

## **The Global Financial Crisis – A Primer**

*Professor Barry K Gills in conversation with Stacey Davies*

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### **A Short History**

The theme of the swinging of the pendulum is about historic changes in the way the world economy works and the ideas that are governing it.

Firstly, I’d like to say thank you to Professor Gills for coming to talk to us today about the Global Economic Crisis and in particular his editorial entitled “The Swinging of the Pendulum” which discusses the historic changes that the world economy has experienced over the past years. So, let’s start by talking about laying the foundations for August 2007. I imagine this crisis won’t be something that emerged suddenly.

That’s right, certainly this global crisis is not something that began only 15 months ago, but has a very long background. We could go back some 25 years or so to the time when Ronald Reagan and Margaret Thatcher were in power; there was a perception that the Keynesian policies that had been dominant for some decades after the 2<sup>nd</sup> World War had run out of solutions in the face of endemic problems especially stagflation, which is a combination of recession and inflation. President Reagan and Prime Minister Thatcher introduced a very important change of emphasis away from Keynesian policies of state intervention towards a free market ideology where the idea was that through the use of the globalisation of capital, deregulation of capital, and the freeing of markets from protectionism, that profitability would be restored both domestically and globally.

You mentioned there that the Keynesian policies – the policies of John Maynard Keynes - had run out of solutions, could you tell me a little more about that?

Well, it’s important to remember that Keynes was responding to a very long term deep contraction in global growth and domestic economic activity in Britain, a global crisis – we call it the ‘Great Depression’ or ‘The Long Slump’. Liberal theory, which was dominant then, insisted on letting the market find its own equilibrium and believed that it would so long as government did not interfere in any significant way- it was a non-intervention ideology. At the same time the dominant idea was that budgets – government budgets – should always remain in a positive balance and not go into debt. However, Keynes critique was that these ideas are incorrect; he launched a very powerful intellectual critique which was world changing, to show how and why these ideas misunderstood how economies really work. One key problem was: How can you restart investment in an economy, to get production moving in the real economy and therefore create more jobs and therefore income for people and have a virtuous circle moving again – how can you start this process in an economy that is at a very low level of activity and has mass unemployment and has experienced huge numbers of bank failures and corporate failures?

So what were the solutions that Keynes offered?

So Keynes laid out a new doctrine where, over the economic cycle of expansion and contraction, which is a long term cycle, that when an economy is at its low ebb, the government needs to come in as a 'spender of last resort', and that in that period the government should spend much more money than it normally would, and to raise that money the government borrows it, because if they raise taxes it just increases the problem because it puts the burden on those who have to pay the taxes. And so the government borrows more money in order to spend to stimulate activity in the economy. They can do that in a number of ways, for example: large infrastructural projects to build roads, dams, electricity systems, schools, hospitals, etcetera. Another way is to redistribute the income directly to low income groups because low income groups will normally spend a high proportion of whatever income they receive, whereas if you redistribute wealth and income to high income people, they have a greater propensity to save whatever increase they receive- so it isn't a stimulus. This is the whole idea of a fiscal stimulus, borrowing in order to spend in order to stimulate an expansion of production and employment and thus income which creates more demand in the economy, and Keynes used the concept 'aggregate demand' and 'demand management'; that you keep these levels up through state spending at a time when the cycle is at its low ebb.

Many governments had accepted essentially free market ideas by when this crisis intensified. We've seen many if not most of them radically changing their position on this and taking up a broad support for Keynesian approaches which means that they are willing to borrow large sums of money and use it for fiscal stimulus in order to spend the money in the economy to try to restart the virtuous cycle of investment and production and employment. So in that sense "we are all Keynesians now". That is a quote from Milton Friedman, the Nobel economist who is known as the father of monetarism who said that in 1965 and it was later quoted by President Richard Nixon in 1971 who was not actually a Keynesian and in fact had said that he would not intervene in the economy and impose wage and price controls but he reversed himself because the economy in a sense forced him to reverse himself. So we're in the same kind of situation now where many politicians are using Keynesian techniques in order to try to prevent this current downturn from becoming much, much worse.

