How the 2008 and COVID-19 Crises Exacerbated the Failure of Modern-Day Capitalism

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Among economists, it is common practice to compare and contrast economic crises, and to try to ascertain root causes and identify similarities with previous crises. Thus, if we take the recent COVID-19 crisis that has brought the world economy to a halt, it is a common narrative for economists and experts alike to compare this crisis with the 2008 Great Recession. In my opinion, this is a flawed stance, as this crisis is simply an escalation of the 2008 crisis. To understand why this is apparent, we need to understand the neoliberal era we are currently living in, commonly known as the age of financialization. Since the collapse of the Bretton Woods Agreement in 1973, neoliberal policies such as deregulated financial markets have led to unrestrained financial capital flows throughout the global economy. The key issue with the modern way of assessing macroeconomic performance, i.e. comparing fiscal data and analyzing trade flows relative to other countries, is no longer appropriate; instead, macroeconomic performance should focus more on financial capital flows. The age of financialization has changed capitalism and, in my opinion, for the worse. The deteriorating state of modern-day capitalism has been exacerbated since the 2008 financial crisis.

Before the neoliberal era's birth, financial flows were less complex and tended to flow from one country to another to finance trade. Most countries' consumption was linked with domestic producers, and countries such as the US and the UK generally produced far more of the products they consumed relative to the current era. Therefore, assessing a country’s economic strengths and weaknesses was less complex back then; however, things have drastically changed. But why?

One of the most significant moments in capitalism’s history was when the global economy decided to move away from a system where the finance sector was shackled and circumscribed in what they could do, which had created a direct correspondence between the real economy and money flows. This era was known as the Bretton Woods Era, often referred to as the golden era of capitalism. The Bretton Woods Agreement replaced the gold standard with the US dollar as the world’s global currency, making the US the only country that could print dollars. Under the agreement, countries promised to make sure their central banks fixed their exchange rates to the US dollar. In turn, the dollar was pegged to the price of gold. Countries that signed up to the Bretton Woods system technically agreed to refrain from trade wars, e.g. lowering their currencies to be more competitive and boost trade. However, specific provisions stipulated that if FDI started to destabilize economies or if countries were rebuilding after a conflict, those countries were allowed more flexibility. But why was the gold standard replaced?

After the end of the Second World War, the USA had ¾ of the world’s gold, meaning that no other currency had sufficient gold behind it to be able to serve as a replacement. The result was a transition from the gold standard to the US dollar as the world’s reserve currency. Before World War I, most countries were on the gold standard, but this was soon scrapped to pay for war efforts; removing the gold standard allowed countries to print more of their currency to pay for the war. After the war, many countries suffered hyper-inflation due to an excess supply of money relative to demand, which meant many countries returned to the safety of the gold standard. Everything seemed to be going fine until the aftermath of the stock market crash in 1929 when investors started trading commodities, which subsequently drove up the price of gold, resulting in a rush for people to redeem their dollars for gold.

The Bretton Woods Agreement gave countries more flexibility rather than strict adherence to the gold standard. Likewise, it was far more stable than a currency system without any standard; member countries could correct disequilibrium in their current account balance. Initially, the Bretton Woods system led to steady growth, very low inflation, and low unemployment; the system worked well as the US came out of the Second World War with surpluses and began recycling those surpluses through Japan and Europe. Numerous structures were put in place to limit financial capital; hence, many bankers had immense disdain for the system; banks were forced to adhere to reserve controls and follow strict rules related to transnational capital. However, towards the end of the 1960s, the system showed worrying signs of unsustainability as the US moved from a surplus country to a deficit country, incurring trade deficits with Japan, Europe, and China.

Moreover, this situation was made worse as the financial sector on Wall Street was able to attract vast amounts of profit worldwide due to the lack of financial regulation. Eventually, the system began to collapse when the US experienced stagflation, causing weak economic growth and high unemployment levels. The US responded by lowering the dollar’s value in gold, but this had an adverse effect, causing a run on gold wherever investors exchanged their devaluing dollars for it. This subsequently led the US to delink the value of the dollar from gold, which in turn resulted in the collapse of the Bretton Woods system.

