

**THE GLOBAL FINANCIAL CRISIS AND THE COLLAPSE OF
THE NEO-LIBERAL PARADIGM**

by Sir Courtney N. Blackman

Economics Department – UWI – Trinidad & Tobago

Wednesday, October 8th, 2008

**Conference, “The Economy 2008: Planning in a Turbulent
Environment”**

A Tribute to Dr. Trevor Farrell

Introduction

I am deeply honoured by your invitation to deliver the keynote address at this Conference in recognition of the outstanding service of Dr. Trevor Farrell to the Faculty of Economics, in particular, and to the University of the West Indies in general. Indeed, this is my first time speaking on this University Campus in a purely academic context. Almost sixty years ago I first set foot on Trinidadian soil; today I feel that I have at last arrived.

In the interest of full disclosure, I must reveal that Trevor and I have been soul brothers for more than three decades. When I returned to Barbados in 1972, Trevor was the only professional economist in the region who shared my conviction that management was a critical but neglected factor in Caribbean economic development. Over the years we have consoled each other in our loneliness, shared ideas and brought new and important literature to each other’s attention. However, my fraternal relationship with Trevor has not been without its impositions. He sent his graduate students to intern at the Central Bank of Barbados when I was Governor, and later required me to read Masters theses for the less-than-princely sum of US\$50 each, the lowest rate of compensation in my career as a Consultant.

In spite of the costs attached to our relationship, I am delighted to speak on this occasion. But, to be honest, it was only from the promotional literature for this Conference that I was made fully aware of the volume of his academic publication in the fields of Economics and Management, and of the variety of his consultative services to Caribbean and extra regional governments, multinational institutions, and both private sector and civic organizations. I heartily congratulate him on this honour, and commend his colleagues on their recognition of his professional

contributions - contributions which will bear fruit for the Caribbean region and beyond for decades to come.

My original choice of topic, *The Meaning of Management: the Missing Factor in Caribbean Political Economy*, was intended to focus on issues of management and economics that Trevor and I had most frequently discussed. However, the cataclysmic and terrifying implosion of the US financial system, with its shock waves spreading throughout the global financial system, seemed a much more urgent subject. As a resident of the USA over the past two decades, I have had, so to speak, a front row view of the unfolding drama. I have therefore switched to the topic, *The Global Financial Crisis and the Collapse of the Neo-Liberal Paradigm*.

The current crisis is the most devastating in recent economic history. Iconic Wall Street institutions, like Bear Stearns, Lehman Brothers and Merrill Lynch, have vanished; the world's largest mortgage insurers, Fannie Mae and Freddie Mac, have been nationalized, and the world's largest insurance company, AIG, with operations in 100 countries and with over 100,000 employees, survives only by the grace of the US Treasury to the tune of \$85 billion. Martin Wolf, in the *Financial Times* of October 1st, puts it this way,

We are watching the disintegration of the financial system ... Finance is the web of intermediation, binging economic agents to one another, across space and time. Without it, no modern economy could survive.

Indeed the crisis threatens the very position of the United States as the world's sole Super Power, for it is the tremendous advantage it enjoys as the world's leading financial centre, and issuer of the international reserve currency that provides the financial resources to support its global responsibilities and ambitions. The \$700 billion recently voted by Congress is a mere down payment on the cost of returning that country to its former pre-eminence. For one, the problem of foreclosures that have thrown more than one million Americans out of their homes has hardly been addressed.

The thrust of my argument is that this economic crisis, the most severe since the Great Depression of the 1930s, represents a spectacular failure of Neo-Liberalism, and is therefore an occasion for its displacement by a new paradigm or, at least, its radical reconstruction. However, in my

reading of the daily Press - *The Washington Post*, *The New York Times*, *The Financial Times* and *The Economist* – I have come across only one academic economist, Dr. De Grauwe, Professor of Economics at the University of Leuven and Centre for European Studies, who has touched on this issue. His column in the *Financial Times* of July 23rd, 2008, is captioned “Cherished Myths have Fallen Victim to Economic Reality.” With regard to central banks in developed countries he concludes,

The macroeconomic models they have today certainly do not provide them with the right tools to be successful. They will have to use other intellectual constructs to succeed.

