The global financial crises

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PUBLISHED BY THE MONTHLY, FEBRUARY 2009

From time to time in human history there occur events of a truly seismic significance, events that mark a turning point between one epoch and the next, when one orthodoxy is overthrown and another takes its place. The significance of these events is rarely apparent as they unfold: it becomes clear only in retrospect, when observed from the commanding heights of history. By such time it is often too late to act to shape the course of such events and their effects on the day-to-day working lives of men and women and the families they support.

There is a sense that we are now living through just such a time: barely a decade into the new millennium, barely 20 years since the end of the Cold War and barely 30 years since the triumph of neo-liberalism – that particular brand of free-market fundamentalism, extreme capitalism and excessive greed which became the economic orthodoxy of our time.

The agent for this change is what we now call the global financial crisis. In the space of just 18 months, this crisis has become one of the greatest assaults on global economic stability to have occurred in three-quarters of a century. As others have written, it "reflects the greatest regulatory failure in modern history". It is not simply a crisis facing the world's largest private financial institutions – systemically serious as that is in its own right. It is more than a crisis in credit markets, debt markets, derivatives markets, property markets and equity markets – notwithstanding the importance of each of these.

This is a crisis spreading across a broad front: it is a financial crisis which has become a general economic crisis; which is becoming an employment crisis; and which has in many countries produced a social crisis and in turn a political crisis. Indeed, accounts are already beginning to emerge of the long-term geo-political implications of the implosion on Wall Street – its impact on the future strategic leverage of the West in general and the United States in particular.

The global financial crisis has demonstrated already that it is no respecter of persons, nor of particular industries, nor of national boundaries. It is a crisis which is simultaneously individual, national and global. It is a crisis of both the developed and the developing world. It is a crisis which is at once institutional, intellectual and ideological. It has called into question the prevailing neo-liberal economic orthodoxy of the past 30 years – the orthodoxy that has underpinned the national and global regulatory frameworks that have so spectacularly failed to prevent the economic mayhem which has now been visited upon us.

Not for the first time in history, the international challenge for social democrats is to save capitalism from itself: to recognise the great strengths of open, competitive markets while rejecting the extreme capitalism and unrestrained greed that have perverted so much of the global financial system in recent times. It fell to Franklin Delano Roosevelt to rebuild American capitalism after the Depression. It fell also to the American Democrats, strongly influenced by John Maynard Keynes, to rebuild postwar domestic demand, to engineer the Marshall Plan to rebuild Europe and to set in place the Bretton Woods system to govern international economic engagement. And so it now falls to President Obama's administration – and to those who will provide international support for his leadership – to support a global financial system that properly balances private incentive with public responsibility in response to the grave challenges presented by the current crisis. The common thread uniting all three of these episodes is a reliance on the agency of the state to reconstitute properly regulated markets and to rebuild domestic and global demand.

The second challenge for social democrats is not to throw the baby out with the bathwater. As the global financial crisis unfolds and the hard impact on jobs is felt by families across the world, the pressure will be great to retreat to some model of an

all-providing state and to abandon altogether the cause of open, competitive markets both at home and abroad. Protectionism has already begun to make itself felt, albeit in softer and more subtle forms than the crudity of the Smoot-Hawley Tariff Act of 1930. Soft or hard, protectionism is a sure-fire way of turning recession into depression, as it exacerbates the collapse in global demand. The intellectual challenge for social democrats is not just to repudiate the neo-liberal extremism that has landed us in this mess, but to advance the case that the social-democratic state offers the best guarantee of preserving the productive capacity of properly regulated competitive markets, while ensuring that *government* is the regulator, that *government* is the funder or provider of public goods and that *government* offsets the inevitable inequalities of the market with a commitment to fairness for all. Social democracy's continuing philosophical claim to political legitimacy is its capacity to balance the private and the public, profit and wages, the market and the state. That philosophy once again speaks with clarity and cogency to the challenges of our time. Social-democratic governments across the world must rise to the further challenge of developing a practical policy response to the crisis that rebuilds shattered economic growth, while also devising a new regulatory regime for the financial markets of the future. This is our immediate challenge. But if we fail, there is a grave danger that new political voices of the extreme Left and the nationalist Right will begin to achieve a legitimacy hitherto denied them. Again, history is replete with the most disturbing of precedents.

We therefore need a frank analysis of the central role of neo-liberalism in the underlying causes of the current economic crisis. We also need a robust analysis of the social-democratic approach to properly regulated markets and the proper role of the state, in a new contract for the future that eschews the extremism of both the Left and the Right. And we must

integrate this analysis with the unprecedented imperative for global co-operation if governments are to prevail in their task.