Why did the end of Bretton Woods create instability?

The collapse of the Bretton Woods Agreement led to the neoliberal era’s birth, the age of deregulation, debt-fuelled bubbles, and unrestrained speculative behavior. The financiers had their shackles removed, and were no longer restricted and circumscribed in what they did. The new economic system gave rise to unrestricted capital flows and massive trade imbalances that were continuously funded by even more significant sums of money created through the private sector's intricate financial engineering.

At the start of the 1980s, a new capitalist style emerged, the neoliberal type of unrestrained financial flows, which led to the global economy's financialization. Financialization is a process by which the finance sector increases in size in the economy and asserts a greater influence over economic policy, legislation, and economic outcomes. Over the past 40 years, financial institutions, financial markets, and the pursuit of financial motives have played a significant role in how domestic and international economies function. Financial neoliberalism plays a substantial role in many developed economies globally, especially the UK and the US. Neoliberalism emphasizes the importance of laissez-faire deregulated market economies; a greater emphasis has been placed on the financial sector relative to the real sector in most developed economies. This particular political/economic philosophy believes that market-orientated reform policies such as deregulation of financial markets, reducing trade barriers, and eliminating price controls are the most efficient way to manage an economy. Neoliberals believe in limited state intervention, the advocation of privatization, austerity, and reduced government spending. The theory states that these mechanisms lead to greater economic efficiency and economic well-being due to the efficient allocation of resources through a free-market system. This relatively new form of political and economic theory is a stark contrast from the Keynesian consensus, which was widely implemented from 1945 – 1980, which placed an added emphasis on government intervention. However, public officials, politicians, and the media have decided to ignore history lessons; this, in turn, has been replaced with politically and ideologically convenient prejudices. The key player in the new economic system, the US, saw its hegemony grow simultaneously with a growing trade deficit, which was something unique and unheard of at the time.

But how did the US go from a trade surplus country just after the Second World War to a trade deficit country while increasing its hegemony? The answer is somewhat complicated, but let's start from the beginning. When the US moved from a trade surplus nation to a trade deficit country, Wall Street was recycling profits from all surplus countries, especially Germany and Japan. This unbalanced dynamic led to the US becoming the world's biggest importer of other people's profits and commodities. The vast inflows of other countries' profits into Wall Street were recycled and distributed worldwide, further exacerbating the problem of financialization. It was only a matter of time until the new financialized system came crashing down, as it did in 2008. The reason for this was that financialization had created vast volumes of private money unsustainable in the long term, creating debt bubbles that eventually burst. Wall Street's inability to recycle the world's surpluses and make productive investments that create tangible and productive jobs on a large scale was a telling factor. When the financial crash eventually hit in 2008, the major economies were severely wounded and still haven't fully recovered. Indeed, this was a sign that the system wasn't working, and it seemed that the financial sector would surely be held accountable for its reckless speculative behavior. However, the opposite has happened. The major economies' central banks, such as the Federal Reserve, decided to re-float the financial system, allowing those responsible for the collapse to have unlimited access to cheap credit.

