Crisis after crisis: Why financial sector reform is not enough – A Post-Capitalist Alternative

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It is now clear that financial crises are not discrete events but are linked phenomena that have been unleashed on the globe ever since the financial markets were liberalized during the Reagan-Thatcher era in the early 1980's. To take just the three most prominent crashes, surplus capital that could not find profitable domestic outlets after the Japanese bubble burst in the late eighties found its way as speculative capital into Southeast Asia, where it contributed to the Asian financial crisis in 1997-98; and the Asian crisis, in turn, helped generate Wall Street's implosion in 2008 owing to the Asian countries' channeling their financial reserves – accumulated to protect them from a repeat of 1997 – into the US, where they helped fuel the subprime real estate boom.

The turbulence that hit global stock markets last February, causing much fright and a paper loss of 4 trillion dollars, was a reminder that the next big implosion may be just around the corner. A just concluded study by the Transnational Institute reveals that in 10 critical areas where major reform is needed, few to no measures have been taken to prevent a recurrence of 2007.[1] These areas range from shadow banking to fractional reserve banking to international financial governance to central bank accountability.

_Skating on thin ice once more

So, not surprisingly, current indicators show that the world again is skating on thin ice.

First, the "too big to fail" problem has become worse. The big banks that were rescued by the US government in 2008 because they were seen as too big to fail have become even more too big to fail, with the "Big Six" US banks – JP Morgan Chase, Citigroup, Wells Fargo, Bank of America, Goldman Sachs, and Morgan Stanley – collectively having 43 per cent more deposits, 84 per cent more assets, and triple the amount of cash they held before the 2008 crisis. Essentially, they have doubled the risk that felled the banking system in 2008.[2]

Second, the products that triggered the 2008 crisis are still being traded. This includes around $6.7 trillion in mortgage-backed securities (MBS) sloshing around, the value of which has been maintained only because the Federal Reserve bought $1.7 trillion of them.[3]

US banks collectively hold $157 trillion in derivatives, about twice global GDP. This is 12 per cent more than they possessed at the beginning of the 2008 crisis. Citigroup alone accounts for $44 trillion, or 50 per cent more that its pre-crisis holdings, prompting a sarcastic comment from one analyst that the bank seems “to have forgotten the time when they were a buck a share,” alluding to the low point in the bank’s derivatives’ value in 2009.[4]

Third, the new stars in the financial firmament, the institutional investors’ consortium made up of hedge funds, private equity funds, sovereign wealth funds, pension funds, and other investor entities, continue to roam the global network unchecked, operating from virtual bases called tax havens, looking for arbitrage opportunities in currencies or securities, or sizing up the profitability of corporations for possible stock purchases. Ownership of the estimated $100 trillion in the hands of these floating tax shelters for the superrich is concentrated in 20 funds.

Fourth, financial operators are racking up profits in a sea of liquidity provided by central banks, whose releasing of cheap money has resulted in the issuance of trillions of dollars of debt, pushing the level of debt globally to $325 trillion, more than three times the size of global GDP.[5] There is a consensus among economists across the political spectrum that this debt build-up cannot go on indefinitely without inviting catastrophe.

China: Epicenter of the next Big Bang?

It is hard to predict where the next financial implosion will take place. There are, however, several candidates. One of them is China. A close examination of this country’s financial state would show that there is cause to worry.

Conventional wisdom holds that China is on the ascent and the United States is in decline, that China’s economy is roaring with raw energy and that Beijing’s “Belt and Road” mega-project of infrastructure building in Central, South, and Southeast Asia is laying the basis for its global economic hegemony.

Some question whether Beijing’s ambitions are sustainable. Inequality in China is approaching that in the United States, which portends rising domestic discontent, while China’s grave environmental problems may pose inexorable limits to its economic expansion.

Perhaps the greatest immediate threat to China’s rise to economic supremacy, however, is the same phenomenon that felled the US economy in 2008—financialization, or the channeling of resources to the financial economy over the real economy. Indeed, there are three troubling signs that China is a prime candidate to be the site of the next financial crisis: overheating in its real-estate sector, a roller-coaster stock market, and a rapidly growing shadow-banking sector.

The real estate bubble. There is no doubt that China is already in the midst of a real-estate bubble. As in the United States during the subprime-mortgage bubble that culminated in the global financial crisis of 2007–09, the real-estate market has attracted too many wealthy and middle-class speculators, leading to a frenzy that has seen real-estate prices climb sharply.