Around the world today, there is understandable public bewilderment at the speed, severity and scope of the unfolding crisis. While the causes of the global financial crisis are complex, a small number of simple metrics are capable of conveying its magnitude and the havoc it has wrought in financial markets, the real economy and government finances.

Financial markets have suffered the greatest dislocation in our lifetime. Global equity markets have lost approximately US$32 trillion in value since their peak, which is equivalent to the combined GDP of the G7 countries in 2008. Credit markets have all but dried up, with credit growth at its lowest level since World War II. And, at the core of the crisis, house prices are plummeting in many countries, with American prices falling at their fastest rate since modern records began.

The real economy is facing one of its toughest periods on record, with the IMF predicting that advanced economies will contract for the first time in 60 years, causing the number of unemployed to rise by 8 million across the OECD. In developing countries, the International Labour Organization predicts that the financial and economic crisis could push more than 100 million people into poverty.

Furthermore, the crisis is producing unprecedented costs and debts for governments which will be felt for decades to come. It is estimated that the 2009 deficit in the United States will be as high as 12.5% of GDP. And estimates of the combined (actual and contingent) liabilities from the array of bank bailouts and guarantees run to more than $13 trillion – more than the cost of all the major wars the United States has ever fought. What this

means for future American international borrowing is equally unprecedented.

Bewilderment, however, rapidly turns to anger when the economic crisis touches the lives of families through rising unemployment, reduced wage growth and collapsing asset values – while executive remuneration in the financial sector continues to go through the roof, apparently disconnected from the reality of recent events. In 2007, S&P 500 CEOs averaged $10.5 million (some 344 times the pay of typical American workers). The top 50 hedge-fund and private-equity fund managers averaged $588 million each (19,000 times the pay of typical workers). In 2007, the ?ve biggest Wall Street firms paid bonuses of a staggering $39 billion – huge payments to the executives whose investment banks have since been bailed out by American taxpayers.

These are epic numbers, generated by a greed of epic proportions. For a bewildered and increasingly enraged public, they raise the following questions: How was this allowed to happen? What ideology, what policy, what abuses made this possible? Were there any warnings? And if so, why were they ignored?

George Soros has said that “the salient feature of the current financial crisis is that it was not caused by some external shock ... the crisis was generated by the system itself”. Soros is right. The current crisis is the culmination of a 30-year domination of economic policy by a free-market ideology that has been variously called neo-liberalism, economic liberalism, economic fundamentalism, Thatcherism or the Washington Consensus. The central thrust of this ideology has been that government activity should be constrained, and ultimately replaced, by market forces.

In the past year, we have seen how unchecked market forces have brought capitalism to the precipice. The banking systems of the Western world have come close to collapse. Almost overnight, policymakers and economists have torn up the neo-liberal playbook and governments have made unprecedented and extraordinary interventions to stop the panic and bring the global financial system back from the brink.

Even the great neo-liberal ideological standard-bearer, the long-serving chairman of the US Federal Reserve Alan Greenspan, recently conceded in testimony before Congress that his ideological viewpoint was flawed, and that the "whole intellectual edifice" of modern risk management had collapsed. Henry Waxman, the chairman of the Congressional Committee on Oversight and Government Reform, questioned Greenspan further: "In other words, you found that your view of the world, your ideology, was not right; it was not working?" Greenspan replied, "Absolutely, precisely." This mea culpa by the man once called 'the Maestro' has reverberated around the world.

To understand the failure of neo-liberalism, it is necessary to consider its central elements. The ideology of the unrestrained free market, discredited by the Great Depression, re-emerged in the 1970s amid a widespread belief that the prevailing economic woes of high inflation and low growth were exclusively the result of excessive government intervention in the market. In the '80s, the Reagan and Thatcher governments gave political voice to this neo-liberal movement of anti-tax, anti-regulation, anti-government conservatives.

Neo-liberal policy prescriptions flow from the core theoretical belief in the superiority of unregulated markets – particularly unregulated financial markets. These claims ultimately rest on the "efficient-markets hypothesis", which, in its strongest form, claims that financial-market prices, like stock-market prices, incorporate all available information, and therefore represent the best possible estimate of asset prices. It follows, therefore,

that if markets are fully efficient and prices fully informed, there is no reason to believe that asset-price bubbles are probable; and if these do occur, markets will self-correct; and that there is therefore no justification for government intervention to stop them occurring. Indeed, in the neo-liberal view, deviations from market efficiency must be attributable to external causes. Bubbles and other disruptions are caused by governments and other "imperfections", not by markets themselves. This theory justifies the belief that individual self-interest should be given free rein and that the income distribution generated by markets should be regarded as natural and inherently just. In the neo-liberal view, markets are spontaneous and self-regulating products of civil society, while governments are alien and coercive intruders.

