that green objectives can be pursued within an otherwise unreformed capitalist market economy and stakes out a more radical position.

At the core of the Green New Deal are the interests of people. While increasing the number of skilled manual jobs, it will phase out or scale down industries that have caused much of the pollution by which our world is blighted. The transformational opportunities, not only for those able to move into work, but also for those who are looking for more meaningful work are at the core of Green thought. By strengthening local economies and changing the structure of production, the Green New Deal will enhance people's sense of well-being and make their communities more attractive, cohesive and enjoyable.

The transformation will not be restricted to the developed world, but will extend to the Global South. A combination of more aid from rich countries and a radical change in the rules of global trade will help to bring living standards in the world's poorest countries up to levels comparable with those enjoyed by post-war Europe. The beneficiaries will not just be in those countries that see the greatest increases in wealth. By ending the race to the bottom, in which countries are played off against one another in the interests of big corporations, working conditions and pay will become better in rich countries.

By providing an understanding of the economy that takes proper account of our social and environmental assets, together with a set of proposals for tackling the current crisis, Greens can claim critical political space. This is essential both to the growth of Green parties, and to ensuring that the (economic and social) mistakes of the past are not repeated. While Greens have achieved only modest electoral success, the ideas developed by Greens have dramatically changed politics over the past 20 years. The hope is that a Green economic analysis will begin to permeate public life just as Green accounts of the environmental crisis, or of quality of life, have become widely adopted.

With a breakthrough into the Westminster Parliament possible in the next election, Greens have a chance to move beyond local authority politics and disseminate their ideas to the UK public at large, just as European politics has been strongly influenced by the presence of Green MEPs. Hitherto, Greens have often been reluctant to engage with economic issues. This has weakened their appeal, for it cedes the central ground of politics to mainstream parties and neoliberal thinkers. By confronting the twin challenges of promoting Green jobs and building Green communities, we can create a sustainable economy free from the ravages of boom, bust and global capital. The Green New Deal enables Greens not only to explain what a better society would look like, but also to build the sort of electoral success that will help to promote other green ideas: citizens' income, non-militarism, and radical democracy.

■ *Maggie Chapman is a Scottish Green Party councillor in Edinburgh and a member of Democratic Left Scotland.*

NOTE

1. See *A Green New Deal*, (New Economics Foundation, July 2008). www.neweconomics.org

BACK TO THE FUTURE? CRASH, SLUMP AND RECOVERY IN HISTORICAL PERSPECTIVE

This is not the first economic crisis and undoubtedly won't be the last. **David Purdy** asks what can we learn from previous experience and wonders if the target of the primacy of continued economic growth erodes other values that might lead to a more rounded, civilised and happier society.

The crash of 2008 has been variously described as "the worst in sixty years" (Alistair Darling), a "once-in-a-century shock" (Alan Greenspan), a "black swan event" (Nassim Taleb) and a "temporary downturn" (Adair Turner). Daily reports of insolvent banks, tumbling stock markets and global recession have brought echoes of the Wall Street crash of 1929 and the great depression that followed it. In what follows, I compare the current crisis with the slump of the 1930s in terms of scale, causes and policy responses, and in the light of the historical record, reflect on what it means and what it takes to bring about a change of policy regime.

Between 1929 and 1933, the world economy – with the notable exception of the USSR – fell into an abyss.

INTO THE ABYSS

In 1931 Keynes wrote: "We are today in the middle of the greatest economic catastrophe – the greatest catastrophe due almost entirely to economic causes – of the modern world … The view is held in Moscow that this is the last, the culminating crisis of capitalism and that our existing order of society will not survive it … There is the possibility that when this crisis is looked back upon by the economic historian of the future, it will be seen to mark one of the major turning points."[1] This prognosis proved correct. The depression of the 1930s was deeper, longer, more immiserating and more momentous than the cyclical downturns of the nineteenth century or the counter-inflationary recessions of the 1970s, 80s and 90s.

Between 1929 and 1933, the world economy – with the notable exception of the USSR – fell into an abyss. In the US and Germany, the two developed countries worst hit by the slump, industrial production fell by almost half, leaving 27 per cent of the workforce unemployed in the US and a staggering 44 per cent in Germany. Even as late as 1935, industrial production had regained its previous peak in only a few countries. Agriculture, which then accounted for 35 per cent of world trade, was also devastated. The prices of primary products collapsed, impoverishing not only those countries such as Argentina, Australia, Brazil and Egypt whose export earnings depended on one or two agricultural products, but also the still sizeable farming communities of the US and Canada. And the global financial system was convulsed twice over: by the wave of bank failures that followed the Wall Street crash and by the financial crisis that swept across Europe in 1931, culminating in the forced devaluation of sterling and the demise of the gold-exchange standard, which had been suspended during the First World War, but then restored in the 1920s.

