International Debt and Financial Crises

The Greeks Must Endure: Protestors demonstrate against austerity in front of the Greek Parliament in February 2012.

Alessandro Belica/EPAGw.com

Readers of national newspapers have grown used to front-page articles about national debt problems and the ongoing global financial crisis. The burst of the U.S. housing bubble in 2007 caused a global recession that damaged many people’s standard of living. As we write at the end of 2012, there are new storm clouds looming on the financial horizon. The U.S. Congress is still trying to lower the annual federal budget deficit through a combination of spending cuts and tax increases so that the government does not add...
significantly more to the long-term national debt already worth $16 trillion. The festering Greek debt crisis has reached the point where many economists believe Greece would be better off pulling out of the European Monetary Union (EMU). Other members of the Euro zone like Italy, Spain, Portugal, and Ireland continue to have high levels of sovereign debt, leading them to impose more unpopular austerity policies on their societies while seeking more loans from the European Central Bank if they expect to stay in the Euro zone and avoid default. Meanwhile, the entire EMU economy has plunged back into another recession that is expected to last through at least 2013.

You and your family might also be caught up in your own consumer debt crisis. Many people who bought homes in the 2000s later found themselves underwater (owing more than their house was worth) and facing foreclosure. Others lost their jobs, unable to find good-paying alternatives. By September 2012, the average U.S. household had $7,150 of credit card debt. According to the College Board, 57 percent of students who graduated from a U.S. public university in 2010-2011 had debt that averaged $23,800 per person. By the end of September 2011, 13.4 percent of students had defaulted on student loans within the first three years of required repayment. While some of us have dealt with our financial suffering in silent desperation, others joined the Occupy Wall Street demonstrations in late 2011 or staged strikes and anti-austerity protests in Europe throughout 2012 to demand relief from the government.

Finance and debt issues seem to be clouded in mystery and “dark shadows”—supposedly too complicated for ordinary people to understand. Until recently, it was easy to assume that the “experts” would make the right decisions to manage national and global finance with everyone’s best interests at heart. We now know better. Alan Greenspan, the former Chairman of the U.S. Federal Reserve, admitted to a congressional committee investigating the financial crisis in October 2008, “Those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief.” Other central bankers and financial industry leaders have also revealed themselves to have made bad financial decisions based on misleading ideological assumptions and incomplete information.

How did we get into this mess? Why has it been so difficult to clean it up? How do we prevent it from happening again? We will try to answer these questions by examining some of the causes of debt and financial crises since the 1980s and the tradeoffs governments have faced when trying to resolve them. Financial crises always engender struggles over the redistribution of resources. The corrective measures states adopt can profoundly reward some social groups and destroy the dreams of others. Political responses can span the gamut from more protectionism to less protectionism, austerity to stimulus, more fiscal integration to more state sovereignty, and from political inclusion to state repression. Crises can also produce long-term changes in our ideas about state-market relations and what is socially fair and legitimate.

The single most important feature of the global financial system today is the globalization of capital. Twenty-four hours a day, states, banks, and corporations move money around the world, whether to pay for imports, make investments, lend money, or distribute foreign aid. For example, in September 2012, $5 trillion
of foreign exchange was traded per day in global currency markets. Increases in capital mobility and more flexible exchange rates have made the global financial system more interconnected and volatile.

Drawing on some of the themes introduced in Chapter 7, we examine important financial crises—beginning with the Third World debt problems of the 1980s and ending with the European sovereign debt crisis. First, we provide an overview of the different sources of debt and different characteristics of financial crises. Individuals, businesses, and states accrue debt for a variety of reasons, including to stimulate consumption, to make investments, and to finance spending. Their inability to pay it back can contribute to balance-of-payments problems, debt traps, credit crunches, and even economic depression.

Second, we look at debt crises that engulfed developing countries—especially Mexico—in the 1980s and mid-1990s and the role of the IMF in imposing policy changes to dig economies out of trouble. Third, we examine the dynamics of the Asian financial crisis of 1997–1998, triggered in part by speculative attacks that led to a currency crisis in Thailand. An era of unfettered capital flows went on to pummel Russia in 1998 and Argentina in 2001 as both countries’ stock markets and currencies collapsed, forcing them to default on their foreign debt.

Fourth, we review the global financial crisis triggered by the bursting of a home mortgage bubble in the United States in 2007. Banks that had made risky investments teetered on the brink of collapse, requiring government bailouts as the world plunged into a recession. Fifth, we explain how the sovereign debt crisis in Greece spread to other European countries, causing a wider financial and banking crisis which threatens to tear apart Europe’s Economic and Monetary Union (EMU). Sixth and finally, we survey some proposals for how states and IOs should solve current problems and better regulate the global financial structure to prevent future crises.

The key theses woven throughout the chapter are as follows:

- Events of the past thirty years indicate that finance and debt crises are not “black swan” events; rather, they are endemic to market-driven globalization.
- Crises have become geographically broader-based and longer-lasting, posing ever more serious threats to economic and political stability in the United States and Europe.
- The complexity and interconnectedness of global finance have made it more difficult for states and international institutions to manage the financial structure. The polarization of political elites in the United States and Europe and the fragmentation of interests in the Euro zone engender policies of financial brinksmanship.
- There is a growing consensus that the solutions to debt crises proposed by economic liberals—grounded in austerity and the structural adjustments of the Washington Consensus—do not work well and may even delay economic recovery. A more effective system of global governance and national bank regulations is needed to promote stability and mitigate the impact of financial markets on the world’s poorest people.
- From a structuralist perspective, capitalism seems to be laying the seeds of its own destruction. The traditional welfare state is imploding. Inequality and
class warfare are on the rise. As German journalist Cordt Schnibben argues, "Truths about the rationality of markets and the symbiosis of market and democracy have gone up in flames."^2

- In surprising contrast to their experiences in the 1980s and 1990s, the BRICs (Brazil, Russia, India, and China) and some other developing countries have emerged relatively unscathed from the 2007 financial crisis—due in part to their growing middle classes and robust global prices for oil, minerals, foodstaples, and other exported commodities.

**DEBT AND ITS RAMIFICATIONS**

Debt serves a vital function in capitalism—facilitating new investments that help an economy grow and increase productivity. It comes in many varieties. As individuals, we are most familiar with household debt incurred when we use a credit card, get an auto loan, or take out a mortgage on a home. We borrow in order to consume, and if we fail to repay our debts we might go bankrupt or have our assets seized.

Private businesses take on debt for a variety of reasons—most importantly to finance new investments in plants and equipment, acquire other companies, and cover short-term expenses. They raise capital by issuing stocks and bonds or by borrowing from financial institutions. They can face debt repayment problems for different reasons, including loss of competitiveness, lower revenues in the midst of an economic downturn, or changes in exchange rates. Some may become insolvent, meaning they are unlikely to ever repay creditors, while others face liquidity problems, meaning they face short-term cash flow issues but are otherwise still viable businesses. Similarly, state-owned companies typically borrow from their government or from public development banks.

States also borrow money on a regular basis to finance new infrastructure, cover budget deficits, or finance a trade deficit. They typically raise money by selling government securities and bonds. Their national and international creditors (lenders) include foreign governments, corporations, banks, hedge funds, and pension funds—some of the same actors who lend to companies. Lenders base their decisions on how much to lend, at what rate, and for how long based on their assessment of the likelihood that a government will make good on its debt.

Governments can repay debts in their own currency by simply printing more money, but at the cost of devaluing their currency and causing inflation. Banks and investors are constantly looking around the world for places to lend money, and they usually search for the best rates of return given estimated risks that include potential exchange rate fluctuations, changes in global demand, and political instability. Governments and companies can usually roll over or refinance old debt by, printing money or borrowing, unless creditors think they are so indebted that it is too risky to extend them more money—except at a higher interest rate. At this point, debt can become a destructive force, catching borrowers in a "debt trap" of ever-increasing expenses or bankruptcy, which makes it difficult to borrow in the future.

International debt problems can often lead to a balance-of-payments crisis (see Chapter 7). For example, if a country is running a trade deficit, it must try to
export more goods and services, or it has to depend on other states to offset that
deficit with investments in its country. The lack of foreign investment often leads
to a capital account deficit—or financial debt. If the country is also unable to bor-
row from overseas under favorable terms, its international trade will be disrupted
because needed imports may be too expensive to obtain.

