FT Series **Financial crisis: Are we safer now?**

Global financial crisis

Why so little has changed since the financial crash

Martin Wolf on the power of vested interests in today's rent-extracting economy

Martin Wolf YESTERDAY

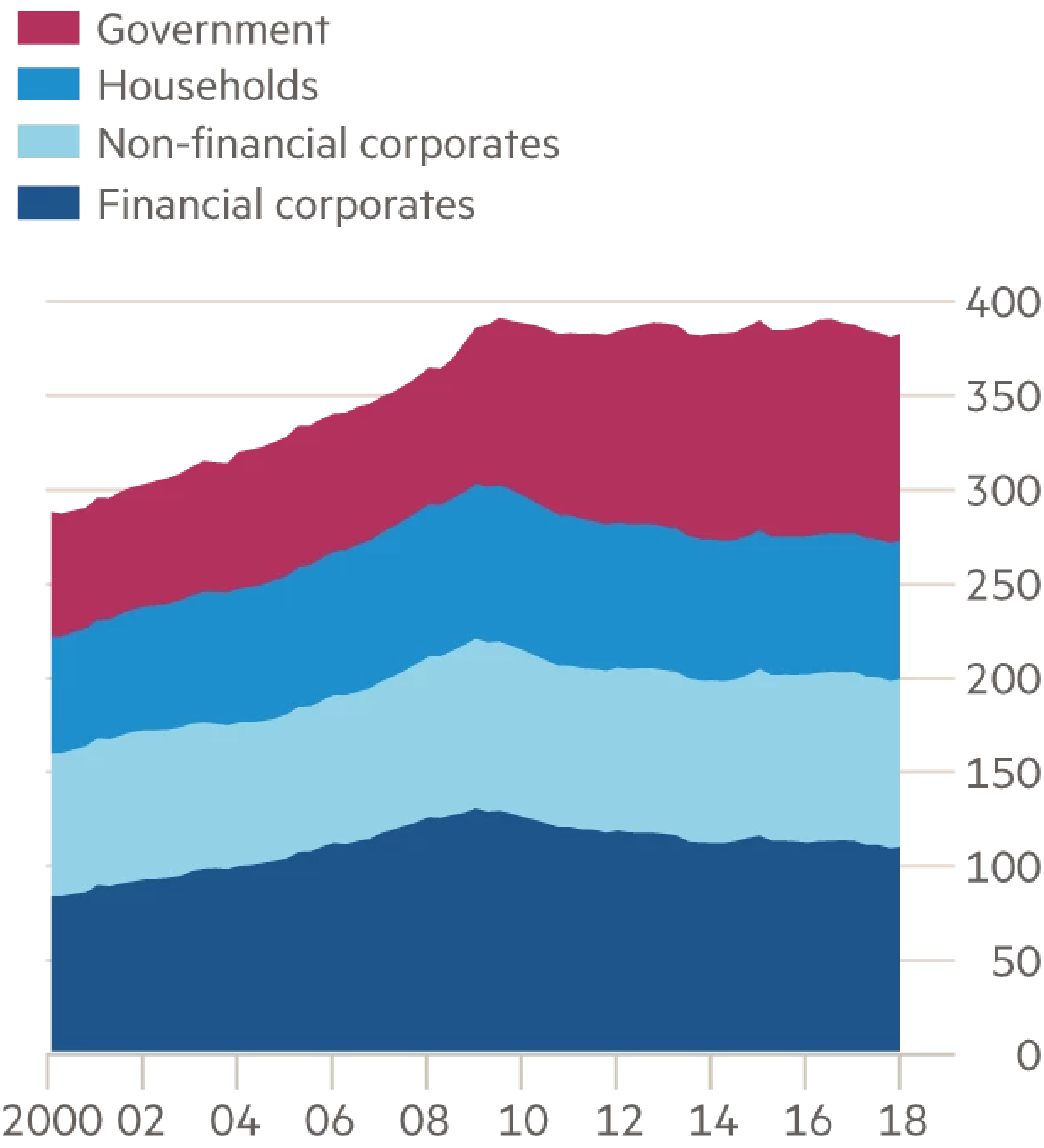
Here I am back again in the Treasury . . . but with one great difference. In 1918 most people's only idea was to get back to pre-1914. No one today feels like that about 1939. That will make an enormous difference when we get down to it." John Maynard Keynes wrote this in 1942. It did make a difference. After the Great Depression and a second world war, people wanted change. They got it. France calls what followed les trentes glorieuses.

