

The global financial crisis: development and consequences¹

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The subject of this presentation is the global crisis unleashed in August 2007 whose consequences continue to affect the economies integrated in the global market. This is an inescapable theme for all who are concerned with the future of the global order. I wish to share with the reader some notions, many of them insights, regarding the root causes of this crisis and its impact on the global economy. But I wish also to look beyond the economic dimensions of the crisis and its immediate afflictions, trying to discern some of its political, social and cultural implications.

I will conclude with some ideas – or, at least, some questions open to further exploration – about the way forward for contemporary societies.

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The global crisis, launched in 2007 with the mortgage question and deepened in 2008 with the meltdown of the financial system, is the culmination of a series of processes involving profound economic, geopolitical, social and cultural changes that evolved over the last forty years. I will start my analysis looking back to the seventies. Even though this was not apparent at the time, it was this decade that marked a break with the world order that had emerged from the ashes of the Second World War (1939 – 1945).

Why do the seventies represent such a historical turning point? Because that particular point in time marks the rise of the new information technologies which would have two major impacts on the world order.

Because this period marks the rise of the new information technologies that had two major impacts upon the world order. First, these new technologies were the precondition for the development of the present form of financial capitalism throughout the world. Second, information society was a decisive factor in the collapse of the Soviet empire and the concomitant political, military and cultural hegemony of American capitalism.

The starting point of the process of globalization in its current form process took place when the revolution in the means of transportation and the new forms of instant electronic communication combined to radically shorten the distance of time and space. As Manuel Castells has shown in his seminal books about Economy, Society and Culture at the Information Age, the new technologies transformed production techniques, organizational structures and command systems within

¹ Based on a conference at the University of Yale on April 13, 2009

companies and government agencies. And, even more decisively, they influenced the whole of society and people's daily life.

These changes led to the global communication networks connected through the Web as the precondition for the multiplication of capital flows and the creation of the new financial products (hedge funds, derivative bonds, future markets, etc.) that are at the heart of today's global crisis. Unlike previous technological breakthroughs – from steam-powered engine to nuclear energy through radio and telegraph - new technologies affected much more profoundly not only the economy but also society and culture. The economic and social impact of TV, computers, the Web and mobile phones was quicker and deeper, reshaping both the production system and the patterns of sociability. This process goes on with the digitalization and the incorporation of new discoveries to people's lives.

Rigid, authoritarian and bureaucratic societies, incapable or unwilling to absorb these changes, were doomed to pay a heavy price. This is what happened to the Soviet Union. The isolation of the Soviet empire may have favored Russia and its allies' economic style, based on rapid growth, pollution and authoritarianism. But, as soon as it appeared, a global interdependent economic system became their Achilles' heel. In contrast to the free flow of knowledge among university, industry and government in the U.S., Soviet Union's high quality scientific research was confined to the military sphere. The lack of porosity between state and society and the fear of loss of control by the Big Brother blocked the spread of information and technological innovation. By 1980, the Soviet Union had surpassed the U.S. in the production of steel, cement, oil, fertilizers and tractors, but lagged far behind in computer technology. The Russian housewife did not benefit from the success achieved in the space or nuclear areas.

Despite this hopeless gap between the promise and the reality, the agony of the Soviet system might have lasted for decades were it not for the political and cultural inability of the bureaucratic power structure to absorb and extend to society the benefits of the scientific revolution. This fatal weakness, however, remained carefully hidden under the façade of military power and spatial conquest. Actually Communism did not collapse only under pressure from its external enemies. It imploded from within due to its incapacity to absorb new technologies – based rather on the miniaturization of electronic artifacts and software than on gigantism - and extend it beyond the military apparatus to society as a whole.

The capacity of the U.S., followed by Europe, Japan and Korea, to make full use of technological innovations to strengthen their open societies and market economies was a key factor in the expansion of economic and financial globalization.

I wish also to call attention to another phenomenon of the seventies, the rise of environmental concerns about the Earth's sustainability, an emergent issue that became critical with the oil shock of 1973 created by the enormous rise in the price of oil enforced by the Arab countries – with the support of the seven big Western oil companies a political weapon to punish the West for their support of Israel.

