From Financial Crisis to Turning Point. How the US »Subprime Crisis« Turned into a Worldwide One and Will Change the Global Economy

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The current financial crisis, progeny of the US mortgage industry, which has been coming upon us gradually since summer 2007,[1] went through a new phase of acceleration and development in early fall 2008. The ensuing stock market crashes and bank emergencies have been the worst since 1929.

This crisis has been labeled »financial« and there is some truth in that, as the securitization process was definitely a key factor. However, the roots of the crisis are far from being purely financial. Rather we are witnessing the collapse of a specific model of capitalism, as well as the breakdown of the post-Bretton Woods international monetary order. The stakes are obviously high and this crisis will be a major turning point in the twenty-first century.

The Nature of the Crisis

The current crisis is in fact a three-tiered process embedded in a particular context. We witnessed a spectacular liquidity crisis between September 20 and October 12, 2008, which was a textbook case of what Keynes termed the »absolute preference for liquidity« and motivated massive state intervention.[2] The liquidity crisis was generated by a global crisis of the financial system and then a general uncertainty concerning sophisticated debt instruments developed over the last ten years through the securitization process. But this global financial crisis has its roots in the credit overextension which developed in the United States and also in the UK, Spain, and Ireland.

1. For a specific analysis, see Sapir, J. (2008): »Global Finance in Crisis,« in: *Real-world Economics Review,* 46 (18) (May), http://www.paecon.net/PAEReview/issue46/Sapir46.pdf.
2. Sapir, J. (2008): »Une décade prodigieuse. La crise financière entre temps court et temps long,« in: *Revue de la régulation,* 3 (2), http://regulation.revues.org/document4032.html.

This credit expansion was the result of structural changes in income redistribution experienced mostly but not only in the US and the UK since the mid-1980s, exemplars of the »neo-liberal« capitalist model.[3] The wage share has declined and corporate profits have surged as inequality of income distribution in the USA has reached levels not seen since just before the 1929 Depression.[4] While the *average* wage increased significantly up until 2006, the *median* wage did not improve at all; it even fell in several »old-industry« US states.[5]

This would have led to economic stagnation with constrained demand, if it had not been for credit expansion. It can therefore be argued that the financial crisis is the result of a model of capitalism that went too far.

The Global Context

The crisis has developed – on three different levels – in a specific context: the dismantling of all residual Bretton Woods principles, ending in a massive international monetary »non-order.« In fact, this is a good place to start in an effort to better understand the crisis (see Figure 1). The monetary non-order, epitomized by the complete freedom of capital movement the US government pursued for decades for both political and economic reasons, led to the 1998 crisis in emerging countries. The inability of the surviving Bretton Woods institutions, the IMF and the World Bank, to check or even manage the crisis[6] led emerging countries, mostly in Asia, to feel that only massive foreign currency reserves could protect them. The logical result of this, in turn, was the implementation by these coun-

3. See Irvin, G. (2007): »Growing Inequality in the Neo-liberal Heartland,« in: *Post-Autistic Economics Review,* 43 (September 15): 2–23, http://www.paecon.net/PAEReview/issue43/Irwin43.htm; M. Brewer, A. Goodman, J. Shaw, and L. Sibieta (2006): *Poverty and Inequality in Britain: 2006*. London: Institute for Fiscal Studies.
4. Pikkety T., and E. Saez (2006): »How Progressive Is the US Federal Tax System? An Historical and International Perspective,« CEPR Discussion Paper No. 5778, CEPR, London.
5. US Congress (2008): *State Median Wages and Unemployment Rates,* prepared by the Joint Economic Committee, table released by the US-JEC (June).
6. Sapir, J. (2000): »Le consensus de Washington et la transition en Russie: histoire d'un échec,« in: *Revue Internationale de Sciences Sociales,* n°166 (December): 541–553.

tries of foreign exchange accumulation policies based on undervalued national currencies and competitive deflation. Restraining their domestic market sharply they turned towards an export-led growth model at a time when the WTO was fostering a new free-trade regime; this enabled Asian emerging countries to implement their mercantilist policies with full effect.

This export-led growth achieved its initial targets. Asian emerging countries' foreign exchange reserves increased considerably, reaching USD 2,734 billion by the end of August 2008. This growth regime led to high savings rates and the emerging countries' policy of attracting investment helped them to enjoy a high rate of labor productivity growth that was not reflected in workers' direct or indirect incomes. As the quality of exports began to rise (Table 1), they exerted a deep wage-led deflationary effect on developed economies, particularly the US economy.[7]

Table 1:
Export Similarity Index with OECD Countries – Development 1972–2005

	1972	*1983*	*1994*	*2005*
Taiwan	0.14	0.17	0.22	0.22
Hong Kong	0.11	0.13	0.17	0.15
Korea	0.11	0.18	0.25	0.33
Singapore	0.06	0.13	0.16	0.15
China	0.05	0.08	0.15	0.21
India	0.05	0.07	0.09	0.16

Source: Schott, P.K. (2008): »The Relative Sophistication of Chinese Exports,« in: *Economic Policy,* 55 (January): 7–40, 26.

