A primer on the Wall Street meltdown

By Walden Bello

http://opinion.inquirer.net/viewpoints/columns/view/20081001-163889/A-primer-on-the-Wall-Street-meltdown

NEW YORK — Flying into New York Tuesday, I had the same feeling I had when I arrived in Beirut two years ago, at the height of the Israeli bombing of that city — that of entering a war zone.

The immigration agent, upon learning I taught political economy, commented, "Well, I guess you folks will now be revising all those textbooks?"

The bus driver welcomed passengers with the words, "New York is still here, ladies and gentlemen, but Wall Street has disappeared, like the Twin Towers."

Even the usually cheerful TV morning shows felt obligated to begin with the bad news, with one host attributing the bleak events to "the fat cats of Wall Street who turned into pigs."

This city is shell-shocked, and most people still have to digest the momentous events of the past two weeks:

• a trillion dollars' worth of capital going up in smoke in Wall Street's steep plunge of 778 points on Black Monday II, Sept. 29, as investors reacted in panic to the US House of Representatives' rejection of President George W. Bush's gargantuan $700-billion bailout of financial institutions on the verge of bankruptcy;

• the collapse of one of the Street's most prominent investment banks, Lehman Brothers, followed by the largest bank failure in US history, that of Washington Mutual, the country's largest savings and loan institution;

• Wall Street's effective nationalization, with the Federal Reserve and the Department of Treasury making all the major strategic decisions in the financial sector and, with the rescue of the American International Group (AIG), the amazing fact that the US government now runs the world's biggest insurance company.

Over $5 trillion in total market capitalization has been wiped out since October of last year, with over a trillion of this accounted for by the unraveling of Wall Street's financial titans.

The usual explanations no longer suffice. Extraordinary events demand extraordinary explanations. But first…

Is the worst over?

No, if anything is clear from the contradictory moves of the last week — allowing Lehman Brothers and Washington Mutual to collapse while taking AIG over and engineering Bank of America's takeover of Merrill Lynch — there is no strategy to deal with the crisis, just tactical responses, like the fire department's response to a conflagration.

The proposed $700-billion buyout of banks' bad mortgaged-backed securities is not a strategy but mainly a desperate effort to shore up confidence in the system, to prevent the erosion of trust in the banks and other financial institutions and preventing a massive bank run such as the one that triggered the Great Depression of 1929.

What caused the collapse of global capitalism's nerve center? Was it greed?

Good old fashioned greed played a part. This is what Klaus Schwab, the organizer of the World Economic Forum, the yearly global elite jamboree in the Swiss Alps, meant when he told his clientele in Davos earlier this year: "We have to pay for the sins of the past."

Was this a case of Wall Street outsmarting itself?

Definitely. Financial speculators outsmarted themselves by creating more and more complex financial contracts like derivatives that would securitize and make money from all forms of risk — including exotic futures instruments as "credit default swaps" that enable investors to bet on the odds that the banks' own corporate borrowers would not be able to pay their debts! This is the unregulated multi-trillion-dollar trade that brought AIG down.

On Dec. 17, 2005, when International Financing Review (IFR) announced its 2005 Annual Awards — one of the securities industry's most prestigious awards — it had this to say: "[Lehman Brothers] not only maintained its overall market presence, but also led the charge into the preferred space by ... developing new products and tailoring transactions to fit borrowers' needs.… Lehman Brothers is the most innovative in the preferred space, just doing things you won't see elsewhere."

No comment.

Was it lack of regulation?

Yes — everyone acknowledges by now that Wall Street's capacity to innovate and turn out more and more sophisticated financial instruments had run far ahead of government's regulatory capability, not because government was not capable of regulating but because the dominant neoliberal, laissez-faire attitude prevented government from devising effective mechanisms with which to regulate. The massive trading in derivatives helped precipitate this crisis, and the US Congress paved the way when it passed a law in 2000 excluding derivatives from being regulated by the Securities Exchange Commission.

But isn't there something more that is happening? Something systemic?

Well, George Soros, who saw this coming, says what we are going through is the crisis of the "gigantic circulatory system" of a "global capitalist system that is…coming apart at the seams."