The stagflation of the 1970s brought a counter-revolution: the 1980s saw a radical change of ideas on the role of the state and markets, the goals of macroeconomic policy and the job of central banks. Again, the aim was a fundamental transformation.

So what happened after the global financial crisis? Have politicians and policymakers tried to get us back to the past or go into a different future? The answer is clear: it is the former.

Aggregate debt soared pre-crisis, then stabilised post-crisis

Mature economies (debt as a % of GDP)



Source: IIF

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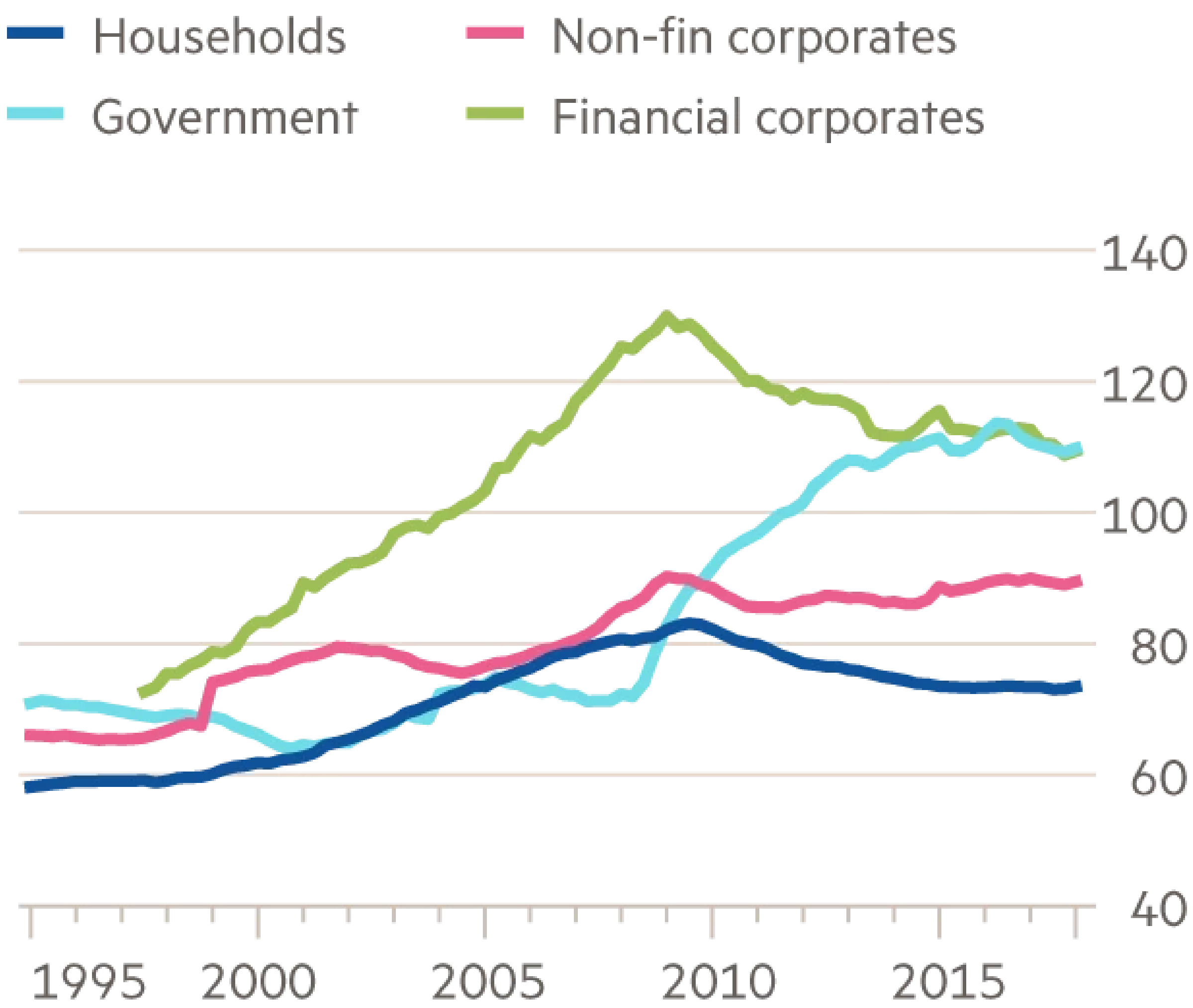
To be fair, they have tried to go back to a better past. That is what happened in 1918. Then they had just come out of a devastating war. So the new ideas were about peace — "collective security" and a League of Nations. But they wanted to return to the prewar economy, especially the gold standard. In 1918, then, they mostly wanted to go back to a better version of the past in international relations. After the crisis of 2008, they wanted to go back to a better version of the past in financial regulation. In both cases, all else was to stay the way it was.

