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The Global Financial Crisis and the End of the Free Market

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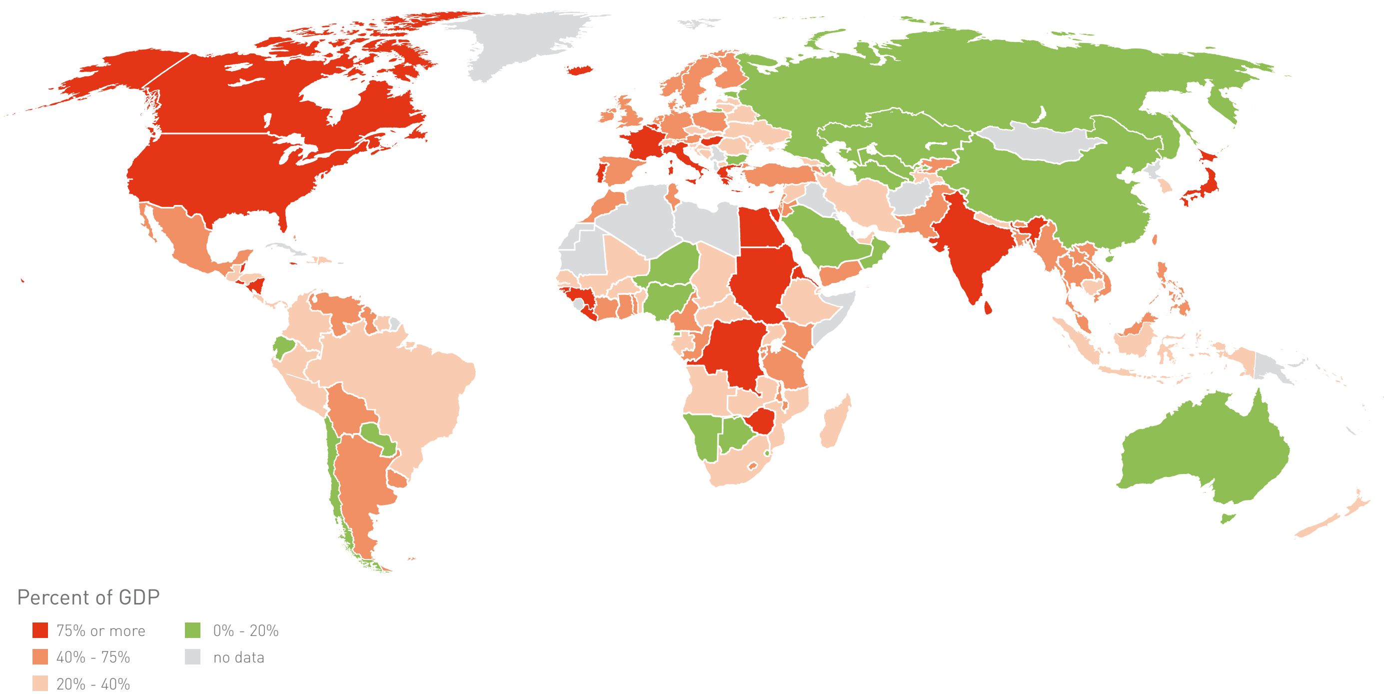
Introduction

The global financial crisis has thrown the global economy into chaos and shattered confidence in the free-market ideology, its ruins visible everywhere: mighty financial institutions tumbled, real estate value plummeted, and stock markets plunged. Yet not only have banks and private corporations failed, but many states have also run into major economic and financial problems. From east to west and north to south, economic indicators show that states have been struggling to cope with the financial crisis and economic recession (see figures 1 & 2), with real GDP growth declining sharply, government debts soaring, currencies depreciating, and national reserves becoming depleted. The list of casualties includes both developed and developing countries.

In the US, the world's largest economy, economic growth contracted drastically, with growth in real GDP falling from 2.7% in 2006 to -2.4% by 2009 and unemployment rising from 5.7% in 2007 to 9.3% in 2009. The euro area fared equally badly as real GDP fell from 2.6% in 2006 to -4.1% by 2009 and unemployment jumped from 7.4% in 2007 to 9.4% in 2009. Economic hardship and political unrest have been felt palpably in highly indebted countries, such as Greece and Ireland. The gravity of the debt crisis and fear of its spread to other European countries have even brought the viability of the euro into question. In the developing world the impact of the crisis was felt in places such as sub-Saharan Africa, where growth in real GDP declined from 6.5% in 2006 to 2.1%