Prevailing ideas and institutions were unable to cope with shocks of this magnitude. In democratic states, those governments which had the misfortune to be in office when the cataclysm struck – whether on the right, like the Hoover administration in the US, or on the left, like Britain's minority Labour government – were ejected. In Japan and most of

Europe, there was a marked swing to the right, most notably in 1933 when the Nazis came to power in Germany. The left had only two victories to celebrate: in Sweden, where the social democrats and their agrarian allies won a watershed election in 1932 and set about laying the foundations for a fifty-year ascendancy; and in the US, where a similar worker-farmer alliance rallied in support of Roosevelt's New Deal.

Even the most pessimistic pundits are not expecting a re-run of the great depression.

These dramatic political shifts heralded the end of laissez-faire and an active search for viable alternative policy paradigms. As Hobsbawm notes, three rival projects competed for intellectual and political hegemony.[2] One was communism, an authoritarian collectivism of the left, exemplified by the state-owned and centrally planned economy of the USSR, which remained conspicuously immune to the capitalist crisis. The second was liberal or social democratic collectivism, a historic compromise between capitalism and socialism, in which the operation of private ownership and market forces would be tempered by selective public ownership, market regulation, macroeconomic management and state welfare. The third option was fascism, an authoritarian collectivism of the right, which though far less coherent than either of its rivals, was attractive to the propertied classes because it removed the danger of communist revolution and eliminated trade unions and other restrictions on employer control over the workforce, thereby making it safe to countenance an ambitious programme of public expenditure aimed at achieving full employment, providing social protection and restoring national prowess.

AFTER THE CRASH

If the crash of 1929 and its sequel count as a seismic shift, the crash of 2008 is no more than a strong tremor, so far at any rate. It is, of course, early days. Sales, output and employment have fallen sharply since the credit crunch went nuclear in mid-September. Will the recession turn out to be V-shaped, U-shaped, W-shaped or L-shaped? Will an eventual recovery, in other words, be swift and strong, slow but sure, faltering and feeble or scarcely detectable? The first scenario looks implausible and the last is too awful to contemplate, but the truth is that no one really knows. At a time of general turmoil when the future is more than normally uncertain, economic forecasts are of little value. All the same, even the most pessimistic pundits are not expecting a re-run of the great depression. To appreciate why, we need to understand why the downturn that began in 1929 was so severe and lasted so long.

As Galbraith points out, it is easier to explain the stock market crash of 1929 than the depression that followed it.[3] Speculative orgies always end in a crash: once they start, the only issue is how long they will last. The forces that give rise to speculative bubbles – a recurrent phenomenon in the later stages of a boom – are always the same: historical amnesia, "irrational exuberance", plentiful funds, financial innovation and weak regulation, though naturally details differ from case to case. Ordinary shares were the main objects of speculation in 1928-9 and the number of people with a direct stake in the stock market was small: 600,000 out of a US population of 120 million, according to Galbraith. Thanks to the growth of owner-occupied housing, the numbers directly affected by recent excesses are much larger.

However, the great depression of the 1930s cannot be attributed to the Wall Street crash. Economic activity in the US declined before the stock market collapse, and while the fall in asset prices led businesses and households to reduce their spending, thereby exacerbating the downturn, it does not explain the exceptional depth and duration of the slump. Three further factors were at work: structural features of the US economy that weakened its resistance to recession, counter-productive policy responses, and the anarchy of international relations.

Then as now, the US was a starkly unequal society. There was virtually no social security, property owners commanded an exceptionally high share of national income, and fully one third of all personal income went to the top five per cent of income recipients. In the "roaring twenties", both production and productivity grew steadily, while wages lagged behind the rise in output per worker. Thus, costs fell and, with prices stable, profits rose, sustaining luxury spending, fuelling business investment and inflating share values. But spending on luxuries and capital goods is more volatile and fluctuates more widely than expenditure by low-income groups. Hence, when the downturn struck, aggregate demand fell by more than it would have done in a more egalitarian society. A broadly similar syndrome is evident in the consumerist boom of the past decade, with the added twist that nowadays low-income, nil-asset households are tempted – indeed encouraged – to borrow in order to keep up with the Joneses: there were no sub-prime mortgages or credit cards in the 1920s.