The chief aim of post-crisis policymaking was rescue: stabilise the financial system and restore demand. This was delivered by putting sovereign balance sheets behind the collapsing financial system, cutting interest rates, allowing fiscal deficits to soar in the short run while limiting discretionary fiscal expansion, and introducing complex new financial regulations. This prevented economic collapse, unlike in the 1930s, and brought a (weak) recovery.

Private deleveraging is offset by government leveraging

Mature economies (debt as a % of GDP)



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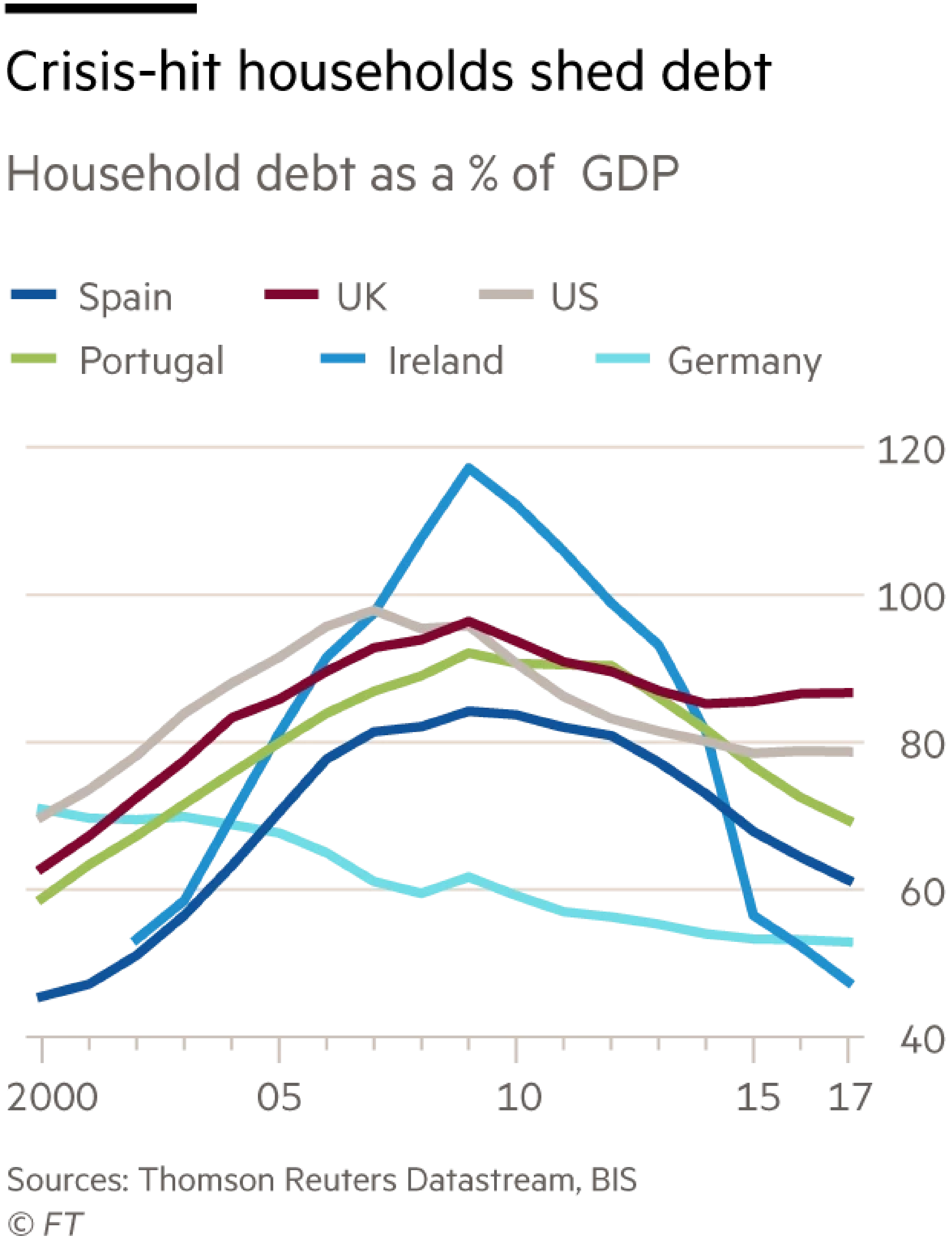
Note how closely these actions hewed to the pre-crisis policy consensus. Central banks acted as lenders of last resort, as they should. They also played the dominant role in macroeconomic stabilisation, as pre-crisis thought suggested. Their principal instrument remained interest rates, though they included long rates this time, because short rates reached zero. Shortly after the worst of the crisis had passed, fiscal policy turned towards austerity. The financial system is much as before, albeit with somewhat lower leverage, higher liquidity requirements and tighter regulation. Efforts to lower debt in the private sector were modest. (See charts.)