Unsustainable Growth in the US

The US economy maintained a high rate of growth by substituting credit – mostly mortgage credit and the now notorious *home equity extraction* mechanism – for labor income. This was helped by a highly pro-active

7. Bivens, J. (2007): »Globalization, American Wages, and Inequality,« in: *Economic Policy Institute Working Paper,* Washington DC (September 6).

monetary policy but also by securitization. In a largely deregulated financial environment[8] securitization helped banks and mortgage brokers to lower interest rates on high-risk mortgages.[9] The cut-throat competition in the mortgage industry was a strong impetus to extend the securitization process to the mortgage industry (with *mortgage-backed securities*).[10]

Mortgages progressively displaced other consumer credit and US household debt reached 100 percent of GDP by 2007, up from 61.4 percent in 1997. Household debt had positively leaped upwards after 1998. Without the *home equity extraction* made possible by the constant increase in home prices between 1990 and 2007, which represented the bulk of the increase in consumption between 2000 and 2007, US growth would have been much lower and would have halted in 2007. Of course, cheap credit helped to boost demand and to increase home prices. The rise of asset prices enabled households to borrow more and more. At the same time, household savings dived to an unprecedented 0.4 percent of disposable income in 2007. Nevertheless, household solvency was not questioned before house prices began to turn down. This was nothing less than a massive instance of Ponzi finance in the US economy. By 2007, US total savings recorded a record low of 13.6 percent of GDP, compared with 23.8 percent in Germany and 20.3 percent in France (not to mention savings rates well over 30 percent in Asian countries).

The consumption-led growth it generated, at a time when labor productivity was falling, explained the huge current-account deficit experienced by the USA from 2000 onwards. The US trade deficit literally exploded, reaching an average of 5.5 percent of GDP between 2004 and 2007. Asian countries used their surplus to buy US debts on a massive scale. This double disequilibrium has somewhat inaccurately been called »Bretton

8. The last step being the Gramm-Leach-Bliley Act of 1999, implemented by the Clinton administration.
9. JP Morgan Credit Derivatives and Quantitative Research (2005): »Credit Derivatives: A Primer,« JP Morgan, New York (January); Ashcraft, A.B. and T. Schuermann (2007): »Understanding the Securitization of Subprime Mortgage Credit,« FIC Working Paper No. 07–43, Wharton Financial Institutions Center, Philadelphia, PA.
10. US Congress (2007): *The Subprime Lending Crisis,* Report and recommendations, US-GPO, Washington, DC (October); see also Li, W. and K. Ernst (2006): »Do State Predatory Home Lending Laws Work?,« Center for Responsible Lending working paper; Bostic, R. et al. (2007): »State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms,« Center for Responsible Lending working paper (August 7), http://ssrn.com/abstract+1005423.

Woods II,« but was intrinsically unstable as it was grounded on unsustainable debt expansion.

European Divergence

European countries too were affected by the wage-led deflation induced by Asian mercantilist policies but in some cases also by EU »new entrants«. However, they were faced with a much more rigid monetary policy imposed by the European Central Bank (ECB), which explained the low growth experienced in the Eurozone.

The single-currency principle was quite problematic for countries with highly heterogeneous production structures, growth in some of which was extremely sensitive to the inflation level[11] in the absence of anything like a large »federal« budget.[12] Economic theory has proved that inflation can actually be *too* low.[13] The zero-inflation consistently targeted by the ECB has had disastrous effects on European economies. Overvaluation of the euro has been estimated to cost the French economy between 0.6 percent and 1 percent of GDP a year.[14] The ECB policy has also contributed to the international monetary disorder leading to the current crisis.[15]

Some European countries – the UK, Spain, and Ireland – responded to the continent's depressed economic climate by emulating the US »neo-

