

Edited by
Franco Amatori - Andrea Colli

The Global Economy

A concise history

 **Routledge**
Taylor & Francis Group



G. Giappichelli Editore

First published 2019
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

and by G. Giappichelli Editore
Via Po 21, Torino – Italia

© 2017 Franco Amatori - Andrea Colli (Edited by), *Il mondo globale. Una storia economica* - Giappichelli Editore

© 2019 Franco Amatori - Andrea Colli

The right of Franco Amatori - Andrea Colli to be identified as authors of this work has been asserted by them in accordance with sections 77 and 78 of the Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this book may be reprinted or reproduced or utilised in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

Trademark notice: Product or corporate names may be trademarks or registered trademarks, and are used only for identification and explanation without intent to infringe.

British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging-in-Publication Data
A catalogue record for this book has been requested

ISBN: 978-0-367-26508-3 (hbk-Routledge)
ISBN: 978-88-921-1734-1 (hbk-Giappichelli)
ISBN: 978-0-429-29355-9 (hbk-Routledge)
ISBN: 978-0-367-26507-6 (pbk-Routledge)

Typeset in Simoncini Garamond
by G. Giappichelli Editore, Turin, Italy

The manuscript has been subjected to the double blind peer review process prior to publication.

Chapter 23

A DIFFERENT KIND OF CRISIS?

SUMMARY: 23.1. The origins of the financial crisis. – 23.2. Bailing out the banking systems. – 23.3. Uncertainties after the crisis. – Bibliography.

23.1. The origins of the financial crisis

The crisis began in 2007 with the first difficulties in the US property market. It then spread to some European countries before turning into a truly global crisis, which is having a profound effect on the process of globalization. The initial *subprime* crisis appeared to involve only the US mortgage market, where a superficial approach to lending meant that when interest rates rose, many low-income borrowers were actually unable to pay their mortgages and interest; however, it gradually revealed the vast extent to which the world economy was now financialized.

In effect, before exploring the complicated mechanisms leading to the crisis, and its different stages in the following years, it is important to consider the profound transformations to the international financial system during the second half of the 1970s and the early 1980s. The mass of capital in circulation following the rise in petrol prices gradually brought changes with both short-term and mid- to long-term impacts. The first phase of globalization of the financial markets involved the interaction of the Eurodollar market (already in existence for about 15 years) and the petrodollar market; the massive use of petrodollars to finance the economies of the developing countries led to the serious international debt crises of the early 1980s, and again ten years later. This was the multiplying effect of two enormous masses of capital; once combined, they produce results that can be quantified in geometric and not mathematical terms. The international financial system has been compelled to adapt to this growing mass of resources by continually adjusting its productive capacity to the money supply: in other words, it has had to innovate by continually inventing new financial tools for the allocation of these huge amounts of money.¹

In 1980, the total value of financial *assets* (including bank deposits, pub-

¹ G. Mellman, *The Vandal's Crown. How Rebel Currency Traders Overthrew the World's Central Banks*, London, 1995; S. Strange, *Mad Money*, Manchester, 1998

lic debt, private debt securities and equities) was \$12 trillion, but their value had risen to \$196 trillion by 2007. In 1980, they represented almost 150% of world GDP, and this share had risen to 351% by 2007. However, many changes were taking place within this framework: this mass of financial resources had gradually moved away from bank deposits (down from 45% to 29% of the total) towards institutional investors. The two items with the highest growth rates were equities (from 23% to 29%) and private debt securities (from 14% to 25%), and this growth was also sustained in the following years. In 2007, the total value of *assets* amounted to just over \$206 trillion, equal to 351% of world GDP.

This meant that there were plenty of warning signs. In December 2006, *The Economist* used a rather more triumphant tone than usual in its forecast for the following year, announcing that "Market capitalism, the engine that runs most of the world economy, seems to be doing its job well".² In mid-February 2007, Federal Reserve head Ben Bernanke presented a relatively rosy situation to Congress, with US economy that was doing well, growing at a more sustainable rate (a new "soft landing", like that described by his predecessor in the mid-1990s). There were no great concerns about the share of the mortgage market that was more at risk, since families' extra-debt was now offset by the fall in long-term interest rates.³ During the same weeks, the IMF stated that "residential investment was a substantial drag on U.S. GDP in the second half of 2006. Over the past few months, there have been some tentative signs of stabilization at least on the demand side, as sales of existing homes, mortgage applications, and potential homebuyer intentions have generally steadied or improved". However, the same publication affirmed that "there remain risks that the fallout from the housing correction could be amplified, particularly if tightening lending standards in the subprime sector were to lead to a broader reappraisal of credit availability across the economy or if household cash flows were to weaken". Such a development – concluded the IMF – "could imply a deeper and more prolonged slowdown or even a recession in the United States, with potential spillovers to other countries".⁴

Returning to the summer of 2007, which was, in a way, just a long beginning, insiders were not completely unaware of what was happening. In mid-July, the managers of an Australian *hedge fund* disclosed that the fund

² *Happiness (and How to Measure It). Capitalism Can Make a Society Rich and Keep It Free. Don't Ask It To Make You Happy As Well*, in *The Economist*, 19.12.2006.