Chinese real-estate prices soared in so-called Tier 1 cities like Beijing and Shanghai from 2015 to 2017, pushing worried authorities there to take measures to pop the bubble. Major cities, including Beijing, imposed various measures: They increased down-payment requirements, tightened mortgage restrictions, banned the resale of property for several years, and limited the number of homes that people can buy.[6]

However, Chinese authorities face a dilemma. On the one hand, workers complain that the bubble has placed owning and renting apartments beyond their reach, thus fueling social instability. On the other hand, a sharp drop in real-estate prices could bring down the rest of the Chinese economy and—given China's increasingly central role as a source of international demand—the rest of the global economy along with it. China's real-estate sector accounts for an estimated 15 percent of GDP and 20 percent of the national demand for loans. Thus, according to Chinese banking experts Andrew Sheng and Ng Chow Soon, any slowdown would "adversely affect construction-related industries along the entire supply chain, including steel, cement, and other building materials."[7]

A rollercoaster stock market. Financial repression—keeping the interest rates on deposits low to subsidize China's powerful alliance of export industries and governments in the coastal provinces—has been central in pushing investors into real-estate speculation. However, growing uncertainties in that sector have caused many middle-class investors to seek higher returns in the country's poorly regulated stock market. The unfortunate result: A good many Chinese have lost their fortunes as stock prices fluctuated wildly. As early as 2001, Wu Jinglian, widely regarded as one of the country's leading reform economists, characterized the corruption-ridden Shanghai and Shenzhen stock exchanges as "worse than a casino" in which investors would inevitably lose money over the long run.[8]

At the peak of the Shanghai market, in June 2015, a Bloomberg analyst wrote that "No other stock market has grown as much in dollar terms over a 12-month period," noting that the previous year's gain was greater "than the $5 trillion size of Japan's entire stock market."[9]

When the Shanghai index plunged 40 percent later that summer, Chinese investors were hit with huge losses—debt they still grapple with today. Many lost all their savings—a significant tragedy for individuals (and a looming national crisis) in a country with such a poorly developed social-security system.

Chinese stock markets, now the world's second-largest, according to some accounts, stabilized in 2017, and seemed to have recovered the trust of investors when they were struck by contagion from the global sell-off of stocks in February 2018, posting one of their biggest losses since the 2015 collapse.

Shadow banking's long shadow. Another source of financial instability is the virtual monopoly on credit access held by export-oriented industries, state-owned enterprises, and the local governments of favored coastal regions. With the demand for credit from a multitude of private companies unmet by the official banking sector, the void has been rapidly filled by so-called shadow banks.[10]

The shadow-banking sector is perhaps best defined as a network of financial intermediaries whose activities and products are outside the formal, government-regulated banking system. Many of the shadow-banking system's transactions are not reflected on the regular balance sheets of the country's financial institutions. But when a liquidity crisis takes place, the fiction of an independent investment vehicle is ripped apart by creditors who factor these off-balance-sheet transactions into their financial assessments of the mother institution.

The shadow-banking system in China is not yet as sophisticated as its counterparts on Wall Street and in London, but it is getting there. Ballpark estimates of the trades carried out in China's shadow-banking sector range from $10 trillion to more than $18 trillion.

In 2013, according to one of the more authoritative studies, the scale of shadow-banking risk assets—i.e., assets marked by great volatility, like stocks and real estate—came to 53 percent of China's GDP.[11] That might appear small when compared with the global average of about 120 percent of GDP, but the reality is that many of these shadow-banking creditors have raised their capital by borrowing from the formal banking sector. These loans are either registered on the books or "hidden" in special off-balance-sheet vehicles. Should a shadow-banking crisis ensue, it is estimated that up to half of the nonperforming loans of the shadow-banking sector could be "transferred" to the formal banking sector, thus undermining it as well. In addition, the shadow-banking sector is heavily invested in real-estate trusts. Thus, a sharp drop in property valuations would immediately have a negative impact on the shadow-banking sector—creditors would be left running after bankrupt developers or holding massively depreciated real estate as collateral.

Is China, in fact, still distant from a Lehman Brothers–style crisis? Interestingly, Sheng and Ng point out that while "China's shadow banking problem is still manageable…time is of the essence and a comprehensive policy package is urgently needed to preempt any escalation of shadow banking NPLs (nonperforming loans), which could have contagion effects."[12] Beijing is now cracking down on the shadow banks, but these are elusive, and unless there is a fundamental reform in its national credit system to end the virtual monopoly by the export-oriented economic complex of the banking system, there will always be a strong demand for these sub rosa entities.