Neo-liberal economic philosophy has its roots in the theories of Hayek and von Mises, who believed that society should be characterised by the "spontaneous order" which emerges when individuals pursue their own ends within a framework set by law and tradition. Ideally, the role of governments is simply to enforce contracts and protect the allocation of property rights. All other economic functions should be left to what Reagan called "the magic of the market". Hayek himself referred to the market as "a game" – specifically the game of "catallaxy", taken from the Greek word "to barter", which according to Hayek is "a contest played according to the rules and decided by superior skill, strength or good fortune". In Hayek's order, "the game" is the only proper determinant of the allocation of resources, in contrast to any "atavistic" concept of social justice alive in the social-democratic project.

The advocates of neo-liberalism have sought, wherever possible, to dismantle all aspects of the social-democratic state. The idea of social solidarity, reflected in the collective provision of social goods, is dismissed as statist nonsense. In the face of vigorous resistance to cuts in public services, the neo-liberal

political project has followed a strategy of “starving the beast”, cutting taxes in order to strangle the capacity of the government to invest in education, health and economic infrastructure. The end point: to provide maximal space in the economy for private markets.

Neo-liberalism progressively became the economic orthodoxy. It was reflected in wave after wave of tax cuts. Governments bragged about their success in reducing measured levels of debt, while refusing to acknowledge the long-term economic cost of non-investment in education, skills and training (which increase productivity), and repudiating an appropriate role for public debt in financing investment in the infrastructure that underpins long-term economic growth. Neo-liberals have also exhibited a passionate commitment to the total deregulation of the labour market. Labour is routinely regarded by neo-liberals as no different from any other economic commodity. In the ideal neo-liberal system, labour-market protections should be restricted to physical safety rather than appropriate remuneration or minimum negotiation standards. Again, contract law, rather than any wider concept of a social contract, should prevail. Neo-liberals in government also become notoriously reluctant to identify and respond to instances of market failure. Climate change is a potent example. What Sir Nicholas Stern legitimately describes as the greatest market failure in human history is dismissed by neo-liberals as a prescription for wanton interference in market forces.

The neo-liberal deregulation mantra has been even more evident in the management of financial markets. In the United States, the pursuit of financial deregulation crossed the Rubicon with the repeal of the Glass-Steagall Act, which had been established in the wake of the Great Depression. In the heady bubble years of the 1920s, American commercial banks, whose

traditional function was simply to take deposits and make loans, plunged into the roaring bull market, trading on their own account, underwriting new stock issues and participating in reckless speculation. When the stock-market bubble burst in 1929, it took commercial banks with it, causing a devastating chain reaction which affected the entire economy for a decade. President Roosevelt implemented Glass-Steagall in 1933 to prevent Main Street commercial banks from being exposed to the vagaries of Wall Street in the future. As Keynes, himself a successful speculator, observed: “When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.”

After a $300-million lobbying effort by the financial-services industry, Glass-Steagall was effectively repealed in 1999, removing the prohibition on commercial banks owning investment banks. The door was now open for the creation of huge financial-services conglomerates. One of the first to take advantage of the new regime was Citigroup, formed from the regular bank Citicorp and Travelers Group, which had previously incorporated the investment bank Salomon Smith Barney. The problem was that such combined entities became too systemically important to fail, yet their investment-banking arms were allowed to engage in speculation on a massive scale – so great as to imperil the finances of any government that had to bail them out. Citigroup was in fact to become the recipient of a taxpayer-funded rescue package worth an estimated $249 billion. It is ironic and – given the anti-government orthodoxy of neo-liberals – grossly hypocritical that the massive exposure to risk of these private financial conglomerates has resulted in a parallel exposure of the government, given the scale of possible government intervention in the event of bank failure. During the bubble, however, no account was taken of this, as massive profits were privatised and prospective losses socialised through the operation of implicit banking guarantees.

At the international level, bank risk is regulated by the Basel Accord. Yet the Basel II guidelines, published in June 2004, have now been demonstrated to be inadequate because they left the determination of risk to flawed credit-ratings processes and the banks' own "self-regulated" internal assessment models. Even then, the Basel rules were easily circumvented using innovative financial structures: structured investment vehicles were deliberately employed to shift risk off bank balance sheets. As Joseph Stiglitz has argued, "many of America's big banks moved out of the 'lending' business and into the 'moving' business," focusing on originating loans, repackaging them and selling them on, with little emphasis on their traditional role of assessing risk and screening credit worthiness.