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11. Angeloni I. and M. Ehrmann (2007): »Euro Area Inflation Differentials,« in: *BE Journal of Macroeconomics,* 7 (1), Article 24: 31, http://www.bepress.com/bejm/vol7/iss1/art24; see also Gali, J., M. Gertler, and D. Lopez-Salido (2001): »European Inflation Dynamics,« in: *European Economic Review,* 45 (7): 1237–1270; Conrad, C. and M. Karanasos (2005): »Dual Long Memory in Inflation Dynamics across Countries of the Euro Area and the Link between Inflation Uncertainty and Macroeconomic Performance,« in: *Studies in Nonlinear Dynamics & Econometrics,* 9 (4) (November), http://www.bepress.com/snde.
12. Sapir, J. (2006): »La Crise de l'Euro: erreurs et impasses de l'Européisme,« in: *Perspectives Républicaines,* 2 (June): 69–84.
13. See Akerlof, G.A., W.T. Dickens, and G.L. Perry(1996): »The Macroeconomics of Low Inflation,« in: Brookings Papers on Economic Activity No. 1: 1–59; Andersen, T.M. (2001): »Can Inflation Be Too Low?,« in *Kyklos,* 54, Fasc. 4: 591–602.
14. Cachia, F. (2008): »Les effets de l'appréciation de l'Euro sur l'économie française,« in: *Note de Synthèse de l'INSEE,* INSEE, Paris (June 20).
15. Bibow, J.: »Global Imbalances, Bretton Woods II and Euroland's Role in All This,« in Bibow, J. and A. Terzi (eds.) (2007): *Euroland and the World Economy: Global Player or Global Drag?,* New York: Palgrave Macmillan.

liberal« capitalist model, with a highly developed mortgage system and a finance-led economy. Household indebtedness soared as savings plummeted. They are now among the countries worst hit by the crisis. Germany avoided wage-led deflation by adopting what might be called a neo-mercantilist model. In industry, sub-assembly production was delocalized in EU »new entrant« countries. The famed »Made in Germany« label was progressively replaced by »Made by Germany,« enabling Germany to maintain a huge trade surplus. However, industrial employment fell and household indebtedness increased, which is now a factor in the problems German banks are facing. France and Italy tried to maintain the »classical« European capitalist model through a relatively expansionist public policy, but at the cost of rising public debt.

However, when it comes to total indebtedness – including household, enterprise, and public debt – countries belonging to the »classical« model are not in the worst situation.

Table 2:
Total Indebtedness as a Percentage of GDP, 2006

	France	*Italy*	*Germany*	*Spain*	*United Kingdom*	*USA (2007)*
Household debt	45	39	68	84	107	100.0
Enterprise debt	73	63	57	104	88	76.3
Total household+enterprise	118	102	25	188	195	176.3
Public debt	63	106	67	39	39	65.1
Total	181	208	192	227	234	241.4

Note: Household debt had reached 112 percent of GDP in Spain by fall 2007.
Source: INSEE, ECB, and UK national accounting system.

Global Unsustainability?

The current crisis is the outcome of multiple failures, above all, that of the international monetary system. Had an effective system been in place, Asian countries would not have felt compelled to accumulate huge amounts of FOREX reserves. Second, US credit-induced growth was not sustainable, but neither were mercantilist policies implemented in re-

sponse to the 1998 financial crisis. The US economy could not increase its current account deficit indefinitely, while for Asian emerging economies accumulating FOREX reserves – which had to be sterilized to prevent an exchange rate increase – had significant costs.[16] Third, the ECB followed a policy that directly contradicted the ostensive target of fostering European integration and in fact promoted structural divergence. Last but not least, the neo-liberal ideology that has promoted widespread deregulation in banking and finance has created a system plagued with endogenous instability, a result forecasted by numerous economic theorists.[17]

Highly competitive markets are not necessarily the best coordination tool in the real world. Fostering more competition could be harmful and the 1997–99 crisis showed several cases of *adverse selection* in the banking sector where competition directly led to structural frailty.[18] Even the IMF has finally acknowledged that financial innovation has increased risk without tangible improvements in the investment process.[19]

Table 3:
Annual Current Account Positions (USD Billion)

	Developed countries			*Emerging countries*	
	Total	USA	Japan	*Total*	China
1999	–107.9	–299.8	114.5	37.8	21.1
2005	–431.6	–759.9	165.7	518.0	160.8
2006	–508.8	–811.5	170.4	681.6	250.0
2007	–499.8	–784.3	195.9	684.2	380.0

Source: FMI, *World Economic Outlook,* Washington, DC (October 2007).