³ *Sunshine and Light, Mostly*, in *The Economist*, 15.2.2007.

⁴ International Monetary Fund, *World Economic Outlook April 2007. Spillovers and Cycle in Global economy*, Washington, 2007, pp. 7-8.

was reducing its investments due to the difficulties of the US credit market "following concerns in relation to sub-prime residential mortgages and have made margin calls".⁵ Before the end of July, the situation began to affect US banks, which fell several points on Wall Street.⁶ On 1st August, the *Financial Times* wrote that "little debt market bombs are starting to explode on the balance sheets of financial institutions around the world".⁷

News arrived thick and fast in August. What at first glance seemed a credit problem was tackled in the usual way; on 17th August the Federal Reserve cut the bank rate by a quarter of a point, an indirect admission that the credit squeeze could cause problems for the US economy. In September 2007, the idea began to spread that the world economy might have reached a turning point. The phase of growth and stability of the last twenty years seemed to have ended, but the economy's greater flexibility gave it more ability to absorb the shock, appearing to produce permanent stability. In that precise moment, it seemed foolish to consider testing this assumption by combining the turbulence of the credit markets with the vulnerability of the property markets. However, the risk remained, related to an excessively generous use of the new financial products, whose *fall-out* was poisoning the short-term credit markets that were vital for the economy to function correctly.⁸

One year later, the situation was completely different. The crisis had become much more serious and threatened the entire international financial system. First came the failure of Fannie Mae and Freddie Mac, two of the USA's biggest providers of mortgage finance. This was followed in September by the bankruptcy of Lehman Brothers, one of the world's most prestigious and important investment banks, and Merrill Lynch was taken over by Bank of America.⁹ Bank employees – some in tears – left the skyscraper with their possessions in cardboard boxes, and these images became symbols of a world unexpectedly discovering its hidden weaknesses.

The deeper underlying causes of the crisis gradually became clearer. China's huge trade surplus generated an excessive amount of capital in Asia, used by Beijing to buy US bonds, which pushed interest rates down

⁵ *Subprime Crisis. The Basis Capital Letter to Investors*, in *Financial Times*, 18.7.2007.

⁶ *Banks Burnt by Credit Meltdown*, in *Financial Times*, 27.7.2007.

⁷ *Subprime Grenades*, in *Financial Times*, 1.8.2007.

⁸ *The Turning Point. Does the Latest Financial Crisis Signal the End of a Golden Age of Stable Growth?*, in *The Economist*, 20.9.2007.

⁹ C. Mollenkamp, S. Craig, S. Ng, A. Lucchetti, *Lehman Files for Bankruptcy; Merrill Sold, in AIG Seeks Cash*, 16 settembre 2008; P. Chapman, *The Last of the Imperious Rich. Lehman Brothers, 1844-2008*, London, 2010.

worldwide in the first few years of the 21st century. The European banks obtained finance in the USA and used these funds to buy unstable equities. All these factors combined to drive the debt level upwards in a world that appeared to have become less risky.¹⁰

Money was unwisely lent to people with a *poor financial story* (no bank account, no credit card). These high-risk debts were passed to financial engineers in the big banks, who packaged them together with low-risk financial products in the mistaken conviction that the US property market behaved differently from one city to another. However, house prices fell across the entire country in 2006. These financial products were used to protect other securities, CDOs (*collateralised debt obligations*), i.e. fixed interest securities protected by a portfolio of obligations, loans and other assets, which were then sliced into portions (*tranches*) according to the level of risk. Investors bought the more secure *tranches* from banks on the strength of AAA ratings assigned by the *rating agencies*, unaware that banks had paid agencies to give a more generous evaluation of the risk level.

When the US property market began to suffer, a chain reaction revealed all the fragilities of the financial system. The products of financial engineering proved to be insufficiently protected, and the value of mortgages based on these products collapsed, falling in some cases to zero. Previously considered secure, CDOs were now worthless and impossible to sell at any price, despite their rating.