The aftermath of the 2008 crisis has led to a separation between the financial elite and the real economy. If you look at the deficit countries, they have many similarities; they are, in effect, condemned to generate debt bubbles. Simultaneously, working classes helplessly watch as industrial areas become decimated; this has happened in major economies like the US and the UK and even small countries like Greece. This is because debt bubbles are the only way you can keep financing external deficits, but once they burst, these countries' working classes are engulfed with unmanageable debt and falling living standards. If we look at surplus countries, they differ significantly from one another; Germany and China both have substantial trade surpluses to other major economies. When looking at Germany and China, there is apparent economic exploitation of the working classes. In China, the numbers are worrying: consumption is well below 50% of GDP; the working class have very little access to the welfare state. Working class incomes in China are extremely low and the ability to save is limited, even when they save, the interest rates are negligible, so there is an exploitation of working-class income and wealth in China. If we look at Germany, the case is similar, although the significant difference is that in China, investment is very high, whereas in Germany, it's very low; German corporations invest much less. Germany relies on internal devaluations to make its export sector more competitive, thus the lower wages burden the working classes. Generally speaking, German aggregate demand relies on credit bubbles that are not created in Germany but built up in the rest of the eurozone like Greece, Spain, and Ireland. Therefore, the problem isn't necessarily about nations clashing against each other; but more about a class war within individual countries. To understand this class war, we need to look at it in the context of international financial flows that support and maintain an unbalanced equilibrium between imbalanced trade and imbalanced financial flows. Fully understanding these clashes and imbalances is crucial to understanding economics, finance, and politics. In essence, we are currently living in a contradictory system of financialized capitalism, combining ever growing imbalances with an equilibrium. Subsequently, those imbalances are inflicted upon the world through financialization.

In 2008, when the financial sector crashed, the world was fully aware that it wasn't big enough to contain and sustain the gigantic amounts of private money financially engineered through CDOs and other complex financial instruments. After this significant collapse of the world financial system, the Federal Reserve and other central banks stepped in to re-float the financial system; one could call it socialism for the financial elites. These steps were taken to ensure the transfer of whatever wealth was necessary from the many to the financial elite, from the real economy to the financial sector. Metaphorically speaking, the financial industry was a sick patient suffering from a financial crisis; and the medicine prescribed to the patient was to pump liquidity into the system. Eventually, the financial system perked up; financial markets have been performing well ever since. Now we have a situation where those bailouts were predicated on austerity; austerity shrinks two key things: investment and people's capacity to buy the things that companies create. When you have austerity for the many and diminishing aggregate demand due to a lack of investment and declining consumption of the many, the only way to prop up the system is to keep pumping it full of more liquidity. Once the system was resuscitated, the excess liquidity had to be channelled somewhere, but where?

The financiers take limitless amounts of money obtained from global central banks at very low rates and at times zero level rates; they then take this excess liquidity and lend it out, as the worst nightmare of a financier is to have excess liquidity they can't pass on. Obviously, in this situation, financiers aren't going to lend this money to the average consumer or business as their incomes are shrinking due to austerity; and the fear of default is high. Thus, financiers lend this money to large corporations like BMW; but what do the CEOs of large corporations like BMW do with this cheap money? Do they invest in creating new jobs, cars, and infrastructure? The short answer is no; corporations like BMW see that the general population can’t afford to buy their vehicles at prices that are profitable for such corporations due to austerity. Thus, corporations do something much easier and take cheap credit to the financial markets and buy back their shares, leading to soaring share prices. The CEOs and boards of directors who have access to cheap finance do very well out of this situation as their bonuses hinge on share prices. The financial markets are booking while the real economy is doing terribly. The result is capitalist system that generates a disconnect between vast quantities of savings and liquidity and shallow investment levels in fixed capital. Subsequently the global economy has seen trillions of dollar-denominated debt in negative-yielding territory mixed with deflationary forces; the consequence of such diabolical economic conditions is the rising prominence of right-wing political sentiment worldwide.

Why has modern-day capitalism failed?