16. See Rodrik, D. (2006): »The Social Cost of Foreign Exchange Reserves,« in: *International Economic Journal,* 20 (3): 253–66.
17. Rothschild, M. and J.E. Stiglitz (1977): »Equilibrium in Competitive Insurance Markets,« in *Quarterly Journal of Economics,* 90 (3): 629–49; Grossman, S.J. and J.E. Stiglitz (1980): »On the Impossibility of Informationally Efficient Markets,« in: *American Economic Review,* 70 (3): 393–408.
18. Miotti, L. and D. Plihon (2001): »Libéralisation financière, speculation et crises bancaires,« in: *Économie Internationale,* No. 85 (1): 3–36.
19. For example, a number of »complex and multilayered products added little economic value to the financial system. Further, they likely exacerbated the depth and duration of the crisis,« IMF (2008): *Containing Systemic Risks and Restoring Financial Soundness,* Global Financial Stability Report (April), Washington, DC: 54.

Three major features of the current crisis are making it truly global. The first is the wage-led deflation induced by a combination of Asian mercantilist policies – and to some extent by the German neo-mercantilist policy backed by the ECB's anti-inflation bias – and WTO-sponsored free trade. This has significantly weakened household solvency. Even Paul Krugman, 2008 Nobel prize winner, going back on his previous position, has acknowledged the negative impact of free trade on income distribution in the current context.[20]

The second important feature is the deregulation of international finance. This has accelerated the development of the credit overhang and at the same time has enabled the US economy to contaminate the world. However, even if neo-liberal ideology has played an important role here it must be understood that when credit seems to be the only way to maintain growth, deregulating finance to help credit expansion is almost unavoidable. Indeed, current French President Sarkozy advocated a US-style mortgage system for France before being elected.[21]

The third key feature is the structural divergence developing inside the EU and even inside the Eurozone. It is raising serious concerns about the survival of the euro as a single currency.

Possible Responses to the Crisis

The current crisis will undoubtedly have a deep impact on developed economies. A recession had already begun before the September-October 2008 liquidity crisis and stock-market crash. It will worsen and spread at the very least until summer 2009 and probably until the end of 2009. The decline of real-sector activity will feed back into financial activity. The current crisis is the worst the developed economies have known since the end of World War II and will force governments to adapt their economic policies significantly, thereby reshaping the global economy, with or without any cooperative attempt to build a better and more efficient international monetary order.

20. Krugman, P. (2007): »Trade and Inequality, Revisited« (June 15), http://www.voxeu.org:index.php?q=node/261.
21. See his statement on March 17, 2005 at a UMP meeting, http://www.u-m-p.org/site/index.php/ump/s_informer/discours/intervention_de_nicolas_sarkozy_president_de_l_ump.

The Crisis and Its Consequences

The financial crisis will affect the real economy through a number of channels. The *credit crunch* has so far drawn the most attention because it is the most spectacular development. However, in many countries asset prices (stocks and real estate) have fallen significantly. This will have an important impact due to the wealth effect. Where economies have followed the US neo-liberal model the sheer necessity of rebuilding savings will severely constrain household consumption for the foreseeable future.

The combined product of the end of *home equity extraction* and a massive *negative* wealth effect triggered by the downward plunge of asset prices will greatly depress consumption in the US economy. *Home equity extraction* amounted to three percent of real disposable consumer income by 2005/2006. The sharp fall in home prices erased this source of consumption and the stock market crash has created a huge problem for retirement pension funds, which must be redressed by increasing the shockingly low household savings rate. US GDP will fall by between −2.5 percent and −3.5 percent for at least the next three – and possibly five – quarters.

The Eurozone too is now entering recession. GDP will fall by at least −1.5 percent until summer 2009 at best, with some countries looking particularly vulnerable (Spain and Italy). Even the German neo-mercantilist model is facing a major challenge. In the rest of the EU, the UK will experience a shock very similar to the one in the US and the »new entrants« will fall into deep recession (Baltic States, Hungary, Romania, Czech Republic and Poland). Mediterranean countries linked to the EU – Morocco and Tunisia – will also suffer from the impact of recession.

The serious contraction of consumer demand, already obvious on the car market and in house building, will increase the number of enterprise bankruptcies. Unemployment, which has already increased rapidly in Spain and the USA, will soar across the board, increasing household insolvency when and where unemployment benefits are too low or too restricted in scope.

Enterprise failures will create new »toxic« debt chains inside the banking sector, and the recession induced by the financial crisis will bring about a new stage of bank and insurance company difficulties during winter and early spring 2009. Governments will be compelled to increase the scope of the financial relief programs adopted in the fall of 2008. The

increasing pressure for a large-scale bail-out of the US car-making industry is just one example of this trend.[22]

In the face of increasing economic hardship governments will respond by increasing budget deficits. The most dramatic move will be in the USA; one can expect the FY-2009 budget deficit to reach or even surpass ten percent of GDP. If we add up all probable budget deficit sources, USD 930–50 billion can be added to the USD 439 billion planned deficit. The total US deficit for FY-2009 could well rise to USD 1,370–400 billion or close to 11 percent of GDP.