Trust, another fundamental element of the international financial system, had already vanished a year before the end of Lehman Brothers. Short-term credit was either interrupted or else granted at extremely high interest levels to discourage the market. At the same time, the immediate return of short-term credit was demanded. This was the situation causing the problems of Northern Rock, a British bank specializing in mortgage loans.¹¹ The failure of one small link plunged the entire debt chain into a crisis. Financial tools like *credit default swaps* (agreements in which the seller compensates the buyer in the case of default by a third party) had been created to spread the risk, but were now seen to concentrate it even more. AIG, a major US insurance company, risked bankruptcy under the weight of the vast number of CDOs it had sold.¹²

¹⁰ J.E. Stiglitz, *Freefall. America, Free Markets, and the Sinking of the World Economy*, New York, 2010.

¹¹ B. Walters, *The Fall of Northern Rock. An Insider's Story of Britain's Biggest Banking Disaster*, London, 2008.

¹² R. Boyd, *Fatal Risk. A Cautionary Tale of Aig's Corporate Suicide*, Hoboken N.J., 2011.

23.2. Bailing out the banking systems

The bankruptcy of Lehman Brothers (\$639 billion, the biggest in US history) caused panic. Three days before this happened, on 12th September, J.P. Morgan had published its forecasts for the following year, indicating that the GDP of the USA would accelerate in the first half of 2009. It is likely that no economic forecast has ever been more mistaken, as Alan Greenspan recalled some years later.¹³ On 22nd September, Morgan Stanley and Goldman Sachs ceased to operate as investment banks, and became traditional commercial banks accepting deposits from private citizens and companies. This began a process of profound change on Wall Street, and was just the first in a series of events disrupting international finance and redefining the relations between the system's principal operators. The Federal Reserve supervised the operation.¹⁴ A week later, on 28th September, the US Congress approved the Troubled Asset Relief Programme (TARP), a \$700 billion rescue plan for the banking sector. According to some experts, this was only an estimate, representing a compromise between the \$1 trillion requested by Wall Street and the initial figure proposed by Treasury Secretary Henry Paulson.¹⁵

It was a sign that government intervention was going to play an extremely important role in the development of the crisis. On the next day, the British government nationalized the Bradford & Bingley, assuming over £50 billion in mortgage loans and debts, providing a further £18 billion to allow Santander to take over two hundred Bradford & Bingley branches. In the following days, the Irish government declared that it would guarantee all deposits in the Republic's banks for two years. The governments of France, Belgium and Luxembourg worked together on a bailout package for Dexia, and the German government did the same for Hypo Real Estate. A few days later, the British government announced a £500 billion intervention package, and in mid-October it provided another £37 billion just to recapitalize the Royal Bank of Scotland. The Dutch government intervened with €10 billion to rescue ING, and Sweden's government provided the country's banks with a 1.5 billion *krone* (€205 billion) credit line. In

¹³ A. Greenspan *Never Saw It Coming. Why the Financial Crisis Took Economists by Surprise*, in *Foreign Affairs*, 2013.

¹⁴ J. Hilsenrath, D. Paletta, A. Lucchetti, *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis. End of Traditional Investment Banking, as Storied Firms Face Closer Supervision and Stringent New Capital Requirements*, in *The Wall Street Journal*, 22.9.2008.

¹⁵ A.R. Sorkin, *Too Big to Fail. The Inside Story of How Wall Street and Washington Fought To Save the Financial System and Themselves*, London, 2009, pp. 446-448.

early November, the US government decided to invest \$40 billion in AIG preferential shares and another \$45 billion to cover its debts, establishing a different approach from the one taken a few months earlier with Lehman Brothers. Although AIG had committed the same sinful mistake (\$400 billion in derivative securities, mainly CDOs to protect other investments), its failure would have had a greater impact, bringing down every financial institution that had insured its credit risk.¹⁶

In the following weeks and months, the crisis hit all the world's stock exchanges, bringing the first signs that the international economic system was in difficulty. The Dow Jones fell by around 50%, from 14,000 in summer 2007 to just over 7,000 in the next two years, as did the S&P500. Between September 2007 and February 2009, the London share index fell from 6,500 to 3,500 points (its lowest point during the crisis).¹⁷

Barack Obama's victory in the presidential elections on 4th November 2008 was decisive for the outcome of many measures introduced in the last period of the Bush presidency, but the biggest novelties came in the very first months of the new presidency. Several bipartisan measures had already been introduced during the transition period between the two administrations, signalling that a new approach would now prevail. The Fed intervened in mid-November to invest \$100 billion in Fannie Mae, Freddie Mac and Federal Home Loan Bank stock, and \$500 billion in their mortgage-backed securities. The intention was to restart the mortgage and property market. Without consumer lending, consumption would fall, bringing increased unemployment, more defaults, and further problems for the financial system. The new administration could not afford to let this happen. The Fed added a further \$180 billion in loans to *hedge funds* and other investors to enable the consumer credit market to pick up again. In order to overcome creditors' last fears, the Fed also declared its willingness to write off the debt in the case of a large number of consumer defaults.