To elaborate on the arch-speculator's insight, what we are seeing is the intensification of one of the central crises or contradictions of global capitalism, which is the crisis of overproduction, also known as over-accumulation or overcapacity.

This is the tendency for capitalism to build up tremendous productive capacity that outruns the population's capacity to consume, owing to social inequalities that limit popular purchasing power. Profitability is thus eroded.

But what does the crisis of overproduction have to do with recent events?

Plenty. But to understand the connections, we must go back in time to the so-called Golden Age of Contemporary Capitalism, the period from 1945 to 1975.

This was a period of rapid growth both in the center economies and in the underdeveloped economies — one that was partly triggered by the massive reconstruction of Europe and East Asia after the devastation of the Second World War, and partly by the new socioeconomic arrangements that were institutionalized under the new Keynesian state. Among the latter, key were strong state controls over market activity, aggressive use of fiscal and monetary policy to minimize inflation and recession, and a regime of relatively high wages to stimulate and maintain demand.

So what went wrong?

Well, this period of high growth came to an end in the mid-1970s, when the center economies were seized by stagflation, meaning the coexistence of low growth with high inflation, which was not supposed to happen under neoclassical economics.

Stagflation, however, was but a symptom of a deeper cause: The reconstruction of Germany and Japan and the rapid growth of industrializing economies like Brazil, Taiwan and South Korea added tremendous new productive capacity and increased global competition, while social inequalities within countries and between countries worldwide limited the growth of purchasing power and demand, thus eroding profitability. This was aggravated by the massive oil price rises of the '70s.

How did capitalism try to solve the crisis of overproduction?

Capital tried three escape routes from the conundrum of overproduction: neoliberal restructuring, globalization, and financialization.

What was neoliberal restructuring all about?

Neoliberal restructuring took the form of Reaganism and Thatcherism in the North and Structural Adjustment in the South. The aim was to invigorate capital accumulation, and this was to be done by (1) removing state constraints on the growth, use and flow of capital and wealth, and (2) redistributing income from the poor and middle classes to the rich on the theory that the rich would then be motivated to invest and reignite economic growth.

The problem with this formula was that in redistributing income to the rich, they were gutting the incomes of the poor and middle classes, thus restricting demand, while not necessarily inducing the rich to invest more in production. In fact, what the rich did was to channel a large part of their redistributed wealth to speculation.

The truth is neoliberal restructuring, which was generalized in the North and South during the 1980s and '90s, had a poor record in terms of growth: Global growth averaged 1.1 percent in the '90s and 1.4 in the '80s, whereas it averaged 3.5 percent in the '60s and 2.4 percent in the '70s, when state interventionist policies were dominant. Neoliberal restructuring could not shake off stagnation.

How was globalization a response to the crisis?

The second escape route global capital took to counter stagnation was "extensive accumulation" or globalization, or the rapid integration of semi-capitalist, non-capitalist or pre-capitalist areas into the global market economy. Rosa Luxemburg, the famous German revolutionary economist, saw this long ago as necessary to shore up the rate of profit in the metropolitan economies. How? By gaining access to cheap labor, by gaining new, albeit limited, markets, by gaining new sources of cheap agricultural and raw material products, and by bringing into being new areas for investment in infrastructure. Integration is accomplished via trade liberalization, removing barriers to the mobility of global capital and abolishing barriers to foreign investment.

China is, of course, the most prominent case of a non-capitalist area to be integrated into the global capitalist economy over the past 25 years.

To counter their declining profits, a sizable number of the Fortune 500 corporations have moved a significant part of their operations to China to take advantage of the so-called "China Price" — the cost advantage deriving from China's seemingly inexhaustible cheap labor. By the middle of the first decade of the 21st century, roughly 40-50 percent of the profits of US corporations were derived from their operations and sales abroad, especially in China.

Why didn't globalization surmount the crisis?

The problem with this escape route from stagnation is that it exacerbates the problem of overproduction because it adds to productive capacity. A tremendous amount of manufacturing capacity has been added in China over the past 25 years, and this has had a depressing effect on prices and profits. Not surprisingly, by around 1997, the profits of US corporations stopped growing. According to another index, devised by economist Philip O'Hara, the profit rate of the Fortune 500 went from 7.15 in 1960-69 to 5.30 in 1980-90 to 2.29 in 1990-99 to 1.32 in 2000-02.