In the EU, too, budget deficits will increase significantly through a combination of government support for the embattled banking sector and activity-boosting measures. By early November 2008 there was strong opposition, led by Germany and Luxemburg, to a coordinated anti-recession plan at the Eurozone level. This will have very unfortunate consequences.

Budget deficits will not be confined to 2009, however. As the credit expansion mechanism looks disabled for the foreseeable future and economic activity will remain depressed for a significant period, public spending will be the only way of avoiding the current recession developing into a full-fledged depression. A quick estimate of financing needs shows that the US public sector would need to borrow to fund all crisis-related spending between 20 and 25 percent of GDP until 2011. In the Eurozone public sector borrowing needs will be between 12 and 15 percent of GDP. If we add non-financial enterprises' borrowing needs, we could reach 28 to 35 percent of GDP for the US economy and 16 to 21 percent of GDP for the Eurozone.

By any standards this is a massive increase in total debt. As interest rates will not be increased – this would risk killing off the banking sector – funding such a debt increase will be impossible without a significant increase in inflation. This, combined with the strong asymmetry between countries' borrowing needs, will induce wild exchange rate fluctuations in the next 24 months. Although the US dollar improved its position in relation to the euro during summer and fall 2008, as US banks, insurance companies and hedge funds were busy repatriating cash to survive, one can expect a strong reversal of this trend once the debt issue comes to the fore. The direct and indirect consequences of the crisis will be of such

22. Hughes, J. and J. Green(2008): »GM Tumbles to Lowest Since '30s, Ford Falls as Aid Plan Falters,« *Bloomberg.com* (November 20), www.bloomberg.com.

magnitude that significant changes are inevitable in economic policies and institutions.[23]

The Re-regulation of Financial Markets and the *Prudential Illusion* Issue

One of the most obvious changes is certainly the trend towards re-regulating the financial markets. Few voices now openly oppose such a move and defend the old neo-liberal credo. This trend will have two distinct consequences.

The first is a strengthening of prudential regulations for banks and financial institutions. This is certainly much needed, but it would be a mistake to take it for a complete cure. Prudential regulations are designed to act against known risks. However, if risk were fully knowable it could be rationally anticipated and prudential regulations would not be needed. The worst risk is the surprise a totally unexpected event would imply, as the late G.L.S. Shackle would have put it.[24]

Taking risk seriously is indispensable in a world that probabilities cannot fully describe. Prudential regulations are necessarily incomplete and imperfect in the face of events that regulators cannot anticipate. As already mentioned, if such anticipation were possible – in a fully probabilistic world – regulations would not be needed. To this logical paradox, undermining the value of prudential regulations, one must add the effect of preference reversals, a well-established phenomenon.[25]

Prudential regulations are usually grounded on incentives. They assume a given structure of individual player preferences. However, if a »framing effect« ensues when an unexpected event happens,[26] the prefer-

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23. Sapir, J. (2008): »How Far Could the US Dollar Fall?,« in: *Real-world Economics Review,* 47 (October 3): 232–36; http://www.paecon.net/PAEReview/issue47/Sapir47.pdf.
24. Shackle, G.L.S. (1949): *Expectations in Economics.* Cambridge: Cambridge University Press.
25. Slovic, P. and S. Lichtenstein (1983): »Preference Reversals: A Broader Perspective,« in: *American Economic Review,* 73 (3): 596–605.
26. Sapir, J. (2005): *Quelle économie pour le XXIè siècle?* Paris: Odile Jacob: Chapters 1 and 4; Tversky, A. and D. Kahneman (1986): »Rational Choice and the Framing of Decisions,« in: *Journal of Business,* 59 (4), part 2 (October): 251–78 and »Loss Aversion in Riskless Choice: a Reference Dependant Model,« in: *Quarterly Journal of Economics,* vol. 107, n°4/1991: 1039–1061.

ence structure will change, which sometimes makes prudential regulations useless when they are most needed. In fact, prudential regulations have never prevented financial market players from being caught up in a frenzy during bubbles. An important lesson of the current crisis is that public policies must take account of the *prudential illusion,* just as they are now becoming aware of the *efficient market illusion*. The crisis has probably swept away the illusion that markets could be efficient and self-regulating. However, falling into the illusion that prudential regulations could be enough to prevent massive financial and economic disorder might have painful consequences. If the new information theory has clearly undermined the competition paradigm and with it the very idea of spontaneously efficient markets,[27] experimental psychology is now challenging the model of rationality[28] on which the whole theory of economic incentives is grounded,[29] including the assumption that prudential regulations could be enough to curb explosive speculation on financial markets.