#### What could be the downside to us "all being Keynesians now"?

We now live in a globalised economic system in which all participate and none are outside. The idea that was previously popular about the de-coupling of Asia, for example, from the rest of the world economy has now been abandoned as being untrue; they are affected by the downturn in the west, very seriously and so everyone is in this crisis together. So Keynesianism really worked with a combination of quite strict domestic controls with an international set of agreements, but today is somewhat different- it's far more globalised. So that means that just one country acting on its own to try to use Keynesian methods and re-stimulate its own national economy may not be very effective and that's why you see many, many politicians and others – economists – saying what we really need is a globally coordinated macroeconomic fiscal stimulus package and also globally coordinated monetary policy. So that's why some are even calling for a new set of global institutions and global banking and capital regulation authority that would then oversee the entire system over and above all national systems. That's an idea that's currently being debated at very high levels.

### *The Present Crisis*

The swinging of the pendulum is certainly upon us, we are witnessing a number of historic turns simultaneously: from boom to bust; from global inflation to global deflation; from the reign of greed in the markets to that of fear; from hyper-privatisation to renewal of nationalisation, and to sum this up- there is a pendulum swing from an excessive reliance on market authority to the restoration of faith in state authority to re-stabilise domestic and global economic systems.

Recently we have been hearing reports that as soon as the banks start lending to each other again, that the crisis will be over. How true do you think that statement is?

Well, it's partly true that it is a central element of this crisis that banks have stopped lending to one another. An analogy you might use for why this has happened, it has to do with the globalising of finance and the diffusion of financial instruments across much of the system to so many counterparties and institutions, let's say you had a batch of salt from a factory and the salt was tainted. Then it's sent out to all the processing factories to make a variety of different types of food that then go out to all the supermarkets, then to people to consume. Subsequently you discover that the salt is tainted, in fact it's poison – it's toxic – but it's in all the food, it's in everything because of the diffusion in the distribution system and you can't really be sure anymore whether this food is tainted or that food isn't tainted and it's extremely difficult to trace. What are you going to do, recall all the food? And it's like that in the banking system, because certain kinds of assets backed by mortgages in the United States that were written on loans that were given to people with weak credit records and maybe not very sufficient income and then as these were resold they were parcelled up into very complex packages with many good assets but then sold on and each time they're resold one party to another around the system, selling a piece of paper that has a debt attached to it but eventually you'll lose track of the nature of the assets that originated this because the chain is long and complex and opaque. And these are spread around the system but then they start to be revealed as very bad assets because the basis in the assets has gone bad with defaults and foreclosures. This is what happened, the sub prime was in a way a trigger, then the whole system is affected and all the banks become very afraid to lend to other banks because there may be a huge risk of further losses when they don't know what losses the other bank may have.

So what happens is the banking system froze because our banking system has become probably more dependent than it should be on constant loaning between banks to cover their transactions. Traditionally banks would loan on the basis of the deposits that they hold from savers and a vast majority if not 100% of their loans would be based on their deposits. But what happened was banks began to increasingly borrow money in international money markets, borrow on short term, and then lend long on mortgages. And a very high proportion of the British mortgage market became based on this kind of bank borrowing from money markets. But when the money markets dried up through this freeze, the so-called "credit crunch", then you see the banks are placed in great difficulty to refinance their own lending base, which put them into a crisis. The funding gap in Britain in the mortgage market is estimated at 700 billion pounds. The funding gap means the difference between the deposit base of the British banks and the money they're lending out in mortgages. The question now is: where

will British banks find 700 billion pounds that they need? If the British banks were to borrow 700 billion pounds they will not be able to borrow it cheaply and that means they have to pass this cost on to the borrowers, their own borrowers. Which is why you see at the present time many banks are not very happy about trying to pass on rate cuts given by the bank of England to their mortgage holders because in effect they feel they can't. Also, banks are anticipating very considerable losses yet to come, especially in 2009 as many businesses cannot pay their loans, so they have non performing loans on their books, so any money they are given they want to hold, they want to 'hoard' as it's called. This is called the 'liquidity trap' that Keynes talked about – John Maynard Keynes – in that you can give banks a great deal of money in a situation like this, and we have, we recapitalised them, given them loan guarantees, given them special windows, a concession from the treasury, from the US federal reserve, many things have been done which are unprecedented to try to support their base, but however much money you give them, you cannot necessarily force them to lend it.