The oil shock was the trigger of the energy crisis that haunts us today and is at the heart of the present discussion about global warming and climate change. This crisis coincided with the ecological concerns articulated by the Club of Rome. In a radical break with the optimistic notion of an endless march on the road to progress, an entirely new set of questions gradually made its way into the global agenda. Warnings about the limits of growth, the threat of overpopulation, the risks of environmental damage and erosion of non-renewable resources all called into question the industrial standards and challenged the sustainability of the Western way of life and patterns of consumption.

No less important in the reconfiguration of global politics was the geopolitical impact caused by the quest for Arab identity and political militancy that came with it. The flames of Islamic Fundamentalism, with its radical critique of the entire Western style of modernity, were stoked by the political and cultural sense of humiliation felt by the Arab world. The unilateral response to 9/11, with the application in Iraq of the of the preemptive-war doctrine and the imposition of a cultural model under the trappings of democracy building, only contributed to exacerbate the tensions in the region and the reactions against American hegemony.

I take all these elements in consideration to insist that the seventies marked a break with the relatively stable order imposed by the Cold War order and paved the way for the transition to a more unpredictable and unstable political arrangement defined by the growing friction between technological changes and the preexisting reality.

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Despite the growing concerns regarding the sustainability of life in the planet in the aftermath of the oil shock, the interplay between technological innovation, American hegemony and the global expansion of financial capitalism intensified to the point of becoming a defining characteristic of the last quarter of the twentieth century. Globalization came to be seen, obsessively, as the last stage in the evolution of the capitalist system and the cradle in which democratic forms of politics would assert themselves *urbi et orbi*.

Nonetheless, we must remember that capitalism has always had a global reach and has always looked ahead seeking to encompassing the whole world. It is enough to remember that we ourselves, American countries, came into being as a consequence of the expansion of European commercial capitalism, Portuguese in the case of Brazil. Actually, there is nothing new or surprising in the scope of the present form of capitalist expansion. What is new and even surprising, given the accelerated pace of globalization, is the drive of financial capitalism and the spread of the productive process all over the world. This process increased in the eighties and nineties and is linked to a mode of production and of culture specific to the current stage of markets integration.

In other words, paraphrasing a notorious quotation, globalization is the contemporary form of capitalist expansion. It is based on an in-depth technological and organization transformation, the prevalence of interconnected financial markets and has created a culture of its own. From the point of view of societies, globalization - although essentially an economic and financial phenomenon – implies the dissemination throughout the world of the mass consumption model, that took place first in the U.S., later reaching out to Europe and Japan as well to segments of Asiatic societies and, in a variety of degrees, to the rest of the world.

This does not mean that all peoples have been absorbed by this form of capitalism but all of them live under its cultural influence or are affected by it.

Indeed the sharp rise in recent years of the emerging economies, especially China, strengthened the perception that the way forward lies in the gradual but steady extension of integrated-markets capitalism to all countries. The sustained expansion of global wealth led to the illusion that, more than at the time of the fall of the Berlin Wall, now we were truly at the threshold of the end of history. It was as if mankind was finally entering into an era of endless and generalized prosperity that would eventually include all countries in a self-replicating process.

The expectation was that emerging countries would continue to reap the benefits of the high prices of basic commodities. The trickle-down from this seemingly abundance of riches would in time extend to the less developed parts of the world, hopefully even to Sub-Saharan Africa. Poverty would ultimately be eradicated. Peace and stability would also be ensured thanks to the growing collaboration between the U.S. and China, with Europe as a counterbalance.

In this rosy picture of a pacified world, the European model of social cohesion was valued for its capacity to mitigate the harshest elements of savage capitalism through the provision of social services and protection to the most vulnerable. Developing countries would, in turn, benefit from a simpler, less refined form of social democracy capable of alleviating the suffering of the poor.

The palpable result of economic growth over the last years was a significant reduction in global poverty and the integration to markets of large segments of people, especially in China. At the same time, profound changes in the production process and the investment of capital in emerging countries drastically reshaped the international economic scene. The power shift from the West to the East and the South indicates that we are rapidly approaching a turning point insofar as where about one-half of annual growth of the global GDP takes place in emerging countries.