The second consequence could be a return to capital flow limitations, especially for high-volatility short-term flows. Introducing some kind of capital controls, coupled with serious limitation of scope for securitization processes undoubtedly harbors the greatest promise for mid- to long-term stability. Various studies prepared by the IMF, whose commitment to capital mobility cannot be contested, show that the real economic value of short-term highly liquid capital asset mobility for economic development has been significantly overstressed.[30] Countries relying less on foreign finance have experienced the highest growth in the long run. Financial globalization has significantly increased the risks for emerging countries without providing the expected benefits.[31]

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27. Stiglitz, J.E.(2002): »Information and the Change in the Paradigm in Economics,« in: *American Economic Review,* 92 (3) (June): 460.
28. Tversky, A.: »Rational Theory and Constructive Choice,« in: Arrow, K.J., E. Colombatto, M. Perlman, and C. Schmidt (eds.) (1996): *The Rational Foundations of Economic Behaviour.* Basingstoke/New York: Macmillan and St. Martin's Press: 185–97.
29. See Ross, S. (1973): »The Economic Theory of Agency: The Principal's Problem,« in: *American Economic Review,* 63 (1): 134–39; and Holmstrom, B. (1982): »Moral Hazard in Teams,« in: *Bell Journal of Economics,* 13: 324–40.
30. Prasad, E., R. Rajan, and A. Subramanian (2007): »The Paradox of Capital,« in: *Finance and Development,* 44 (1); Washington, DC: IMF.
31. Kose, M.A., E. Prasad, K. Rogoff, and S.-J. Wei (2007): »Financial Globalization: Beyond the Blame Game,« in: *Finance and Development,* 44 (1), Washington, DC: IMF.

These positions are now held by authors belonging or close to the IMF. It has been convincingly argued for the last ten years that capital flow controls would be a cheaper and more effective way of enhancing stable growth for emerging economies than financial globalization.[32]

The liberalization of financial markets has certainly been a major force generating instability in emerging economies and has pushed some governments to adopt mercantilist policies for the sake of FOREX accumulation; Jörg Bibow has rightly pointed to the relevance of Keynesian theory on this point.[33]

No one would deny that strengthening prudential regulations is better than relaxing them. But they are not the solution. Questioning financial liberalization and globalization as they have evolved over the last 20 years is probably a better starting point. However, even if some capital flow restrictions are introduced in the coming months, as was done successfully in the wake of the 1998 crash,[34] this would not be enough.

Addressing Wage-led Deflation

Wage-led deflation has played a decisive role in the developments leading to the current turmoil. As household credit will be relatively scarce in the coming months, reversing the profit-friendly income redistribution trend dominant since the 1980s will be the principal cure and the only one able to give developed economies a stable growth path.

However, it would be vain to expect the reversal of this trend and decisive action against wage-led deflation in a free trade environment. One must face the reality that a return to tariffs and protectionist policies is the only way not just of managing the consequences of the current crisis,

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32. Rajan, R. (1999): »Sands in Wheels of International Finance: Revisiting the Debate in Light of the East Asian Mayhem,« Institute of Policy Studies working paper, Singapore (April); Rodrik, D. (1998): »Who Needs Capital-Account Convertibility?,« Essays in International Finance No. 207, Princeton University (May).
33. Bibow, J. (2008): »The International Monetary (Non)-Order and the ›Global Capital Flows Paradox‹,« Levy Economics Institute Working Paper No. 531 (April); Annandale-on-Hudson: The Levy Economics Institute.
34. Mel'nikov, V.N.: »Voprosy valyutnogo regulirovaniya i valyutnogo kontrolya v period finansovogo krizisa,« in: *Den'gi i Kredit,* 12 (December): 36–42; Sapir, J. (2000): »Currency and Capital: Controls in Russia – Why and How to Implement Them Now,« in: *Studies on Russian Economic Development,* 11 (6): 606–20.

but of preventing the developed economies from sinking into a long period of low growth and high unemployment. Tariffs must be designed in such a way as to prevent countries whose labor productivity and export sophistication are converging on those of the advanced industrial countries, but whose social and environmental regulations fall far short, from engaging in social and environmental dumping, the brunt of which would be borne by the advanced countries.[35]

Clearly, such a protectionist policy would not target the poorest of the developing countries. It can be argued that WTO-sponsored free trade has actually been detrimental to the latter.[36] If we remove China from the »developing countries« category, free trade is no longer generating benefits but global costs.[37]