My hopes were later lifted by, of all persons, a theoretical physicist. The title of Mark Buchanan’s column in the *New York Times* of Wednesday, October 1, 2008, read, “This Economy Does Not Compute”. He was commenting on the bumbling efforts of US government officials and leaders in the Congress to come up with a ‘bail out’ plan to bring the financial crisis under control. Part of the reason, he offered,

is that economists still try to understand markets by using ideas from traditional economics, especially so-called equilibrium theory.

He cited the efforts of a few pioneers “who are building computer models able to mimic market dynamics by simulating their workings from the bottom up.”

Readers of my most recent publication, *The Practice of Economic Management: A Caribbean Perspective* (1) will be aware of my relentless criticism, over more than two decades, of the Neo-Liberal paradigm, as encapsulated in the so-called “Washington Consensus”. Following this introduction I examine the concept of the “paradigm”, the intellectual construct on which my presentation hangs. Secondly, I chronicle the rise of the Neo-Liberal paradigm in the 1980s and 1990s. Thirdly, I identify the factors leading up to the current crisis in the US financial system and its effects on the global financial system. Fourth, I speculate on Life after Neo-Liberalism for the United States and the global community. In conclusion, I suggest some lines along which you might proceed in the search for an appropriate paradigm of Caribbean economic development.

The Concept of the Paradigm

The generic meaning of “paradigm” is “model” or “pattern”. Its usage has in recent times been extended to mean the model underlying the theories and practice of a scientific subject, no doubt reflecting the influence of Thomas Kuhn’s seminal work, *The Structure of Scientific Revolutions*. (2) Kuhn adopted the concept of the “paradigm” to explain the processes by which radical changes in scientific thinking are introduced – what modern scholars now refer to as a “paradigm shift”. The most famous case of a scientific revolution was the overthrow of the Ptolemaic geocentric paradigm, placing the earth at the centre of the universe with the sun and planets revolving around it, by the heliocentric Copernican paradigm, which places the sun at the centre of the cosmos with the earth and other planets revolving around it.

Kuhn at first identified two essential conditions for a successful paradigm change: first, the existing paradigm must suffer an unacceptable technical breakdown, thus creating a crisis; secondly, a novel and clearly superior paradigm must be available. He did concede, however, that in the above example “several factors external to science played a particularly large role.” (3) In his postscript to the third edition of *The Structure of Scientific Revolutions* he therefore introduced the element of community into his concept of the paradigm: “ ... it stands for the entire constellation of beliefs, values, techniques, and so on shared by the members of a given community.” (4) He goes on, “If this book were being rewritten, it would therefore open with a discussion of the community structure of science, a topic that has recently become a significant subject of sociological research and that historians of science are also beginning to take seriously.” (5) In other words, pressures from the community can critically influence the overthrow or triumph of a paradigm. This is especially true in respect of the social sciences for reasons that Magnus Blomstrom and Bjorn Hettne explain:

Since society is in a continuous state of flux, the social sciences are particularly prone to paradigm crises; however, the process of adjustment is hampered by the fact that theories may serve both ideological and legitimizing purposes. The paradigm change must therefore be politically sanctioned. (6)

Rise of the Neo-Liberal paradigm

Neo-Liberalism is the direct descendant of the *laissez-faire* paradigm inaugurated by Adam Smith's The Wealth of Nations in 1776 and elaborated by successive Classical economists, culminating with Alfred Marshall's Principles of Economics in 1920. The Classical paradigm failed to deal effectively with the Great Depression of the 1930s and was superseded by the Keynesian paradigm. Throughout the Cold War there were two competing paradigms, the Keynesian in the West and Marxist-Leninist in the Eastern Bloc. While leaving the vast majority of economic decisions to the Private Sector, John Maynard Keynes, in 1936, had advocated contra-cyclical regulation of government spending through the use of monetary and fiscal policy towards the maintenance of economic stability with full employment (7). Marxist-Leninism espoused a command economy in which the vast majority of economic decisions were taken by a central planning authority. When in the 1980s Keynesian policies failed to resolve the problem of "stagflation", i.e. the simultaneous occurrence of inflation and unemployment, President Reagan in the United States and Margaret Thatcher in the United Kingdom gave ideological respectability and political legitimacy to a vigorous counter-revolution launched by the Chicago School of Economics, under the leadership of Milton Friedman. Keynesianism was overthrown and the Classical *laissez-faire* paradigm reinstated.

