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Ghosts of the GFC haunting our fragile economies

Illustration: Eric Lobbecke

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On August 9, 2007, France's biggest listed bank, BNP Paribas, froze €1.6 billion worth of funds backed by subprime mortgages, signalling the beginning of the global financial crisis.

Ten years later, the wounds that crisis inflicted are still far from healing. Trapped in the slow lane, the advanced economies seem - incapable of generating the productivity growth needed to durably lift living standards, while their political systems are torn by the accumulated pressure of irreconcilable demands.

As frustration turns into exasperation, the public mood shows no signs of the optimism that had underpinned expansion in the - period preceding the collapse.

And with China's debt-fuelled growth reaching its limits, even the locomotive that dragged Australia's economy through the crisis is poised to totter.

That makes it all the more important to understand the disaster that started a decade ago. Its causes are, and will no doubt remain, contentious. What is clear, however, is that the form the crisis took was related to a longer-term process by which financial markets came to play an increasingly central role in economic life.

From the beginning of the 20th century to the 1970s, the ratio of borrowings by households and businesses to gross domestic product in the advanced economies fluctuated around the 50 to 60 per cent mark. But towards the end of the 70s it started to rise, before surging by some 30 percentage points in the decade before the GFC. Having stood at 62 per cent in 1980, by 2010 private borrowings had reached 118 per cent of GDP.

"Financialisation", as that trend came to be called, yielded many benefits, including stronger and more durable economic growth. There is plenty of evidence too that it enhanced the advanced economies' ability to cope with routine shocks, allowing firms and households to smooth their spending despite fluctuating incomes.

But it also brought a greater vulnerability to large crashes. And the dense international networks on which modern finance rests meant those crashes would cascade through the global economy, amplifying their severity.

At the same time, the likelihood that a crash would be followed by a period in which borrowers drastically cut their spending so as to reduce debt levels meant the resulting downturn risked being exceptionally prolonged, particularly in a low-inflation environment.

It was therefore crucial for governments, regulators and central banks to be vigilant. Unfortunately, they were anything but.

In the US, successive administrations and the Federal Reserve observed an unprecedented rise in property values with an air of benign neglect — when they weren't actively stoking the flames.

Equally, in Britain, which had an asset price bubble of its own, the Bank of England's 2007 Financial Stability Report opened with the immortal statement: "The UK financial system remains highly resilient." As for the European Commission and the European Central Bank, their energies were consumed in a lavish celebration of the euro.

As the markets came tumbling down, it was hard not to see parallels to August 1914. Nor did the subsequent performance of governments, regulators and central banks do much to lessen the similarities. Everywhere billions of taxpayer dollars were squandered in poorly designed programs whose costs vastly outstripped their benefits. It is true that, as Barbara Tuchman put it in *The Guns of August*: "In the midst of war and crisis nothing is as clear or as certain as it appears in hindsight"; but as she also memorably wrote, the "one constant was the disposition of everyone on all sides not to prepare for the harder alternative, not to act upon what they suspected to be true".

To say that is not to deny the obvious differences between countries: for all its faults, the American political system proved more effective than its European counterparts in responding to the crisis, as did the Federal Reserve compared to the ECB.

That helps explain why recovery occurred sooner in the US, and why American per capita GDP is about a quarter closer to potential output than that in the eurozone, whose performance has been even poorer than Japan's. But the Fed and the US Treasury also made errors; if the American economy could shrug them off, it was first and foremost because of the flexibility of its labour market.

As the OECD's latest Employment Outlook finds, had the US been burdened with European-style labour market regulations, the increase in its unemployment rate would have been twice as great, and would have lasted much longer. Instead, the unemployment rate in the US fell below its pre-crisis level last year, while that in the eurozone is still 1.5 percentage points higher, without even counting the millions of Europeans who have abandoned any hope of finding work.

Yet that lesson remains largely ignored, with Labor and the ACTU clamouring for Australia to adopt the very labour market regulations that crippled Europe. The OECD estimates that those regulations would have made our unemployment rate during the crisis a quarter higher than it was. But their real cost going forward would be substantially greater.

After all, the world economy is even weaker and less resilient than it was when the crisis broke. World trade growth has dwindled, as has productivity growth. Meanwhile, debt levels are dangerously high while inflation rates are uncomfortably low. And with all their problems unaddressed, the eurozone and China have merely postponed the reckoning.

The conclusion the great historian Fernand Braudel reached in the final volume of his trilogy on capitalism and civilisation resonates: each major epoch of capitalism, he argued, ends with a burst of financialisation which presages the "unspeakable chaos" that accompanies the transition to a new, structurally different, phase of expansion.

But that new phase seems as remote as ever. Stuck between the past and the future, the next decade could be every bit as dangerous as the last.