CHAPTER 6

GLOBALIZATION AND THE CURRENT CRISIS

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Prime Minister Gordon Brown is fond of saying that the current crisis for the British economy originated as an offshoot of the sub-prime debt problem that erupted in the United States. Although this claim seems a bit like the “Not me guv, nothing to do with me,” line taken by accused villains, there is some truth in it. To understand how far it is true it is necessary to take into account the way in which the current recession differs from previous recessions, specially the two most recent ones in the early 1990s and the 1980s. What is not different is that like the recession of 2007–2008, both these recessions had a worldwide coverage. They were recessions of a globalized world economy. This was so even when, as with the bursting of the dot.com bubble, the United States was the leading driver of the downturn. The typical story of past recessions is that a booming economy displays increasing indications of inflation. Central banks raise interest rates, bubbles burst, and economies go into recession. This soon moderates inflation and recovery follows after two or three years. The 2007–2008 recession deviates from this typical story. At its start inflation was not high; it was at an unprecedented low level. There were bubbles, notably in stock
markets and in housing markets, but this is now more obvious with the benefit of hindsight than it was at the time. This was inescapably a globalized world. China, if the name of a leading international player can serve as a short-hand for broader influences, was making its influence felt on rich countries. Cheap imports of manufactures were bearing down on inflation in these countries despite their high levels of capacity utilization. Responding to low inflation central banks cut interest rates and real interest rates were low. Add to this the downward pressure on wage rates in industrial countries that Chinese competition imposed (with help from the bias of technical change), and it is no surprise that corporate profitability was at the highest level seen for forty years.

Hubris and Regulation

The developments described above led many, who were by no means stupid, to think that a structural change had taken place that made the seemingly impossible perfectly sustainable. Apparently unending economic growth combined with low interest rates was seen to justify booms in housing markets (in Ireland, Spain, the United Kingdom, and to a lesser extent in the United States). The high corporate profitability projected forward made equities seem reasonably priced when they were actually expensive. Financial institutions were released from regulatory leashes, and the results seemed to be only positive. The private sector boomed, profits seemed to be enormous, and the tax revenues that followed were pleasing to governments. Capital markets seemed to work with great efficiency, and large-scale borrowing supported by loose collateral was commonplace. Hedge funds, private equity and gearing were high fashion. The new situation generated new institutions. Northern Rock was a new kind of building society, a bank, in that it relied mainly on the wholesale capital market for its loan funds. And it competed aggressively, offering better terms than its competitors, including cash-back deals that meant that loan to value ratios could be as high as 120 percent. All this was on Gordon