

The U.S. economic crisis: Causes and solutions

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THE U.S. economy is currently experiencing its worst crisis since the Great Depression. The crisis started in the home mortgage market, especially the market for so-called “subprime” mortgages, and is now spreading beyond subprime to prime mortgages, commercial real estate, corporate junk bonds, and other forms of debt. Total losses of U.S. banks could reach as high as one-third of the total bank capital. The crisis has led to a sharp reduction in bank lending, which in turn is causing a severe recession in the U.S. economy.

This article analyzes the underlying causes of the current crisis, estimates how bad the crisis is likely to be, and discusses the government economic policies pursued so far (by both the Fed and Congress) to deal with the crisis. The final section makes recommendations for more radical government policies that the left should advocate and support in response to this crisis.

1. The decline of the rate of profit

To understand the fundamental causes of the current crisis, we have to look back over the entire post-Second World War period. The most important cause of the subpar performance of the U.S. economy in recent decades is a very significant decline in the rate of profit for the economy as a whole. From 1950 to the mid-1970s, the rate of profit in the U.S. economy declined almost 50 percent, from around 22 to around 12 percent (see Figure 1). This significant decline in the rate of profit appears to have been part of a general worldwide trend during this period, affecting all capitalist nations.

According to Marxist theory, this very significant decline in the rate of profit was the main cause of the “twin evils” of higher unemployment and higher inflation, and hence also of lower real wages, experienced in recent decades. As in past periods of depression, the decline in the rate of profit reduced business investment, which in turn resulted in slower growth and higher rates of unemployment. An important factor in the postwar period was that many governments in the 1970s attempted to reduce unemployment by adopting expansionary fiscal and monetary policies (more government spending, lower taxes, and lower interest rates). However, these policies generally resulted in higher rates of inflation, as capitalist firms responded to the government stimulation of demand by rapidly raising prices in order to restore the rate of profit, rather than by increasing output and employment.

In the 1980s, financial capitalists revolted against these higher rates of inflation, and generally forced governments to adopt restrictive policies, especially tight monetary policy (i.e., higher interest rates). The result was less inflation and a return to higher unemployment. These facts demonstrate that government policies have affected the particular combination of unemployment and inflation at particular times, but nevertheless the fundamental cause of both of these “twin evils” has been the decline in the rate of profit.

2. Strategies to restore the rate of profit

Capitalists have responded to this decline by attempting to restore the rate of profit in a variety of ways. In the U.S. economy, the last three decades have been characterized above all else by attempts by capitalists to bring the rate of profit back up to its earlier, higher levels.

I have already mentioned the strategy of inflation, i.e., of increasing prices at a faster rate, which reduced real wages, or at least avoided increases in real wages, so that all the benefits of increasing productivity in recent decades have gone to higher profits. More recently, more and more companies in the U.S. are actually reducing money wages for the first time since the Great Depression. Many workers have been faced with the choice of either accepting lower wages or losing their jobs.

Another widespread strategy has been to cut back on health insurance and retirement pension benefits. Workers are having to pay higher and higher premiums for health insurance, and many workers who thought that they would have a comfortable retirement are in for a rude awakening: having to work until an older age and leaving fewer jobs for younger workers. A recent article in the *New York Times Magazine* was entitled “The end of pensions.”

Another very common strategy to increase the rate of profit has been to make workers work harder and faster on the job; in other words, enforcing a “speedup.” Such a speedup in the intensity of labor increases the value produced by workers and therefore increases profit and the rate of profit. The higher unemployment of this period contributed to this speedup, forcing workers to compete with each other for the limited jobs available by working harder. One common business strategy has been “downsizing,” i.e., lay off 10–20 percent of a firm’s employees and then require the remaining workers to do the work of the laid-off workers. This method also generally increases the intensity of labor even before the workers are laid off, as all workers work harder so that they will not be among those whose jobs are cut.