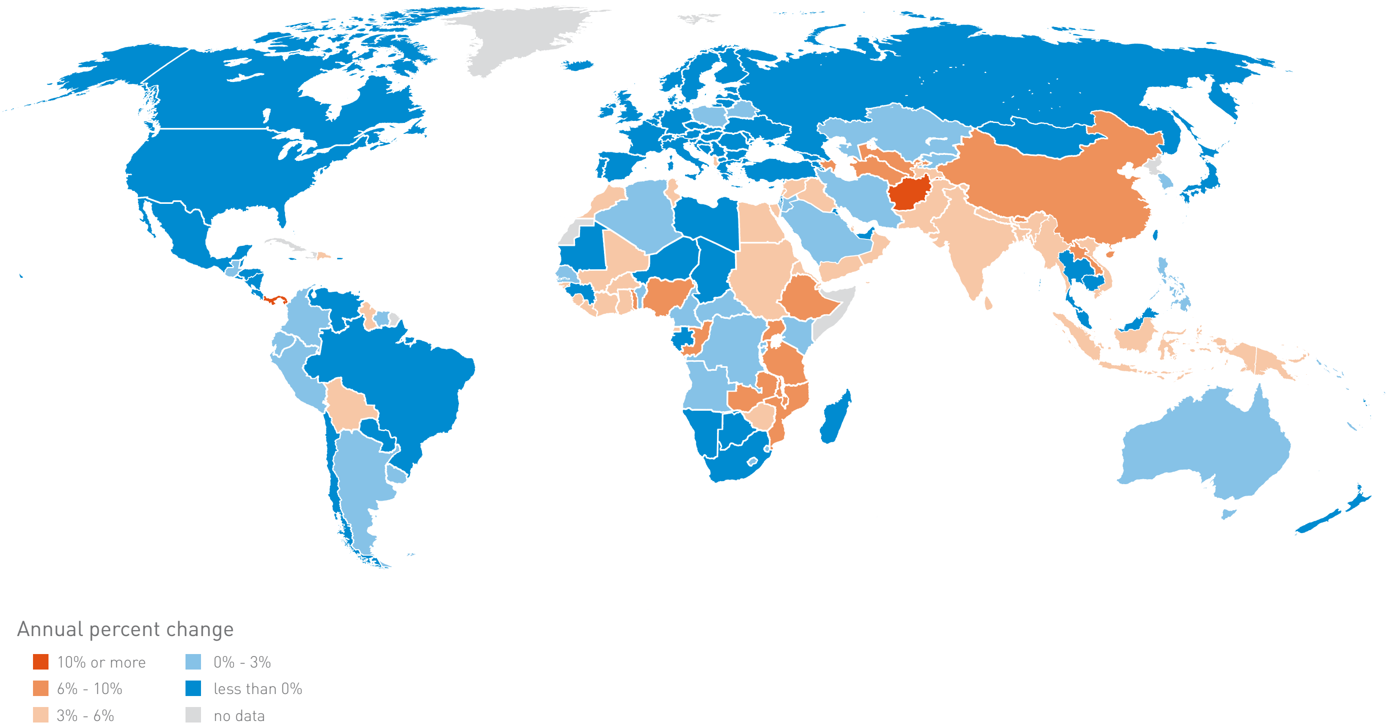
MEDIAN DEBTS (2009)



Source: IMF Data Mapper ®, based on: Fiscal Affairs Departmental Data.

Figure 1: Debt as percentage of GDP

REAL GDP GROWTH (2009)



Source: IMF Data Mapper ®, based on: World Economic Outlook (October 2010).

Figure 2: Annual percentage change in GDP

in 2009, as well as South America and Mexico where real GDP fell from 5.4% in 2006 to -1.9% in 2009. To avert a financial meltdown, address unemployment, and pull the economy out of recession governments have responded with loose monetary policy (including quantitative easing and cuts in key interest rates) and large fiscal incentive packages.

Whether the liberal economic system can be resurrected from the ashes of the financial crisis or will be replaced by a system of state control is an urgent issue facing leaders around the world. What is certain is that the financial crisis has prompted major economic and political changes. It has cast doubt on the future of pro-market ideology, halted, if not reversed, the reduction of trade barriers, prompted state capitalism and resource nationalism, and has hastened a shift in the international political order.