These conditions can result in capital flight, when investors lose confidence in
an economy and transfer their bank accounts out of the country to “safe harbor”
nations. In turn, this creates an extreme shortage of funds in the debtor nation’s
banks, which sends national interest rates shooting up. It also puts pressure on
states to defend the value of their currency by providing stronger currencies to
those who cash out of the local currency on their way out of the country. If they
cannot, officials may have no choice but to devalue the currency, which can easily
destabilize their economy and society.

Debt problems related to a balance-of-payments crisis brought on by specu-
lation and capital flight can disrupt trade and international financial relation-
ships. A crisis in one nation can spawn additional crises elsewhere, as it did during
the Great Depression of the 1930s. Resulting economic problems become political
problems because it usually falls on the state and its leaders to implement the
harsh policies necessary to get some relief from a “lender of last resort” like the
IMF to bring international payments back into balance.

THE DEBT CRISIS OF THE 1980s
AND EARLY 1990s

Mexico kicked off the LDC debt crises in 1982 by announcing that it would default
on its bank debt, stoking fears that other debtor countries like Brazil would follow
its lead. This crisis had its roots in the 1970s, when OPEC oil exporters recy-
cled their petrodollars into Western banks and financial institutions, who in turn
sought new investment possibilities and higher returns in LDCs. Western officials,
who were giving out less Official Development Assistance (ODA), encouraged
developing countries to borrow, especially because inflation rates were running
ahead of interest rates on loans—creating negative real rates, which traditionally
favor borrowers. Instead of these loans resulting in rapid economic growth, the
uncoordinated actions of financial markets generated a debt trap for both debtor
states and their creditors. In retrospect, too much was loaned to too many.

International banks headquartered in places like London and New York continued
to throw good money after bad, just so that governments could sustain interest
payments on earlier loans. Eventually, with so much debt outstanding, the banks
were in as much trouble as the debtor nations—a typical Keynesian concern. The
IMF—in coordination with the World Bank—stepped in to extend new loans to
debtors in exchange for their adoption of trade liberalization and cutbacks in state
spending. Once an IMF package was put together, commercial banks rescheduled
debts, and Western governments and banks extended new loans. In essence, debtor
states only refinanced their loans and stretched out the time period for repayment.
While a few countries like South Korea and Turkey recovered and generated new
income from exports, others went deeper into the red.
Facing these problems in 1985, U.S. Treasury Secretary James Baker came up with the so-called Baker Plan, whereby commercial banks and Western governments would extend larger, longer-term loans to fifteen big debtors in exchange for their implementation of market-oriented structural changes that would help them “grow” their way out of the debt. However, the plan did not work, in part because new sources of credit from banks and the World Bank were ill-timed and slow in coming. Moreover, while countries tried to expand their exports all at once, commodity and oil prices collapsed, leaving some nations even worse off. Compounding this problem was a recession in industrialized countries that shrunk the market for LDC exports. In some cases, loan money was used in unprofitable projects or was siphoned off by corrupt leaders.6

By the late 1980s, debtor states faced acute social and political tensions stemming from dissatisfaction with international debt management. A number of Latin American states threatened to unilaterally suspend all or part of their debt-service payments. The Reagan administration promoted some gimmicky forms of financial relief such as debt swaps, whereby some amount of debt could be swapped with a bank for land or valuable properties in debtor countries. Although it would have been in the collective interest of banks to clear their books of bad loans so as to reduce the risks that debtors would completely default, the banks were caught in a situation referred to as the “prisoner’s dilemma.” Each wanted others to forgive some of the debt but was unwilling to do so itself, for fear that it would bear a cost that would not be shared by those who paid nothing to solve the problem.

In 1989, President George H. W. Bush initiated another program—the Brady Plan—whereby banks gave debt relief to debtors in exchange for low-risk bonds issued by the debtor countries that were backed up by U.S. Treasuries as collateral. Thanks to Washington’s intervention, countries like Mexico benefited from some debt relief (in exchange for more economic reforms), banks were sure to get a good amount of their principal back, and the U.S. government avoided increasing international financial instability. The formula between debtors, creditors, and the hegemon of shared risk, shared responsibilities, and mutual obligations eased the debt-service burdens of developing countries and allowed them to break out of their debt traps.

A New Role for the IMF

During the mid-1980s, the United States pushed the IMF to work closely with the World Bank to solve debt problems in the less developed countries (LDCs). During this period the Washington Consensus gradually emerged as the recommended strategy for developing nations (see Chapter 11). According to the neoliberal Reagan administration, debt would be overcome as economies opened up and integrated into the growing global economy.

In addition to helping member states deal with balance-of-payments problems, the IMF became a “lender of last resort” in the international economy to help nations overcome their debt burden. World Bank and IMF loans were made subject to structural adjustment policies (SAPs), a series of actions to which the borrowing government had to agree before receiving a loan.
This IMF conditionality is controversial because it involves a number of politically unpopular SAPs designed to restore economic balance. Some of the required policies include currency devaluation to generate exports; price stability to control inflation and encourage savings; fiscal austerity to cut state spending and subsidies while privatizing national industries; tariff liberalization to promote competition in the domestic economy; higher interest rates to attract investment in the short run; and sound social programs for the lower classes to counteract higher import prices, fewer subsidies, and higher taxes.

The IMF-instigated policies were designed to reduce the current account deficit by increasing exports and reducing imports—and simultaneously to help bolster the capital account by stemming capital flight and limiting new borrowing needs. In the long run, these policies were supposed to generate economic growth, allowing a nation to repay its old debts and be less dependent on credit in the future. In the short run, the policies usually lowered living standards and imposed hardship, especially on the poor—in some cases leading to civil unrest. Although in theory the IMF and the debtor-nation governments worked together, in practice their relationship was often conflictual, with the IMF responsible for international financial stability while debtor-nation governments had to suppress domestic forces opposed to SAPs.

The Peso Panic of 1994

The Mexican Crisis of 1994–1995 was the first crisis in the new era of global finance and investment, where global financial flows were more volatile and harder to regulate nationally. Economist Paul Krugman applies the term “contagion crisis” to describe a financial crisis that spreads internationally to the point that it threatens to unleash a worldwide depression.

The years leading up to Mexico’s entrance into the North American Free Trade Agreement (NAFTA) in 1994 contributed to an investment speculation bubble. Venture capitalists and large investors were convinced that Mexico’s membership in the regional alliance would improve its prospects for political stability and economic growth. Capital flowed into Mexico from many sources, including pension funds holding the money of retirees, authors, clergy, and grandmothers. Everyone felt that the new era of “emerging markets” had arrived—bringing high rates of return in its wake. What followed was a euphoric phase in which the economic ambitions of fund managers and middle-class Northerners were disconnected from political and social realities. Many investors made a good deal of money—at first. As word spread, more investors jumped in, driving up the prices of Mexican real estate, stocks, and bonds.

The wheels fell off the wagon in 1994 when a rebellion broke out in the poor region of Chiapas and the ruling party’s presidential candidate was assassinated. Suddenly, foreign investors had doubts about Mexico’s political stability. As they began shifting funds out of Mexico, pressure mounted on Mexican officials, who wanted to keep their exchange rate fixed to the dollar. The government had an obligation to give investors U.S. dollars when they sold their Mexican stocks, bonds, and pesos. As this pushed up the value of the dollar, the government knew that Mexican banks would soon run out of dollars. On the other hand, officials
wanted to stem the outflow of money from Mexico. To do so they would have to raise interest rates to make rates of return on foreign investments look more attractive. The tradeoff was that this would also slow down the Mexican economy by making bank loans for Mexican borrowers much more expensive.

Inevitably, domestic interests prevailed and the peso was devalued, signaling to foreign investors that they were going to lose lots of money on their investments. They scrambled (panicked) to get out of Mexico before things got even worse. The price Mexico paid for the stampede and the drastic depreciation of the peso was a severe recession. The inflation rate doubled and unemployment jumped to 7.6 percent by August 1995. Mexico’s GDP fell off dramatically in 1995, effectively wiping out the short-term economic gains from the NAFTA boom. Exports recovered due to the peso’s lower value, but higher interest rates, a credit crunch, and higher poverty gave the country what critics called a “tequila hangover.”

THE ASIAN FINANCIAL CRISIS

Less than two years after the Mexican crisis, the Asian financial crisis struck, threatening the financial stability of the entire globe and causing economic damage that lasted for years afterwards in East and Southeast Asia. It demonstrates how easily crises occur—even in states with otherwise sound economic policies—when global market actors lose confidence in a government’s ability to manage its finances or live up to external expectations.