The government also supported the plan to rescue Citigroup, the biggest US bank, by accepting to absorb 90% of the bank's losses on \$300 billion of toxic assets. This move was also symbolic: for years, Citibank had been to the forefront in demanding repeal of the Glass-Steagall Act. There was criticism when the bank's managers were not removed as a condition of its bailout, although Citigroup was effectively under government control, since a former Treasury Undersecretary during Clinton's presidency, Robert Rubin, was a senior adviser. Rubin's protégé, Timothy Geithner, presi-

¹⁶ H. James, *The Creation and Destruction of Value: The Globalization Cycle*, Harvard, 2009, pp. 114-115.

¹⁷ <http://www.dowjones.com>; <https://uk.finance.yahoo.com>.

dent of the Fed in New York, was nominated to the Treasury by the new administration. On taking office, Geithner immediately made it clear that he was opposed to nationalization of the banks in difficulty, even on a temporary basis; it would damage the prospects of recovery and create uncertainties about the banks' daily operation, while the international press would see the "spectre of nationalization" as something to avoid.¹⁸

Consolidation of US finance was entrusted to the Public-Private Investment Program for Legacy Assets (PPIP) launched in February 2009. This was accompanied by the Fiscal Stimulus or Recovery Act, officially known as the American Recovery and Reinvestment Act of 2009 (ARRA) and worth \$785 billion, which was then increased to \$831 billion.¹⁹ The new measures were aimed at stimulating US economic recovery by saving existent jobs and creating new ones. Other objectives were to provide temporary relief programs for those most affected by the recession, to invest in infrastructure with prospects of long-term benefits, in education, health, and renewable energy, and to stabilize the finances of local and state governments.²⁰

During the 2008 presidential election campaign, some conservatives had criticized Obama as wanting to allow socialists and their ideas into the White House, and these measures appeared to strengthen his enemies' convictions. There were interventions in favour of the US car industry in April 2009, when the government was forced to mount a massive rescue operation to save General Motors and Chrysler, the biggest US car manufacturers, from bankruptcy. This involved temporary purchase of 50% of GM shares, reduction of its workforce, and an injection of liquidity to silence its creditors. Chrysler's recovery was managed in part with FIAT, which was immediately granted a 20% stake in the company in return for its role in the restructuring process; FIAT had the prospect of becoming Chrysler's majority shareholder within a few years, when recovery would be complete and the company would be able to repay the government loan.²¹

¹⁸ *The Spectre of Nationalisation. There Are Ways for Governments to Revitalise Banks without Taking Them Over*, in *The Economist*, 22.1.2009.

¹⁹ B. Eichengreen, *Hall of Mirrors. The Great Depression, the Great Recession, and the Uses – and Misuses – of History*, Oxford, 2015, pp. 289-301.

²⁰ *The Obama Rescue. This Week Marked a Huge Wasted Opportunity in the Economic Crisis*, in *The Economist*, 12.2.2009.

²¹ S. Mufson, *Gm's New Escape Route. Partial Nationalization*, in *Washington Post*, 28 aprile 2009; *Chrysler and General Motors End Game*, in *The Economist*, 30.4.2009.

23.3. Uncertainties after the crisis

The 2007-2008 crisis immediately became a case for economists and financial historians to study, and thousands of books, articles, essays and papers about it were soon published. The discussion was not entirely confined to academic circles and became partly public, precisely because the crisis had such dramatic effects on the lives of millions of people in different countries. The debate about the origins of the crisis was not a mere academic exercise, nor was it limited to the financial sector. In March 2009, the *Financial Times* wrote: the "credit crunch has destroyed faith in the free market ideology that has dominated Western economic thinking for a generation. But what can – or should – replace it?" These words then gave rise to a series of articles, and the replies proposed various ways to avoid a repetition of the crisis.²² Not all the many international interventions were seen as effective. The report from the US government-appointed Commission states very clearly that the crisis could have been avoided. However, this report was not unanimously approved. Four of the Commission's ten members presented a minority report, criticizing its failure to provide an accurate evaluation of the amount of international capital looking for profitable investments in the US mortgage market²³, what upset public opinion the most was the multi-million dollar bonuses paid to the *top executives* who had led the banks into the crisis and – in some cases – into bankruptcy. In the following years, the general worsening of economic conditions meant that public opinion became even more hostile towards the fat salaries of these top managers. On the other hand, few of these top executives were actually accused of criminal action, although their behaviour was heavily criticized and some actually resigned.²⁴ Galbraith told the Senate Judiciary Committee that those who had made mistakes, even the regulators,

²² *The Future of Capitalism*, in *Financial Times*, 23.3.2009.