The concept of capitalism has dramatically changed, and Adam Smith’s idea of the capitalism of the butcher, the baker, and the brewer has been replaced by multinational corporations and conglomerates such as Ford, General Electric, and Apple. Subsequently, we have moved from a competitive market to a global economy that is a monopolies market. For these huge institutions to function, they require vast amounts of capital to finance them. Since the start of the neoliberal era, we have seen commercial banks merging with investment banks to form giant banking institutions. However, unlike commercial banks, investment banks don’t invest in skills and tangible jobs; instead, they engage in financial engineering, creating complex financial instruments. But who are these complex financial instruments designed for, the average man on the street? Not exactly, they are typically created for massive institutional investors such as pension funds; the debt is purchased using the accumulated power of workers who make pension contributions. When pension funds buy such debt, many speculators enter the market, placing bets on whether these complex instruments appreciate in value. The investment banks make huge profits from selling such complex debt instruments; the profit generated from these sales is then lent to corporations who use this financial capital to boost share prices. The problem here is that there is a growing disconnect between the real world of labor and the financial sector, resulting in a few super funds in the financial sector owning overwhelming proportions of the planet.

The wealthier the financial elites become, the greater the incentive to create even more unsustainable sums of money. The danger of such a system is that banks create amounts of money that are vastly larger than the value of goods and services produced as a result of this process. Bankers manufacture money far greater than the resulting values, further creating a disconnect between the real economy and the financial sector. The more financial capital is recycled into corporations, the more the share prices rocket, and thus there are more customers for investment banks to sell their ever-growing complex debt instruments to. The result is an economy where banks and corporations turn into mega institutions; again, socialism for the financial elite and unstable and unregulated markets for the many. The consequences of such a volatile and unstable system are enormous profits for the financial elite when things go well. However, when the speculative bubble bursts, society is left to bail out the financial sector. The system is falling apart; trillions of dollars of predominantly financially engineered debt are now receiving negative interest rates due to unrestrained financial flows. These unrestricted flows eventually lead to bubbles that ultimately pop; thus, every subsequent crisis is exacerbated, and the common denominator is always the same, unrestrained financial flows. Enter the COVID-19 crisis!

Two paradoxes: how is the COVID-19 crisis shaping the future?

For capitalism to function efficiently, it requires an equilibrium that correlates to the real interest rate, so there is a balance between investment and savings. In simplistic terms, savings represent the supply of money and investment demand represents the demand for money, with the interest rate being the price of money. For the economy to reach an equilibrium, there must be an interest rate that equilibrates savings and investment. Suppose savings exceed investment in an economy. In that case, deflationary forces will set in, which further encourages consumers to save more, and this in turn has a negative impact on aggregate demand and the stock markets. A significant problem between 2008 and the COVID-19 crisis is that the real interest rate needed to equilibrate economies didn’t exist.

Consequently, we have had negative interest rates and quantitative easing (QE) prevalent throughout, which has had significant repercussions on many economies. The critical point is that the interest rate has been insufficient to equilibrate savings and investment. Therefore, if interest rates drop below zero, pension funds would be destroyed; if such an instance occurs, the financial markets’ ripple effect would be devastating. Many economists argue that if the interest rate needed to equilibrate savings and investment had existed, savings could have been turned into investment, and the financial crisis may have been avoided.

A key point to consider is that in 2008 it wasn’t the banking bubble that burst but the corporate debt bubble. The availability of cheap credit from central banks incentivized corporations to overindulge in cheap credit. Such availability allows corporations to roll over their debt and endure low and even negative profitability levels. Cheap credit will enable firms to buy back their shares and, in turn, boost share prices, making fortunes in the process thanks to the printing presses of central banks. The abundance of cheap liquidity for corporations led to a gigantic bubble looming over the financial sector. The difference between 2008 and 2020 is that in 2008 it was the banking sector sitting on the bubble; however, this bubble has now extended across the entire corporate sector. The current COVID-19 crisis has further exacerbated the problem; when the bubble eventually bursts, the effect will be much more significant than 2008; the continued refinancing of the financial sector by central banks will create a liquidity storm that could devastate the whole corporate sector.