A major casualty of this paradigm-shift was the banishment of development economics from the mainstream of the discipline. Indeed, it has almost disappeared from the curricula of leading American universities. The findings of distinguished development economists on the critical importance of institutions in economic development were thrown out the window and, flying in the face of history, the catalytic role of Government in economic development was denied. Our own Nobel Laureate, Sir Arthur Lewis, had made the latter case most forcefully:

No country has made economic progress without stimulus from intelligent governments, least of all England, the foundations of whose greatness as an industrial power were laid by a series of intelligent rulers, from Edward III onwards; or the United States, whose governments, state and federal, have always played a large part in shaping economic activity...(8)

Instead, economic development was treated as subject to the law of free market infallibility. Once we got prices right, *The Economist* argued, economic development would automatically follow.

The collapse of the Soviet Union in 1989 was seen as a victory for *laissez-faire* economics over Marxist-Leninism, and a more virulent and triumphalist mutation, known as “Neo-Liberalism”, evolved to become the dominant economic paradigm in the 1990s. Neo-Liberal economists soon began to occupy the top posts at leading American universities and the US Treasury, and there was a changing of the guard at the IMF and World Bank. The new dispensation came to be known as the “Washington Consensus”, and its mandate, in the words of President George W. Bush, was “to ignite a new era of global economic growth through free markets and free trade.”

The underlying tenet of the Neo-Liberal paradigm is that the unfettered workings of the free market ensure outcomes that cannot be improved upon by government intervention. A collateral aspect of Neo-Liberalism is the valuation of the interest of individuals above those of society. As Mrs. Thatcher infamously remarked, “There are no societies, only individuals.” As if individuals could survive in the absence of society! The markets postulated within the Neo-Liberal paradigm are even more remarkable than those of the Classical and Keynesian paradigms, which at least distinguished between various types - monopolistic, imperfect, monopoly, etc. Neo-Liberal markets are populated by ‘rational’ participants, are universally ‘efficient’ and can process all available information, making it impossible for mere mortals to outperform them. Above all, Neo-Liberal markets always know what is best for human beings.

Moreover, price theory, the central model of the paradigm, can be used, according to Karl Brunner, “to explain the whole range of social phenomena.” (9) Indeed, Neo-Liberal markets more resemble deities than intellectual constructs. No wonder that one often hears politicians, businessmen, and even professional economists, proclaim their “belief” in the “free market”. My response is that I believe only in God!

The major policy prescriptions of the Neo-Liberal school were:

1. Financial liberalization: removal of interest rate ceilings, abolition of exchange rate controls and the floating of currencies.

2. Financial globalization: removal of restrictions on inward and outward capital flows.
3. Deregulation and privatization of government enterprises
4. Free trade: removal of restrictions on imports and exports.

The Washington international financial institutions, together with the World Trade Organization, were the agencies designated to carry out the mandate of the “Washington Consensus”.

Cracks in the Neo-Liberal paradigm have been evident for some time. In the 1990s attempts at financial liberalization promoted by the IMF - under the influence of Dr, Ronald McKinnon’s thesis of “financial repression” - turned out badly in Latin America, while in Jamaica the entire indigenous banking sector collapsed. The same decade also saw the eruption of financial crises in Mexico, Argentina, Brazil, Russia and Thailand, following the opening of their financial markets to unfettered inflows and outflows of capital. (10) Meanwhile, the FTAA negotiations have gone nowhere and the latest WTO negotiations are deadlocked.

The spectacular collapse of Long Term Capital Management, a hedge fund run by Nobel Laureates Myron Scholes and Robert Merton, proved, in retrospect, to be a shadow cast by coming events; only a “bailout” by its creditors, orchestrated by the Federal Reserve Bank of New York, avoided a wider collapse in the financial markets. The events of the last few weeks leave the Neo-Liberal paradigm completely discredited. It is a bitter irony that Government, whose intervention into the free market is so deplored by Neo-Liberals, has had to come to the rescue of the “free market”.