²³ The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report. Final Report of The National Commission. The Causes Of The Financial And Economic Crisis In The United States*, Official Government Edition Submitted By Pursuant To Public Law 111-21, Washington, 2011; *The Official Verdict America's Fcic Report is Big, Surprisingly Readable and a Disappointment*, in *The Economist*, 3.2.2011.

²⁴ Top 12 CEO Departures of 2009, in *Forbes*, 15.12.2009; <http://ig.ft.com/sites/2015/bank-ceo-compensation-2015/>; <http://www.reuters.com/article/us-swiss-vote-pay-idUSBRE9ANOBW20131124>; C. Copley, *Swiss voters reject proposal to limit executives' pay*; <http://blogs.worldbank.org/allaboutfinance/executive-pay-and-the-financial-crisis>, L. Bebchuk, *Executive Pay and the Financial Crisis*, 31.1.2012; J. Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis*, in *The New York Times Magazine*, 30.4.2014.

should be treated so harshly that they would feel "in their bones, the power of the law".²⁵

When the report was eventually published, the international financial system was very different from the way it had been a few years earlier; the crisis had shaken its very foundations, and there was even talk of a new world order.²⁶ Nevertheless, the data on the total value of financial assets show an almost immediate recovery. The 2007 value of \$206 trillion dropped to \$189 trillion in 2008, but then recovered in 2009 to its level at the start of the crisis in 2007; it rose to \$219 trillion in 2010 and to \$220 trillion in 2011. The single items most affected by the crisis were shares, which fell from \$64 trillion to \$47 trillion between 2007 and 2011, government bonds, which rose from \$32 trillion to \$46 trillion (indirectly due to the cost of the crisis), and non-securitized loans, which rose from \$50 trillion to \$60 trillion. When the McKinsey Institute published these data (in mid-2012), it was still uncertain about the outlook; it was unclear whether the system was in a phase of contraction or reorganization.²⁷

In effect, a far-reaching reorganization of the banking system had been effected through mergers with the banks that were in difficulty. The ownership structures of some of the major world banks had changed when the sovereign investment funds of the Arab Emirates, Singapore, and, most importantly, China began buying shares during the most difficult period of the crisis in 2008-2009. In 2008 alone, their total investments in the financial system amounted to over \$75 billion. The major US, Swiss, Italian and German banks were involved in these operations, which did not generally have positive results.²⁸ The regulatory system was reformed in the aftermath of criticisms related to its loose surveillance of the markets. In Great Britain, the tripartite system established in 1998 (Treasury, Bank of England and Financial Services Authority, FSA) was criticized for its ineffectiveness and slowness to intervene before and during the crisis. In 2012-2013, the FSA was replaced by two bodies: the Financial Conduct Authori-

²⁵ utip.gu.utexas.edu/Flyers/GalbraithMay4SubcommitteeCrine.

²⁶ P. Coggan, *Paper Promises. Money, Debt and the New World Order*, London, 2011.

²⁷ McKinsey Global Institute, *Financial Globalization. Retreat or Reset? Global Capital Markets 2012*, New York, 2013.

²⁸ *The Invasion of the Sovereign-Wealth Funds. The Biggest Worry about Rich Arab and Asian States Buying Up Wall Street is the Potential Backlash*, in *The Economist*, 18.1.2008; J. Willman, *Sovereign Wealth Funds. Yesterday's Bad Guys Ride to the Rescue*, in *Financial Times*, 21.1.2008; L. Anderioni, D. Vandone, *Sovereign Wealth Fund Investments in the Banking Industry*, working paper n. 2012-24, University of Milan, Department of Economics, Management and Quantitative Methods, December 2012.

ty, and the Prudential Regulation Authority, which was directly controlled by the Bank of England.²⁹