The crisis started on July 2, 1997, when Thailand’s currency, the baht, suddenly collapsed in value. This currency crisis was initially reported only on the back pages of the financial sections of world newspapers. But it started a chain reaction of economic, political, and social effects, together referred to as the Asian financial crisis, because it spread like a contagion to Indonesia, Malaysia, Taiwan, Hong Kong, and South Korea.

The Thai government had guaranteed that the exchange rate between the Thai baht and the U.S. dollar would be fixed at a rate of 25 baht per dollar. Capital was attracted to Thailand because the country’s interest rates were higher than those in the United States. The government’s pledge of a stable currency value encouraged Thai finance companies to borrow U.S. dollars on global markets, convert them to Thai baht at the fixed exchange rate, and then lend them out at a higher interest rate in Thailand. Banks and borrowers used the funds to expand businesses, purchase property, and even speculate in Thai stocks. Consequently, business bubbles began to inflate in Thailand and other countries in the region.

Problems developed when Thai banks were found to have many bad loans on their books—loans that were unlikely to be repaid on time and perhaps could never be repaid at all. Some of these bad loans were blamed on crony capitalism—a system in which the government gave some Thai banks favorable treatment in return for bribes or loans from the banks. In other words, public officials and business elites scratched each other’s backs. When the bad loans were revealed, international investors became concerned about the health of the Thai economy and began to pull their funds out of Thailand. This meant that for every 25 baht withdrawn, the Thai government had to give $1 U.S. in return. As the flow of
funds out of Thailand increased, the Thai government’s supply of dollar reserves was drawn down. Conjecture began that the government would not be able to keep its promise of a fixed exchange rate—what would it do when it ran out of dollars?

This speculation soon turned into a kind of self-fulfilling prophecy. When everyone tried to pull out quickly and unexpectedly, it was impossible for the Thai government to pay everyone their dollars. These conditions were perfect for a speculative attack, which is essentially a confrontation between a central bank, which pledges to maintain its country’s exchange rate at a certain level, and international currency speculators, who are willing to wager that the central bank is not fully committed to its exchange-rate goal.

Currency speculators can attack a local currency by borrowing huge amounts of it and then selling it on the market for a foreign currency. The central bank can keep its pledge by using its foreign currency reserves to buy up the local currency the speculators are selling. If the central bank keeps its pledge, speculators stand to lose very little because they can buy back the local currency to repay their loans at about the same rate at which they sold it. If, however, the central bank is not willing to intervene to keep its local currency stable, or if it runs low on the foreign reserves it needs to do this, then the local currency’s value will depreciate in international markets. Speculators will be able to buy back the local currency at a lower price resulting in great profits after they have paid back their loans in local currency.

Typically, central banks have billions of U.S. dollars of reserves and access to considerably more funds through agreements with other countries’ banks. How, then, is it possible to “break the bank” with such apparent ease? It is because global financial markets, when focused on a single country or industry, have even greater resources. Hedge funds are private investment funds that profit from betting on small pricing anomalies between assets such as stocks, bonds, and currencies that are trading at different prices in different places. They must be able to mobilize vast sums of money—hundreds of millions or even billions of dollars—with each dollar invested earning a small but quick return. Tidy profits come from small profit margins on lots of money. Hedge funds can be controversial when speculation zeroes in on a currency that appears to be trading at a higher price than is justified by political-economic conditions. Then the hedge funds can engage in the kinds of speculative currency attacks that were responsible for the collapse of the Indonesian rupiah and the Malaysian ringgit in 1997–1998, as well as the British pound and the Italian lira during 1992–1993. As long as investment capital is freely mobile between countries, currency crises caused by speculative attacks and investment bubbles are likely to occur.

When the Thai government in July 1997 was forced to abandon its fixed exchange rate of 25 baht per dollar, the baht’s value fell to about 30 baht per dollar in a matter of days. Seeing the crisis in Thailand, investors “sold Asia,” pulling their investment funds out of other countries in the region. The Asian currency crisis continued through the summer and into the fall. When the dust settled, the Thai currency’s new exchange rate was about 30 baht per dollar, with similar collapses in other Asian countries. This had a number of serious effects. For Thai citizens, the most direct effect was that foreign goods were suddenly
more expensive. A $10 bottle of a U.S.-made prescription drug that used to cost 250 baht was now priced at about 500 baht. But U.S. citizens benefited, for example, when a 100-baht sack of Thai jasmine rice, which used to cost $4, was now just $2. Of course, this also put pressure on U.S. rice farmers to match the lower Thai prices.

However, the biggest effects were in the financial sectors where even Thai businessmen who had made good business decisions or lent money efficiently could not possibly repay their U.S.-dollar loans because it required twice as many baht as expected. Many went bankrupt. Many people in Southeast Asia had acted rationally and worked hard but found themselves deep in debt, their life savings wiped out, and with few prospects for short-term recovery. The losses in Thailand were enough to lower the average per-capita-income of the entire country by about 25 percent in one year. For many, the economic collapse was similar to the Great Depression.

The Asian financial crisis had ramifications beyond Asia for a number of years. We will briefly mention three important effects that it had on global financial conditions. First, Russia became the next domino to fall in 1998. It was still struggling from the collapse of communism and had trouble collecting enough taxes to fund government spending. Having spent a lot of money fighting in the breakaway region of Chechnya, it also lost export earnings from oil due to the Asian crisis. As foreign and domestic investors worried about Russia’s economic stability, they sold off government securities and rubles and pulled their money out of the country. An IMF bailout worth $4.8 billion failed to help. The stock market tanked 75 percent in the first eight months of 1998 and the country’s central bank used up more than $25 billion of foreign reserves trying—in vain—to maintain the value of the ruble. The ruble collapsed, inflation skyrocketed, and Moscow temporarily suspended foreign debt payments. But within a year, Russia was recovering quickly, as devaluation helped local manufacturers and world oil prices rose.

Second, Argentina soon had its own crisis from 1999 to 2002. Since 1991, it had pegged the peso to the U.S. dollar to control inflation, but it had run up a dangerously high foreign debt. A recession beginning in 1999 forced the government to implement a series of budget cuts and IMF-required austerity measures that lasted for two years. By the end of 2001, unemployment was 20 percent and political unrest was becoming unbearable. A run on banks and capital flight forced the government to announce a freeze on all bank withdrawals for a year. It devalued the peso and unilaterally converted dollars held in bank accounts into pesos at the new exchange rate, effectively forcing depositors to lose a large amount of money. In 2002 the government defaulted on more than $100 billion in public debt—much of which was never repaid to foreign creditors. By 2003 robust growth returned, thanks in part to rising prices for commodities exports.

Third, all of these crises badly tarnished the reputation of the IMF and other international financial institutions. IMF bailouts were too little, too late, and the conditions attached to them made the economic downturns even worse. Emerging countries became convinced that austerity, higher taxes, unregulated financial flows, and privatization were the wrong prescriptions for a country during a financial crisis. Even if these measures might have paid off in the long run, in the
short run the economic pain and severe political instability were too much for a society to tolerate. Through most of the 2000s, developing countries shunned the IMF as best they could by building up foreign currency reserves in case they faced financial problems. It was not until the global financial crisis that developed countries would begin to understand why emerging markets rejected their Washington Consensus and neoliberal certainties.

**THE GLOBAL FINANCIAL CRISIS OF 2007**

The current global financial crisis is not a unique event but the latest in a long line of financial crises. By September 2008, the U.S. real estate-mortgage problem had resulted in a full-blown global financial debacle, essentially freezing the circulation of credit within and between states. By the summer of 2009, some of the world’s largest financial institutions had either gone bankrupt, been nationalized, or been rescued by the government. Simultaneously, the financial turmoil produced a deep global economic recession with dizzying job losses, record home foreclosures, and a substantial increase in poverty. Public confidence in governments’ handling of economic affairs faltered, so much so that ruling parties and coalition governments were ousted in countries such as Iceland, Latvia, and Japan.

Why did this happen—especially in advanced, industrialized countries whose economic institutions were supposed to be some of the most well-regulated in the world? Heated debates on the causes of the crisis have occurred in the halls of officialdom, in the news media, and in academia. Some often-mentioned causes include the following:

- A global economic imbalance rooted in a U.S. balance-of-payments problem
- A U.S. regulatory regime that led to excessive debt and imprudent lending practices by banks, mortgage companies, and other financial institutions
- A myopic ideology that promoted globalization and the “magic of the market” without accounting for market failure and the impact of deregulation on financial institutions
- The irrational, unethical, and even illegal behavior of some individuals and companies
- Weak global governance

What follows is a chronological discussion of the causes of the crisis and the key actors in it.