The financial crisis was a devastating failure of the free market that followed a period of rising inequality within many countries. Yet, contrary to what happened in the 1970s, policymakers have barely questioned the relative roles of government and markets. Conventional wisdom still considers "structural reform" largely synonymous with lower taxes and de-regulation of labour markets. Concern is expressed over inequality, but little has actually been done. Policymakers have mostly failed to notice the dangerous dependence of demand on ever-rising debt. Monopoly and "zero-sum" activities are pervasive. Few question the value of the vast quantities of financial sector activity we continue to have, or recognise the risks of further big financial crises.



It is little wonder populists are so popular, given this inertia, not to mention the miserable experience of so many citizens since the crisis and, in important cases, before that. Politics abhors a vacuum. Ideas as dangerous and divisive as those of US president Donald Trump or Matteo Salvini, Italy's deputy prime minister, are bound to fill it. One cannot beat something with nothing.

The persistent fealty to so much of the pre-crisis conventional wisdom is astonishing. The failure of Keynesianism in the 1970s was significant but certainly no greater than the combination of slow economic growth with macroeconomic instability produced by the pre-crisis orthodoxy. What makes this even more shocking is that there is so little confidence that we could (or would) deal effectively with another big recession, let alone yet another big crisis.

What explains the complacency? One reason might be the absence of good ideas. The economist Nicholas Gruen argues just that in a provocative article. Yet there are some perfectly good ones.

Globalisation of finance fell, but remains high

Global cross-border capital flows ($tn)