A more recent strategy has been to use bankruptcy as a way to cut wages and benefits drastically. Companies declare Chapter 11 bankruptcy, which allows them to continue to operate, to renegotiate their debts, and, most importantly, to declare their union contracts null and void. This strategy was pioneered by the steel industry in the 1990s, and spread to the airline industry in recent years. Half of the airline companies in the U.S. are currently in Chapter 11 bankruptcy, and they are making very steep cuts in wages and benefits (25 percent or more).

The most recent example of this drastic strategy occurred at Delphi Auto Parts, the largest auto parts manufacturer in the U.S., which was owned by General Motors until 1999. Delphi declared Chapter 11 bankruptcy in October 2006 and announced that it is cutting wages by approximately two-thirds (from roughly \$30 per hour to roughly \$10 per hour) and reducing benefits correspondingly. The Delphi chief executive (who used to work in the steel industry) has publicly urged the automobile companies to follow the same strategy. This strategy could spread to the unionized companies in the rest of the manufacturing sector of the economy in the years ahead.

Another increasingly important strategy used by capitalists to reduce wage costs has been to move their production operations to low-wage areas around the world. This has been the main driving force behind the so-called "globalization" of recent decades: a worldwide search for lower wages in order to increase the rate of profit. This is the essence of globalization. This strategy also puts more downward pressure on wages in the U.S., because of the much greater threat of outsourcing jobs to other countries. NAFTA and CAFTA are of course very important parts of this overall globalization strategy to reduce wages and increase the rate of profit.

The strategies used by capitalist enterprises to increase their rates of profit in recent decades have in general caused great suffering for many workers—higher unemployment and higher inflation, lower living standards, and increased insecurity and stress and exhaustion on the job. Marx's "general law of capitalist accumulation"—that the accumulation of wealth by capitalists is accompanied by the accumulation of misery for workers—has been all too obvious in recent decades in the U.S. economy (and of course in most of the rest of the world). Most American workers today work harder and longer for less pay and lower benefits than they did several decades ago. An era in which blue-collar workers in the U.S. could be considered part of the middle class appears to have ended.

It also appears that this all-out campaign by capitalists to increase the rate of profit in all these ways has been fairly successful in achieving its objective. It has taken a long time, but the rate of profit is now approaching the peaks achieved in the 1960s, as we can see from Figure 1 (charts available only in hardcopy version of this article). The last several years, especially since the recession of 2001, have seen a very strong recovery of profits, as real wages have not increased at all, and productivity has increased rapidly (4–5 percent a year). And these estimates include only profits from domestic U.S. production, not the profits of U.S. companies from their production abroad. They also do not include the multimillion dollar salaries of top corporate executives. On the other hand, these estimates do include a large and increasing percentage of profits from the financial sector (approximately one-third of total profit in recent years has been financial profit), much of which will probably turn out to be fictitious (i.e., anticipated future earnings that are "booked" in the current year, but will probably never actually materialize because of the crisis). All in all, I conclude that there has been a very substantial and probably almost complete recovery of the rate of profit in the United States.

As we have seen above, this recovery of the rate of profit of U.S. companies has been accomplished at the expense of U.S. workers. It has also been accomplished without a major depression in the U.S. economy. I think this would have surprised Marx, who argued that just cutting wages by itself would, in general, not be enough by itself to fully restore the rate of profit, and that such a restoration would usually require, in addition, a deep depression characterized by widespread bankruptcies that would result in a significant devaluation of capital. That has not yet happened in the U.S. economy, and yet the rate of profit appears to be more or less fully restored. But I don't think Marx envisioned reducing wages by as much as the 90 percent made possible by "globalization" and the doubling of the industrial reserve army.

3. Search for new borrowers—low-income workers

Surprisingly and disappointingly, the recovery of the rate of profit has not resulted in a substantial increase of business investment, and thus has not led to the kind of increase in employment that would normally be expected. Figure 2 shows that non-residential investment as a percentage of GDP has remained at low levels in spite of the recovery of the rate of profit. Instead, owners and executives have chosen to spend their higher profits in other ways besides investing in expanding their businesses: (1) They have paid out higher dividends to stockowners (i.e., to themselves); (2) they have "bought back" shares of their own companies, which has increased the prices of their stock and their executive compensation; and (3) they have loaned the money out (e.g., for mortgages), thereby contributing to the financial speculative bubble in recent years. Consequently, workers have not even benefited through the "trickle down" effect of more investment leading to more jobs. Instead, capitalists have spent their increased profits on luxury consumption (e.g., airplanes, expensive

automobiles, multiple vacation homes, etc.) and invested their profits in low-wage areas of the world, rather than in the United States (“globalization,” as discussed above).