The rapid growth of global production and trade had a huge impact and not only in the manufacturing sector. The services sector, mainly banking and finance, as well as those related to a wide variety of personal services, from call centers to hi-tech

medical diagnostic, started to be provided by emerging countries, in a process known as outsourcing.

In the words of Michel Pébereau, president of the European Banking Federation, microelectronic was put at the service of profit and people. For better or worse, the virtual and the real world became closely interlaced. Innovative mass data processing led to gigantic gains in productivity. Information technology reduced production costs by replacing workers by computers. Computers enabled service supply around the clock, connecting on line all the planet's latitudes, in addition to making room for new financial products, such as the so-called derivatives. The volume of daily financial transactions far exceeds the value of a country's GDP and the very quantification of the awesome mass of values would be impossible without the electronic tools offered by the information revolution, without which its global spread would also have been impossible. The flow of derivatives – non existent until the nineties – reached \$20 trillion in 2001 and \$38 trillion in 2006. Taken in their entirety, the value of financial products grew from \$220 trillion in 2001 to \$380 trillion in 2006, more than five times the world's GDP.

However, very few economists were capable of understanding let alone explaining exactly what kind of reality these numbers express, despite the risk that all of us incur with the 'virtual economy' floating over our heads, despite the obvious contribution that an appropriate knowledge about the new financial environment might have had to enhance the stability of the global economy.

This expansion of financial capital took place under almost complete absence of transparency and accountability. Over the years the United States undermined the creation within global financial institutions of an effective regulatory framework that might have tamed the 'irrational exuberance' of financial markets. They put their trust on the self-regulation strength of markets and on the capacity of the American government (Treasury and Fed) to intervene efficiently in critical moments, dispensing the need for multilateral supports.

This pattern of unilateral decisions is not new. At Bretton Woods in 1945, the U.S. Treasury overruled the proposal by the British negotiator, none other than Lord Keynes, for the creation of a new international currency, Special Drawing Rights (SDR), available to the International Monetary Fund, which would serve to provide liquidity to the financial system in case of need. The IMF would thus function as a global Central Bank and would not be only, as it become in the past, an instrument to ensure the reimbursement of debts to the lending countries.

Instead of a system of floating exchange rates, currencies would express their value in gold and the United States would commit itself to maintaining the dollar conversion to gold. The dollar thus became both a national and a transnational currency, convertible everywhere. In the seventies, the Nixon Administration unilaterally broke with the dollar-gold convertibility. From that day on, the dollar floated according to the strength of the American economy and power.

In the last two decades, the United States - government, corporations and consumers - incurred in huge debts financed by the rest of the world that buys dollars and Treasury Bills to protect their savings. The world became a net creditor of the U.S. Treasury bonds, including among the creditors some emerging economies, like China, obviously, but also Brazil.

In the light of what is happening with the operations to rescue the American economy the question may be: how will the world evaluate the credibility of the dollar in the future? Will the debt contracted by the US be paid in due time, in real terms, or will inflation corrode these assets?

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The crisis of 2008 was triggered by a segment of this huge deficit: the mortgages contacted to ensure the loans to American families that were buying houses. But it was not contained within this sector: it quickly spread to the whole financial system, domestic and abroad. Responsibility for the original bonds, previously in the hands of the lending bank or financial agency, was dispersed over many holders. As we know today, the carelessness in the evaluation of the paying capacity of the initial debtor and the enormous facility to access credit led to a huge expansion both of the construction and the financing market. Until the moment when incapacity to pay struck hard and house of cards of the financial system crumbled at the national and international level.

If the technological revolution was the engine of globalization, then financial capital was the driver of the process of wealth creation. It is important to stress that all the financial innovations had a huge positive impact on world trade and economic growth. The "hedge funds", in a similar way to what happened with the so-called "rotten mortgages", were also "securitized", that is to say, shared among many holders, serving as protection cushion against currency variations and so forth. The fact is that, thanks to these inventions, international trade grew at a higher speed than each country's GDP while the volume of financial flows reached unbelievable proportions.

It was the reckless and irresponsible way in which these financial mechanisms were used to artificially expand wealth that led us to the current crisis.