The Countdown to Crisis

I claimed earlier to have had a front seat view of the unfolding drama but neglected to tell you that the drama was of the *genre* of Greek tragedy. The Hero in the play is the personification of the CEOs of Wall Street investment and banking houses, the most powerful and best paid business leaders in the world. But the Hero is flawed by the vice of greed, and succumbs to the lowly but toxic “sub-prime” mortgage loan. President Bush is the unsuspecting human agent that Fate uses to set in motion a series of seemingly unremarkable events that conspired to ruin our Hero.

In 2002 President Bush persuaded Congress to pass a \$1.6 trillion tax cut bill that, in one fell swoop, transformed President Clinton's legacy of fiscal "surpluses as far as the eye can see" into fiscal deficits that reached far beyond the horizon. (11) In so doing he transgressed the Keynesian principle of contra-cyclical macroeconomic policy in which surpluses accumulated in the economic upswing are drawn down in time of recession in order to kick-start economic recovery. The Bush tax-cuts effectively removed the fiscal policy option from the table, and the full load of economic stabilization fell on monetary policy which, as John Maynard Keynes famously observed, was like pushing on a string.. As the recession that had begun in 2001 deepened and the fear of deflation grew, the US Federal Reserve aggressively cut interest rates to as low as one percent, only to stumble into the classic Keynesian liquidity trap. The combination of low mortgage rates and easily available loans set off a housing bubble and spawned the deadly "sub-prime" mortgage loan.

A sub-prime mortgage loan is one made to a borrower who does not qualify for a loan at the most concessionary interest rate, and must therefore pay a higher rate to reward the lender for the extra risk he is taking. Some lenders find it more profitable to package and 'securitise' sub-prime loans for on lending to other investors. Between 2001 and 2004 the sub-prime mortgage market grew from \$160 billion to \$540 billion. Under pressure from the Administration and Congress, Fannie Mae, the Government sponsored mortgage insurer, brought on its books \$300 billion of sub-prime loans that it either retained or sold to domestic and foreign investors – including some in the Caribbean. When the housing bubble burst in 2006 home prices fell precipitously, and in many instances homeowners' equity fell below their mortgage indebtedness.

Meanwhile, our Hero had fallen victim to a most perverse incentive. At the Columbia Graduate School of Business in the 1960s, I was taught that Management was responsible for the "just" distribution of corporate earnings among all stake-holders – workers, suppliers, customers, Government, the Community and shareholders – the so-called "stakeholder theory". Stakeholder theory was superseded in the 1990s by the principle of "maximization of shareholder value". To align CEO interests to those of the shareholder, CEOs were paid an increasing proportion of their compensation in bonus awards of company stock and stock options as an incentive to put the interests of shareholders first. Whereas in 1980 stock options constituted only two per cent of executive pay in major corporations,

the proportion is now estimated at over 60 per cent, while the ratio of corporate pay to the median wage of workers increased from about 35:1 in 1980 to over 350:1 today.

The linkage of CEO pay to stock prices exposed CEOs to a moral hazard that many of them could not rise above. Since an increase in stock prices also raised their own income, they began to manage the stock price and ceased managing the company, often “cooking” the books to inflate profits and push up the stock price. Enron and WorldCom are infamous cases of corporate greed leading to the destruction of enterprises, with the loss of shareholder investment and workers’ jobs and pensions. Many senior executives would be marched off to prison.

On Wall Street, the Management of revered institutions forgot that their primary fiduciary responsibility was the safety of their clients’ deposits and investments. Instead, they chased after off-balance-sheet profits from investments in exotic derivatives and hedge-fund bets. Tragically, it was the lowly sub-prime mortgage loan that brought our Hero down, and with him everyone else in the building and vicinity.

Throughout it all, Federal Reserve Chairman, Alan Greenspan, himself a confirmed Neo-Liberal, refused to regulate trading in the new and increasingly complex financial markets, confident the “free market” would regulate itself. (12) I have no doubt that it was the culture of selfishness emanating from the Neo-Liberal paradigm that led to our present predicament.