What about financialization?

Given the limited gains in countering the depressive impact of overproduction via neoliberal restructuring and globalization, the third escape route became very critical for maintaining and raising profitability: financialization.

In the ideal world of neoclassical economics, the financial system is the mechanism by which the savers or those with surplus funds are joined with the entrepreneurs who have need of their funds to invest in production. In the real world of late capitalism, with investment in industry and agriculture yielding low profits owing to overcapacity, large amounts of surplus funds are circulating and being invested and reinvested in the financial sector — that is, the financial sector is turning in on itself.

The result is an increased bifurcation between a hyperactive financial economy and a stagnant real economy. As one financial executive notes, "There has been an increasing disconnect between the real and financial economies in the last few years. The real economy has grown … but nothing like that of the financial economy — until it imploded."

What this observer does not tell us is that the disconnect between the real and the financial economy is not accidental — that the financial economy exploded precisely to make up for the stagnation owing to overproduction of the real economy.

What were the problems with financialization as an escape route?

The problem with investing in financial sector operations is that it is tantamount to squeezing value out of already created value. It may create profit, yes, but it does not create new value — only industry, agriculture, trade and services create new value.

Because profit is not based on value that is created, investment operations become very volatile and prices of stocks, bonds, and other forms of investment can depart very radically from their real value — for instance, the stock of Internet startups that keep on rising, driven mainly by upwardly spiraling financial valuations, and that then crash.

Profits then depend on taking advantage of upward price departures from the value of commodities, and then selling before reality enforces a "correction," that is, a crash back to real values.

The radical rise of prices of an asset far beyond real values is what is called the formation of a bubble.

Why is financialization so volatile?

Profitability being dependent on speculative coups, it is not surprising that the finance sector lurches from one bubble to another, or from one speculative mania to another.

Because it is driven by speculative mania, finance-driven capitalism has experienced about 100 financial crises since capital markets were deregulated and liberalized in the 1980s.

Prior to the current Wall Street meltdown, the most explosive of these were the Mexican Financial Crisis of 1994-95, the Asian Financial Crisis of 1997-98, the Russian Financial Crisis of 1996, the Wall Street Stock Market Collapse of 2001, and the Argentine Financial Collapse of 2002.

Bill Clinton's treasury secretary, Wall Streeter Robert Rubin, predicted five years ago that "future financial crises are almost surely inevitable and could be even more severe."

How do bubbles form, grow, and burst?

Let's first use the Asian Financial Crisis of 1997-98 as an example.

• First, capital account and financial liberalization at the urging of the IMF and the US Department of Treasury;

• Then, entry of foreign funds seeking quick and high returns, meaning they went to real estate and the stock market;

• Overinvestment, leading to a fall in stock and real estate prices, leading to panicky withdrawal of funds — in 1997, $100 billion left the East Asian economies in a few weeks;

• Bailout of foreign speculators by the IMF;

• Collapse of the real economy — recession throughout East Asia in 1998.

Despite massive destabilization, efforts to impose both national and global regulation of financial system were opposed on ideological grounds.

Let's go to the current bubble. How did it form?

The current Wall Street collapse has its roots in the Technology Bubble of the late 1990s, when the price of the stocks of Internet startups skyrocketed, then collapsed, resulting in the loss of $7 trillion worth of assets and in the recession of 2001-02.

The loose money policies of the Fed under Alan Greenspan had encouraged the Technology Bubble, and when the US fell into a recession, Greenspan, to try to counter a long recession, cut the prime rate to a 45-year low of 1.00 per cent in June 2003 and kept it there for over a year. That had the effect of encouraging another bubble: the real estate bubble.

As early as 2002, progressive economists, such as Dean Baker of the Center for Economic Policy Research, were warning about the real estate bubble. However, as late as 2005, Ben Bernanke, then chairman of the Council of Economic Adviser and now chairman of the Federal Reserve, attributed the rise in US housing prices to "strong economic fundamentals" instead of speculative activity. Is it any wonder that he was caught completely off guard when the subprime crisis broke in the summer of 2007?

And how did it grow?