Source: McKinsey Global Institute

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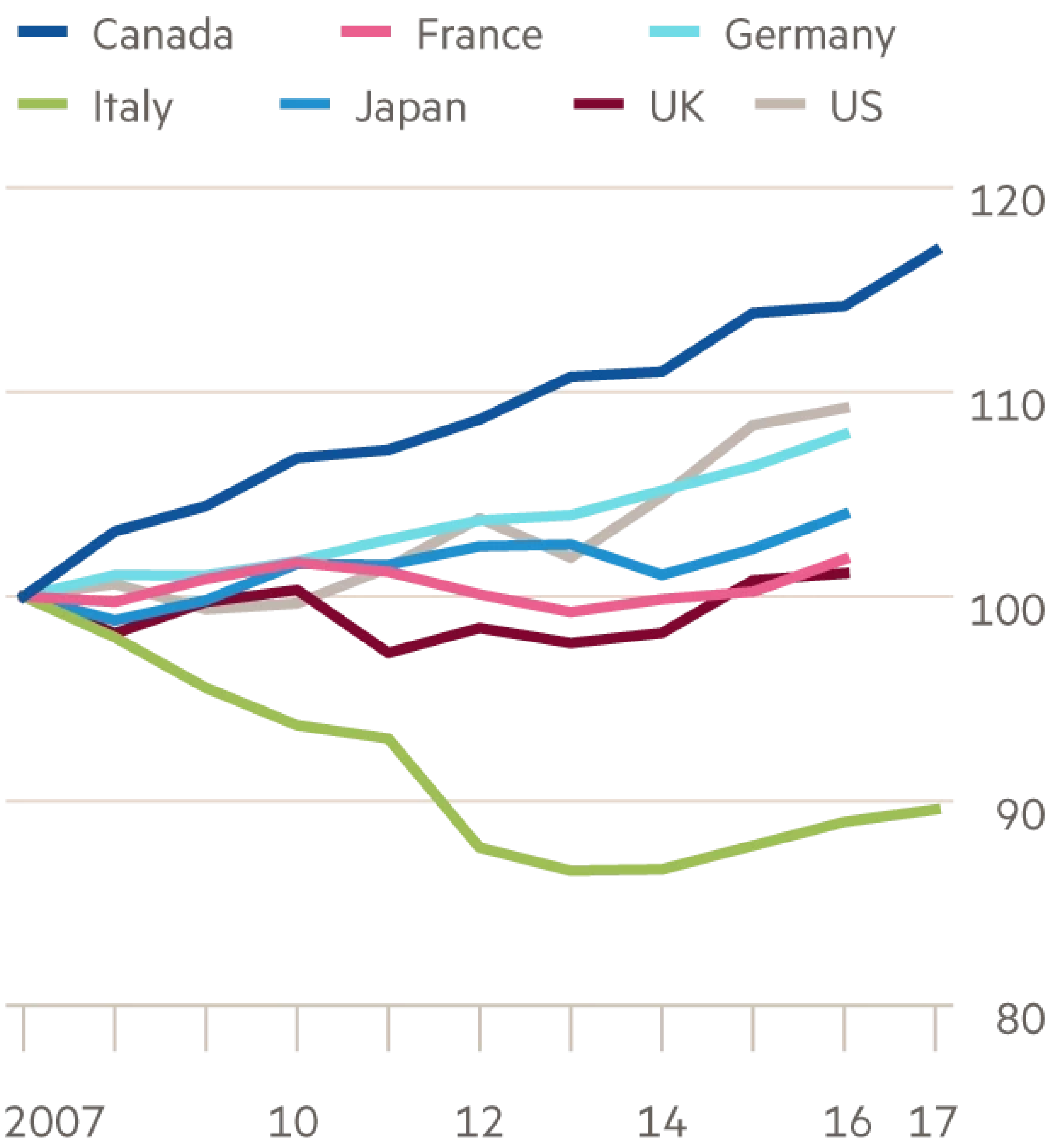
Some have argued for a shift from debt to equity finance of house purchases. Others have called for the elimination of the tax deductibility of debt interest. Some note the perverse impact of executive incentives. Some argue convincingly for higher equity requirements on banks, rejecting the argument that this would halt growth. Others ask why only banks have accounts at central banks. Why should every citizen not be able to do so? Some wonder why we cannot use central banks to escape dependence on debt-fuelled growth.

