

Wall Street Meltdown Primer

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Many on Wall Street and the rest of us are still digesting the momentous events of the last 10 days. Between one and three trillion dollars worth of financial assets have evaporated. Wall Street has been effectively nationalized. The Federal Reserve and the Treasury Department are making all the major strategic decisions in the financial sector and, with the rescue of the American International Group (AIG), the U.S. government now runs the world's biggest insurance company. At \$700 billion, the biggest bailout since the Great Depression is being desperately cobbled together to save the global financial system.

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 to collapse while taking over AIG, and engineering Bank of America's takeover of Merrill Lynch - there's no strategy to deal with the crisis, just tactical responses. It's like the fire department's response to a conflagration.

The \$700 billion buyout of banks' bad mortgaged-backed securities is mainly a desperate effort to shore up confidence in the system, preventing the erosion of trust in the banks and other financial institutions and avoiding a massive bank run such as the one that triggered the Great Depression of 1929.

Did greed cause the collapse of global capitalism's nerve center?

Good old-fashioned greed certainly 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 said in an interview 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 such 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 down AIG.

On December 17, 2005, when International Financing Review (IFR) announced its 2005 Annual Awards - one of the securities industry's most prestigious awards programs - 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. This wasn't because the government was incapable of regulating but because the dominant neoliberal, laissez-faire attitude prevented government from devising effective regulatory mechanisms.

But isn't there something more that is happening?

We're seeing the intensification of one of the central crises or contradictions of global capitalism: the crisis of overproduction, also known as overaccumulation or overcapacity.

In other words, capitalism has a tendency to build up tremendous productive capacity that outruns the population's capacity to consume owing to social inequalities that limit popular purchasing power, thus eroding profitability.

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 time 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 World War II, and partly by the new socio-economic arrangements institutionalized under the new Keynesian state. Key among the latter 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?

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 wasn't 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. Meanwhile social inequality within countries and between countries globally limited the growth of purchasing power and demand, thus eroding profitability. The massive increase in the price of oil aggravated this trend in the 1970s.

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.

This formula redistributed income to the rich and gutted the incomes of the poor and middle classes. It thus restricted demand while not necessarily inducing the rich to invest more in production.

In fact, neoliberal restructuring, which was generalized in the North and South during the 1980s and 1990s, had a poor record in terms of growth: global growth averaged 1.1% in the 1990s and 1.4% in the 1980s, whereas it averaged 3.5% in the 1960s and 2.4% in the 1970s, when state interventionist policies were dominant. Neoliberal restructuring couldn't 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. This was the rapid integration of semi-capitalist, non-capitalist, or precapitalist 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: 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 that was integrated into the global capitalist economy over the last 25 years.

To counter their declining profits, many 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 of China's seemingly inexhaustible cheap labor. By the middle of the first decade of the 21st century, roughly 40-50% of the profits of U.S. corporations were derived from their operations and sales abroad, especially China.

Why didn't globalization surmount the crisis?

This escape route from stagnation has exacerbated the problem of overproduction because it adds to productive capacity. A tremendous amount of manufacturing capacity has been added in China over the last 25 years, and this has had a depressing effect on prices and profits. Not surprisingly, by around 1997, the profits of U.S. corporations stopped growing. According to one index, the profit rate of the Fortune 500 went from 7.15% in 1960-69 to 5.3% in 1980-90 to 2.29% in 1990-99 to 1.32% in 2000-2002.

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. The financial sector has thus turned 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 doesn't tell us is that the disconnect between the real and the financial economy isn't accidental. The financial economy has 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 doesn't create new value. Only industry, agricultural, trade, and services create new value. Because profit is not based on value that is created, investment operations become very volatile and the prices of stocks, bonds, and other forms of investment can depart very radically from their real value. For instance, in the 1990s, prices of stock in Internet startups skyrocketed, driven mainly by upwardly spiraling financial valuations rooted in theoretical expectations of future profitability. Share prices crashed in 2000 and 2001 when this strategy got completely out of hand. Profits then depend on taking advantage of upward price departures from the value of commodities, then selling before reality enforces a "correction." Corrections are really a return to more realistic values. The radical rise of asset prices far beyond any credible value is what fosters financial bubbles.

Why is financialization so volatile?

With profitability depending on speculative coups, it's not surprising that the finance sector lurches from one bubble to another, or from one speculative mania to another.

And because it's driven by speculative mania, finance-driven capitalism has experienced scores of 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 string of emerging markets crises and the US tech stock bubble's implosion in 2000 and 2001. The emerging markets crises primarily included the Mexican financial crisis of 1994-95, the Asian financial crisis of 1997-1998, the Russian financial crisis in 1998, and the Argentine financial collapse that occurred in 2001 and 2002, but they also rocked other countries including Brazil and Turkey.

One of President Bill Clinton's Treasury Secretaries, 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 took place Thailand and other countries at the urging of the International Monetary Fund (IMF) and the U.S. Treasury Department. Then came the entry of foreign funds seeking quick and high returns, meaning they went to real estate and the stock market. This overinvestment made stock and real estate prices fall, leading to the panicked withdrawal of funds. In 1997, \$100 billion fled the East Asian economies over the course of just a few weeks.

That capital flight led to an IMF bailout of foreign speculators. The resulting collapse of the real economy produced a recession throughout East Asia in 1998. Despite massive destabilization, international financial institutions opposed efforts to impose both national and global regulation of financial system on ideological grounds.

What about the current bubble? How did it form?

The current Wall Street collapse has its roots in the technology-stock bubble of the late 1990s, when the price of the stocks of Internet startups skyrocketed, then collapsed in 2000 and 2001, resulting in the loss of \$7 trillion worth of assets and the recession of 2001-2002.

The Fed's loose money policies under Alan Greenspan encouraged the technology bubble. When it collapsed into a recession, Greenspan, to try to counter a long recession, cut the prime rate to a 45-year low of one percent in June 2003 and kept it there for over a year. This had the effect of encouraging another bubble - in real estate.

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

And how did it grow?

According to investor and philanthropist 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. "The subprime mortgage crisis wasn't a case of supply outrunning real demand. The demand was largely fabricated by speculative mania on the part of developers and financiers that wanted to make great profits from their access to foreign money that has flooded the United States in the last decade. Big-ticket mortgages were aggressively sold to millions 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). The mortgage originators worked 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.

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

And five million more defaults from adjustable rate mortgages and other "flexible loans" will occur over the next several years. These securities, the value of which run into the trillions of dollars, have already been injected, like virus, into the global financial system.

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.

And many others will join them as other speculative operations such as credit cards and different varieties of risk insurance seize up. The 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. According to Soros, 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 U.S. government bond market. The huge size of the assets that could go bad if AIG collapsed made Washington change its mind and intervene after it let Lehman Brothers collapse.

What's going to happen now?

There will be more bankruptcies and government takeovers. Wall Street's collapse will deepen and prolong the U.S. recession. This recession will translate into an Asian recession. After all, China's main foreign market is the United States, and China in turn imports raw materials and intermediate goods that it uses for its U.S. exports from Japan, Korea, and Southeast Asia. Globalization has made "decoupling" impossible. The United States, China, and East Asia in general are like three prisoners bound together in a chain-gang.

In a nutshell...?

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

The 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. It has led to speculative bubbles that produce temporary prosperity for a few but 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 U.S. 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 will be the next bubble. But that's another story.

P.S.

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