Economic Model

The era of neoliberal market reforms ushered in by US President Ronald Reagan and the British Prime Minister Margaret Thatcher has been dominant for nearly three decades. By promoting deregulation, privatization, and trade and financial liberalization, Reagan and Thatcher unleashed unfettered market forces which spread around the globe. These forces came to a crashing halt with the eruption of the financial crisis in 2008. The magnitude and the spread of the crisis have shattered confidence in the pro-market model.

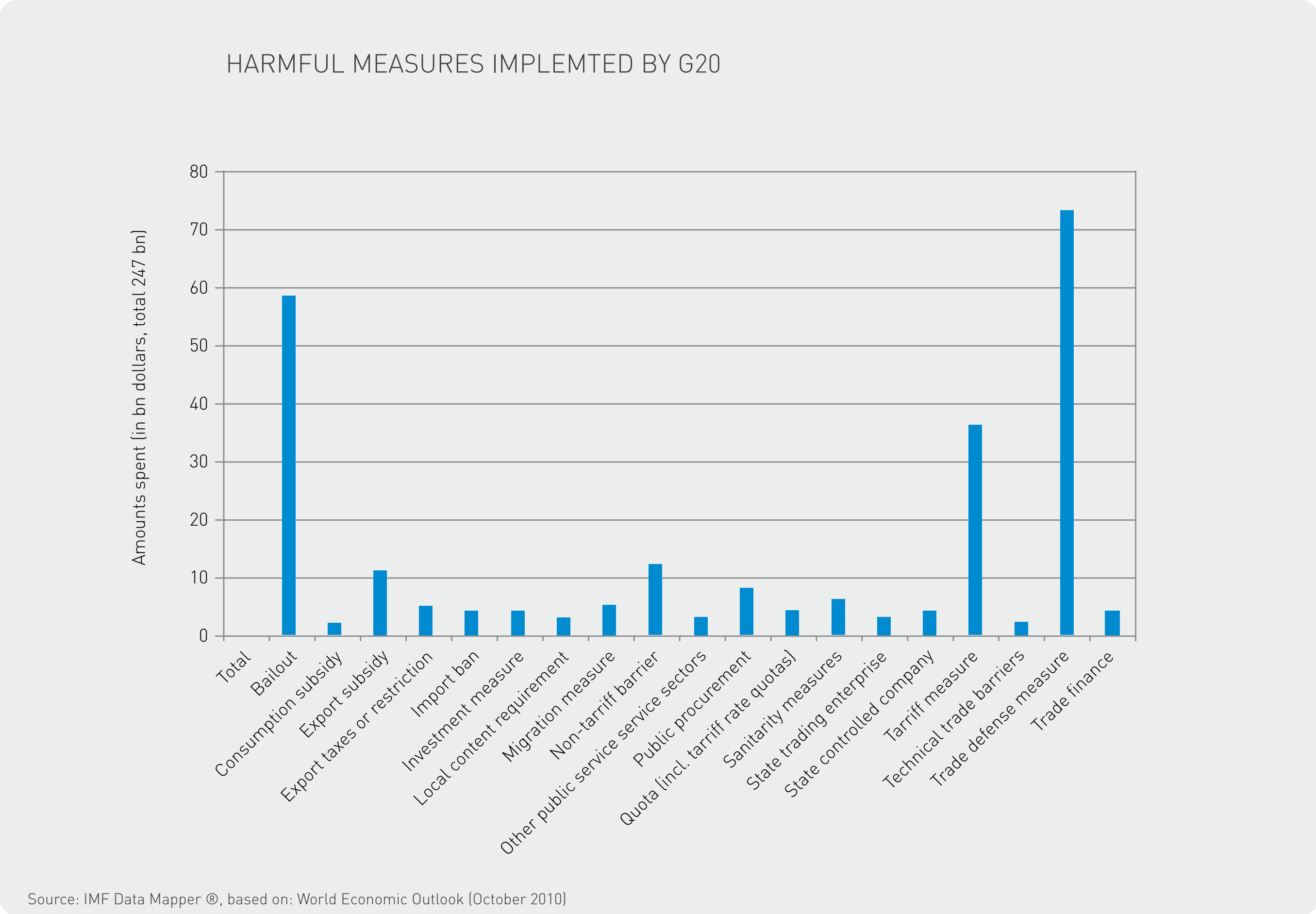


Figure 3: Protectionist measures

Countries that have long benefited from the free-market dogma are now questioning the conventional wisdom of the invisible hand, reversing established liberalization and privatization trends. Even the most outspoken and respected defender of deregulation and liberalization, Alan Greenspan, Chairman of the U.S. Federal Reserve for eighteen years, conceded the errors in a congressional hearing. Meanwhile, a new economic ideology has gained popularity around the world. The "Beijing Consensus", China's authoritarian model of economic growth, is now being seen as an alternative to free-market ideology (see *WFF Beijing Consensus Issue Brief*).