Instead, the crucial risk-assessment function was passed, in large part, to the ratings agencies. Dependent as they were on the banks for their revenue, the agencies were hopelessly conflicted by the lure of big profits in return for easy ratings. Jerome Fons, former managing director for credit quality at Moody's, admitted in October 2008 that "the focus of Moody's shifted from protecting investors to being a marketing-driven organization ... management's focus increasingly turned to maximizing revenues." Ultimately, this focus on the bottom line contributed to an atmosphere in which a number of private ratings agencies became too inclined to take a favourable view of the risks inherent in their clients' investments.

Financial liberalisation also gave rise to a plethora of new, unregulated financial institutions in what is now broadly defined as the bank-intermediation market: hedge funds, private-equity funds, mortgage brokers. Investment banks with debt-to-equity ratios of 30:1 were also propped up by weak and defective accounting standards, which encouraged listed companies to "mark to market" their assets: that is, to effectively revalue their assets at market prices as they soared during booms.

A series of major national and international financial crises over the past decade should have begun to give pause for reflection, intervention and action. The Asian financial crisis of 1997 caused large-scale economic and social devastation and led to a flurry of calls for a "new international financial architecture". But these calls were always smugly discounted by the advanced economies as being primarily for the benefit of the Asian and other developing economies that had been caught up in the crisis. It was easier to blame "crony capitalism" than to look at the fundamentals of the neo-liberal orthodoxy (including unrestrained hedge-fund assaults on national currencies) that continued to govern global financial markets. Further warning signs came, including the bailout of the hedge fund Long-Term Capital Management (LTCM) in 1998 and the spectacular dotcom bubble and bust of 2000-01.

Each time a crisis arose, the US Federal Reserve came to the rescue by significantly lowering the federal funds rate, in order to pump liquidity back into the market and avert any further deterioration. After the 1987 stock-market crash, the Gulf War, the 1994 Mexican crisis, the 1997-98 Asian financial crisis, the LTCM debacle of 1998 and the 2000-01 bursting of the internet bubble, the response was always the same.

Investors increasingly came to believe that when things went bad, they would be protected by monetary policy in what came to be known as the "Greenspan put" – low interest rates, high liquidity and the protection of asset prices. Easy monetary policy was seen as an elixir that could cure any market instability that arose. In fact, it added yet more fuel to the fire, in the form of cheap money available for lending.

Low interest rates brought forth a new class of borrowers in the US who were encouraged by mortgage brokers to buy their own home. As a result, a huge amount of capital rushed into the sub-prime mortgage market, where it was directed towards borrowers with weak credit histories. At the same time, the

prevailing anti-regulation culture in financial markets fostered a new banking model – the so-called originate-and-distribute model. Mortgage brokers originated loans that were then sold on to others, including hedge funds and structured investment vehicles, thereby severing the link between the assessor of credit worthiness and the ultimate holder of the loan. This is where the two worlds met: the world of easy credit as the defining characteristic of Greenspan's neo-liberal financial order, and the other neo-liberal world of unregulated financial institutions with its new banking model that effectively atomised risk. The combination was toxic: it produced an asset bubble of unprecedented proportions and, most critically, with unprecedented reach across the global financial system through the bank-intermediation market. Were the bubble to burst, the links to the mainstream commercial-banking system, with its implicit government guarantees, meant that the state (*not* the market) would be left carrying the can. This is the essence of the neo-liberal legacy now left to taxpayers – both today and into the future.

The rest, of course, is history. The annual volume of US sub-prime and other securitised mortgages rose from approximately $160 billion in 2001 to over $600 billion in 2006. Low interest rates and high demand for housing caused house prices to soar. In comparison to the 1.4% average annual appreciation of American home values during the 30 years leading up to 2000, the values of homes increased at 7.6% annually from 2000 to 2006, with massive growth in the sub-prime market. Indications of financial instability slowly became apparent to all who cared to look. Business leader Warren Buffett had recognised the emerging risks of financial innovation, easy money and weak regulation in 2003 when he noted that many of the new financial instruments were akin to "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal".

The Bank for International Settlements, always more sceptical than most, was the first official institution to sound the alarm. In its 2007 annual report, the BIS warned that "years of loose monetary policy have fuelled a giant global credit bubble, leaving us vulnerable to another 1930s-style slump." Despite this, no systemic action was taken.

Despite three crises in a decade, despite the clear warnings that came with them and after them, the neo-liberals were so convinced of the ideological righteousness of their cause, and so blinded by their unquestioning belief that markets were inherently self-correcting, that they refused even to recognise the severity of the problems that emerged. The problems did not fit the model, so the evidence was simply discarded. Hardline neo-liberals were not interested, because they knew in their hearts they were right.

The time has come, off the back of the current crisis, to proclaim that the great neo-liberal experiment of the past 30 years has failed, that the emperor has no clothes. Neo-liberalism, and the free-market fundamentalism it has produced, has been revealed as little more than personal greed dressed up as an economic philosophy. And, ironically, it now falls to social democracy to prevent liberal capitalism from cannibalising itself.