**The Run-Up to the U.S. Financial Crisis**

Cyclical recessions have been regarded as one of the side effects of capitalism. As noted in Chapters 2 and 3, from the 1930s to the 1960s, officials in the United States and Europe viewed their economies through a Keynesian lens. In pursuit of socioeconomic and political stability, states used fiscal policy to control inflation, minimize recession, and support rising wages. Beginning in the late 1960s, Keynes’s ideas were gradually replaced by more orthodox economic liberal (OEL) ideas, which featured “minimally fettered” capitalism—or a limited state role in the economy (see Chapter 2).
In the early 1980s, U.S. President Reagan and British Prime Minister Thatcher reduced taxes and deregulated many sectors of the economy, including banking. They insisted that markets—not states—could best redistribute income to those who were most efficient, innovative, and hardworking. By the end of the Cold War in 1990, many Western ruling elites encouraged former Soviet states and developing nations to adopt democracy, open markets, and privatization.

Throughout the go-go 1990s under President Clinton, stock prices skyrocketed and new communications technologies enhanced market activity. Many developing nations competed for huge amounts of unregulated “hot money.” As discussed above, these funds destabilized the Mexican economy in 1994 and helped produce the collapse of many Asian economies in 1997. In 1999, the U.S. Congress repealed the depression-era Glass–Steagall Act, thereby allowing commercial banks with deposits insured by the FDIC (Federal Deposit Insurance Corporation) to become affiliated with investment banks that made many high-risk investments. Although a dot-com investment bubble burst in 2000 and 2001, taking with it $7 trillion in assets as technology stocks tanked, the new Bush administration and the Federal Reserve under Alan Greenspan remainedadamant about the need for deregulation. They continued to believe that markets were efficient, self-regulating, and good at assessing financial risks and setting prices—beliefs that Nobel Prize-winning economist Paul Krugman says in retrospect were “dangerously simplistic, naive, and ahistorical.”

Mounting structural problems in the U.S. economy played a role in the onset of the financial crisis in 2007. First, the United States was running a huge trade deficit, financed by big exporters like China and Japan that bought enormous amounts of U.S. stocks, Treasury bills, and other securities. In effect, the trade-surplus countries were loaning money to Americans who had an insatiable appetite for cheap imported goods and speculation. Beginning in 2001, the Federal Reserve lowered interest rates, which made it easy for Americans to borrow money and spend more, even though their average incomes stagnated after 1999. The United States gradually built up an unsustainable level of personal and public debt.

Many mortgage companies and big banks that dominated the New York Stock Exchange expanded programs first started in the 1990s to profit from the fast-growing home real estate market. They created new “exotic” loan products such as ARMs (adjustable rate mortgages) and loans with “teaser rates” or no money down to attract first-time buyers and especially those who otherwise might not have been able to purchase a home (so-called NINJAs—people with no income, no jobs, and no assets). With the government unwilling to exercise oversight and prohibit lax lending standards, lenders intentionally signed up mortgage customers they knew would have difficulty making their monthly mortgage payments. In particular, subprime mortgage loans (loans made to risky borrowers with weak credit scores who were often allowed to make interest-only repayments early in the loan cycle) are believed to have caused many buyers to make irrational decisions often based on incomplete (hidden) information. Banks were often less interested in the qualifications of the borrower than in “making the deal” to collect lucrative sign-up fees and improve their rating in the eyes of investors. Moreover, many borrowers believed that as the economy continued to grow, the market value on
homes would increase and they would be in a better position to borrow against the increased future value of their house or sell the house for a hefty profit.

Things got messy and opaque when banks and lenders packaged risky home loans in bundles and then resold them as securities to other banks, hedge funds, and foreign financial institutions. Investors throughout the international financial system saw these securities as good investments with the potential for high returns, but the securities concealed the weakness of many of the underlying mortgages. Global investors mistakenly believed that they were making safe, “can’t lose” bets. Speculation also translated into increased demand for risky mortgages and other assets in countries such as Britain, Spain, Ireland, Lithuania, and Estonia.

With an expectation of making huge profits, banks and other financial institutions (like hedge funds, private equity firms, and insurance companies) kept borrowing more money to make riskier loans and buy big pools of mortgages. Big investment banks like Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns, and Morgan Stanley became highly leveraged—that is, the ratio of loans they made over the amount of funds they kept in reserve grew to unprecedented levels. Based on mathematical models associated with derivatives (see the Coding the Money Tree box that follows), they packaged and bought mortgage-backed securities and other investments whose true underlying values were nearly impossible to measure.

**CODING THE MONEY TREE**

Although created to spread default risk over a broad range of assets so as to make them safer to invest in, poorly regulated derivatives contributed to the financial crisis. While a proverbial “money tree” was created on paper, derivatives were used by banks that cared more about their own profits than the security of their clients’ investments.

Derivatives were first concocted in financial mathematics research departments. Michael Osinski was the first to create a program that streamlined their production. Looking back on his work, Osinski remarks, “I have been called the devil by strangers and ‘the Facilitator’ by friends. It’s not uncommon for people, when I tell them what I used to do, to ask if I feel guilty. I do...ish.” At first, paper traders could offer highly liquid investments with a negligible default risk and an enormous high return; what wasn’t to love about them? Soon everyone wanted them. These instruments shifted from complex sources of short-term gain to dangerous, volatile, mispriced financial weapons. With an overwhelming demand for these assets in the 1990s and the first decade of the 2000s, investment bankers faced very few consequences for losing increasingly disposable clients. Banks and traders started to roll the dice ever more, diversifying into even riskier investment sectors like real estate.

When banks expanded into the subprime housing markets, deciding when, and if, mortgage-backed securities would go under became a difficult task, especially since credit agencies granted many AAA ratings. Yet as Osinski comments, “Throw some epsilons and thetas on a paper, toss a few Ph.D.’s behind your name, and now you’re an expert in divining the future.” This mantra took much of the worry out of derivatives and allowed Osinski’s program to spread throughout Wall Street.
Regulation is warranted when the rational choices of individuals result in collective failure. In this particular instance, it was best for individuals, banks, and investment firms to pursue short-term profits. Regulators had been dissuaded from doing more to limit derivatives. Yet, many of these institutions seem to forget that market prices can easily drop. The collapse of many derivatives destabilized the global economy, leading the media to point fingers, first at banks and financial mathematicians for developing these tools, then at traders for misusing them, and finally at economists for promoting the ideology that markets are self-correcting.

However, banks perhaps should not be faulted for misusing tools that regulators and public officials viewed as too complex to regulate. Arnold Kling, a former senior economist at Freddie Mac, once commented that of all the traders he knows, only a small handful actually understand derivatives.

Officials are left with many concerns: How much state regulation is needed to prevent private interests from damaging society? Are some financial processes too complex to regulate? Should society try to clean up private financial actors’ mistakes? Whatever the answers, we can be sure that the bold new world of financial innovation has more surprises waiting for us.

References

* Jordan Anton researched and drafted the material for this box feature.

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The Bubble Bursts

During the George W. Bush administration, a number of experts, including Nouriel Roubini at New York University and Robert Schiller at Yale University, warned public officials about a growing real estate bubble, but their forebodings attracted little attention until the subprime mortgage market started to crumble in 2006. By early 2007, a slew of large mortgage companies, with portfolios of subprime loans worth $13 trillion—20 percent of U.S. home lending—filed for bankruptcy. Mortgage markets in other countries, including the United Kingdom and Japan, began reflecting the same trend occurring in the United States.

Fed Chairman Ben Bernanke and Treasury Secretary Hank Paulson finally expressed alarm about mounting troubles at many financial companies around the world in 2007. Merrill Lynch, Citigroup, and other large financial institutions reported billions of dollars of losses on subprime mortgage investments. Governments responded to these problems in an ad hoc manner. By the end of 2007, the U.S. Federal Reserve and the European Central Bank had lowered interest rates and injected several hundred billion dollars into the money supply for banks to borrow at a low rate. At the same time, some sovereign wealth funds from the Middle East and Asia provided capital to markets by buying at least $69 billion worth of shares in financial companies in 2007.