The 'great recession' casts a long shadow

Real household disposable income per head (rebased)



Source: OECD

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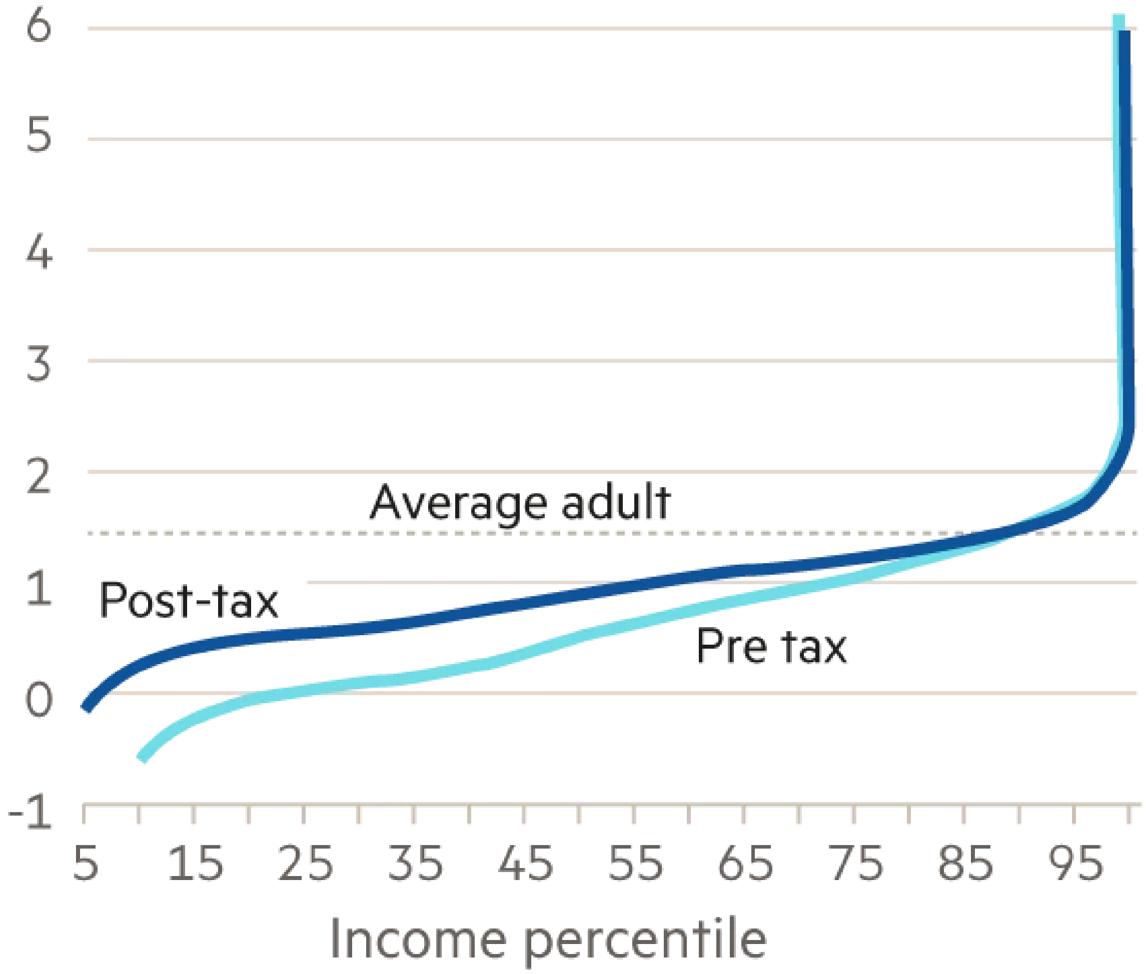
Beyond finance, it seems ever clearer that protection of intellectual property has gone too far. Also, why not shift taxation on to land? Why are we letting the taxation of capital collapse? And why are we not trying to revitalise antitrust?

An all-embracing new ideology may be unavailable today. That is probably a good thing. But good ideas do exist. A more likely cause of inertia is the power of vested interests. Today's rent-extracting economy, masquerading as a free market, is, after all, hugely rewarding to politically influential insiders.

To those who have it has been given

Income growth in the US (real average annual growth by percentile, 1980-2014, %)



Source: Gabriel-Zucman, UC Berkeley

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Yet the centre's complacency invites extremist rage. If those who believe in the market economy and liberal democracy do not come up with superior policies, demagogues will sweep them away.

A better version of the pre-2008 world will just not do. People do not want a better past; they want a better future.

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