Not yet over: 2008

I had only just started as editor in chief of VBA Journaal when the credit crisis ('the global financial crisis') erupted. This event had a huge impact on both my professional life and my personal life. The investment funds that I oversaw were at risk of collapsing, banks were being held afloat with all sorts of buoyancy aids and the media were asking me to explain all this. My children, who were still very young at the time, wondered whether cash machines would continue to dispense money and whether their grandparents' pensions were safe. My own portfolio halved in value. Through robust government intervention, the problems were controlled relatively quickly.

The most common explanation for the credit crisis is that the neoliberal market system failed. The fact that the markets – and especially the financial sector – were given a free rein, made it possible for lending to grow unconstrained. US families in particular, took on huge amounts of debt in order to maintain their spending behaviour. The mortgages that were granted – including sub-prime loans – were converted into tradable bonds. When the crisis erupted the risks were not clear – how large they were and who was exposed to them. Everyone – investors, supervisory authorities and the man in the street – was in the dark. As a result, the market collapsed and in a number of countries there were long queues of people outside closed bank branches and empty ATMs. If you would like to relive all this, just watch *Boom Bust Boom*.

Advancing insight

As time went on, my view on this crisis and its causes changed. I have come to the conclusion that the one-sided view on those causes needs to be revised. Is the neoliberal market system indeed the only cause, or were there more complex underlying reasons?

The1980 structure break

The credit crisis happened almost 30 years, after the big change in course that took place in the early 1980s, when the central banks in the Western world, led by Paul Volcker, took unprecedently tough measures to end the stagflation of the 1970s. By means of draconic interest rate hikes they forced a deep recession, which caused unemployment to rise sharply. This shock therapy proved remarkably effective. The power of the labour unions was broken, and consequently wage rises did not keep up with inflation. The lower rate of inflation allowed bond yields to come down, also in real terms. This allowed companies to start investing in their businesses again. The modest wage trend led to a recovery of corporate profits, which caused share prices to rise. All this resulted in an exuberant development of financial sector: the value of financial assets rose sharply. No price inflation, but asset inflation.

But that was not the only change. In many Western countries, governments withdrew from various sectors. Several sectors, including telecommunications, airlines and also banking, were liberalised. Meanwhile we also saw far-reaching global integration of the real sector ('main street'). Companies in the Western world transferred their production activities to emerging countries. This enabled them to control wages even more effectively and indirectly also eroded the power of the labour unions even further. The internationalisation of the corporate sector – particularly the financial sector – further weakened the grip that governments and regulatory authorities had on companies with international operations. This had various consequences. One example is the emergence of large platform companies, that operate worldwide and are very good at reducing their effective tax rate by means of fiscal arbitrage. The banking sector also got better and better at arbitraging against the supervisory rules. The rapid growth of securitisation allowed a rapid expansion of lending, evading the pressure of solvency supervision. The national regulators increasingly lost their grip on financial institutions. A good example is that in early 2008, when the first large cracks in the financial system and also in the real world were already clearly visible, ING pressured DNB to allow it to repurchases shares. This would reduce the bank's solvency, which DNB had issues with. But because ING threatened to leave the Netherlands, DNB nevertheless agreed. A few months later, ING had to ask the Dutch government for support.

Due to the rapid growth of lending that preceded the credit crisis, combined with the rising value of financial assets, the financial sector came to represent an increasingly large section of the economy. In its assessment of the credit crisis, the Netherlands Scientific Council for Government Policy refers to the concept of 'too much finance'. In the Western world, a structural discrepancy in the balance between the real economy and the financial sector developed. Governments did little to address this. They did not impose stricter solvency requirements and neither did they take steps to address the tax benefits of taking on debt, and continued to facilitate

pension accrual. Every country, its government and its people, took pride in its growing and increasingly international financial system. Companies took full advantage of this competition between financial centres.