In general, greater controls were introduced at all levels, obliging the banking system to behave differently and make radical changes to strategy. In any case, while the problem was to avoid the fear voiced in the title of a well-known book – *too big to fail* – the aftermath of the crisis made the problem more acute. The banks were now even bigger and even more interconnected with the entire system (in 2013, the six major US banks were 37% bigger than in 2008-2009). Some new legislation, such as the Dodd-Frank Act, could not be applied immediately, since it required interventions by around a hundred financial institutions. However, the banking system resisted well, although certain limitations contained in the reform (making it more difficult for the Fed to intervene in a liquidity crisis of healthy banks) threatened to greatly reduce the central banks' role as lenders of last resort, one of the cornerstones of the modern banking system.³⁰

For this reason, the regulators tried to do what they had always done, and just made the regulations stricter, e.g. regarding the *ratios* for banking work, the work inside the banks, and the links between banks. They introduced a far-reaching innovation that has been described in a very simple way: instead of asking all the banks "precisely how their payment system functioned", the question had become "show me how it works". This has allowed – or should allow – entry to much more complex areas of the banking system, which had been (to use a euphemism) somewhat shady. The regulators had obtained a role in decisions; this is the difference between *conduct regulation* and *prudential regulation*, the terms used for the new regulatory bodies created in Great Britain.³¹

At the global level, the most important intervention in this sense came from the Basel Committee on Banking Supervision (BCBS), which in 2001 introduced Basel III, an international regulatory framework to strengthen the regulation, supervision and risk management of the banking sector. The framework is based on the interaction between two approaches, defined as "microprudential" (related to the regulation at the level of single banks) and "macroprudential" (related to the system risks that may build up in the banking sector, and their procyclical amplification over time). The principal points of the framework include the need to make the banking sector more resilient to the impacts of economic and financial tensions, irrespec-

²⁹ *Review of HM Treasury's Management Response to the Financial Crisis*, London, 2012.

³⁰ B. Eichengreen, *Hall of Mirrors*, cit., pp. 323-324.

³¹ *Chained but Untamed*, in *The Economist*, 12.5.2011; *A Dangerous Embrace*, *ibidem*.

tive of their origins; to improve risk management and *governance*, and lastly, to make the banking sector more transparent.³² These regulations form the basis of the European Banking Authority's stress tests on banks.

However, these interventions cannot ensure that history will not repeat itself, and many people are still convinced that the bankers have not yet learned their lesson.³³ The strictest measures to avoid the repetition of certain risks can be adopted only in relation to the banking and financial system. In any case, what emerged during the crisis was that a large share of the operations and products most at risk were actually managed by operators who the financial authorities were juridically unable to control, thus making all attempts at regulation extremely difficult. This is known as the *shadow banking system*. It is estimated to be extremely large, and thus represents a potential danger for the system, also because of its close links to the "official" banking and financial system.³⁴ The most recent estimates (based on data from 26 countries) of its size range from a minimum of \$36 trillion (59% of these countries' GDP and 12% of the total global financial system) to a maximum of \$137 trillion (40% of the financial system's total assets). If the first estimate were exact, it would indicate a drop of \$36 trillion from the 2007 peak while the second figure would indicate an increase of 125%.³⁵

The crisis began as an economic and social problem among the weaker sectors of US society. Borrowers were unable to pay the interest on mortgages provided by an over-generous banking system, which then had to pursue its customers in order to increase its volume of business during a period of low interest rates. The crisis firstly affected the US financial sector, and then turned into a global crisis. Attempts made by various governments to inject resources into their countries' economies had little effect.³⁶

³² Bank for International Settlements, *Basel III. A Global Regulatory Framework for More Resilient Banks and Banking Systems*, Basel, 2011.

³³ A. Admati, M. Hellwig, *The Bankers' New Clothes, What's Wrong with Banking and What to do about it*, Princeton, 2014.

³⁴ Financial Stability Board, *Global Shadow Banking Monitoring Report 2015*, Basel, 2015.

³⁵ Federal Reserve Bank of New York – Staff Reports, T. Adrian, Hyun Song Shin, *The Shadow Banking System. Implications for Financial Regulation*, Staff Report No. 382, July 2009; Brookings Papers on Economic Activity, A. Metrick, G. Gorton, *Regulating the Shadow Banking System*, Fall 2010, <http://www.brookings.edu/about/projects/bpea/papers/2010/regulating-shadow-banking-system-gorton>.