Crises are not a surprise or an exception in the history of capitalism. They are a constituent part of its dynamic. Even the form taken by the current crisis is not new. It is enough to remember the financial crisis generated by the Tulip Bulb Mania of the sixteen hundreds to acknowledge the periodic recurrence of the same mechanism. Each time there is a brutal expansion in financial capital, sooner or later there comes a tipping point in which some borrower is no longer able to pay, setting in motion a chain reaction that implodes what, retrospectively, looks like the weak spot of a fragile house of cards.

At the heart of the present meltdown, as in past crises, is the disconnection between real assets – goods and the productive basis – and financial assets. What is original in this crisis and amplifies its effects is the magnitude of this disconnection. The technological revolution enabled the system to engineer financial products of increasing complexity and obscurity. Similarly, it ensured the irresistible speed with which they spread to all countries, given the interconnected nature of the global economy.

After the collapse, many are asking whether all this wealth lost with the crisis really existed. Was it a reality or an illusion? It was real if we consider that up to the breaking point these financial instruments had real buying power and could be exchanged for money. It was an illusion if we consider the artificial manner in which this wealth was generated and how it evaporated overnight.

What is certain is that the financial collapse produced an immense loss in terms of global wealth. It is difficult to quantify the amount, insofar as the erosion continues, but estimations range from thirty to fifty trillion dollars. Americans, alone, have lost one-quarter of their net worth in just a year and a half, since June 2007.

There is, for sure, a growing demand for measures that would prevent the return to the era of easy money, with enormous gains, leading to the disastrous repetition of the financial crisis. Since the Reagan and Thatcher governments, the world has lived under the assumption that markets are endowed with the powers of self-correction and self-regulation that would prevent abuses. The current crisis may well have generated the largest self-destruction process of the so-called “market fundamentalism”, putting to rest the illusion regarding the self-regulatory capacity of markets.

Years ago, Warren Buffet defined the so-called “innovative” financial instruments as “weapons of mass destruction”. With the crisis, fear replaced greed. The crisis of liquidity evolved into a crisis of trust, fueling the bank’s fear to lend to each other, as expressed in the sudden rise in interest rates for bank to bank lending. With the credit freeze, the real economy paid the price of the follies practiced by the financial system. And this is where we stand, with the fall in sales, in exports and imports and, lastly, in production with the concomitant rise in unemployment.

The crisis started, as we know, at the heart of the financial system of the most developed economies. Only later did it reach the productive sector and the less developed economies. Its spread was, thus, clearly different from what happened in previous decades when several crisis occurred in emerging markets, whose countries bore the brunt of all kinds of recriminations for their governments “bad behavior” in dealing with the economic policies predicated by the Washington Consensus.

When economic players do not trust each other, lending and investment come to a halt. The credit crunch stops production and transactions, which, in turn, leads to

unemployment, by far the most perverse social consequence of the downward spiral generated by the crisis.

Actually, the heart of capitalism is not the factory. It is the bank. Without the bank, the factory cannot operate.

In the aftermath of the crisis of '29, governments held back credit and stopped the provision of resources to the banking system, leading to a tremendous crisis of liquidity: markets dried up. Today the credit crunch is the foremost concern. And yet, despite the injection by governments of an incalculable amount of money in the financial system, credit flows have not yet been revived.

To make a bad situation even worse, nobody knows the real extension of banks and companies contamination with toxic assets papers that threaten them. Given the levels of uncertainty, mistrust and lack of transparency, prices in the real economy, especially house prices and the value of mortgages and financial derivatives, have not yet stopped falling. The only thing we can say at this point is that we have not yet reached the bottom of the pit.

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Governments' bailout programs represent a tremendous process of losses socialization. The U.S. Treasury so far has poured more than 180 billion dollars only to rescue AIG from insolvency. This sum offers a telling contrast with the 40 billion dollars, which was the amount of the Brazilian foreign debt in the early eighties, whose default was presented as fatal threat to the stability of the global economy. The same applies to the moratoria of several countries, whose financial dimension was minimal compared to what is at stake today.

The growing payment of bonus payments to executives of companies rescued by US government was considered a matter of minor importance by some economists, but represents nonetheless a warning that people's patience is not limitless and that governments' political capital can also be rapidly squandered.