With the demise of neo-liberalism, the role of the state has once more been recognised as fundamental. The state has been the primary actor in responding to three clear areas of the current crisis: in rescuing the private financial system from collapse; in providing direct stimulus to the real economy because of the collapse in private demand; and in the design of a national and global regulatory regime in which government has ultimate responsibility to determine and enforce the rules of the system.

The challenge for social democrats today is to recast the role of the state and its associated political economy of social democracy as a comprehensive philosophical framework for the future – tempered both for times of crisis and for times of prosperity. In doing so, social democrats will draw in part on a long-standing Keynesian tradition. Social democrats will also need to reach beyond Keynes, given some of the new realities we face some 70 years after the publication of Keynes's *General Theory*.
Long before the term 'Third Way' was popularised in the policy literature of the 1990s, social democrats viewed themselves as presenting a political economy of the middle way, which rejected both state socialism and free-market fundamentalism. Instead, social democrats maintain robust support for the market economy but posit that markets can only work in a mixed economy, with a role for the state as regulator and as a funder and provider of public goods. Transparency and competitive neutrality, ensured by a regime of competition and consumer-protection law, are essential.

Social justice is also viewed as an essential component of the social-democratic project. The social-democratic pursuit of social justice is founded on a belief in the self-evident value of equality, rather than, for example, an exclusively utilitarian argument that a particular investment in education is justified because it yields increases in productivity growth (although, happily, from the point of view of modern social democrats, both things happen to be true). Expressed more broadly, the pursuit of social justice is founded on the argument that all human beings have an intrinsic right to human dignity, equality of opportunity and the ability to lead a fulfilling life. In a similar vein, Amartya Sen writes of freedom as the means to achieve economic stability and growth, but also as an end in itself. Accordingly, government has a clear role in the provision of such public goods as universal education, health, unemployment insurance, disabilities insurance and retirement

income. This contrasts with the Hayekian view that a person's worth should primarily, and unsentimentally, be determined by the market.

Social-democratic governments face the continuing challenge of harnessing the power of the market to increase innovation, investment and productivity growth – while combining this with an effective regulatory framework which manages risk, corrects market failures, funds and provides public goods, and pursues social equity. Examples of such a government are the Australian Labor governments of Bob Hawke and Paul Keating during the 1980s and early '90s. Hawke and Keating pursued an ambitious and unapologetic program of economic modernisation. Their reforms internationalised the Australian economy, removed protectionist barriers and opened it up to greater competition. They were able dramatically to improve the productivity of the Australian private economy, while simultaneously expanding the role of the state in the provision of equity-enhancing public services in health and education.

In the current crisis, social democrats therefore have the great advantage of a consistent position on the central role of the state – in contrast to neo-liberals, who now find themselves tied in ideological knots, in being forced to rely on the state they fundamentally despise to save financial markets from collapse. This enables social-democratic governments to undertake such current practical tasks as credit-market regulation, intervention, and demand-side stimulus in the economy. The uncomfortable truth for neo-liberals is that they have not been able to turn to non-state actors or non-state mechanisms to defray risk and restore confidence, rebuild balance sheets and unlock global capital flows. This is only possible through the agency of the state.

In the early stages of the global financial collapse, the centrality of the state was reaffirmed by governments of both the classical Left and Right as they acted to guarantee the integrity of the banking system. Die-hard neo-liberals invoked "moral hazard" – akin to arguing about who should pay for the fire brigade while the house itself is burning down. The alternative to government intervention, as the global banking fraternity knows all too well, was systemic collapse. The first step towards preserving confidence and restoring liquidity in late 2008 was the provision of an explicit guarantee of deposits placed in mainstream financial institutions. The willingness of the public, as expressed through their respective governments, to accept the associated contingent liabilities reveals a widely held perception that the stability of banking systems is itself a public good. As Robert Skidelsky, Keynes's biographer, observed: "when the crunch came, we discovered that national taxpayers still stand behind banks, and national insolvency regimes matter."

Subsequently, governments have also demonstrated a willingness to undertake unprecedented interventions in private credit markets. Specifically, governments have involved themselves in the capitalisation of banks, the direct purchase of bank and corporate securities, the establishment of joint-purpose vehicles to share risk with private financial institutions, and in sovereign guarantees to underpin inter-bank lending. In the United States, the rescue of Citigroup and the Bank of America amounts to a de facto nationalisation. This followed the placing into conservatorship of Fannie Mae and Freddie Mac, and the effective nationalisation of AIG, the world's largest insurance company. Once again, the social-democratic state, not the unfettered forces of the market, was called to the rescue.