In the first half of 2008, the volatile U.S. stock market suffered big losses. The Federal Reserve helped JPMorgan Chase acquire Bear Stearns, Wall Street’s fifth largest and most highly leveraged bank. Because big banks had become so interconnected (interdependent), losses tied to U.S. mortgage securities and other risky investments spread throughout the world banking system.
In the summer of 2008 many analysts recognized that banks would eventually not be able to cover their “toxic securities,” making them increasingly riskier investments. Growing corporate and consumer debt added to concerns. The real estate bubble began to tear in July 2008 after panic-stricken investors started unloading their stocks in the government-backed Fannie Mae and Freddie Mac loan agencies, which together owned or guaranteed $6 trillion of the $12 trillion mortgage market in the United States. Congress hastily passed a “rescue plan” to try to assure investors that the loan agencies would remain solvent, but many investors began seeking safer havens for their money. They focused on hot commodities like oil, gold, rice, and wheat, raising fears of higher inflation and negative growth. Oil prices reached $147 a barrel in July 2008, causing increased concerns about the ripple effects of high energy costs on consumers and businesses.

In September, a series of cascading financial crises caused stock markets to plunge and global credit markets to freeze up, almost overnight. Like the Asian crises in 1997, many investors previously willing to take a risk now panicked, causing many stocks and retirement funds to lose a large percentage of their value. On September 7, the U.S. government announced that it would put Fannie Mae and Freddie Mac into “conservatorship”—meaning they would be nationalized. When the U.S. government refused to rescue Lehman Brothers, a big investment bank, the latter collapsed and filed for bankruptcy.

Soon thereafter, the U.S. Fed came to the rescue of the American International Group (AIG), one of the world’s largest bank insurers, pumping in $85 billion to become an 80 percent owner of the company. AIG had been heavily involved in issuing credit default swaps (CDSs)—contracts that give banks insurance against default by borrowers and that allow investors to bet on the possibility that companies would default on their loans. As subprime defaults and bankruptcies rose, AIG did not have the money to pay claims on CDSs, which were worth over $45 trillion. The Fed’s aid to AIG—which eventually became a nearly $150 billion bailout package—was a hedge against the possibility that failure of AIG would cause the entire global financial system to collapse.

Big banks merged or bought up the dying remains of others: Bank of America took over Merrill Lynch and Bear Stearns; JPMorgan Chase absorbed Washington Mutual; and Wachovia merged with Wells Fargo. Ironically, this process made too-big-to-fail banks even bigger! Most of them had billions of dollars of toxic assets (mainly home mortgages) on their books. Likewise, many of them were overleveraged—they had borrowed too much money in relation to their own capital held in reserve. They were reluctant to lend to one another or to smaller banks on “Main Street” who financed local businesses and home sales.

When manufacturers and service providers could not find capital to borrow, they started laying off or firing people. Declines in tax revenues meant that state and local governments had to cut spending on schools and social services. As personal incomes dropped, consumers cut spending significantly, drove up their personal debt by using credit cards to substitute for the loss of pay, and hoarded what cash they had left. One out of ten homeowners in the United States could not make payments on their homes. Mortgage and bank defaults also rose to record levels in England, Ireland, Iceland, Italy, and Eastern Europe. Banks were stuck
with properties they were forced to auction off at huge losses. Both the freezing up of credit markets and the downward economic spiral seemed inexorable.

We Are All Keynesians Now

As the fear of not only a deep recession but a second Great Depression mounted, many public officials—including the widely admired former Fed Chairman Alan Greenspan—began to sound more like Keynesian HILs than Milton Friedman-type OELs (see Chapter 2). A temporary coalition of officials and academics agreed that the U.S. Federal Reserve and central banks in other nations would have to become the “lenders of last resort.” While many OELs preferred to let the market run its course and call a number of big banks, most HILs and mercantilist-oriented policy makers supported a quick outlay of new national monies to unfreeze financial markets. The Bush administration (and later the Obama administration) believed that if the U.S. government failed to do something, the global financial system would suffer a total meltdown. With the United States’ encouragement, many states did adopt a variety of measures—so-called “stimulus” packages—to restart their economies. These rescue packages flew in the face of the economic liberal ideology that had shaped-state-market relations since the early 1980s. They also angered many ordinary folks who felt that the bailouts rewarded the very same financial elites who caused the crisis in the first place.

On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act to create the Troubled Assets Relief Program (TARP), which authorized Treasury Secretary Henry (Hank) Paulson to use up to $700 billion of taxpayer money to buy up bad assets in banks in the hopes of keeping credit moving. Soon U.S. officials injected $2.50 billion of TARP money into U.S. banks. As the crisis went on, some financial institutions built up their cash reserves rather than lend money and continued to pay their executives generous bonuses. Beginning in late 2008, Paulson also gave TARP funds to AIG, Chrysler, GM, and GMAC (GM’s finance corporation). It is important to note that TARP was not a government giveaway; it was primarily a federal government purchase of shares and equity stakes in companies. When it wound down by the end of 2010, TARP had actually disbursed only $415 billion ($245 billion to banks, $68 billion to AIG, and $80 billion to the auto industry). The government got back much of its money through bank repayments and sales of shares. (By late 2012, the government’s overall loss from TARP was only about $24 billion, according to the Congressional Budget Office).

Contagión Takes Over

In October 2008, central bank officials and finance ministers of the United States, the European Union, Canada, China, Sweden, and Switzerland met and agreed to further cut interest rates to stimulate the world economy. Meanwhile, the U.S. Dow Jones Industrial Average dropped 22 percent—its worst week ever—with stocks worth $8.4 trillion less compared to the market high in 2007. In mid-November, a handpicked group representing the world’s largest economies—the
new G20 (not to be confused with the WTO’s G20)—met in Washington, D.C. Although they failed to agree on detailed proposals to “reform” international financial markets, the inclusion in negotiations of countries such as China, South Korea, and Saudi Arabia signaled that officials wanted emerging powers to invest in the United States and other industrialized nations. In effect, globalization would work in reverse, helping rescue the developed nations while making them more dependent on the developing nations.

In November, the U.S. Federal Reserve became a “lender of last resort” by extending huge emergency loans to about 700 banks, in the hopes that this new money would encourage them to make more home, student, auto, and small business loans. (By the time the program ended in July 2010, as much as $15 trillion in low-interest, short-term loans had been lent on a rolling basis—without Congress’ knowledge—to U.S. and European banks). The Fed ultimately recouped its loans, with interest, so the central bank did not lose money, but the scale of its interventions suggests how deeply dependent the financial markets were on the government.

By December 2008, the global economy was clearly in a recession. The Federal Reserve and the Bank of England began a policy of quantitative easing—increasing the money supply by purchasing hundreds of billions of dollars of bonds and other assets from financial institutions. But stock markets in Europe and the United States closed the year having suffered declines of approximately 40 percent in their indexes. In January 2009, companies in the United States and Europe announced huge layoffs of workers.

O'er the Ramparts We Watched

During his inaugural address in January 2009, President Obama said he would impose tough sanctions on banks that had “nearly destroyed the economy.” He also said that he would focus on putting people back to work, building a new infrastructure, and supporting middle class priorities in education and health care. His administration quickly ratcheted up the Bush administration’s support to Chrysler, GM, and GMAC (GM’s finance corporation) from $25 billion to $75 billion by the end of 2009. In February 2009, Congress passed Obama’s signature legislation, the American Recovery and Reinvestment Act. This $787 billion stimulus plan—sort of a mini New Deal—included massive spending on infrastructure to boost job creation and consumer demand.

Not unexpectedly, many Republicans and Blue Dog (conservative) Democrats attacked these measures, widening an already deep ideological rift between them and moderate-to-liberal Democrats. The clash between a still-dominant neoliberalism and a resurgent Keynesianism resulted in legislative deadlock. Why?

Congressional Republicans have promoted policies of “fiscal conservatism” that often include the following:

- Cutting the national debt and shrinking the budget deficit (the difference between taxes and spending)
- Shrinking the size of the government
- Cutting spending on Medicare and Social Security
Yet, many liberals and progressives felt that the countermovement was half-hearted and short-lived. Obama was seen as politically pragmatic to a fault, agreeing with Republicans in 2010 to support an extension of the Bush tax cuts for two more years in exchange for an extension of unemployment benefits for only a few months. HILs specifically criticized him for pandering to economic elites. His selection of Timothy Geithner—a former president of the Federal Reserve Bank of New York—as Secretary of the Treasury and Larry Summers as Director of the National Economic Council raised doubts about the president’s commitment to financial reforms. These advisors seemed more interested in reestablishing financial stability than helping Main Street. In her 2012 book Bull by the Horns, former FDIC chair Sheila Bair called Geithner a “bailout in chief” who threw money at banks with almost no strings attached, refused to support mortgage modifications for struggling homeowners, and later watered down reforms in the Dodd-Frank Act.11

Little was done to impose tighter limits on executive pay and bonuses in exchange for government bailouts. CEOs’ compensation continued to grow during the Obama presidency. In 2011, the “median pay of the nation’s 200 top-paid CEOs was $14.5 million.”12 Meanwhile, struggling homeowners failed to receive significant mortgage relief such as a lowering of principal owed. Between September 2008 and September 2012, 3.8 million U.S. property owners lost their homes to foreclosures.