An important further consequence of the higher profits and the continued weakness of business investment was that financial capitalists had lots of money to lend, but non-financial corporations did not have much need to borrow. Therefore, financial capitalists went searching for new borrowers. Meanwhile, workers were strapped with stagnant wages and were all too eager to borrow money to buy a house or a new car, and sometimes even basic necessities. So financial corporations increasingly focused on workers as their borrower-customers over the last decade or so, especially for home mortgages. The percentage of bank lending to households increased from 30 percent in 1970 to 50 percent in 2006. The total value of home mortgages tripled between 1998 and 2006. And the ratio of household debt to disposable income increased from 60 percent in 1970 to 100 percent in 2000 to 140 percent in 2007 (see Figure 3). This was an extraordinary increase of household debt, unprecedented in U.S. history.

However, financial capitalists soon ran out of “credit-worthy” workers who qualified for “prime” mortgages. But they still had lots of money to lend out, so they decided to expand into subprime mortgages for less credit-worthy workers who had less income. These subprime mortgages required little or no down payments and little or no documentation of the borrower’s income (for this reason, these mortgages were sometimes called “liar loans”). Subprime mortgages as a percentage of total mortgages increased from 7 percent in 2000 to 20 percent in 2006. The most extreme of these new types of mortgages were called NINJA loans, with NINJA standing for “No Income, No Job, No Assets,” and yet borrowers still “qualified” for mortgages (several companies actually advertised with green turtles).

You might think that this new strategy of financial capitalists—to lend to low-income workers—would be very risky and not very profitable. There would seem to be a high probability that these low-income workers would sooner or later default on their loans and the financial capitalists would lose money. However, further details of this strategy were supposed to take care of this problem.

To begin with, borrowers were given low mortgage rates that they could probably afford for the first two to three years (these initial low rates were called “teaser rates”). And the strategy was that by the time the teaser rates expired and the rates were to be adjusted upward, the value of their homes would have increased enough so that a new mortgage could be taken out and the old mortgage paid off. However, this strategy worked only as long as housing prices were increasing. When housing prices stopped increasing in 2006, this strategy no longer worked. Old mortgages could no longer be refinanced, so the borrowers were stuck with higher reset mortgage rates that they could not afford, and the default rates started to increase.

4. Structure of home mortgage market

The structure of the U.S. home mortgage market in recent decades also contributed to the expansion of mortgages to low-income workers. Commercial banks used to make mortgages and own them for their entire thirty-year term, and thus had a strong financial incentive to try to make sure that the borrowers were credit-worthy and likely to be able to keep up with their mortgage payments. But beginning in the 1980s, commercial banks no longer held onto these mortgages “in their own portfolio,” but instead sold the mortgages to investment banks, which in turn pooled together hundreds and even thousands of mortgages as “mortgage-based securities” (securitization). The investment banks then sold these mortgage-based securities to hedge funds, pension funds, foreign investors, etc.

One important result of the securitization of mortgages was that the “originators” of mortgages—commercial banks and mortgage companies—no longer had a financial incentive to make sure that the home buyers were creditworthy and were likely to be able to keep up with their monthly mortgage payments. Indeed, these originators have perverse financial incentives to lower credit standards and to ignore possible problems with creditworthiness, both because they will soon sell the mortgage to other investors, and also because they earn their income from “origination fees,” not from the eventual monthly mortgage payments. So the more mortgages originated, the more fees, and the more income for the originators, no matter what the creditworthiness of the borrowers might be (or not be). Investment banks have a similar perverse incentive in their role as brokers or middlemen in the securitization process. Investment banks primarily buy mortgages from the originators and sell them to the final investors, and make most of their money from “processing fees” (or “broker fees”). So again, the more mortgage-based securities sold, the more fees and income for investment banks, whether or not the borrowers can make their payments down the road.