Life after Neo-Liberalism

The damage to the US economy and to the national psyche has been severe. The recession, already underway, can be expected to last for two or three years more. US consumers, who have suffered huge losses in the stock market and from home foreclosures, face rising unemployment. They will hardly be able to play their traditional role of buyer of last resort, and exports to the US, including oil, will certainly fall off. We in the Caribbean must brace ourselves for adverse times. It is especially important for trade unions to take note and modify their wage demands accordingly.

Kuhn’s first condition for a paradigm-shift has been satisfied, in that Neo-Liberalism has failed comprehensively; however, no obvious alternative waits in the wings. Nevertheless, the strong opposition by

Congress to the “bailout” of Wall Street, a general revulsion to the conduct of Wall Street CEOs, and a call in most quarters for increased regulation of the financial sector, suggest weakening support for the Neo-Liberal paradigm. A Democratic victory next month might hasten the process.

Some Final Thoughts

Whether or not the Neo-Liberal paradigm is overthrown, reconstructed or merely modified, we economists in the Caribbean must not be content with hand-me-down economic models from so-called ‘mainstream’ economists. As my late friend Lloyd Best reminded us *ad nauseam*, we must tailor our economic models to fit our own history, culture, circumstances and aspirations. Indeed, that is what our New World Group of economists so gallantly attempted in the 1960s and 1970s. They failed, in my judgment, for epistemological, not intellectual reasons, and gave up the quest. But that is no reason why we should not try again to formulate a development paradigm that fits our needs - especially since Neo-Liberalism has failed in such a spectacular fashion.

In today’s climate of uncertainty, I suggest that you begin by going back to first principles. Here are some lines of approach you might consider:

1. Economies are comprised of **people**, not of graphs, mathematical symbols or statistical data.
2. The market is a concept; it does not cerebrate. only **people** do. It does not know better than we do.
3. Only people, not economies and markets, have problems. Our theories must therefore be **people** oriented
4. The market is a social tool for the **inexpensive, not optimal**, allocation of resources. We must determine what we want it to do for us, not *vice-versa*. Moreover, it is useful towards the solution of **only some, not of all problems!**
5. If we can live with market outcomes, we accept them; if we cannot, we must intervene as robustly as needed – even as the

Americans and Europeans have done in response to the current global financial crisis.

Finally, economic development derives from the efforts of people, usually working in groups. Their activities will be productive only if well managed. Good management promotes productivity, profitability, the creation of new capital and, ultimately, economic growth and development. On the contrary, poor management results in the destruction of capital and economic disaster – often with amazing swiftness, as the current crisis so vividly illustrates. This is the lesson that Dr. Trevor Farell has relentlessly kept before us for over three decades, and it is for this reason that we honour him today.

NOTES

1. Blackman, Courtney N., The Practice of Economic Management: A Caribbean Perspective, Ian Randle Publishers, Kingston, Jamaica, 2006.
2. Kuhn, Thomas S., The Structure of Scientific Revolutions, (Third Edition), University of Chicago Press, 1996.
3. Ibid. p.75.
4. Ibid. p.75.
5. Ibid. p.176.
6. Blomstrom, Magnus & Hettne, Bjorn, Development Theory in Transition: The Dependency Debate & Beyond, London, Zed Books Ltd., 1984, p. 197.
7. Keynes, John Maynard, The General Theory of Employment, Interest and Money, New York, Harcourt, Brace & World, Inc., 1983.
8. Lewis, W. Arthur, The Theory of Economic Growth, New York, Harper & Row, 1970. p.376.
9. Brunner, Karl, as quoted by Arjo Klamer in, Conversations with Economists, Roman and Allenheld Publishers, New Jersey, 1984, p.183.
10. McKinnon, Ronald, Financial Liberalisation and Economic Development, Washington, D.C., The Brookings Institute, 1973.
11. The author severely criticized the Bush tax-cuts at the time of their enactment. cf., The Practice of Economic Management: A Caribbean Perspective, op. cit., p.349.

12. Not long after this presentation, former Chairman of the US Federal Reserve Board, Alan Greenspan, admitted to a Congressional Committee that there had been a “flaw” in his ideology, and that he had erred in assuming that financial markets could properly regulate themselves.