Let's hear it from one key market player himself, George Soros: "Mortgage institutions encouraged mortgage holders to refinance their mortgages and withdraw their excess equity. They lowered their lending standards and introduced new products, such as adjustable mortgages (ARMs), 'interest only' mortgages, and promotional 'teaser rates.' All this encouraged speculation in residential housing units. House prices started to rise in double-digit rates. This served to reinforce speculation, and the rise in house prices made the owners feel rich; the result was a consumption boom that has sustained the economy in recent years."

Looking at the process more closely, the subprime mortgage crisis was not a case of supply outrunning real demand. The "demand" was largely fabricated by speculative mania among developers and financiers that wanted to make great profits from their access to foreign money — lots of it from Asia — that flooded the US in the last decade. Big-ticket mortgages or loans were aggressively made to millions of people who could not normally afford them by offering low "teaser" interest rates that would later be readjusted to jack up payments from the new homeowners.

But how could subprime mortgages going sour turn into such a big problem?

Because these assets were then "securitized" with other assets into complex derivative products called "collateralized debt obligations" (CDOs), by the mortgage originators working with different layers of middlemen who understated risk so as to offload them as quickly as possible to other banks and institutional investors. These institutions in turn offloaded these securities onto other banks and foreign financial institutions. The idea was to make a sale quickly, make a tidy profit, while foisting the risk on the suckers down the line.

When the interest rates were raised on the subprime loans, adjustable mortgages and other housing loans, the game was up. There are about six million subprime mortgages outstanding, 40 percent of which will likely go into default in the next two years, according to Soros' estimates.

And five million more defaults from adjustable-rate mortgages and other "flexible loans" will occur in the next several years. But securities whose values run in the trillions of dollars have already been injected, like a virus, into the global financial system. Global capitalism's gigantic circulatory system is fatally infected.

But how could Wall Street titans collapse like a house of cards?

For Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac and Bear Stearns, the losses represented by these toxic securities simply overwhelmed their reserves and brought them down. And more are likely to fall once their books — since lots of these holdings are recorded "off the balance sheet" — are corrected to reflect their actual holdings of these assets.

And many others will join them as other speculative operations, such as credit cards and different varieties of risk insurance, seize up. American International Group (AIG) was felled by its massive exposure in the unregulated area of credit default swaps, derivatives that make it possible for investors to bet on the possibility that companies will default on repaying loans. Such bets on credit defaults now make up a $45-trillion market that is entirely unregulated. It amounts to more than five times the total of the US government bond market. The mega-size of the assets that could go bad should AIG collapse was what made Washington change its mind and salvage it after it let Lehman Brothers collapse.

What's going to happen now?

We can safely say, then, that there will be more bankruptcies and government takeovers, with foreign banks and institutions joining their US counterparts; that Wall Street's collapse will deepen and prolong the US recession; and that in Asia and elsewhere, a US recession will translate into a recession, if not worse.

The reason for that last point is that China's main foreign market is the US and China in turn imports raw materials and intermediate goods that it uses for its exports to the US from Japan, South Korea and Southeast Asia. Globalization has made "decoupling" impossible. The US, China and East Asia are like three prisoners bound together in a chain-gang.

In a nutshell...?

The Wall Street meltdown is due not only to greed and the lack of government regulation of a hyperactive sector. It stems ultimately from the crisis of overproduction that has plagued global capitalism since the mid-1970s.

Financialization of investment activity has been one of the escape routes from stagnation, the other two being neoliberal restructuring and globalization. With neoliberal restructuring and globalization providing limited relief, financialization became attractive as a mechanism to shore up profitability. But financialization has proven to be a dangerous road, leading to speculative bubbles that lead to the temporary prosperity of a few but which ultimately end up in corporate collapse and in recession in the real economy.

The key questions now are: How deep and long will this recession be? Does the US economy need another speculative bubble to drag itself out of this recession? And if it does, where will the next bubble form? Some people say the military-industrial complex, or the "disaster capitalism complex" that Naomi Klein writes about, is the next one, but that's another story.

Walden Bello is president of Freedom from Debt Coalition, senior analyst at Focus on the Global South, and professor of Sociology at the University of the Philippines.