The reader might ask: didn’t someone care about and pay attention to the creditworthiness of the borrowers? Surely, the final investors or owners of the mortgage-based securities should have cared. However, these mortgage-based securities are extremely complicated and consist of hundreds or thousands of mortgages. It is a very time-consuming and tedious task to carefully examine the creditworthiness of such large numbers of borrowers. Therefore, the final investors depended to a large extent on the bond rating agencies (Moody’s, Standard and Poor’s, Fitch’s) to evaluate the risks in the mortgage-based securities and to assign ratings to

them, similar to their rating of corporate bonds. The highest rating for the lowest risk securities is AAA, and the ratings go down from there as the risk of the securities goes up.

However, there was a perverse incentive at work with the rating agencies as well. Rating agencies are private, profit-making businesses that compete with one another for the rating business of the investment banks. Rating mortgage-based securities became a very lucrative business in recent decades, along with the growing securitization of mortgages. Therefore, there was a very strong incentive for the rating agencies to give the highest AAA rating to even risky mortgage-based securities, so they would continue to get the business of these investment banks in the future. It has recently come out that in some cases investment banks requested that specific employees of the rating agencies be removed from rating their mortgage-based securities because of the "excessive diligence" of these employees, and these requests were generally granted.

In sum, the securitization of mortgages was a process that was filled with perverse incentives to ignore the credit risks of the borrowers, and to make as much money as possible on volume and processing fees.

5. The current crisis

The housing bubble started to burst in 2006, and the decline accelerated in 2007 and 2008. Housing prices stopped increasing in 2006, started to decrease in 2007, and have fallen about 25 percent from the peak so far. The decline in prices meant that homeowners could no longer refinance when their mortgage rates were reset, which caused delinquencies and defaults of mortgages to increase sharply, especially among subprime borrowers. From the first quarter of 2006 to the third quarter of 2008, the percentage of mortgages in foreclosure tripled, from 1 percent to 3 percent, and the percentage of mortgages in foreclosure or at least thirty days delinquent more than doubled, from 4.5 percent to 10 percent. These foreclosure and delinquency rates are the highest since the Great Depression; the previous peak for the delinquency rate was 6.8 percent in 1984 and 2002. And the worst is yet to come. The American dream of owning your own home is turning into an American nightmare for millions of families.

Early estimates of the total number of foreclosures that will result from this crisis in the years to come ranged from 3 million (Goldman Sachs, International Monetary Fund) to 8 million (Nuriel Roubini, a New York University economics professor whose forecasts carry some weight because he was one of the first to predict several years ago the bursting of the housing bubble and the current recession). So far (as of January 2009), there have already been almost 3 million mortgage foreclosures. Another 1 million mortgages are ninety days delinquent (foreclosure notices usually go out after ninety days), and another 2 million were thirty days delinquent. Therefore, a total of about 6 million mortgages either have already been foreclosed, are in foreclosure, or are close to foreclosure. Six million mortgages are about 12 percent of all the mortgages in the United States. The situation could get a lot worse in the months ahead, due to the worsening recession and lost jobs and income, unless the government adopts stronger policies to reduce foreclosures.

Defaults and foreclosures on mortgages mean losses for lenders. Estimates of losses on mortgages keep increasing, and many are now predicting losses of \$1 trillion or more.

In addition to losses on mortgages, there will also be losses on other types of loans, due to the weakness of the economy, in the months ahead: consumer loans (credit cards, etc.), commercial real estate, corporate junk bonds, and other types of loans (e.g. credit default swaps). Estimates of losses on these other types of loans range up to another trillion dollars. Therefore, total losses for the financial sector as a whole could be as high as \$2 trillion.

It is further estimated that banks will suffer about half of the total losses of the financial sector. The rest of the losses will be borne by non-bank financial institutions (hedge funds, pension funds, etc.). Therefore, dividing the total losses for the financial sector as a whole in the previous paragraph by two, the losses for the banking sector could be as high as \$1 trillion. Since the total bank capital in the U.S. is approximately \$1.5 trillion, losses of this magnitude would wipe out two-thirds of the total capital in U.S. banks!* This would obviously be a severe blow, not just to the banks, but also to the U.S. economy as a whole.