Trade Protectionism

Economic insecurity and current account imbalances have sparked various forms of export restriction and currency manipulation. According to Global Trade Alert, G20 members announced or implemented 390 trade-damaging measures (like subsidies, tariff and non-tariff measures, and stricter trade regulations) between November 2008 and December 2009 (see figure 3). Equally alarming are restrictions and embargos on important commodities.

In September 2010 China imposed a rare-earth element embargo on Japan. One month later, it announced that it

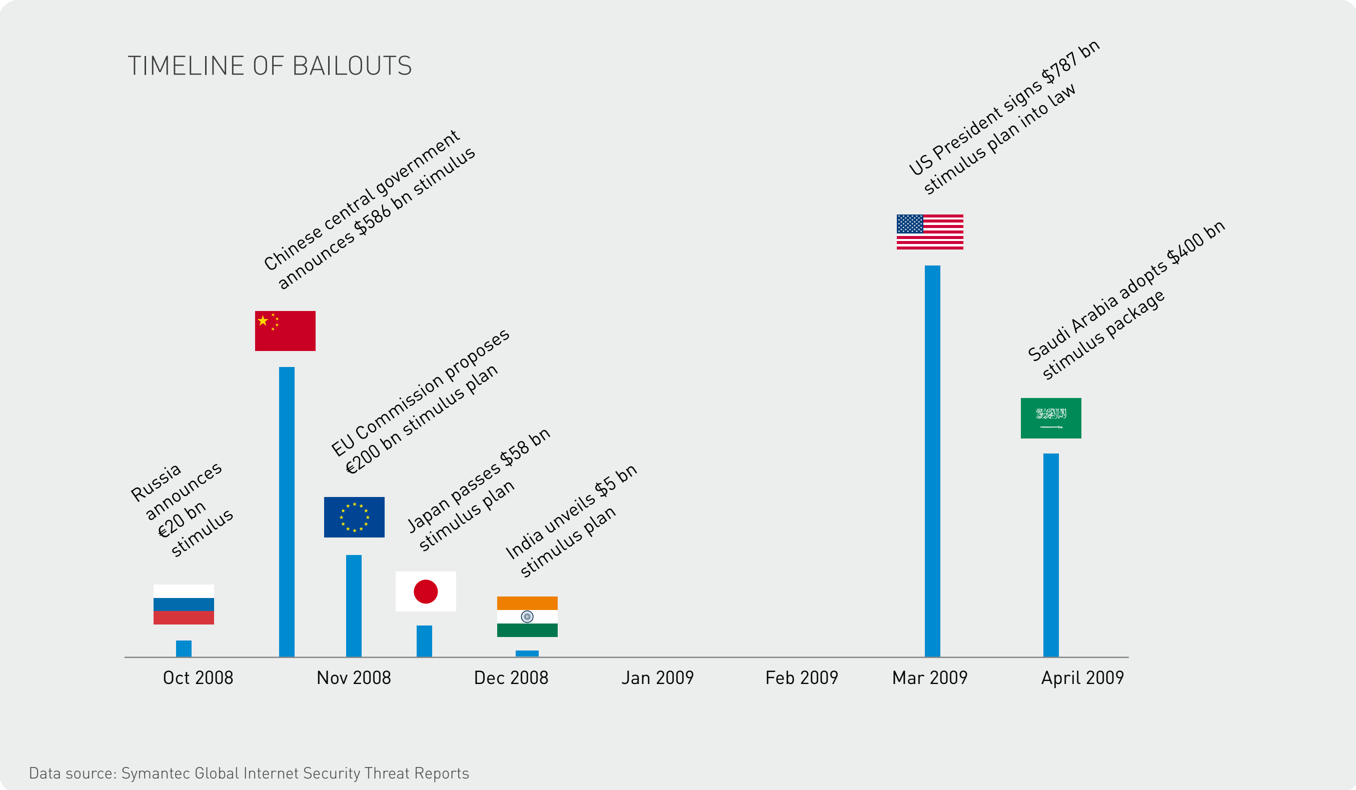


Figure 4: The largest bailouts

would be halting shipments of some rare-earth elements to Europe and the US. Given that China mines 95% of the world's rare-earth elements, curtailment of Chinese supplies would inevitably cause major challenges for many industries that rely on these elements, such as green-energy and military technologies as well as high-tech electronics. Similarly, Russia banned grain exports in the summer of 2010. Trade protectionism has also been manifested in disputes over currency valuation. A currency crisis has flared-up on the heel of the financial crisis.