The administration also refused to prosecute Wall Street insiders for apparent illegal improprieties leading up to and during the crisis; in a rare exception, millionaire investor Bernie Madoff was convicted in 2009 of running a Ponzi scheme that defrauded customers of more than $50 billion. After 2008, banks continued to engage in illegal practices such as robo-signing, whereby they foreclosed on homeowners with falsified or unverified documentation. Not until 2012 did the federal government and state attorneys general negotiate a $25 billion settlement over these fraudulent practices with the five largest banks in the United States.

To critics, measures that Congress has adopted to reform the banking and finance sectors are quite timid. Despite Senate Republican opposition, a Consumer Protection Financial Bureau (CPFB) was finally set up to conduct risk assessment of the financial system. In 2010 Congress approved the Dodd-Frank Act, a law that, among other things, requires banks to keep more capital and collateral in reserve and allows the Commodity Futures Trading Commission to regulate some types of derivatives trading. One of the law’s most controversial proposals is the Volcker rule, which prohibits banks from owning hedge funds and engaging in certain risky trading. Despite these supposedly sweeping changes, JPMorgan Chase in 2012 lost at least $6.2 billion on a complicated hedging strategy that went bust. Trades made in the bank’s London office involved the same kind of credit default swaps that contributed to the 2008 crisis. CEO Jamie Dimon had bitterly opposed regulations of the banking system that would limit the use of derivatives, at one point calling them “un-American.” He later admitted that JPMorgan Chase had engaged in “dumb risk-taking.”

How can we explain the relative weakness of financial reforms under the Obama presidency? Keynesians blame, in part, the banking lobby—what Simon Johnson and James Kwak call a “new American oligarchy” of six megabanks—that spent tens of millions of dollars opposing strong regulations. Even with Dodd-Frank, claim Johnson and Kwak, “The ideology of finance—the idea that
behemoth banks peddling increasingly incomprehensible products are somehow good for ordinary people—though shaken, remains dominant in Washington." Structuralist Robert McChesney points out that most politicians turn to vested interests to help finance their election campaigns, creating an undemocratic system of influence peddling—a dollarocracy—whereby corporate lobbyists get favorable treatment from lawmakers that exacerbates political and economic inequality.

Another reason may be U.S. political culture. Free-market ideas resonate strongly with public and private elites who have been conditioned to fear potentially authoritarian "big government." There has historically been significant public opposition to a "nanny state" that oversteps its boundaries. Tied to that opposition has been widespread resistance to higher taxes since the early 1980s. In the same vein, the notion that the United States is a "land of opportunity" with high social mobility runs deep—even if it is largely a myth since 2007. As former Republican presidential candidate Herman Cain said in 2011, "Don't blame Wall Street, don't blame the big banks, if you don't have a job and you're not rich, blame yourself."

**Occupy Wall Street: "We Are the 99%"
**

To the delight of many HILs and structuralists, Occupy Wall Street (OWS) seemed to put a dent in the popularity of neoliberalism with its key slogan "We Are the 99%." Beginning with a September 2011 demonstration in New York against big banks, OWS soon spread to other U.S. cities such as Chicago, Atlanta, and Oakland—and later to global metropolises such as London, Rome, Santiago, Madrid, Athens, Sydney, and Toronto. Inspired by mass demonstrations during the Arab Spring, its most important policy recommendations are as follows:

- Reduce inequality by raising taxes on the rich and redistributing wealth
- Re-regulate banks and limit the influence of corporate money in the political system
- Provide bailouts (like mortgage relief, tax cuts, unemployment benefits, and student loan forgiveness) to ordinary families and workers
- Expand the welfare state and workers' rights
- Reject electoral politics in favor of direct political action

The OWS's inchoate mix of populist, anarchist, and anti-capitalist ideals appealed to a segment of middle and working class Americans frustrated with political gridlock and rising inequality. A leaderless social movement, OWS called for a breakup of "too-big-to-fail" banks, the five largest of which controlled $8.5 trillion at the end of 2011—half of all banking industry assets in the United States. Like structuralists, many OWS members have argued that both the Democratic and Republican parties are running a corporate state that reproduces the conditions for the survival and growth of capitalism. Ironically, says public intellectual Chris Hedges, the ruling elites are undermining their own system as they "retreat into hedonism," "pillage their own institutions," and "devote their energies to stealing and exploiting as much, as fast, as possible."

These self-destructive tendencies, according to OWS-leaning scholars, stem in large part from the ruling elite's unwillingness to acknowledge the need for a fairer, more moral political economy. Robert Reich points out that there is an
“unprecedented concentration of income, wealth, and political power in the top 1 percent” who control more than 40 percent of U.S. wealth and receive more than 20 percent of national income.\(^{36}\) According to the Federal Reserve, average family wealth shrunk 14.7 percent between 2007 and 2010 and average family income fell 11.1 percent in the same period.\(^{17}\) Moreover, the U.S. Census Bureau reports that in 2011, 47 million Americans were living below the poverty line (defined as an average annual family income of $22,400).\(^{19}\)

THE EUROPEAN DEBT CRISIS: IS THE DREAM OVER?

As we write at the end of 2012, the European Monetary Union and the seventeen countries that use the euro as their currency are at a crossroads! For almost five years many European states have experienced intractable debt problems that could easily lead to national defaults—failures to pay back tens of billions of euros to creditors. In particular, five EMU countries—Portugal, Ireland, Greece, Spain, and Cyprus—have had to turn to the “troika” comprised of the European Central Bank (ECB), the European Commission, and the IMF for assistance in meeting their debt obligations and saving their banks (see Chapter 12). Greece received its first EU-IMF bailout worth €110 billion in May 2010. In November 2010, Ireland got an EU-IMF loan of €85 billion; in May 2011 Portugal got a €78 billion EU-IMF loan (see Table 8-1). However, private investors drove the interest rate on government bonds issued by Portugal, Italy, Greece, and Spain, making it much more costly for these countries to borrow.

Among other things, the troika have required that Portugal, Ireland, and Greece raise taxes and make deep cuts in the number of civil service workers, pensions, education, and social services. For example, in exchange for a second bailout of €130 billion in February 2012, the Greek government was required to lay off more than 150,000 government workers and decrease the minimum wage by more than 20 percent.\(^{19}\) Even Italy and France have been forced to make painful cost reductions to lower their budget deficits (see The “Bitter Medicine” of Austerity). Germany and many private lenders have argued that austerity is the best medicine to reduce the level of sovereign (national) debt and restore investor confidence.

Yet, as might be expected, the public has strongly resisted these strident policies. Between 2010 and 2012, eleven governments in the seventeen-member Eurozone fell apart or were voted out, an indication of how frustrated voters are. There is a widespread perception that international lenders are inflicting severe socioeconomic pain on people who were not responsible for the crisis.

How events in Europe unfold will have tremendous consequences for one of history’s most admired experiments in regional integration. One thing at stake is the viability of the modern welfare state. In an ironic twist, Jin Liqun, the head of China’s sovereign wealth fund, said in November 2011 that European countries had a “worn out welfare society” with labor laws that “induce sloth, indolence, rather than hardworking.” Scholar Thomas Wright also predicts that a collapse of the euro could damage Europe’s soft power in the world, cause a long-lasting global depression, and end multilateral cooperation within the transatlantic alliance.\(^{20}\)
On April 4, 2012, Dimitris Christoulas committed suicide near the Greek Parliament. He left a note that said his pension had been cut and that he could not bring himself to eat out of trash cans. On May 24, 2012, Antonis Perris, an unemployed musician, and his 90-year-old mother with Alzheimer's both jumped to their deaths from the roof of their apartment building in Athens. Perris had posted a note online saying they had run out of cash. On November 9, 2012, a woman named Amaia Egan in a Basque town leapt to her death from her apartment just before she was to be evicted for failing to make her mortgage payments. Hours after her suicide, thousands of demonstrators marched through her town chanting "Banker, remember—we have rope," "It is not a suicide, it's a homicide," and "We must stop financial terrorism." In response to this and other suicides, the Spanish government on November 15 placed a two-year moratorium on evictions of poor people who have defaulted on their home mortgages.