The blow to the rest of the economy would happen because the rest of the economy is dependent on banks for loans—businesses for investment loans, and households for mortgages and consumer loans. Bank losses result in a reduction in bank capital, which in turn requires a reduction in bank lending (a credit crunch), in order to maintain acceptable loan to capital ratios. Assuming a loan to capital ratio of 10:1 (this conservative assumption was made in a recent study by Goldman Sachs), every \$100 billion loss and reduction of bank capital would normally result in a \$1 trillion reduction in bank lending and corresponding reductions in business investment and consumer spending. According to this rule of thumb, even the low estimate of bank losses of \$1 trillion would result in a reduction of bank lending of \$10 trillion! This would be a severe blow to the economy and would cause a severe recession.

Bank losses may be offset to some extent by "recapitalization," i.e., by new capital being invested in banks from other sources. If bank capital can be at least partially restored, then the reduction in bank lending does not have to be so significant and traumatic. So far, banks have lost about \$500 billion and have raised about

\$400 billion in new capital, most of it coming from “sovereign wealth funds” financed by the governments of Asian and Middle Eastern countries. So ironically, U.S. banks may be “saved” (in part) by increasing foreign ownership. U.S. bankers are now figuratively on their knees before these foreign investors offering discounted prices and pleading for help. It is also an important indication of the decline of U.S. economic hegemony as a result of this crisis. However, it is becoming more difficult for banks to raise new capital from foreign investors, because their prior investments have already suffered significant losses.

In addition to the credit crunch, consumer spending will be further depressed in the months ahead due to the following factors: decreasing household wealth; the end of mortgage equity withdrawals (which were very significant in the recent boom); and declining jobs and incomes. All in all, it is shaping up to be a very severe recession.

6. Government policies

The federal government has acted fairly vigorously in attempts to prevent a more serious crisis, and has been modestly successful in the short-run, but it remains to be seen how successful it will be in the long run.

6.1 Federal Reserve. The Federal Reserve initially adopted very expansionary policies (lower short-term interest rates and increased loans to commercial banks) in the hopes that banks would increase their lending to businesses and households. However, these traditional policies have not been effective, because banks have been unwilling to increase their lending, both because they do not trust the creditworthiness of the borrowers and also because the loss of capital that they have suffered (and will continue to suffer) requires that they reduce their lending in order to maintain acceptable loan to capital ratios.

Because of this failure of traditional policies, the Fed began to improvise with new unprecedented policies. It broadened the eligible collateral for its loans; previously only Treasury bonds were eligible, but now all sorts of more risky securities are eligible, including mortgage-based securities. Most importantly, the Fed extended loans to investment banks for the first time in its history. Investment banks are not regulated by the Fed, so it has always been thought that the Fed had no responsibility to act as “lender of last resort” to investment banks when they are in trouble. However, when the investment bank Bear Stearns was on the verge of bankruptcy in late March, the Fed decided that it had to act as lender of last resort to Bear Stearns and JPMorgan Chase, which took over Bear Stearns. Since Bear Stearns was heavily indebted to so many different financial institutions, its bankruptcy would have caused very widespread losses and could have resulted in a complete meltdown of the U.S. financial system—nobody lending money to anybody for anything—and a disaster for the economy. That was Fed chief Ben Bernanke’s nightmare, and why the Fed intervened so quickly and decisively as lender of last resort to these investment banks. The Fed justified its going beyond its traditional boundaries by saying that “the financial system of the U.S. was at risk.” The Fed’s statement and its action are clear evidence of how fragile and unstable the U.S. financial system is at the present time.