³⁶ *China Seeks Stimulation. A Stimulus Plan to Inject \$586 Billion into China's Economy. But the Devil Lies in the Detail*, in *The Economist*, 10.11.2008; D. Weinland,

The world economy has now been in a state of crisis for almost a decade. Although global GDP rose from \$57.5 trillion in 2007 to \$78.1 trillion in 2014, it fell to \$73.4 in 2015; GDP growth was around 4% in 2000, fell below 3% after the crisis, and now stands at just a little over 2.5%. GDP in the USA has grown at around 2.5% since 2010, and Japan's economic growth rate has hovered around zero for about 20 years. EU growth rates from 2000 to 2007 ranged between 2% and 4%, but have been between 1% and 2% since 2010 (and slightly lower than this in the Eurozone).³⁷

Since emerging countries and markets are also growing more slowly, and aging populations are no longer a problem only for the most advanced economies, there is a risk that the world economy has entered a long – “secular” – phase of stagnation, to quote Larry Summers, Bill Clinton's former Treasury Secretary.³⁸ The structural changes to the economy caused by globalization have probably brought about a “substantial change” in the natural balance between savings and investments, causing a decline in the balance or in the normal interest rate associated with full use. Imbalances between the countries with large trade surpluses, like China and Germany, and the countries with structural deficits have an increasingly destabilizing effect on the world economy.

The answer many people give today is no different from what Keynes said in the 1930s: the problem lies with demand, not supply. Demand must be revived, but this requires policy makers to understand exactly where the problem lies. This is the only way to overcome the dilemma of knowing whether or not “this time is different”.

If they cannot diagnose the problem correctly, there is the risk of confirming the words of those who say that this time is no different.³⁹

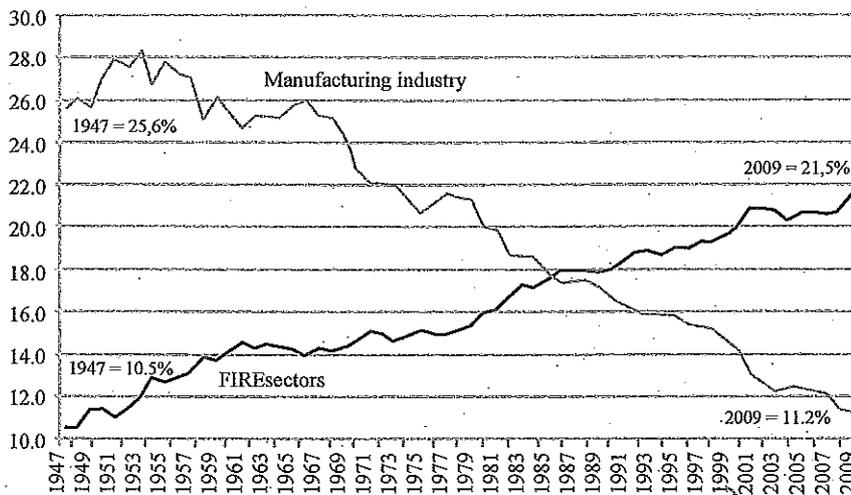
G. Wildau, *China Financial Regulator Clamps Down on Shadow Banking. Chinese Banks have Disguised Risky Loans as Investment Products*, in *Financial Times*, 2.5.2016.

³⁷ <http://www.worldbank.org>.

³⁸ L.H. Summers, *U.S. Economic Prospects. Secular Stagnation, Hysteresis, and the Zero Lower Bound*, in *Business Economics*, 49, 2, pp. 65-73; Id., *The Age of Secular Stagnation*, in *Foreign Affairs*, March/April 2016, pp. 2-9.

³⁹ C.M. Reinhart, K.S. Rogoff, *This Time Is Different. Eight Centuries of Financial Folly*, Princeton, 2009, p. XXXV.

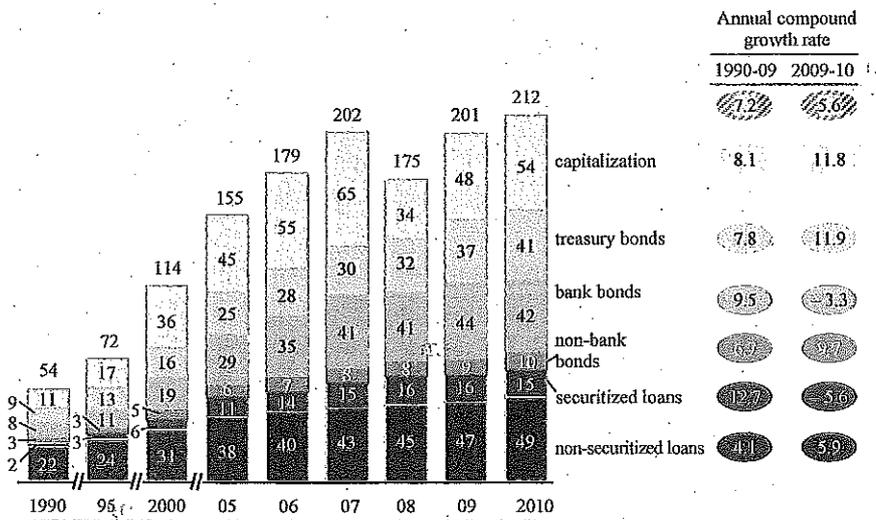
Figure 23.1. US FIRE economy and manufacturing (added value per sector % of GDP, 1947-2009)



Note: FIRE economy (Finance, Insurance & Real Estate).