Despite all these difficulties, the expectation remains that at a given point in time prices will reach such a low threshold as to induce people to start buying again. If and when we get to such a point, then we will have reached the bottom of the pit. This will be the moment to take a deep breath, look around and see what has been left. Today the absolute priority for policymakers is to prevent recession from turning into depression. What is to be done with the ashes is a question to be tackled once the fire is brought under control. To quench the fire governments did whatever seemed necessary: huge amounts of cash were transferred to banks and companies, chunks of the financial system and even of companies were put under state control, central banks honored commercial papers and Fed lent to other central banks, even in the absence of any demand.

The perspectives are dire.

During the government of George W. Bush, the U.S. fiscal deficit increased as a consequence of the Iraq war and the deficit in the external trade balance. These deficits have been financed through the emission of bonds bought by the rest of the world, mainly China and Japan, countries with a hefty surplus in their trade balance. Now, with the global recession deepening, there will be a reduction in this surplus. This risk leads some to think of an fear a weakening of the dollar, especially if there is a rise in U.S. inflation as it is likely to happen in the medium term.

This is what led the Chinese Premier Wen Jiabao, to say clearly: *"We are a little bit worried. We have loaned huge amounts of money to the U.S., so of course we have to be concerned"*.

In a telling counterpoint to a strictly economic reasoning, in December 2008 Edgar Morin applied his theory of complex systems to the current crisis and made a strong call for a paradigm shift:

"Crises do not generate only uncertainty. They also generate opportunities and risks. The opportunities are a challenge to intelligence and imagination leading to unforeseen solutions. When a system is no longer capable to deal with its vital problems, it enters into a process of regression and runs the risk of disintegrating itself. Or, on the contrary, it manages to create a richer meta-system, more capable to deal with these problems. Hence, there are always two solutions to crises: destruction or self-reconstruction"

My sense is that the current crisis will not be just a parenthesis of some months or a couple of years that can be closed and things will go back to normal. This is a crisis that will entail a drastic reordering of U.S. and its global priorities. The same will happen with the other effective or potential players in the global scene. The way forward will depend, as always, on human agency. On what not only governments and businessmen but also ordinary citizens and societies will do.

Margaret Thatcher, in a reductive view, once said: "there is no such thing as a 'society'. There are individual men and women, and there are families". And yet, in Tony Judt's words, the problem is that whenever resources are drastically diverted from the public to the private sector, whenever people no longer have obligations toward each other and the public good, the public space becomes a market place. And, added Judt, correcting Thatcher, people do not live isolated in markets. They live in communities and societies.

So far ordinary people – those who are outside of governments and of the sphere of decisions affecting markets - have hardly had any say in the debate about the way out of the crisis. It is as if economics, this least exact of all sciences, still retained a magical power to prevent unhindered debate. This paralysis of critical thinking seems to have affected even the *altermondialistes*, the anti-globalization movement. They, who were so forceful in the denunciation of the evils of

globalization, even if inspired by a kind of regressive utopia, now seem strangely mute.

And yet, the call for equity, social solidarity, ecological balance, trust and transparency is not only part of a necessary moral discourse. It is also a political imperative. The challenge for political leaders is to mobilize informed citizens and societies around an agenda for change, grounded on values and oriented toward paradigmatic shifts. Only thus, with the crisis subdued, shall we be able to rebuild the domestic balance of countries and strengthen the global order without repeating the concentration of political and financial power that perpetuates inequalities.

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I wish to conclude with a brief mention to some inescapable points of this new agenda, a sort of international New Deal. The global economy needs global regulation, although soft in order not to squash markets creativity. It is also necessary to move forward in terms of a more global and democratic governance. The strengthening and democratization of global financial institutions, especially the IMF and the World Bank, are evident priorities. They must be given the resources needed to cope with financial and investment problems in today's scale. The Bank of International Settlements of Basle must also be strengthened so as to ensure the application by all countries of its prudential regulatory instructions. Likewise, the voting rights systems of these institutions must be reframed to reflect the growing power of emerging countries.