These measures have not been implemented on the basis of socialist ideology, nor are they a return to state ownership and

control. When the financial system stabilises and the global recession eases, we can expect to see governments pulling back from direct involvement in the ownership and operation of the banking sector. The object of the current intervention is to secure private credit markets so that they can serve the needs of private businesses and consumers. But clearly the days of effective non-regulation and unconstrained financial innovation are gone, and must not be allowed to return. The consequences for the economy are too great.

Stabilising the financial system is a necessary first step towards preventing systemic collapse. But the collapse of the speculative bubble and the subsequent credit squeeze have already brought about a slowdown in economic growth, rising unemployment, and the possibility of a lengthy global recession. Neo-liberals such as Alan Moran, of the Australian Institute of Public Affairs, argue that the cost of the recession should be borne by employees, through wage cuts and retrenchment – exactly the position of US Treasury Secretary Andrew Mellon at the outset of the Great Depression. Social democrats, by contrast, stress the central role of the state in maintaining aggregate demand, both for consumption and investment spending, at a time of faltering growth. That is, the state must involve itself in direct demand-side stimulus to offset the large-scale contraction in private demand. The IMF revised its growth forecast for 2009 down four times, by a total of 3% of global GDP. This “growth gap” indicates the dimensions of the fiscal-stimulus task that now lies ahead for governments if the demand-side gap is to be met and massive unemployment avoided. This is classic Keynesianism, pure and simple.

Keynes argued that, in Stiglitz’s words, “in a severe downturn, monetary policy was likely to be ineffective. Fiscal policy was required.” He believed that in times of dramatically slowed economic growth, monetary authorities would find themselves in a liquidity trap, unable to “induce an increase in the supply of

credit in order to raise the level of economic activity". Or, as others have described it, monetary policy becomes ineffective because it is just "pushing on a string". Indeed, as Paul Krugman suggests, "the failure of monetary policy in the current crisis shows that Keynes had it right the first time." The truth is, fiscal policy must reinforce monetary policy in aggregate demand. Neither by itself is sufficient.

Reasoning that the costs of failing to provide fiscal stimulus will outweigh the negative effect on budgets, Tony Blair implores current leaders to "do whatever it takes ... to get the blood pumping back round the financial system again". The challenge for new Keynesians is also to ensure that this stimulus is targeted, timely and temporary. As private consumption and business investment recover, fiscal stimulus should be reduced commensurately, so as not to push up inflation during the period of economic recovery.

In proposing active measures to stimulate demand, it is therefore important to emphasise the central tenet of Keynesian economic management: the need to balance budgets over the course of the economic cycle. Failure to do so, along with excessive tolerance for inflation, was a major contributor to the breakdown of Keynesian economic management in the early 1970s. Increases in public investment and direct transfers to households will stimulate the economy, but they will have to be paid for in the future, when strong economic growth has resumed.

Social democrats have always emphasised the potential for systemic shocks arising from speculative bubbles and busts driven by what Keynes referred to as the unpredictable "animal spirits" of investors. Financial regulation must allow banks and other financial institutions to be intermediaries between household savings and business investment, without themselves becoming a source of systemic instability. This requires prudential regulation beyond simply ensuring that

individual institutions adhere to standards designed to guard against their insolvency under normal economic conditions. The sector *as a whole* should be constrained from actions that promote systemic risk, such as excessive expansion of derivatives markets. Equally important in light of the recent crisis is that a social-democratic framework recognises the effect of incentive structures within firms on the level of risk-taking by individuals. For social democrats, systemic stability and integrity represent public goods in their own right – public goods which will always take precedence over individual opportunities for profit maximisation.

A further challenge for social democrats in dealing with the current crisis is its almost unprecedented global dimensions. This has two aspects: the integration and interdependence of financial markets, which has brought about a rapid spread of the contagion; and the consequences for the real economy as collapsing demand in one country affects exports from another.

Instead of distributing risk throughout the world, the global financial system has intensified it. Neo-liberal orthodoxy held that global financial markets would ultimately self-correct – the invisible hand of unfettered market forces finding their own equilibrium. But as Stiglitz has caustically observed: "the reason that the invisible hand often seems invisible is that it is not there." Financial markets have not self-corrected. Global financial innovation has compounded the problem of asset bubbles, not reduced it. Neo-liberalism's anti-regulation agenda rapidly converted a problem in American mortgage markets into a full-blown global financial and economic crisis that now threatens the future of open global markets – yet another example of capitalism cannibalising itself, but this time on a frightening, global scale.

Three cardinal principles emerge: first, national financial markets require effective national regulation; second, global financial markets require effective global regulation, if for no other reason than that the quantum of global financial transactions is now capable of overwhelming most single national economies standing alone; and third, the means for achieving effective regulation in both can only be delivered by national governments operating together. There has been no private financial-market solution on offer to deal with the scale and complexity of global systemic instability we now face.