Then, in September 2008, when the bankruptcy of Lehman Brothers (at the time the fourth largest investment bank in the U.S.) triggered a worsening of the crisis, the Fed took an even more extraordinary and unprecedented step to bail out an insurance company, AIG, the largest insurance company in the world. AIG had dominated the market for credit default swaps, which are a form of insurance against the default of bonds, including high-risk, mortgage-based securities, as well as a form of speculation that bonds and other securities will default. But AIG was in such financial trouble that the Fed feared the company would not be able to pay off on all the insurance policies that it had sold. And failure by AIG to pay off would mean losses for banks (and others) that had bought this insurance, adding more losses to the already staggering losses suffered by banks. So once again, the Fed decided that it had to bail out AIG in order to “save the financial system.”

So far, the Fed’s unprecedented policies have been mildly successful, but by no means a complete success. At least an all-out financial collapse has been averted (for now). And investor confidence seems to have been restored somewhat by the demonstrated commitment on the part of the Fed to do everything possible to avoid a financial disaster. However, commercial banks and investment banks have still not increased their lending. And the Fed’s policies do not solve and cannot solve the fundamental problems of too much household debt, declining housing prices and rising foreclosure rates.

6.2 Congress. In February 2008, Congress quickly passed an “economic stimulus” bill of \$168 billion that included tax rebates for households and tax cuts for businesses. These tax cuts had some positive effect on the economy last summer, but their effect was small and temporary. At best, the tax rebates provided a one-time boost to consumer spending, since these rebates could be spent only once.

The incoming Obama administration and Democrats in Congress are working on a second, much larger stimulus package of about \$850 billion, which will consist of two-thirds increased spending (with emphasis on aid to states, education, unemployment benefits, and public works infrastructure projects and one-third tax cuts (mainly on payroll taxes). This second stimulus package will be somewhat more effective than the first, mainly because it is so much bigger, and also because more of the total money is for increased spending rather than lower taxes. So this stimulus will make the recession somewhat less severe than it otherwise

would have been, but I don't think it will generate a recovery of the economy in the last half of 2009, as most economists think. I think the downward forces in the economy are so strong right now—cutbacks here leading to further cutbacks there, in a mutually reinforcing downward spiral—that the economy will continue to decline at least through 2009 and probably most of 2010.

The positive effects of this second stimulus will be short-lived, like the first one. If the economy is still contracting in 2010, there will probably be a need for a third stimulus plan. But will that be possible? And in the long run, there are possible negative effects of this wildly expansionary fiscal policy. When the recovery finally comes, it will be slower than usual, because interest rates will have to be higher and taxes will have to be higher in order to pay for today's stimulus spending and tax cuts. Plus, expansionary fiscal policy does not solve the fundamental problem in the economy—the heavy debt burdens of households and businesses that threaten bankruptcies and restrain spending. A significant portion of this debt must be written off if this fundamental problem is to be solved.

In July 2008, Congress passed an anti-foreclosure measure, which allows for the refinancing of existing mortgages, which are in default with new mortgages that would have a value of approximately 85 percent of the current market value of the houses, and would be guaranteed by the Federal Housing Administration. However, the lenders must initiate this refinancing, and so far very few lenders have been willing to initiate these new mortgages with write-downs of the principle owed.

In early September 2008, Fannie Mae and Freddie Mac, the two giant home mortgage companies that own or guarantee almost half of the total mortgages in the U.S., were in danger of bankruptcy due to the continued deterioration of the home mortgage industry. The Treasury responded by taking over Fannie and Freddie in a conservatorship and guaranteeing to pay all their debts in full. This bailout will probably cost taxpayers hundreds of billions of dollars. William Poole (ex-president of the St. Louis Fed) has estimated that the total cost to taxpayers could be in the neighborhood of \$300 billion.

The justification for this bailout of Fannie and Freddie was similar to that of Bear Stearns—that they were in danger of going bankrupt, and if that happened, then the U.S. home mortgage industry and the home construction industry probably would have collapsed almost completely, which would have dealt a serious blow to the U.S. economy as a whole.