[At the moment, the state responses at a national level could be described as quite often promises of what seem to be endless loans to help support and bolster the financial market. In light of what you've just said, what's your opinion of this remedy?](#)

To date, several trillion pounds sterling have been marshalled by the governments of the world in order to support the banking system and recapitalise the banking system and stabilise it. In addition to that money, we're now going to see a round of further borrowing. In 2009 governments of the world will borrow over 2 Trillion euros to use for fiscal stimulus. The governments in effect announce how much money they intend to borrow and spend. They then have to borrow it. And they borrow it from those who are willing to buy government bonds, which is basically government debt with a promise to pay. The problem is that you'll have so many governments trying to raise this money at the same time and we assume there will be enough buyers out there and there probably are, but some governments may find it more difficult to sell their bonds than others and they will have to pay more in order to attract the investors. When you pay more to attract investors to buy your bonds, it means that you are increasing the debt for the future that has to be repaid and that means that tax payers and citizens in the future are burdened with yet more debt that they have to repay. There's another problem which is that all of this in the aggregate may have the effect of crowding out private investors, in other words we already see that raising money in the private sector for corporations – businesses – is becoming difficult and more expensive and as it becomes more expensive, puts even greater pressure on the balance sheets of companies and pushes them closer to defaulting on loans. The more that you put pressure on companies to default, their loans are not repaid to the banks, which then the banks have to write off as losses, if they go bankrupt they obviously can no longer employ people and all of those people are not earning income in the economy and may have to go to the state for support and benefits.

It becomes a vicious circle, a syndrome of contraction. And as it gains momentum, it causes more contraction, more downturn, and that's the problem, that's what you see people around the planet struggling to prevent because we do know how these things operate, we have seen them in the past. This one is potentially the most serious in a century and that is why the governments are concentrating their minds in order to prevent it getting worse. Our advantage this time is precisely that we understand it historically much better than at any time in the past and that we have the

communications technology and apparently the good will amongst most governments to cooperate and take swift action and that's different than what had happened in the 1930s when many governments did nothing and then they competed with each other in what was called "beggar thy neighbour" policies, to do what they thought was best for themselves, even if it was at the expense of others.

[The western economic system isn't the same as, for example, the eastern block countries or South America – could you talk about how the credit crunches are manifesting themselves in other regions?](#)

I've been saying and others have been saying that this is not a crisis 'in' the system, for example just in a financial sphere, but this is a crisis 'of' the system. This is a crisis of global capitalism, so it involves everyone. But traditionally crises tend to have differential effects and the worst effects of global crises - which have occurred in the past - tend to be felt by the weaker economies and the poorer people around the world who are less able to defend themselves, have less ability to adapt and adjust, so that is likely to be true this time as well. The effects we are already seeing in Eastern Europe are quite indicative of what could happen on a broader scale if the crisis deepens in 2009 as it is expected to do. For example in Ukraine and Hungary, which had in effect a financial crisis, their balance of trade deteriorated, their balance of payments deteriorated, they had high levels of debt with lowered commodity prices for what they sell abroad, falling demand in their markets abroad – these kinds of factors combine, then they need external help in order to cover their liabilities, their debts. In the case of Ukraine and Hungary you've seen a combination of mainly the International Monetary Fund coming in and the European Central Bank- actually through a special window. Some are advocating that the International Monetary Fund be 'resurrected' in effect, because it actually has been playing a low key role since the Asian crisis of 97/98 when it came under very great criticism for what were regarded as mistakes in handling that crisis. Today, there are those – as example in the G20 – who are saying that well, the IMF exists, we can use it, we will give it more money because it has a mere 250 billion in its base, which is now regarded as a small amount of money and in comparison to the possible need, so that there is discussion going on as to whether the IMF should once again be prepared to 'take on' the crisis as it develops and lend money to those states which need it most. There is a concern that there will be further insolvencies on national level, for example there's a great deal of concern currently about Russia. Not long ago, Russia seemed to be going from strength to strength and was flexing its economic muscle, whereas now, you see that their currency is tumbling, the Rouble, they are spending large amounts from their foreign currency reserves to try to defend the Rouble. The economic situation in Russia is not good and there are some who think that as oil has reached a low point, around 40 odd dollars per barrel, this is a critical point for oil exporting economies like Russia and has a very serious effect on them. So there's a potential that a number of countries will become insolvent some point in 2009 and then they will all need possibly very large bailouts and that money has to come from the international community.