The mistakes of 2001 and what went before

In early 2001 several events occurred that culminated in the credit crisis. In the course of 2001 the Internet hype came to a painful end. Share prices fell over 50%. The share price falls were reinforced when news about a series of frauds at large companies emerged. But these problems faded into insignificance compared with the disastrous impact of events such as the destruction of the twin towers on September 11. The authorities had little choice but to cut interest rates. Especially in order to control short-term panic, they had to use the interest rate instrument to calm things down. This is what they had learned during the previous, brief, financial crisis at the time of the implosion of Long Term Capital Management in 1998. The so-called Greenspan put had become a 'magic tool'. Greenspan also saved the system after Black Monday in 1987.

Combined with other policy errors, the deployment of the interest rate weapon also had some very negative side effects. The low interest rate level resulted in a sharp increase in lending. This rapid expansion was possible because the sharp increase in credit demand could be met by means of tradable mortgages. This form of lending took place within a barely regulated circuit of shadow banks, relying on the risk models of the banks and those of rating agencies. Their effectiveness was not tested by the authorities and was based on limited historical data. In hindsight, these models were seriously flawed. For instance, the risk of a systemic crisis was not taken into account and neither were assessments adjusted for changes in economic conditions.

Especially the US government was a major contributor to the credit explosion. Owing to a generous system of credit guarantees, low income groups and borrowers with little security also got access to mortgages. This resulted in risky behaviour by all parties involved. Financial institutions generously provided loans, because the government would foot the bill. Borrowers took on huge loans, because in case they defaulted they would be able to transfer their asset to the bank. Society became the big loser.

The policy mistake of 2001 was that the authorities assumed that spending would recover if household expenditure was boosted by cutting interest rates. It would have been better if instead something had been done to address the eroded income position of households. The chosen policy option ignored the fact that families had little or no financial resistance. Quite the opposite in fact, as they were being seduced to take on even more risk. Of course bankers behaved reprehensibly by providing virtually unlimited credit, but it was the government that made that very easy for them.

The government keeps coming to the rescue

Even when in 2008 the crisis had become reality, the government played a remarkable part. In most Western countries large-scale bailouts took place. In the US as well as in Europe, central banks and governments threw the financial sector some costly lifelines. This was a classic case of 'Privatizing Profits and Socializing Losses'. Time and again, the government has acted as the ministering angel and even kept paying bankers' bonuses.

Whoever thought that after 2008 we would have learned our lessons, will be disappointed. After 2012 central bankers and governments again proved willing to come to the rescue the financial sector. Greece, despite years of deceit, was effectively bailed out. The ECB is prepared to add the debts of defaulting European countries to its balance sheet. This rewards the refusal of various countries to restructure their economies and once again we are saving the financial institutions. Even during the Covid crisis, the government stepped into the breach, although the nature of the crisis made this inevitable. But the current energy crisis again forces the government into its role of ministering angel. The cost of the shocks is largely being borne by society. Partly because in the wake of a crisis, a rapid rollback of the measures taken, including a rapid reduction of repurchase programmes, proved and is still proving difficult for political and institutional reasons. *If you press down hard on the accelerator, you must also be prepared to brake very quickly and very hard.*

Are the problems that we are currently facing really only due to the neoliberal policy model? This view is too one-sided, because there is more at play. The government applied too little counterforce 40 years ago, when it set out on the path of liberalisation. The position of workers was allowed to become increasingly marginalised. Not enough was done to stop fiscal arbitrage by multinational companies and the financial sector was given too much leeway. Taking on debt was and remains attractive and too little is done to address the risks of excessive debt.

Local governments do not provide counterforce

The lesson of the financial crisis that we have still not learned is that the government has insufficiently redefined its role. Liberalisation and stimulating a free market system do not mean that the market can do as it pleases. The government needs to set clear rules and, especially, enforce these. That is not happening now, which has left the government at the mercy of the market. Consequently, there is a growing need for governments to take coordinated action. This will need to be done with regard to financial sector policy, but also in the areas of climate and fiscal policy. Local governments are not able to effectively address the global problems. Global problems demand a global approach. It is time for society to reassume the position that it has lost.

My personal observation is that the great crisis has eroded society's trust even further. Despite all the support measures, voters mistrust institutions and polarisation is increasing. For 40 years, soulless and uninspired policy has been pursued. It is high time for a coherent view of our society. If not for ourselves, let's at least do this for our children.

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