It should also be understood that the relationship between free trade and development has been grossly exaggerated in the mid- and long-term perspective.[38] The argument that tariffs deepened the 1929 depression is counterfactual.[39] International trade collapsed in the early 1930s not because of protectionism but because international liquidity was brutally squeezed when banks collapsed one after the other and because no international institution could provide back-up for countries facing a huge foreign exchange or gold shortage.[40] Bilateral trade agreements actually helped to rebuild a limited amount of foreign trade. After 1945, interna-

35. This has already been advocated in Sapir, J. (2006): *La fin de l'euro-libéralisme.* Paris: Seuil.
36. Sapir, J. (2007): »Libre-échange, croissance et développement: quelques mythes de l'économie vulgaire,« in: *Revue du Mauss,* 30. Paris: La Découverte: 151–71.
37. Ackerman, F. (2005): »The Shrinking Gains from Trade: A Critical Assessment of DOHA Round Projections,« Global Development and Environment Institute, Working Paper No. 05–01, Tufts University, Medford, MA (October).
38. Bairoch, P. and R. Kozul-Wright (1996): »Globalization Myths: Some Historical Reflections on Integration, Industrialization and Growth in the World Economy,« UNCTAD Discussion Paper No. 113, Geneva (March); Clemens, M.A. and J.G. Williamson (2001): »A Tariff-Growth Paradox? Protection's Impact on the World around 1875–1997,« Working Paper, Center for International Development, Harvard University; Cambridge, MA (August).
39. Estevadeordeal, A., B. Frantz, and A.M. Taylor(2002): »The Rise and Fall of World Trade, 1870–1939«, NBER Working Paper Series, National Bureau of Economic Research, Working Paper 9318; Cambridge Ma., (November); http://www.nber.org.papers:w9318.
40. Foreman-Peck, J.(1995): *A History of the World Economy. International Economic Relations Since 1850*. New York: Harvester Wheatsheaf: 197.

tional trade developed rapidly in a fairly protectionist global environment because the international liquidity issue had been partially addressed by the Bretton Woods system, but in fact much more effectively in Western Europe by the European Payments Union.[41]

With Barack Obama's election as the new US President, a return to tariffs now looks extremely probable, as was forecasted some years ago.[42] The real issue now is to understand how it could be implemented at the EU level.

Returning to an effective »common import tariff,« as was the rule in the »Common Market,« would be a first step. However, in the wake of enlargement social and environmental dumping are now taking place inside the EU itself. As a provisional system before more effective decisions are taken on social and economic convergence, the »monetary compensatory amount« used in the 1960s and 1970s should be revived. It could be used to increase the common EU budget – enabling the implementation of large development projects – and would prevent the development of neo-mercantilist policies inside the EU.

What New Monetary Order?

The analysis of the roots of the crisis presented in this article highlights the responsibility of the current international monetary non-order in the process. There is no doubt that a deep and far-reaching reform of the monetary order will be a condition of getting out of the crisis and finding a new stable growth path.

Huge debt accumulation and inflationary trends as a consequence of the crisis will induce such volatility on currency exchange markets that the current situation might become unbearable relatively quickly. However, the road towards a »new Bretton Woods« is fraught with difficulties.

Clearly the best option would be an international monetary system modeled closely on the ideas espoused by Keynes around 1942 to 1945

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41. Kaplan, J. and G. Schleiminger(1989): *The European Payments Union – Financial Diplomacy in the 1950s.* Oxford: Clarendon Press; Triffin, R.(1957): *Europe and the Money Muddle – From Bilateralism to Near-convertibility, 1947–1956.* New Haven/London: Yale University Press.
42. Sapir, J. (2006): »Retour vers le futur: le protectionnisme est-il notre avenir?,« in: *L'Economie Politique,* 31 (3).

and combining restraints on mercantilist policies, symmetric and balanced international liquidity, and wide political scope for national economic policies aiming at full employment.[43] But it is improbable that the US government, even under the new administration, will accept principles likely to restrict the power of the dollar, at least in the short run. Even among EU members the idea of introducing capital flow restrictions will meet with resistance. In this context it is reasonable to expect a period of turmoil and unstable regional alliances before a truly global solution can be implemented.

This raises the issue of the euro's ability to survive. As inflationary pressures grow as a consequence of the crisis, the asymmetrical effects of ECB policy on Eurozone members will become more and more unbearable. Note that if restrictions on short-term capital flows return to fashion, as one might expect, the relevance of the Eurozone for interest rate harmonization will decrease significantly.