America's banking system was a further source of weakness. The US did not permit giant banks with nation-wide networks, as in Europe. Most banks were small and local. Even in good times, localised misfortune or mismanagement could set off a chain reaction in which banks fell like dominoes. When the whole economy went into recession, bank failures became an epidemic, leading to further cuts in spending by the banks' clients. By early 1933, some 9,000 banks with total deposits of $7 billion had closed – proportionately the most rapid contraction of the money supply in US history. What was needed was intervention to provide the banking system with liquidity. Why the Federal Reserve did not pursue this policy is unclear. The low level of interest rates may have misled it into believing that monetary policy was easy.

Fiscal policy was no less misguided. Most governments clung to the belief that balancing the budget was the only way to restore business confidence. Until 1938, even the Roosevelt administration subscribed to this doctrine and was perpetually on the defensive over the Federal government's deficit. (Most state and local governments were legally obliged to balance their income and spending). And since budgets went into deficit as tax yields fell, the pursuit of balance implied higher tax rates or lower public spending, depressing rather than stimulating aggregate demand. Policy was further hobbled by fear that leaving the gold standard would somehow be inflationary, despite the fact that prices were falling. This fear reinforced the demand for balanced budgets and blocked efforts to lower interest rates and ease credit. It also precluded the use of devaluation as a tool for boosting exports, reducing imports and improving the balance of payments. In short, given the ideas underlying policy, there was nothing governments could do to escape from or even mitigate the slump.

Of course, governments wielded far less economic clout then than now. Budgets were so small than even when a deficit occurred, the expansionary effects were minuscule. To make up for the fall in national income experienced by the US between 1929 and 1930, public expenditure would have had to increase by 50 per cent – an impossible requirement given the state's administrative capacity, the balance of political forces and prevailing economic beliefs. Governments did gain room for manoeuvre once they left the gold standard. In 1931, for example, Britain was able to devalue the pound and adopt a cheap money policy. For good measure, after winning a landslide election victory on the slogan "safety first", the National Government ditched free trade and erected import tariffs to protect domestic industry and raise extra revenue. But in the absence of international policy co-ordination, such "go-it-alone" protectionism tended to provoke retaliation by other countries, aggravating international tension, strangulating cross-border trade and ultimately benefiting no one, except in so far as it induced primary producing countries to pursue import-substituting industrialisation behind tariff walls.

RECOVERING FROM DEPRESSION

Compared with the policy disasters of the 1930s, responses to the current crisis have been models of enlightenment. To be sure, policymakers were slow to appreciate the gravity of the credit-crunch and reluctant to abandon neo-liberal nostrums. And even after the British and US governments had acquired a direct stake in failing banks, they were loath to interfere with dividend payouts, executive remuneration, business models and lending practices. Nevertheless, once the crisis broke in mid-September, they acted quickly to recapitalise banks, inject liquidity, insure loans, guarantee deposits, lower interest rates, cut tax rates and increase public spending. And although there were some egregious examples of "beggar-my-neighbour" tactics, on the whole international co-operation was robust. To cite just two instances: the G8 group of countries was rapidly enlarged to become the G20, in tacit acknowledgement that the balance of economic power is shifting from West to East; and supranational agencies such as the IMF and the European Commission weighed in behind national governments as they sought to stave off financial collapse and shore up aggregate demand.

In this sense, the economic lessons of the 1930s have been learned. It does not follow, however, that the world will soon recover from the shock it has received, nor that neo-liberalism will soon be replaced as the ruling paradigm of economic policy. On both these points, it is instructive to examine the pattern of recovery from the great depression.

Compared with the policy disasters of the 1930s, responses to the current crisis have been models of enlightenment.

In the 1930s, only two governments presided over successful recovery programmes: the social democrats in Sweden and the Nazis in Germany. The US enjoyed a strong upturn in 1934–6, but output and employment remained well below the economy's potential, and in 1937–8 there was a renewed recession – itself caused, in part, by a misconceived fiscal contraction at a time when household and business spending had begun to falter. Moreover, unlike Sweden and Germany, the US did not direct public expenditure towards the construction and capital goods industries. New Deal programmes were largely designed to bring relief to destitute groups such as small farmers or to appease politically sensitive groups such as war veterans. This garnered popular support for Roosevelt in his epic battles with the business class, the Republican Party and the Supreme Court, but it did nothing to restore business confidence, which had been shattered by the depression and did not really recover until the Second World War. Only in 1938 did the US government implement a fully-fledged counter-cyclical policy. Thereafter, mass unemployment finally disappeared in the great mobilisation of the 1940s.

In France and Britain too, unemployment remained a major scourge. The French economy stagnated throughout the 1930s and the programme initiated by the Popular Front government in 1936–7 was a total failure. From the outset, the government – a coalition of Socialists and Radicals supported in parliament by the French Communist Party – aroused deep mistrust among the business class, leading to capital flight and the loss of gold and foreign exchange reserves. Employers were alarmed by the wave of strikes and factory occupations that followed the Popular Front's victory at the polls, by legislation to reduce the standard working week to 40 hours with no change in weekly wages, and by the government's seeming unconcern about the budget deficit. And beyond these immediate anxieties lay the fear that if the Popular Front succeeded in tackling the crisis, it would move to expropriate private capital, as was indeed being demanded by the left.