[Would it be fair to describe the US as being the hegemonic power when it came to the international fiscal markets?](#)

Yes, in fact the post war global economic system has really been predicated on US hegemony, in its ability to be a stabiliser in the system and to provide public goods

and the weight of its economic strength, its financial system and so on, liquidity of its markets, the safety of the dollar, the dollar as the reserve currency for much of world trade, all these factors have been taken for granted now for many decades. In this situation today, there is considerable concern that the American position has significantly weakened and that their financial strength is no longer taken for granted. Even saying that, recently you've seen many investors around the world rush into the dollar as a safe haven which supported the dollar in its role in the world as a reserve currency and that therefore helps the United States to stabilise itself. No one can strictly speaking predict the fate of the dollar but there are concerns that if things were to go badly in this situation the dollar could be under threat and eventually the reserve currency role of the dollar could end or be dramatically lessened. The last time that happened it was from sterling to the dollar and that was a long time ago and that was accompanied by the rise of US hegemony. Now of course people do seriously talk about the decline of US hegemony in a new way with a sense of urgency.

[If there is a decline in US hegemony, would you think it's fair to say that power is just going to move to a new state, maybe to Asia, or do you think an international organisation may be a better option?](#)

Well these are questions that many people are asking, quite rightly, because this is a kind of epochal change. These hegemonic transitions are infrequent and they carry with them a very large range of repercussions, really profound, for the entire world really. Now, it is possible that the United States, with skill and with the goodwill of many partners, could rebuild a new coalition with itself still in a very prominent role, but I think it's a certainty that this would have to be a more inclusive kind of coalition than previously and it is, again, very clear- as in the G20 summit recently- that Asian powers will be included in these new kinds of elite intergovernmental decision making processes; that especially includes China and India, but also others from around the world- Brazil, South Africa. So the world is definitely changing, but there is a possibility that we could have a very positive outcome where we don't have a transition from one great hegemonic state, like the US, to another hegemon, for example say China or even the European Union, but instead that does not happen and we redesign the way international institutions are constituted and the inclusiveness becomes the central factor. So cooperation, coordination to address the key problems in the world- beyond this economic crisis- because the world faces many other crises simultaneously now – the foremost of which is climate change. So we need historically much higher levels of cooperation than we've probably ever seen. There's a good chance that we'll actually see them happen.

### **What The Future May Hold**

We can probably all agree that if the pendulum has swung from excessive reliance on market authority to a renewed faith in an emphasis on state authority, that means that the era of anti-statist ideology has passed and the era of pro-market ideology has also passed. That puts me in mind of the tradition of the so-called mixed economy which I think will possibly experience a renewal of interest. That means that it seems natural that an economy has a mixture of many types of organisation, where some are in the private sector, some are in the cooperative sector, some are worker owned, some are public companies owned by the state; the state has certain kinds of interventionary and regulatory roles that are accepted, and the state redistributes wealth through taxation and fiscal policy and so on, and guarantees social security. We now begin to see that the state is not necessarily some kind of thing to be avoided, always in favour of the market, but we re-establish a balance and we see that 'mixed economy' is perhaps a more stable type of structure than an excessively market orientated economy.

If we can say that de-regulation of capital, financialisation of capital, and too much reliance on free market ideas brought us to this crisis, then we could also conclude that we need a 'reverse course' on those very same things in order to get out of this crisis and put ourselves on a more stable basis in the future.

[Could you give me an example of what action is being considered or taken to help ease the situation?](#)

One of the things that is being discussed and may happen in the course of this crisis over the coming year is that if the banking system continues to be frozen and is not carrying out its necessary functions of lending in the economy to businesses in particular then it may be that government will have to become the banking system in effect. That can happen in two ways, either the governments nationalise the entire banking system and then direct its lending according to policy that they set down to assist the real economy and prevent bankruptcies in firms and sustain employment, or they become the banking system themselves for example from the federal reserve and the treasury in the US and they directly lend to businesses and corporations and guarantee loans of business and corporations and buy bad assets of businesses and corporations and buy the equities of businesses and corporations – all of these sorts of things. In other words, if the crisis deepens and the banking system cannot actually be restarted, to lend as it should, there is the possibility the government will step in to act as the banking system.