The euro would not necessarily become obsolete, however. It could survive very effectively by evolving from the *single currency* we currently have, which probably may not survive the current crisis,[44] into a *common currency* on the pattern of Keynes's BANCOR, into which all European currencies would be convertible. Regulated exchange rates would then be adjusted every six to 12 months to prevent the accumulation of structural current-account surpluses or deficits and to cope with diverging inflationary trends induced by the different growth to inflation sensitivities of individual European economies.

The ECB's status would have to be completely redefined and full employment and financial stability introduced as key targets on a par with the reduction of inflation. As the ECB has already been seriously burdened with »toxic« assets since the beginning of 2008 it is unavoidable that the Central Bank's independence principle will be called into question in the near future when Eurozone governments will have to recapitalize the ECB. In fact, the independence principle does not have a sound theoretical basis.[45] Such a development would be a considerable and even traumatic

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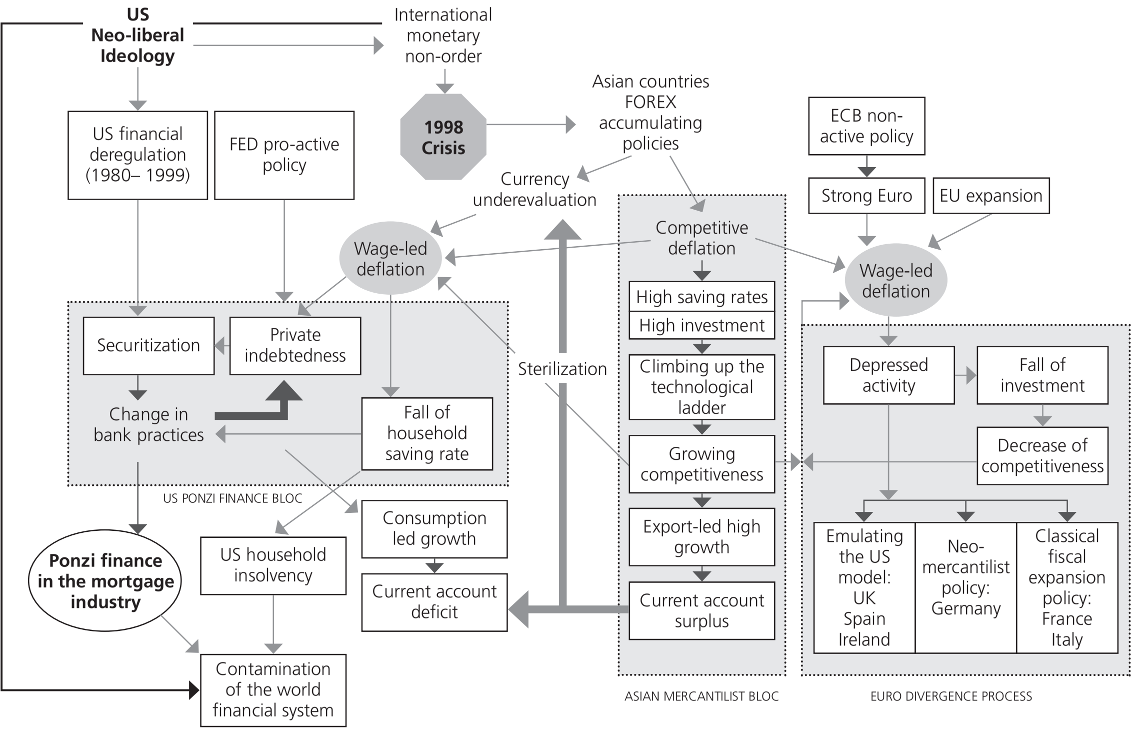
43. Bibow, J.: »The International Monetary (Non)-Order and the ›Global Capital Flows Paradox‹,« op. cit.
44. Sapir, J.: »La Crise de l'Euro: erreurs et impasses de l'Européisme,« op. cit.
45. Wray, L. Randall (2007): »A Post-Keynesian View of Central Bank Independence, Policy Targets, and the Rules-versus-Discretion Debate,« Levy Economics Institute Working Paper No. 510. Annandale-on-Hudson: The Levy Economics Institute (August).

Figure 1



change. The alternative, however, is an exit strategy for some countries that would lead to the complete dissolution of the Eurozone. Evolving from a »single currency« to a »common currency« is probably the only way of keeping the euro alive, even if under a radically different system.

This new European Monetary System, combining the euro as a common »supranational« currency and national currencies, would be a regional variant of what Keynes proposed at Bretton Woods. It would be better suited to stabilizing growth and trade at the continental level and would provide greater flexibility in coping with huge macroeconomic shocks. Backed by a renewed European Payments Union and a new European Investment Bank it could be a decisive innovation to foster stability and growth.