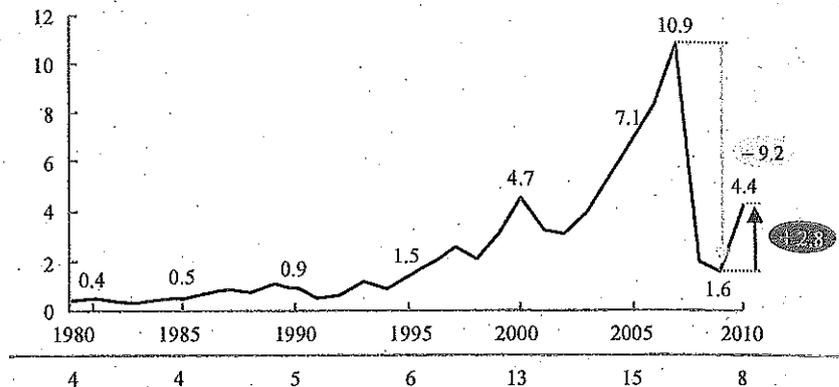
Source: US Bureau of Economic Analysis.

Figure 23.2. Global stock of debt and of principal financial products (1991-2010, in a sample of 79 countries)



Source: Bank for International Settlements; Dealogic; SIFMA; Standard & Poor's; McKinsey Global Banking Pools; McKinsey Global Institute Analysis.

Figure 23.3. Total foreign investments (% of global GDP, in a sample of 79 countries, \$trillion at constant 2010 exchange rates)



Note: Total foreign investments refer to assets purchased by non-residents (including banks) and include direct foreign investments, portfolio investments (shares and government bonds) and foreign loans.

Source: International Monetary Fund; Institute of International Finance; McKinsey Global Institute Analysis.

Bibliography

- Rajan R.G., *Fault Lines. How Hidden Fractures Still Threaten the World Economy*, Princeton, 2010.
- Reinhart C.M., Rogoff K.S., *This Time Is Different. Eight Centuries of Financial Folly*, Princeton, 2009.
- Sorkin A.R., *Too Big to Fail. The Inside Story of How Wall Street and Washington Fought To Save the Financial System and Themselves*, London, 2009.
- Stiglitz J.E., *Freefall. America, Free Markets, and the Sinking of the World Economy*, New York, 2010.
- Strange S., *Mad Money*, Manchester, 1998.

AUTHORS

Franco Amatori is Professor of Economic History at Bocconi University, where he teaches History of Italian Business, Business History and Comparative Business History. He edited the volume; he is the author of chapters 6, 7, 24.

Andrea Colli is Professor of Economic History at Bocconi University, where he teaches Economic History, Business History and Global History. He edited the volume; he is the author of chapters 14, 15, 16, 17, 18.

Guido Alfani is Professor of Economic History at Bocconi University, where he teaches Globalization, Divergence and Inequality in Historical Perspective. He is the author of chapters 1, 2, 3.

Silvia A. Conca Messina is Assistant Professor in Economic History at the University of Milan, where she teaches Economic History and History of Economic Policy. She is the author of chapters 4, 5.

Gianluca Podestà is Professor of Economic History at the University of Parma, where he teaches Economic History and History of Financial Markets. He is the author of chapters 10, 11, 12, 13.

Marina Romani is Associate Professor of Economic History at the University of Genoa, where he teaches Economic History and History of Money and Financial Markets. She is the author of chapters 8, 9.

Luciano Segreto is Professor of Economic History at the University of Florence, where he teaches Economic History of Globalization, Business History in Global Economy and International Economic History. He is the author of chapters 19, 20, 21, 22, 23.

AUTHORS OF THEMATIC SECTIONS

Matteo Di Tullio (Bocconi University and University of Pavia): Demographic transition.

Roberto Giulianelli (Marche Polytechnic University): Mass Emigration from Europe.

Marina Nicoli (Bocconi University): Industrial Revolution.

Mario Perugini (Bocconi University): Workplace Organization and International monetary systems.