[There must be some concerns about returning to a more active state role?](#)

In the current atmosphere some are saying, particularly in the United States, that this is socialism. That returning to an active state role – state intervention, state support and even some nationalisations or quasi-nationalisations – amounts to socialism, but really that is an exaggeration. It isn't socialism; it is, however, the return of state interventionism. And this state interventionism has come about by necessity, many of the people who are pursuing this state interventionism are conservatives and they certainly are not intending to build socialism and they are not building socialism. It is just a restoration of a necessary balance in the economy and also taking immediate

action to try to stop the situation going completely out of control, and only the state can act as this kind of spender of last resort and lender of last resort to support the entire economic situation when the system goes into a crisis like this.

[Governments are currently underwriting loans, but just where is this money coming from?](#)

Well the governments are borrowing the money - and very, very considerable sums. If you add it up globally in the trillions will be borrowed in the next two years. But one of the key problems at the moment is that even this level of borrowing may not be sufficient to overcome this crisis, and there is the worry of deflation, where prices go into a downward spiral. So governments are considering what they're now calling quantitative easing. Quantitative easing basically means that they print money and they increase the money supply, then they spread this money into the economy. It should be a counter to deflation; it should ease the credit problems, the availability of credit and therefore help stimulate the economy. The problem with quantitative easing is that it has to be done very carefully. It can, if taken to excess, lead to rampant inflation, it could lead to increased pressure on the value of currencies where the governments are engaging in quantitative easing, which has all sorts of knock on effects for an economy and could get it into very serious trouble. One of the worries is that governments will overdo their measures of borrowing and quantitative easing and even though they may help in the short term to overcome this crisis, they will build up problems for the future, in other words, another crisis will come around in a few years time based on the problems that were created by solving this crisis. So the worst thing that can happen with quantitative easing is that you basically just run the printing presses and spread vast amounts of money out into the economy which then brings the situation -which people will recall from their school days- where in Germany people would get a wheelbarrow and fill it with notes in order to go down and buy their lunch or lets say, what's currently happening in Zimbabwe – worst, worst case scenario, where you have over two million percent inflation and the printing presses run out of paper because they just can't keep up with the demand for the notes because prices are rising so fast every day. Now, I don't think we're in that kind of situation in the west and in most countries, but it is the spectre that haunts the option of quantitative easing.

[We talked a little earlier about the possibility of the international community handing out loans – possibly resurrecting the International Monetary Fund. Quite often when the international community make these they come with conditions attached. What conditions should be attached to them in order to stimulate the economy and are they necessarily the conditions that will be attached?](#)

That's a very important question indeed because if we take the example of the last major crisis in 1997/98 in East Asia, the IMF was criticised because it used typical conditionality for what it would have regarded as normal or routine situations and that involved stringent conditionalities which bring austerity measures- which means cut backs and contraction and also higher interest rates, making capital more expensive to borrow in the economy and cutting back at a time when the economy is already contracting. All these things worsened the crisis in what were the most dynamic industrial economies on earth with the highest growth rates on earth. Therefore people concluded from that that these policies were counterproductive, that they were damaging, they did exactly the wrong thing in effect with this conditionality and made

the crisis worse. We don't want to repeat that mistake this time and especially not this time because the consequences of that could be very, very serious – the contraction is bad enough already and the last thing you want to do is start a domino effect where more and more countries actually go into deeper recession rather than coming out of it. So, there are those who are advocating that the IMF should come in and rescue countries in this crisis but already the IMF has shown a new flexibility where they have made a certain amount of money available for countries that they regard as having good economic policies and practices but which are somewhat vulnerable, for example one is South Korea. Those loans and guarantees are without conditionality. Now in my view that should be the policy for all the countries that receive funds during this crisis over the next year or two, and that's because I think if we learn the lessons of 1997/98 we should realise that what we need now is the recycling of surpluses from those countries that have a surplus to those countries that have a deficit, and we should do so in a way that simply provides the money and says to the country- under a certain timeframe you do have to repay this money, but your domestic policies are up to you.