That is why the world has turned to co-ordinated governmental action through the G20: to help provide immediate liquidity to the global financial system; to co-ordinate sufficient fiscal stimulus to respond to the growth gap arising from the global recession; to redesign global regulatory rules for the future, including a new Basel III; to reform the existing global public institutions – especially the IMF – to provide them with the powers and resources necessary for the demands of the twenty-first century. The tragedy is that after decades of neo-liberal ascendancy, the IMF, Keynes's child from Bretton Woods, for a time became the agency through which neo-liberal doctrines were spread around the world – to the detriment of the fund's long-term standing and with a real impact on its capacity to act effectively in the current crisis with the various national economies it has treated poorly in the past.

Governments must craft consistent global financial regulations to prevent a race to the bottom, where capital leaks out to the areas of the global economy with the weakest regulation. We must establish stronger global disclosure standards for systemically important financial institutions. We must also build stronger supervisory frameworks to provide incentives for more responsible corporate conduct, including executive remuneration.

Further, the IMF's authority to undertake prudential analysis must be expanded and its early-warning system for institutional vulnerabilities enhanced. And its governance arrangements must be reformed. It makes no sense for the governance structure of the global financial system today to reflect the balance of power in 1944. It is only reasonable that if we expect fast-growing developing economies like China to make a greater contribution to multilateral institutions such as the IMF, they should also gain a stronger decision-making voice in these forums.

The longer-term challenge for governments is to address the imbalances that have helped to destabilise the global economy in the past decade: in particular, the imbalances between large surplus economies such as China, Japan and the oil-exporting nations, and large debtor nations such as America. In the short term, these imbalances are likely to increase as America's budget deficit balloons. In the medium term, overcoming these imbalances and working towards a more stable global macroeconomic framework will demand new levels of global economic co-operation and co-ordination. Any sudden change in managing these global imbalances – for example, if China sharply reduced the purchase of US government bonds – would send tremors through foreign-exchange markets, with dire consequences both for the US dollar and for the prospects of global economic recovery. Again, this looms as a challenge for statecraft; we cannot simply hope that individual market participants somehow magically do the right thing.

There is one further dimension to the role of social democrats in dealing with the current global crisis. The impact of the crisis on poverty and political stability in the developing world has not fully registered in the global debate about policy responses to the crisis so far. World Bank intervention, bilateral official development assistance and the continued implementation of the Millennium Development Goals become essential elements

in managing the effects of a crisis that will otherwise throw much of the developing world back into poverty. Social democrats, both by instinct and by tradition, are predisposed to engage in this, but it will become harder and harder as developed countries' budgets come under ever more stress from the unprecedented domestic demands now placed upon them by the crisis.

Neo-liberals, like neo-conservatives (their ideological bedfellows in the foreign-policy sphere), are intrinsically suspicious of all forms of multilateral governance. In fact, there is a parallel between neo-liberals' hostility to *national* governments intervening in national markets and their hostility to *international* governmental institutions intervening in global markets. Again, the contrast with social democrats is instructive, given social democrats' long tradition of internationalism – itself an accommodating attribute given the complexities of global market governance, co-operation and co-ordination we all now confront. The truth is that there are no credible unilateral solutions on offer, given the increasing dispersal of global economic power.

The political home of neo-liberalism in Australia is, of course, the Liberal Party itself. Over the past decade, the Howard government reduced investment in key public goods, including education and health. It also refused to invest in national economic infrastructure, notwithstanding multiple warnings from the Reserve Bank of the impact of long-standing capacity constraints on economic growth. The Liberals in government also set about the comprehensive deregulation of the labour market – based on the argument that human labour was no different to any other commodity. Driven by a philosophy of minimal government intervention in the markets, the Liberals ignored both the 2003 Dawson Review and multiple reports

from the ACCC calling for the criminalisation of cartel conduct. They refused to act to prevent the accumulation of market power through creeping acquisitions. They refused to effectively regulate consumer credit or credit-rating agencies. And they ignored calls – from the Financial Stability Forum in 2000, the Australian Prudential Regulatory Authority submission to the HIH Royal Commission in 2002, and the 2006 IMF Financial Sector Assessment Program – to implement a deposit-insurance scheme that would bring our deposit protection in line with almost all other OECD nations. Most critically, the Howard government oversaw an unprecedented increase in household and national debt. The average ratio of household debt to annual gross disposable income more than doubled to 114.5%, up from 49.8% under the Hawke-Keating governments; household net savings to net disposable income fell to an average of 1.1%, down from an average of 7.9% under the Hawke-Keating governments; and the level of Australia's net foreign debt increased to 55.5% of GDP, up from 37.9% of GDP under the Hawke-Keating governments.