Then in late September, as the crisis worsened, Treasury Secretary Paulson requested and Congress approved (in the threatening environment of a rapidly falling stock market) \$700 billion to purchase high-risk, mortgage-based securities (“toxic waste”) from U.S. banks. \$700 billion is a lot of money; it is \$2,300 for every man, woman, and child in the United States. Soon after the law was passed, Paulson changed his mind, and decided to use the \$700 billion to “inject capital” into banks (rather than purchase their toxic securities), in the hopes that this would be a better way to encourage banks to increase their lending. So far, the first half of the \$700 billion has been spent, as a giant bailout of the banks and their bondholders, but banks have still not been willing to increase their lending. Prospects are similar for the second half of this bank bailout money.

The justification for this bailout, like the previous ones, is that, if the government did not bail out the banks and their bondholders, then the whole financial system in the U.S. would collapse (in the memorable words of the worst president in U.S. history: “this sucker would go down”). Even the dreaded “d-word” is heard more and more, like a gun to our heads. It is a kind of economic “Sophie's Choice”—either bail out the bondholders with taxpayers' money or suffer a deep recession or depression.

Having to choose between these options represents a stinging indictment of our current financial system. The situation suggests that the capitalist financial system, left on its own, is inherently unstable, and can only “avoid” crises by being bailed out by the government, at the taxpayers' expense. There is a double indictment here: the capitalist financial system is inherently unstable and the necessary bailouts are economically unjust.

7. Nationalize finance

Thus we can see that there is a cruel dilemma in capitalist economies for governments and the public and also for the left. When a financial crisis threatens, or begins, there seem to be only two options: bail out the financial capitalists in some way or suffer a more severe financial crisis, which in turn will cause an even more severe crisis in the economy as a whole, which will cause widespread misery and hardships.

The only way to avoid this cruel dilemma is to make the economy less dependent on financial capitalists. And the only way to accomplish this greater independence from financial capitalists is for the government itself to become the main provider of credit in the economy, especially for home mortgages, and perhaps also for consumer loans, and maybe even eventually for business loans. In other words, finance should be nationalized and operated by the government in the interest of public policy objectives.

What this means in the U.S. today is, first of all, the quasi-nationalization of Fannie Mae and Freddie Mac that has already occurred should be made permanent, and these government mortgage agencies should be used to achieve the public policy goal of decent affordable housing for all, rather than profit maximization. Secondly, major banks (“systematically significant” banks that are “too big to fail”) that are in danger of

bankruptcy should be nationalized and operated in order to achieve similar public policy objectives. These nationalizations should also involve a significant writedown of the existing debt of Fannie and Freddie and the nationalized banks (as is usually done in bankruptcy proceedings), in order to make these financial institutions solvent again without costing taxpayers anything.

We have to do something like this. Otherwise, we will continue to face the same cruel dilemma of either bailing out financial capitalists or suffering a worse economic crisis over and over again in the future, as will our children and their children. Within the institutional framework of financial capitalism, these are the only two options. In order to create other options (more worker-friendly options), we have to change drastically the institutional framework of financial capitalism; we have to convert capitalist finance into nationalized government finance.

The nationalization of banks would not solve the current economic crisis completely, but it would help stabilize the banking system and could lead to increased lending to creditworthy businesses and consumers. A full solution to the current crisis requires above all else a significant writedown of the huge mountains of debt built up in recent decades—home mortgage debt, consumer debt, business debt, bank debt, etc.

The nationalization of banks is not socialism, but it could be an important step on the road to socialism. The use of government banks to pursue important public policy objectives, rather than profit maximization, would be a model for the rest of the economy. More and more people would realize that an entire economy run according to democratically decided policy objectives would be better for the vast majority of Americans than our current economy, which is run according to profit maximization, produces great inequality, and is highly unstable and prone to crises, like the present crisis, that cause great suffering and hardship. Surely we can create an economic system better than this.

* Editor's note: Since this article was written, the losses may have already gone beyond this point. New York University Professor Nouriel Roubini argued in January that, "I've found that credit losses could peak at a level of \$3.6 trillion for U.S. institutions, half of them by banks and broker dealers.... If that's true, it means the U.S. banking system is effectively insolvent because it starts with a capital of \$1.4 trillion." (Henry Meyer and Ayesha Daya, "Roubini predicts U.S. losses may reach \$3.6 trillion," Bloomberg, January 20, 2009.)