Following on from that, should we be concerned that the international community might try to get too involved and perhaps start prescribing domestic policies that typically national governments have been very protective over?

Well that's quite right and I think the way the debate is being framed is there are two scales on which you could focus reforms. So one is the national level, when, as you say, we'll maintain the principle that all states have the right to determine their own policies regardless of what others may do, according to what they feel their own situation is and what's best for their own people and their own economy, so that each state will take it's own actions in its own way. So, on the one hand you have this reinforcement of national sovereignty and on the other hand you have people advocating that this is a global crisis of globalised capitalism and therefore it requires a new set of global regulatory authority in order to solve it once and for all.

There's another way, though, if a set of common standards on policy could be devised and widely accepted it could be implemented at national level simultaneously by a great many governments. The argument is that it's at the national level there is greatest democratic accountability (in those states where that exists) and that is something very much to be preserved because, there's a criticism that when you go up to higher levels of international authority and international bureaucracy there may be a democratic deficit. We've experienced that with other institutions and that's a very serious issue. This is going to be a debate which is going to go on for a long time now.

The G20 recently met in Washington DC in November in order to try to have a more inclusive group, representing 90% of the world's gross domestic product, in order to make some kinds of statements about common principles. But the criticism of the G20 process has been that, well, this of course is only a first step and you cannot expect the G20 in a weekend - or even in a few months – to come up with a workable long term solution. Critics point out that this is a process that is so complex, involves so many interests, so many countries, it realistically should be a long term process of dialogue and negotiation. I would advocate that [a long term process of negotiation] is a serious way in which to come up with some comprehensive agreement on reforming this

global economy and putting it on a much more sustainable and just basis for the future.

So what's the way forward out of this crisis? You'll hear a great deal in time to come about a "Global New Deal" or a "Green New Deal". These ideas refer to the Great Depression and the policies used by President Franklin Delano Roosevelt, the "New Deal" which relied on extensive state action, intervention, and spending in order to stimulate the economy and get it out of depression. But today, the Global New Deal or the Global New Green Deal have the sense of leading us to a new phase in history where we not only address this recession immediately by expansionary spending by the states, but also create a whole new economy, and this economy will be based on post petroleum energy systems – renewable energy, energy efficiency, conservation, a whole range of innovations, new technologies, new fuels and the redesign of buildings, every kind of thing imaginable where we will move to a time when we have a carbon neutral economy which is sustainable with our environment and at the same time creates a whole new range of professions, employment and so on. So that's what people in effect mean when they say the Global Green New Deal, which I think is actually very hopeful and a positive way of looking at this crisis.

### *The Lessons*

The first lesson of this present crisis situation is that when markets fail, they can fail spectacularly, but when globalised markets fail, they fail even more spectacularly.

We had the notion that markets would regulate themselves if allowed to be freely self governing and that they would find their own equilibrium, but what we're learning is that if you allow market actors too much freedom they actually can destabilise the market system.

We've also learned that when globalised markets fail, it is only very wide scale and coordinated state action between governments that can really begin to restore stability to the economy and future growth.

We also have learned, as in the situation in the 1930s, that if a crisis occurs, if states do nothing, this will probably guarantee that the crisis will get much worse and it is only by state action that this worst case scenario can possibly be avoided.

We've also been reminded that economic crisis, financial crisis, downturns, recessions, and possibly depressions are all part of the historic nature of our economic system. In other words, they are not really something that can be entirely eliminated- you cannot have a capitalist market system, especially one that is globalised and highly complex, without understanding that there is the possibility and indeed the expectation that there might be crises at some point.

However we also know that the worst elements of crisis can probably be avoided and certainly should be avoided. That means that we have to learn the lessons of the past and of the present and restore the balance between the market and the state so that we can hopefully put in place those kinds of mechanisms which keep us safe from great depression.

As globalisation binds everyone closer together into a single overarching system in which all are a part and no one is outside, when crisis threatens we are obliged to increase our level of cooperation in order to address the current crisis and also to prevent future ones. You could see globalisation in that sense as a type of stimulus to historical evolution in global governance- that when you have very, very high levels of globalisation in the economy, it may very well mean that you will need a parallel and commensurate level of intergovernmental coordination or even a new level of transnational government authority in order for that system to work.