The contrast between the competing political traditions within Australia on the role of governments and the market is clear. Labor, in the international tradition of social democracy, consistently argues for a central role for government in the regulation of markets and the provision of public goods.

Consistent with this tradition, the Labor government has acted decisively through state action to maintain the stability of the Australian financial systems in the face of the economic crisis. The government acted in October to guarantee all deposits. To support intra-bank lending by the Australian majors, it intervened to provide a facility for guaranteeing wholesale funding of financial institutions. To encourage liquidity, the government legislated to increase by $25 billion the maximum value of government bonds that can be issued at any one time. It also initiated a program to purchase residential mortgage-

backed securities. To protect financial institutions from predatory speculators, a temporary ban on short selling was introduced. Labor has also acted to help the real economy, to stimulate economic activity by investing in targeted job creation; in the reform of services in health, education, disabilities and homelessness; and in roads, rail, ports and other critical infrastructure. All through decisive state action.

The Liberals, embracing the neo-liberal tradition of anti-regulation, seek to reduce the agency of the state in private markets as much as possible. The distinction is reflected in the previous prime minister's statements that "competitive capitalism within free markets remains the most effective economic paradigm, both domestically and internationally"; that "the right responses will be grounded in free-market orthodoxies"; and that "we should avoid the resort to re-regulation." This ideology has not served Australia well in preparing for the current crisis.

To respond effectively to the global financial crisis in the future requires the resolution of profound questions from the past, principal among which is: What caused such a crisis to result in widespread economic and social devastation? The magnitude of the crisis and its impact across the world means that minor tweakings of long-established orthodoxies will not do. Two unassailable truths have already been established: that financial markets are not always self-correcting or self-regulating, and that government (nationally and internationally) can never abdicate responsibility for maintaining economic stability. These two truths in themselves destroy neo-liberalism's claims to any continuing ideological legitimacy, because they remove the foundations on which the entire neo-liberal system is constructed.

The extent to which social democracy responds effectively and sustainably to the challenges now left to us by the neo-liberals remains an open question. Tempering any tendencies towards

ideological triumphalism from the centre-Left at neo-liberalism's demise is Robert Skidelsky's recent and reflective reminder of the cycles of history:

> *Societies are said to swing like pendulums between alternating phases of vigour and decay; progress and reaction; licentiousness and puritanism. Each outward movement produces a crisis of excess which leads to a reaction. The equilibrium position is hard to achieve and always unstable.*
> *In his Cycles of American History (1986), Arthur Schlesinger Jr defined a political economy cycle as "a continuing shift in national involvement between public purpose and private interest" ...*

Others have argued that we are seeing a more fundamental regime change: the third in postwar history, starting with the Keynesian model, from the 1940s to the '70s; the neo-liberal ascendancy, from 1978 to 2008; followed by a new regime, which is currently being shaped. Perhaps this new regime will come to be called 'social capitalism' or 'social-democratic capitalism', or simply the term 'social democracy' itself. Whatever the nomenclature, the concept is clear: a system of open markets, unambiguously regulated by an activist state, and one in which the state intervenes to reduce the greater inequalities that competitive markets will inevitably generate.

Either way, seismic changes are underway, fault lines yielding to fractures which in time may yield to even deeper tectonic shifts. Neither governments nor the peoples they represent any longer have confidence in an unregulated system of extreme capitalism. As President Sarkozy put it: *"Le laissez-faire, c'est fini."* Or, as China's Vice Premier Wang Qishan reportedly said, somewhat more elliptically: "The teachers now have some problems."
For social democrats, it is critical that we get it right – not just to save the system of open markets from self-destruction, but

also to rebuild confidence in properly regulated markets, so as to prevent extreme reactions from the far Left or the far Right taking hold. Social democrats must also get it right because the stakes are so high: there are the economic and social costs of long-term unemployment; poverty once again expanding its grim reach across the developing world; and the impact on long-term power structures within the existing international political and strategic order. Success is not optional. Too much now rides on our ability to prevail.

I believe that social democrats can chart an effective course that will see us through this crisis, and one that is also capable of building a fairer and more resilient order for the long term. This can only be achieved through the creative agency of government – and through governments acting together. How could it possibly now be argued that the minimalist state of which the neo-liberals have dreamt could somehow be of sufficient potency to respond to the maximalist challenge we have been left in the wake of this most spectacular failure of the entire neo-liberal orthodoxy? Government is not the intrinsic evil that neo-liberals have argued it is. Government, properly constituted and properly directed, is for the common good, embracing both individual freedom and fairness, a project designed for the many, not just the few.

KEVIN RUDD