Similar incidents have occurred all over Europe where many poor and working class citizens blame austerity policies for the extraordinary amount of suffering they are now enduring. The famous European social safety net was designed to help those without jobs, providing them with health coverage and public assistance until they could find employment. But now the welfare state is under attack.

One of the ways to cut the level of government debt is to "sack" (lay off) large numbers of public employees and trim the benefits of those who remain. Simultaneously, many countries have introduced "labor-market flexibility," meaning reducing wages and worker benefits and making it easier to hire and fire. Even countries thought to be relatively insulated from the repercussions of austerity have felt the crunch. For instance, France has seen a sharp increase in short-term contract labor, which rarely provides workers good benefits or a decent enough wage to live on. Likewise, some unemployed white-collar workers have taken to living in trailers in French parks.

Many kinds of public services have been cut, including education, elderly care, transportation, and garbage pickup. It is not hard to find lines at local soup kitchens. In October 2012, the Spanish Red Cross launched a public campaign called Ahora + que nunca (Now More Than Ever) to raise money to give food parcels to the poor. One of the advertisements ran on Spanish TV showed a father opening an empty refrigerator, then sharing with his two children an omelette made with one egg.

The working class and poor have been saddled with higher taxes. Greece went out of its way to increase the chances of collecting new taxes by attaching them to everyone's power and water bills. In some cases, people have allowed their utilities to be cut off and have moved in with relatives or friends. Because a large sales tax hike in Portugal has made going out to a restaurant expensive, there has been a "sudden proliferation of the 'marmita,' or lunch box, used by employees to take their home cooking to work." It remains to be seen if Europe's political elites can weather anti-austerity protests and offer a light at the end of a long tunnel of social suffering.

References
Matthew Pedro, Dave Balaam, and Brad Dillman researched and wrote this box feature.
The EMU Debt Trap: Beware the Greeks

When fifteen EMU countries adopted the euro as their common currency in 2002, they began to experience strong growth rates linked to the injection of large amounts of capital into their economies by banks and private investors. However, a sovereign debt problem emerged after the U.S. housing bubble burst in 2007 and recession spread across the Atlantic. What caused the crisis? Many neoliberal analysts have been quick to blame countries like Greece and Italy for reckless government spending, corruption, and lax tax collection. However, the European debt problem cannot simply be attributed to excessive government borrowing; there is actually a more complicated story that involves structural flaws in EU institutions, political constraints, and reckless lending.

First, before adopting the euro, each European country could devalue its own currency if it needed to increase its competitiveness; increased exports would then provide more income to service debts. However, by joining together in a monetary union, the seventeen Euro zone countries could no longer individually print money or use devaluation to resolve individual debt problems. Instead, the Frankfurt-headquartered European Central Bank set monetary policies for all members. It has had a free-market orientation and a reluctance to let inflation rise too high.

Although the Maastricht Treaty of 1992 required EMU members to meet specific criteria regarding the size of their budget deficit and government debt, they did not strictly adhere to their own rules. Why would they care about it as long as members were doing quite well economically? For example, Ireland—once one of the poorest countries in Europe—grew so fast between 1994 and 2007 that it attained one of the world's highest per capita GDPs. Multinational financial institutions and private investors bankrolled Europe's IT industries, real estate, tourism, green energy projects, and infrastructure. London, Paris, Barcelona, and Milan were booming metropolises. Reborn after reunification, Berlin sought to claim its status as one of Europe's wealthiest and most cultured cities.

Second, the debt crisis can also be partly attributed to the unwillingness of countries like Italy and Greece to reform their economies so as to increase productivity and competitiveness. They got complacent while the going was good, ignoring potential problems. Let's look briefly at the records of now-troubled countries (also see Table 8-1, which presents data included in Table 12-2):

- While borrowing was easy, Greece kept its official retirement age at 58 and expanded welfare benefits. It invested in a lot of new infrastructure, especially for the 2004 Olympics in Athens.
- The so-called Celtic Tiger, Ireland, adopted policies to attract huge foreign investors such as Microsoft, Intel, Google, and Citi. Yet, the Irish overbuilt new offices, homes, and apartments, generating a speculative bubble that burst in 2007. In September 2008, the Irish government guaranteed all of the €106 billion debt of the six largest banks that had financed the real estate bubble. The government then borrowed €85 billion from the troika to finance its deficit and to pay bank bondholders, making taxpayers responsible for what had been private debt.
- Many neoliberals blame Portugal's socialist government for mismanaging the government for the past forty years. Yet, before May 2011, Portugal had one of the best rates of economic recovery in the European Union. It consistently ranked
TABLE 8.1
Debt and Economic Indicators of Selected European Countries

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<td>Greece</td>
<td>299</td>
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<td>309</td>
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</table>

Sources: World Bank Indicators; Eurostat News Release 150/2012 (October 24, 2012); World Bank Quarterly External Debt Statistics; OECD Harmonised Unemployment Rates, Updated; November 2012; OECD Economic Outlook No. 93 (May 29, 2013).

above other member states in measures of high school graduates, exports, and entrepreneurial innovation. However, the state did spend heavily on a public sector with too many well-paid bureaucrats. As bond traders and speculators drove up the interest rate, Portugal had to pay on bonds it issued to raise money for debt repayments. Portugal turned to the EU and the IMF in May 2011.

- Italy has had a history of overspending and widespread tax evasion. Although its banks were not saddled with a lot of bad real estate loans, its high public debt (120 percent of GDP) made foreign investors wary of lending it more money except at high interest rates. In 2011 the government sold off some public real estate, increased the retirement age, and privatized some public services.

- Spain had a healthy budget surplus until 2008. It did not even have a sovereign debt problem: its government debt-to-GDP ratio in mid-2012 was just 68 percent, lower than that of France and Germany. However, many bank loans made during the real estate bubble went sour after 2007, plunging the economy into a recession. Unemployment reached a staggering 25 percent in October 2012. Spain applied to the EU for €100 billion to bail out its struggling banks, effectively raising its debt-to-GDP ratio substantially.

Whatever overborrowing Portugal, Italy, Ireland, and Greece may have undertaken was not a problem as such until the crisis started. Before that, many of the top people in Europe’s banks and businesses had “made a killing,” as the saying goes. Structuralists point out the irony of private banks and private bondholders “socializing” their potential losses, i.e., transferring the cost of their bad loans
to European taxpayers—and liquidating assets in southern Europe as fast as they could. Just as is the case in the United States, the middle class and poor are left to pay the bill.

A third cause of the European sovereign debt crisis is the flip side of the over-borrowing: over-lending. Egged on by ratings agencies that masked the riskiness of investments, international and domestic creditors of Portugal, Italy, Ireland, Greece, and Spain extended loans and bought government bonds at low interest rates before the downturn after 2007. They failed to anticipate a systemic crisis in the Euro zone. Germany for many years had been running a huge trade surplus with southern European countries. As southern European countries became less competitive within the Euro zone, they were unable to boost exports through devaluation of their own currency. So trade deficits in these countries were covered with capital inflows from northern European countries that caused excessive indebtedness.21

What does the future hold for Europe? We note three potential scenarios that will be touched on in Chapter 12. First, the major players in Europe may continue to muddle through with more austerity. But is this the way out of recession and the debt crisis? Contrary to what was expected, debt levels of Portugal, Italy, Ireland, Greece, and Spain have actually increased since the imposition of harsh spending cuts. Therefore, Keynesians believe a better approach is pro-growth stimulus spending with shared sacrifice throughout Europe.

Second, things may get worse if Europe cannot find ways to deal with Greece—the supposed “spoiled child” of Europe—and other big borrowers. Greece partially defaulted on its debt in February 2012 and has been debating whether or not to reissue its own currency, the drachma. Between October 2009 and June 2012, Greeks withdrew an estimated €22 billion from banks. Similarly, between July 2011 and July 2012, Spaniards, Portuguese, Irish, and Greeks together took €326 billion ($425 billion) out of local banks, transferring funds to safer accounts in countries such as Germany, France, and Switzerland.22 So alarmed were EU officials by these slow-motion bank runs (which pundits called “bank jogs”) that in June 2012 they privately prepared contingency plans to impose capital controls in the Euro zone and limit the amount people could withdraw from ATM machines. If contagion spreads, some states might withdraw from the euro, or the EMU could totally collapse.