Another important topic on the agenda is the proposal, formulated among others by Joseph Stiglitz, for the creation of a new global reserve currency. Keynes advocated, in other terms, for a similar initiative in 1944. Recently several important Chinese leaders spoke about this issue that seems to hang over the international scene like a cry of warning.

On the geopolitical level, the crisis precipitated the inescapable recognition of the G-20 as a more strategic and representative forum of discussion than the G-7/8. It is true that convergences of opinion among leaders hinge upon national governments and international institutions for effective implementation, but at the very least it is possible to coordinate political stands, as we saw recently in the London Summit. Let us hope that the progression toward a global and democratic decision making system will not be hindered by narrow national interests, as we saw in Bretton Woods. A broader spirit of partnership regarding of matters of common concern is certainly a better recipe to tame the dysfunctions of the financial system than a return to protectionism.

All that has been mentioned does not preclude the reformulation and strengthening of the United Nations. The fact that this recurrent theme has no practical solution in sight does not make it less important.

Next, in this reviewing of the fundamental points of the Global New Deal, comes the recasting of the energy matrix, a core component of any strategy to tackle the question of global warming. This issue represents a critical point of intersection between the economic and ecological agendas. Barack Obama clearly grasped this strategic connection, setting the transition for clean energy as a priority of his transformational agenda and a central point of first budget proposal.

The energy issue has also connections with the broader cultural question involving changes in lifestyles and patterns of consumption. As such, this is another issue of relevancy concerning the economic crisis: which patterns of consumption will be compatible with a growth rate allowing for a recovery of economies without condemning countries to a recessive cycle, as it happened with the explosive combination of reckless credit and exacerbation of consumption?

Given the enormous loss of wealth generated by the crisis and the freefall in global demand, it is likely that the world will have to cope, at least for a while, with reduced rates of growth. Painful adjustments will have to be made by all countries. The next decade will probably be a time of affliction and reduced expectations.

It is easy to imagine the kind of political and social tensions that will be generated by the reduction, however temporary, of standards of living that people, at least in the West, consider the natural order of things. In this context of restrictions, the discussion about what 'quality of life' really means to different people in different cultures will probably gain renewed importance in the public debate. The resources of governments will be focused on the rebuilding of shattered economies. This would be facilitated if a less arrogant and more collaborative approach to international questions led to a reduction in global tensions and the building of a more stable world order.

The decline of U.S. hegemony and the rise of the emerging economies paved the way for the emergence of a multipolar and multicultural world. In this new reality, soft power – the power of attractiveness driven by cultural models - tends to gain prominence to the detriment of military might. The U.S., epicenter of today's crisis, is well positioned thanks to its spirit of freedom, creativity of its society and cultural innovation characteristic of its history. Perhaps this will be their main strength to play a leading role of a different type in this emerging world, interconnected by symbolic networks.

I want finally to argue that today's global threats – from climate change and nuclear proliferation to epidemics, terrorism and transnational crime – can only be properly addressed through the participation both of states and of non-state actors. For decades, activists, thinkers and scientists, local authorities, spiritual leaders have been generating ideas and policy proposals on planetary issues. It is time to listen to their many voices.

The same is true concerning the quest for a new balance. The same goes with the search for a new balance between personal freedom and social solidarity, between individual autonomy and civic commitment.

Speaking from different social and historical backgrounds, they are part of the global conversation on how to deal with the difficult challenge of combining the defense of universal human rights with the respect for cultural diversity.

The same goes regarding the search for a new balance between personal freedom and autonomy, social solidarity and civic commitment. This broader approach is the way forward to a new culture and a new spirit of the times that would transcend both possessive individualism of market economics and stifling collectivism intrinsic to authoritarian state and party intrusion.

In times of social dislocation, the debate about alternative values is the best safeguard against the resurgence of false prophets with their tragic stock of authoritarian and regressive solutions.

In the cosmopolitan Vienna of the early twentieth century, Hugo Hoffmanstahl alerted against the rising power of demagogues in times of crisis. In his own words: *Politics is magic. He who knows how to summon the forces from the deep, him will they follow.*

Let us, thus, not minimize the risk posed by demagogues and authoritarians. Collective intelligence and public debate remain the best antidote against the ever-present regressive risk of monopolistic and authoritarian trends.