Britain's National Government, by contrast – nominally a coalition, but dominated by the Conservatives – had no programme for tackling the slump. When a recovery began in 1933, it owed more to market forces than to public policy. The government's main contribution was cheap money and tariff protection. Low interest rates helped to revive housebuilding, while protection channelled demand away from imports and facilitated the growth of new mass production industries such as cars and electrical goods. Keynes's pleas for deficit-financed public works and active demand management were still considered dangerously unsound by the Treasury. Indeed, in the field of economic policy, the central divide in the 1930s ran not between the major political parties, but between economic radicals and economic conservatives: representatives of both camps were to be found in all three main parties. Keynesian ideas did not displace the "Treasury view" until the budget of 1941 when, ironically, the problem facing the government was no longer how to conquer unemployment, but how to pay for the war without causing inflation and setting class against class.

Continued economic growth in affluent societies has brought little, if any, gain in personal happiness.

REGIME CHANGE

Recovery from a capitalist crisis may well take years. A sudden and severe break in the rhythm of accumulation and growth is liable to overwhelm the established policy regime. What then happens depends on the relative capacities of rival political actors to mobilise broad-based support for policies that not only offer solutions to immediate problems, but also bring about a change of regime. The qualities required for success in this contest are strength of purpose, creative intelligence and strategic skill.

In Sweden, the social democrats, a party of the urban working class, reached out to small farmers and introduced a Keynesian programme avant la lettre, taking care to reassure employers that they had no designs on private property or managerial prerogatives. In Germany, the Nazis, having gratified conservatives and industrialists by eliminating their political opponents and banning trade unions, took bold action to eliminate mass unemployment and broaden their popular base. In the US, Roosevelt was hailed as a saviour by workers, farmers and liberal intellectuals, but was resisted at every turn by a capitalist class that saw the New Deal as a harbinger of communism. And notwithstanding FDR's charisma and guile, his adherence to economic orthodoxy was a handicap. In France, the Popular Front chose to confront employers rather than work to build a new regime and soon fell from power. In Britain, a change of regime was eventually effected, but not until May 1940 when, in conditions of dire national peril, dissension in the parliamentary Conservative Party made it possible to replace the discredited Chamberlain government by an authentic coalition in which Churchill took charge of foreign and military policy, while Liberal intellectuals and Labour leaders secured popular backing for the war effort and embarked on the road to 1945.

Of course, programmes and strategies that proved effective in surmounting capitalist crisis 75 years ago are of little relevance to our current predicament. In developed countries today, public expenditure absorbs between 30 and 60 per cent of GDP, tax tolerance is low and there are limits on how far governments can rack up public borrowing without spooking the financial markets. Communism, fascism and Keynesian social democracy have long since passed away and some version of the "market state" now provides the basic template for public policy. Yet continued economic growth in affluent societies has brought little, if any, gain in personal happiness, while the extension of market forces to social activities from which they used to be largely excluded, from pension provision and postal services to child-rearing and higher education, has eroded the social dimension of citizenship and damaged social cohesion. And beyond recession loom the problems of climate change and global inequality, which cannot be tackled within a framework of free trade and boundless growth, but call for a globally managed process of convergent economic development aimed at restraining the growth of world GDP, halting the build-up of greenhouse gases and closing the gap between rich and poor nations. These goals could be achieved within the lifetime of a child born in the West today. But to bring them within the horizon of political possibility, we must find the courage to think the unthinkable and remake our politics – just as our forebears did.

■ *David Purdy is a member of Democratic Left Scotland.*

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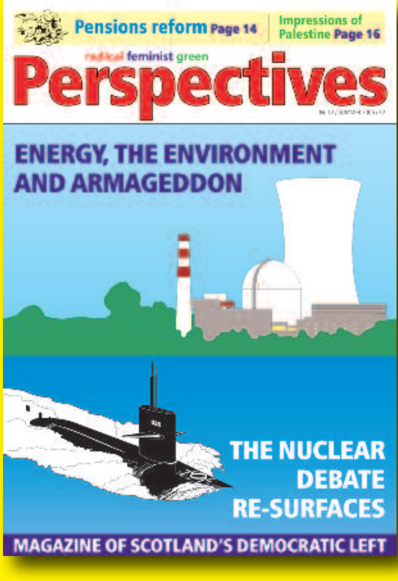

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