When a crisis occurs, in one way it's actually a crisis of crisis management. What I mean by that is in the past, we learned that you could probably effectively manage the onset of crisis with very long term measures and institutionalise these measures, but what has brought this current crisis about -in the eyes of many analysts including myself – was a long term, wide scale and indeed systematic removal of mechanisms that had been placed there in the past in order to manage crisis and prevent severe crisis; so that as we removed those safety mechanisms we actually increased the risk that the system would fail and we would experience a very severe crisis.

So if the cause of the crisis was a removal of mechanisms of crisis management, then the solution to the crisis means a restoration of, and in fact invention of new types of crisis management institutions, so that we don't have to re-experience this kind of problem again in the future.

In this particular crisis we see that yes, there has been a rather spectacular market failure, but in my view there has also been a state failure. It is both that make this particular crisis very severe. And the state failure might be understood as the state having effectively facilitated the deregulation of capital, the removal of past safety mechanisms, helping to aid and abet financialisation of capital and the whole mentality and culture that economic growth be based on very high risk investment strategies.

Another lesson of this crisis is that we have underestimated systemic risk in our dominant economic paradigm. In fact some people had begun to regard systemic risk as only a marginal problem if they even recognised it at all. But what this current crisis is showing us is that you can never dispense with systemic risk and in fact systemic risk should be a central aspect of economics and of our understanding of how the economy should work. That's because we want to take every measure we can to reduce or minimise systemic risk and avoid making mistakes that increase systemic risk.

An example of this systemic risk is the way finance has leveraged itself – leveraging is basically building assets upon debt and you can leverage up your assets through borrowing money on money that you borrowed on money that you borrowed- ad infinitum. It's like a pyramid scheme, so as long as it is going up, everyone is happy to join, but like every other pyramid scheme, eventually it stops and you realise that it's built on 'very little if nothing' except perception of things going up -and then the downside can be very steep and very painful.

Another lesson of this crisis is that we have placed too much faith in our economic models - in abstract economic models, in highly complex mathematical models of the way stock-markets work, of the way monetary systems and exchange rates work, of the way risk can be managed by firms, by banks – and we began to have a divorce between theory and reality. So this lesson is that it is unwise to believe that there's some kind of perfected economic science or economic theory that can always permanently tell us or predict how the system will work. No such economic science exists. No such models exist. None of them are perfect and it is wise to have caution to all of them. It reminds us that you always need experience, judgement, you have to remember to stay close to realities, close to real practice and not rely on an abstract model to tell you how things are supposed to work.

It also means that there is no ready made panacea, a perfect package of monetary policy and fiscal policy or other measures that we can just take off the shelf and apply to these problems. This is not 1929, this is not 1974, this is the crisis of 2007 and 2009 and it is different. Some lessons of the past are still relevant, but many things are new and therefore we have to be very careful to try to recognise what these things are and act on the basis of what's likely to work in our circumstances and not just try to apply measures that were used long ago in the past.

In that sense we have to reinvent our economics and reinvent our economic paradigm and come back to some reasonable sense of balance and of appreciation of reality and applying the lessons of experience in a pragmatic way.

One of the final lessons of this crisis is if one is to have a market economy and a capitalist system we have to recognise that there is an inherent possibility of instability, fluctuation, disequilibrium, and even of crisis, and serious crisis such as we're experiencing now, a crisis 'of' the system. The system is not static, it's highly dynamic and therefore it can be volatile. This is probably the end of capitalism as we have known it in this past 25 years, but that doesn't mean that it's the end of our world economy. It is an opportunity to undertake reform, domestically and internationally, and this could be very positive. One example of this is that we know that we face very serious problems in the financial system but we also have already quite good ideas about how to restore stability in the banking system and much of that is already in motion in order to bring banking back to a sensible sustainable model and separate high risk investment strategies away from ordinary banking. At the same time we also know that we face other crises simultaneously, most importantly climate change, but there is a way to address this crisis which can address both the needed reform in the financial and economic system and the climate change crisis. And so at the end of the day the crisis is an opportunity for some very positive and probably necessary kinds of transformation in the whole global system.