Third, structural weaknesses of EU institutions might be overcome. European policy makers could either try to extend their reach and power or throw in the towel and return to a less-integrated, less-supranational community. The EU has taken some steps to construct a common fiscal policy, at the cost of Euro zone members giving up more sovereignty to the ECB and Brussels.

CONCLUSION: CRISIS, CHOICE, AND CHANGE

In their famous comparative politics reader Crisis, Choice, and Change, Gabriel Almond et al. examined how different societies handle occasional crises.23 A crisis conditions countries’ political, economic, and social institutions in unexpected ways, and some handle their crises better than others. Today the world faces a situation that could easily turn into a global catastrophe. In this conclusion, we discuss some potential corrections and courses.
Rebalancing the Global Glut

Many OELs (also known as austerians or deficit hawks) and some HILs (also known as Keynesians) point out that trade-surplus economies should stop holding huge foreign currency reserves as a form of self-insurance against having to turn to the IMF for loans. Countries like China, Japan, and Saudi Arabia should let their currencies appreciate and increase spending and consumption at home. In Europe, Germany could reduce its trade surpluses by either letting inflation rise or pulling out of the Euro zone and letting a new deutsche mark appreciate against the euro. Alternatively, many austerians support a withdrawal of Greece from the EMU, as long as it is done in an “orderly” manner, so that the country can devalue its currency and get out of its debt trap with export growth.

The misaligned balance of payments demonstrates that markets do not automatically self-correct. Thus, relying on other countries to underwrite the mounting debt of the United States, Italy, France, and Spain is not sustainable in the long run.

Regulation of the Domestic Economy

Domestic regulation, or lack thereof, contributed to both the Asian, U.S., and European crises. Most OELs argue that states intervened too much in the market. They blame Asian mercantilist states for restricting investments and using industrial policies that picked winners and losers. The Federal Reserve (with the support of two U.S. presidents) dropped interest rates, making it easier for lending agencies to extend reckless amounts of credit. Governments should limit bailout packages, allow banks to fail, and decrease taxes, especially for higher-income groups.

In contrast, Keynesians like Paul Krugman argue that deficit spending gives “more bang for the buck” to the economy than cutting taxes. Krugman also notes that, historically, the level of debt relative to GDP is low in the United States, and it is unlikely inflation will be a big problem in the future provided the economy grows enough to overcome the debt. HILs wish to strengthen regulation and increase competition as a “disciplining force” over banks. To counter rent-seeking and limit risk taking, big banks should be broken up and required to maintain bigger capital reserves to back up their loans. HILs also stress the urgent need to regulate the so-called shadow banking system—a collection of credit intermediaries such as hedge funds, private equity groups, and money market funds that use exotic instruments like derivatives and securitization to borrow and invest trillions of dollars.

Structuralists believe more effort should be made to sever close ties between state officials and the banks they are supposed to regulate. As the crisis worsened, bank mergers and acquisitions increased, leaving only five major banks in the United States—a concentration of capital with negative effects on democracy.

Addressing Economic Ideology and Inequality

Because asset bubbles have driven many financial crises, many HILs have insisted on the need for better economic theories that include a human element. Economists should investigate human psychology and the effects of inequality on political legitimacy, rather than limiting their focus to a rational-choice methodology. They should do more empirical work and test their methods in the real world. Castigating the economics discipline for being “isolated from the ordinary business of life,” Nobel Prize-winning economist Ronald Coase stresses that “it is suicidal for the field to slide into a hard science of choice, ignoring the influences of society, history, culture, and politics on the working of the economy.”

Keynesians believe that globalization can be made to work but that developing countries must protect themselves, at least until they can compete on a more equal footing with the industrialized states. Like mercantilists, many HILs note that China and India did not open up to the global financial system as much as others and yet achieved high rates of economic growth by “cherry-picking” the policies that work best for them (see Chapter 13).
If confidence and trust are to be restored in the financial system, the common good cannot be left to markets that have produced rising inequality in Western societies in the last thirty years. The gap between the rich and poor has significantly widened in almost all the OECD countries—with the top 1 percent earning between 11 and 20 percent of all pre-tax income in 2007 in Germany, Canada, Britain, and the United States. To raise tens of billions of dollars to redistribute to the global poor, a number of European leaders are pressing for a “financial transaction tax”—a tiny tax on all trades of stocks, bonds, derivatives, and currencies.

Joseph Stiglitz has made a compelling case that inequality in the United States is causing economic dysfunction, slowing growth, weakening democracy, and undermining the sense of fair play. He argues that the financial industry has become “rent-seeking”—it tends to speculate, evade taxes, and rip people off with fraud and indecipherable fees. Facing stagnant median wages and high debt, the lower and middle classes cannot raise aggregate demand to fuel growth. The key to solving debt and finance crises, then, is to redistribute wealth downward through a progressive tax system.

In Europe, Keynesians see the need for shared sacrifice between the rich and poor, not more hurtful austerity that by October 2012 caused unemployment to rise to 11.6 percent in the Euro zone—and to 23 percent among youth under the age of 25. The European Union’s uncommunitarian and short-sighted financial policies are tragically eroding the model of regional cooperation that Europe offered to the world. It’s a Greek tragedy, literally and figuratively.

Global Governance

Lack of management at the global level almost certainly did not cause the crisis but rather contributed to it. While many OELs prefer less global governance and more laissez-faire globalization, HILs advocate reforms to the IMF and World Bank that allocate more voting power to the BRICs. Many HILs want regional institutions such as the EU and the new G20 to help states coordinate their national stimulus packages. Reformers would like to see the G20’s Financial Stability Board supervise and regulate international financial institutions, especially by imposing capital adequacy requirements on banks and reining in derivatives and hedge funds.

As the world moves from monetary crisis to monetary crisis, the IMF is often blamed for making problems worse. But the greater problem is the inability of member states to square domestic interests with global obligations. For example, they would collectively benefit from suppressing tax competition—a dynamic where each state lowers taxes to attract corporate investment and banking activities.

States must determine how to minimize risk taking and speculative bubbles. The classical solution, which Walter Bagehot presented over a hundred years ago, is to designate an international lender of last resort, to lend when no one else will and hold open the “shutting gate” of Terschellingspanik to stop the panic. It is clear that the IMF is not and cannot be the global lender of last resort. And yet due to the high degree of international interdependence and integration of capital markets, the global governance structure must expand to match market forces or risk the catastrophic collapse of markets as occurred in the 1930s.

Today’s international political economy requires a stable and adaptable finance system. Arguably, the principles and policies that produced the shadow of darkness that has beset the world are, paradoxically, the very same ones that policy makers are trying to preserve through economic recovery programs. If Keynes were here, he might see an opportunity to practice politics as the art of the possible. Undoubtedly, he would suggest that we ask whom we believe the economy ought to serve—the rich and powerful or the poor and weak?
KEY TERMS

structural adjustment policies (SAPs) 183
speculative attack 186
subprime mortgage
loans 189
sovereign wealth funds 191
crony capitalism 185
credit default swaps 192
Troubled Asset Relief Program (TARP) 193
quantitative easing 194
Volcker rule 196
shadow banking system 203

DISCUSSION QUESTIONS

1. Compare and contrast the different types of debt problems that were discussed in this chapter in terms of (a) the source of the debt, (b) the interests of major actors in each situation, and (c) how the situation was resolved, if it was.
2. Why so much fuss over speculation? Why do you suppose Keynes would be concerned about it today? Use Chapter 7 to help answer this question.
3. Explain the connection between debt that results from borrowing money and the debt associated with a deficit in the balance of payments. Use examples from the readings.
4. What lessons could Europeans learn from previous crises that could help them resolve their own financial crisis?
5. Explain the role of the IMF in helping to solve balance-of-payments crises. Do you feel the IMF could do more? Why? Why not?
6. If you were to write up a brief outline of how to solve current crises, what measures would you emphasize? Explain.

SUGGESTED READINGS


NOTES

3. For a good overview of the 1980s’ debt crisis, see Benjamin J. Cohen, In Whose Interests? (New Haven, CT: Yale University Press, 1986); especially Chapter 8, “Latin Debt Storm.”
4. Negative real interest rates exist when inflation rates exceed the interest rate over the term of a loan. This benefits the borrower, because loan repayments have lower real value than the amount borrowed.
7. See, for example, David Vines, Pierre-Richard Angenor, and Marcus Miller, Asian Financial Crisis: Causes, Contagion, and Consequences (Cambridge: Cambridge University Press, 2004).


24. For a sophisticated discussion of this argument, see Martin Wolf, *Fixing Global Finance* (Baltimore, MD: Johns Hopkins University Press, 2008).