The second paradox is the overinflating of asset prices since 2008; since the great recession, the recovery has been anemic to say the least. The outbreak of COVID-19 has resulted in a dramatic decline in supply and demand; however, the financial markets are performing exceptionally well; how is this possible? The answer is not dissimilar with the answer to the first paradox. Vast amounts of liquidity are being pumped into the financial sector through the QE. In essence, public money is being used to re-float the financial sector, which has over-inflated asset prices. Such instances are always at the expense of the real economy and its citizens in many developed countries; the QE measures add to public debt and often lead to austerity measures resulting in job cuts, inequality, poverty, and reduced social mobility chances. The disconnect between the financial sector and the real economy is growing, and at the expense of the public. The question remains what can be done to remedy this unjust form of capitalism to produce jobs, increase equity, and reduce inequality?

There are numerous “new deals” or economic models such as investment in a Green New Deal; such investment would steadily shift savings to investment, which could generate good quality jobs and provide the sustainable economic environment that society craves. However, implementing a US-style New Deal would depress asset prices relative to other prices because asset prices are kept artificially low through the constant re-floating of the financial markets. Many modern-day corporations survive simply due to the cheap availability of credit, meaning repayment on their loans is minuscule. The continuous availability of cheap central bank credit allows corporations to maintain their high asset prices; these high asset prices are vital in allowing corporations to preserve the value of their collateral; thus, allowing the constant flow of credit to flood the corporate sector. Therefore, the situation looks bleak if asset prices aren't deflated. The prospect of good quality jobs and a sustainable environment will be forgone at the expense of an over-inflated corporate sector. On the other hand, if asset prices are deflated, corporations will collapse; thus, these two paradoxes contradict globalized capitalism. So, the crucial question remains: what comes after neoliberal capitalism?

What does post neoliberal system look like?

The current system of capitalism, especially in Europe, is a system where the role of financial institutions, financial markets, and financial motives is increasing at unprecedented rates. The financialization of such economies has led to structural changes that in turn have led to mass structural unemployment in many developed nations. The scale and scope of the financial sector in many developed economies relative to the real economy have rocketed. The balance sheets of many developed nations' banking sectors, such as the UK, have increased significantly, and at the expense of areas that have been deindustrialized. The emphasis on the financial sector in many developed countries has led to the reduction of productive jobs in favour of the financial sector. The global economy needs a system that focuses on directing finance into the productive sectors of the economy that will be sustainable in the long term. Currently the system is focused on speculative behaviour that is focused on short term profiteering rather than long term sustainable economic development. We need a system where the economy becomes more democratized, moving towards more democratized ownership; a system where workers have a bigger say in the functioning of corporations. Empowering workers and consumers alike can help increase productivity and boost investment.

In this system, labor would be placed before capital, providing productive and tangible jobs that provide liveable wages. Such an environment would also mean workers would be represented on company boards to which they are elected as worker directors sitting alongside shareholders. Such a system would help democratize corporations by allowing workers to have valid input on their respective corporations' running and act as a voice for the labor force. Allowing workers to have a vested interest in the company would motivate workers, improve morale, and boost productivity. Moreover, having supervisory boards that are more representative by having workers and consumers alike represented would make corporations accountable to all stakeholders. Such a system could incentivize corporations to think long-term and invest, thus boosting the economy in the long term. More accountable boards could lead to companies focusing more on long-term strategy rather than short-term profiteering, which tends to burden the working classes. Such models of democratized corporations already exist in Germany and Sweden, where worker representation on boards is commonplace; this style of corporation needs to be implemented more to create a more productive and sustainable environment.

Another key area of importance is collective bargaining for wages; most EU countries have coverage: roughly 60% of EU employees. However, the UK, one of the founders of the neoliberal ideology, has extremely low collective bargaining levels. The UK has a rate of around 28%, and more worryingly, over 75% of countries worldwide prevent some or all collective bargaining. The eradication of workers' rights has led to the exploitation of the working classes while unrestrained and unregulated financial capital flows increase. More often than not, this leads to debt bubbles that end up being socialized, subsequently increasing the level of inequality in society and reducing living standards. The current financialization system isn't working, and the question is, what will replace it when it runs its course? Are we going to move to a more democratized economy, or are we going to head into a constant state of dystopia?