At the heart of the currency dispute is China's undervaluation of its currency. Despite mounting pressure, China has refrained from letting the value of the Yuan float on the world market. By the same token, the US faced criticism for its loose monetary policy of "quantitative easing." Recently, Zhou Xiaochuan, the governor of China's central bank, called for the creation of an international reserve currency. Emerging market economies have also intervened in markets to ensure their currency does not appreciate due to strong capital inflow.

State Capitalism and Resource Nationalism

While the free-market ideology has triumphed in liberal democracies, government intervention in the market has flourished in non-democracies for decades. However, as a result of the financial crisis, democratic and non-democratic government intervention in markets has increased dramatically (see figure 4). Not only has the taboo against government intervention been broken in liberal democracies but also emerging economies

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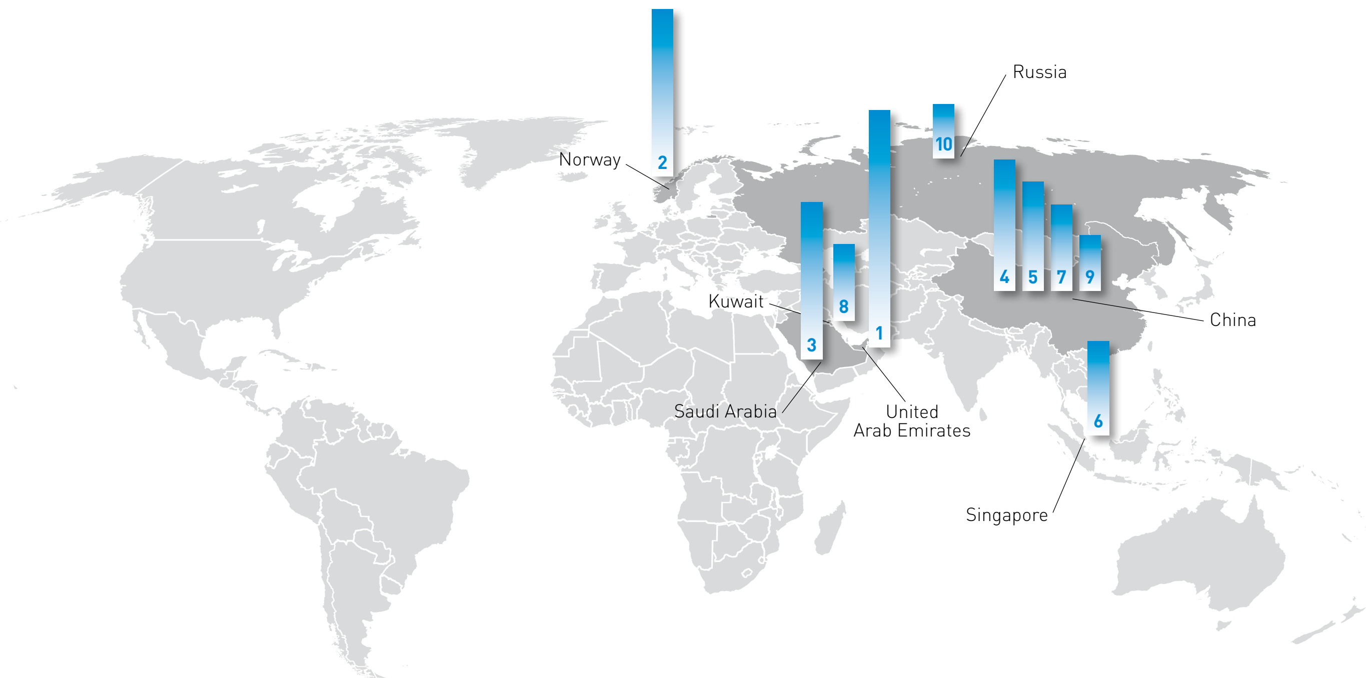
TOP 10 SOVEREIGN WEALTH FUNDS



1. Abu Dhabi Investment Authority ....$627 bn
2. Government Pension Fund ....$442 bn
3. SAMA Foreign Holdings ....$415 bn
4. SAFE Investment Company...$347.1 bn
5. China Investment Corporation..$288.8 bn
6. Government of Singapore Investment Corporation ....$247.5 bn
7. Hong Kong Monetary Authority Investment Portfolio ....$227.6 bn
8. Kuwait Investment Authority..$202.8 bn
9. National Social Security Fund ....$146.5 bn
10. National Welfare Fund ....$142.5 bn

Figure 5: Top sovereign wealth funds

have increased government ownership of enterprises and management of financial resources. In advanced economies governments have fully or partially nationalized troubled banks and companies. The US government took over Fannie Mae and Freddie Mac, and the US Treasury invested $182 in AIG alone and more than $200 billion in hundreds of banks and the auto industry. Many European countries acted in similar fashion, for example, banks nationalization in Iceland, Spain, Belgium, the Netherlands, and the UK.

State ownership of enterprises also increased because sovereign wealth funds (SWFs) have increased their investments in a wide range of assets. Over the last year the amount of wealth accumulated by the growing number of SWFs have risen and continues to grow. According to IMF estimates, the holdings of SWFs in 2007 amounted to $2-3 trillion and are estimated to reach $10 trillion by 2012. Recent investment deals and bids include Kuwait's wealth fund investment in the French nuclear energy group, Areva, Qatar's wealth fund bid for Sainsbury, and the Chinese sovereign wealth fund's investment in Noble Group. Daimler, Barclays, Citigroup, the Chrysler Building, and Manchester City are examples of the variety of investments pursued by SWFs (see figure 5). In some sectors, state-owned enterprises are the dominant players. For example, energy where not a single multinational oil company is in the top 10. State-owned companies dominate the energy market. Top companies include Saudi Armco, Gazprom (Russia), China National Petroleum Corporation (CNPC), National Iranian Oil Company (NIOC), Petróleos de Venezuela (PDVSA), Petróleo Brasileiro (Petrobras), and Petronas (Malaysia). Collectively the top 14 national oil companies control 77% of the world's oil proven reserves.

Political Turmoil and Realignment

Not only have the economic recession and financial crisis crippled advanced economies, they have also weakened their relative political power in the international system and accelerated the arrival of a multi-polar order. High unemployment rates, austerity measures, and rising poverty have fueled public discontent in many western democracies. In Europe, the debt crisis has bankrupted the political legitimacy of highly indebted countries and raised serious concerns about the viability of the euro. Protests erupted across Europe, including Spain, Ireland, Italy, Greece, Portugal, and France. Many analysts believe the financial crisis has dealt an irreparable blow to US political leadership. Because of large budget deficits, western governments cut military budgets. For example, the US government announced plans to cut its military budget by $150 billion in the coming years. Similar measures have been taken in the UK, Italy, France, Germany, and the Netherlands.

Meanwhile, the newly emerging economic powers of Asia have become more significant players in international affairs. For example, China is increasingly playing an important role in Africa and Asia, and has vowed to support economically distressed European countries such as Portugal and Greece. In many developing countries, the Beijing Consensus is seen as a viable alternative to the once dominant Washington Consensus. Furthermore, because of its massive holdings of US Treasury securities, China has gained a new form of political leverage over the US. In general, the shift in economic power implies a change in the nature and direction of economic statecraft: while western countries have been in the forefront of using economic instruments for political or security purposes, the newly emerging powers are now well-positioned to apply similar economic pressure on western countries.

The New Approach

No doubt the financial crisis has shattered confidence in the pro-market orthodoxy, accelerated a shift in economic power from west to east, and challenged the primacy of western influence. Consequently, it has prepared the ground for countries to raise trade barriers, adopt parochial and uncompromising economic policies, and resort to power politics. However, history suggests that such measures will only strangle economic growth and trigger political tension and conflict. To return to prosperity and ensure political stability, emerging economies and western powers need to embrace global solutions. To that end, governments must forge an agreement on the next steps: first, strive to strike a balance between implementing the necessary reforms, especially in the financial sector, and upholding the free-market principles; second, make use of the G20 and other high-level venues to address and resolve outstanding global challenges such as trade imbalances, the role of the dollar, and currency intervention; third, resist recourse to "beggar thy neighbor" policies and, instead, seek consultation and coordination with each other; and, finally, strengthen the supervision and monitoring role of international organizations, such as the WTO, the IMF, and the World Bank.

This publication is part of a series of WFF Issue Briefs that offer background information on themes to be addressed at the World Foresight Forum. The Issue Briefs aim to inform and stimulate the debate on global challenges. The views and opinions expressed here are those of the authors and do not necessarily express the official views of the WFF or any of its speakers or sponsors.

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