In sum, finance is the Achilles' heel of the Chinese economy. The negative synergy between an overheating real-estate sector, a volatile stock market, and an uncontrolled shadow-banking system could well be the cause of the next big crisis to hit the global economy, rivaling the severity of the Asian financial crisis of 1997–98 and the global financial implosion of 2008–09.

While most of the players in China's real estate and stock markets are mainly Chinese, a speculative earthquake there is likely to have a major impact on China's vast holdings of US treasury bills and on China's real economy, which has become tightly integrated into the global economy. Thus a major impact of such an event on the global economy is inescapable. In 2008, China was not a significant buyer of Wall Street's mortgage-backed securities and other complex derivatives. Though it escaped the immediate consequences of the collapse of these Wall Street instruments, it was still hit indirectly, when the real economy of the US contracted, greatly reducing Chinese exports to the US and leading to a significant reduction in China's GDP growth in 2008 and 2009. Today, with China being a major consumer of raw materials and agricultural products from developing countries and agricultural and advanced technological imports from the US and Europe, much of the rest of the world would be negatively affected by a crash of China's real economy triggered by a crisis in its financial sector.

The gyrations of global finance continue to pose a threat to the world economy, and the continuing absence of effective regulation means speculative bubbles may build up in different nodes of the world economy. Today the bubble could be building up in China. Tomorrow it could be in Germany. When bubbles grow, then interact with other economic factors and even geopolitical ones, great uncertainty ensues, much like the anxiety that gripped the world when stock markets began spiraling downwards in February 2018, resulting in the loss of four trillion dollars in paper wealth. The 2018 stock market turmoil passed, but the next one may not pop without a bang.

What is to be done?

In the recently completed TNI study, the rationale is laid out in detail for 10 major imperatives for the global financial sector. These are: 1) Restrict operations of hedge funds and close tax havens; 2) Ban mortgage-backed securities and derivatives; 3) Move towards 100 per cent reserve banking; 4) Nationalize financial institutions that are "too big to fail"; 5) Reinstitute the Glass Steagall Act that placed a Chinese wall between commercial banking and investment banking; 6) Place drastic limits on executive pay; 7) Phase out credit ratings agencies; 8) Convoke a new Bretton Woods Conference to set up new institutions and rules for global financial governance, end the dollar's monopoly as the world's reserve currency, and establish new, fair arrangements for development and climate finance; 9) Make central banks accountable; and 10) Move towards full political, fiscal, and monetary union in the Eurozone countries or exit from the euro.

The aforementioned proposed measures, it must be pointed out, constitute a "minimum program," that is, a set of moves that strengthen the world's defenses against another financial crash while not eliminating the possibility of such an event. Capitalism as a system is structurally prone to generate financial crises, and the program outlined above assumes a global economic system that continues to function under the rules of capitalism. The successful implementation of these reforms will be a giant step in a longer process of transformative change. That change cannot, however, take place without addressing in a fundamental way all other key dimensions of capitalism, especially its engine: the insatiable desire for greater and greater profits.

Reformed capitalism or post-capitalism?

Ultimately it is the dynamics of the real economy that are the real determinant of developments in the financial economy. This is not a novel insight. From the perspective of Marxist economists, the gyrations of the financial economy are a result of the deep-seated contradictions of the real economy, in particular the tendency towards overproduction, or supply outstripping demand owing to the persistence of great inequality.

If weak demand in the real economy brought about by inequality is the problem, then it is obvious that the measures taken over the last few years by financial authorities, such as quantitative easing and negative interest rates, can only bring very limited and temporary relief to an economy in crisis and may in fact deepen the crisis in the medium term. Indeed, without addressing the crisis of demand in the real economy, a reformed financial sector would find it difficult to resist for long the intense pressures for capital to seek profitability in finance rather than in a stagnant productive sector.

For some, the most urgent need is the reform of capitalism. A program of financial reform would have to be integrated into a more comprehensive program of reform of capitalism. This enterprise would have to seriously address the lack of demand rooted in increasing inequality. It would have to bravely acknowledge its roots in the unequal power relations between capital and labor, how this unequal power translates into increasing inequality, and how inequality translates into anemic demand that acts as a brake on the expansion of production.

For others, capitalism's constant search for profitability is a fundamental source of instability that will ultimately undermine all efforts to reform it – as happened to post-war Keynesianism in the late 1970s. Moreover, what must be addressed is not just socio-econmic inequality but the productive system's drive to grow at the expense of the biosphere. What is needed, they say, is a post-capitalist program, one that is made all the more urgent by the climate catastrophe that is already unfolding.

One thing is certain. Calls from establishment reformers for a renewed commitment to capitalist globalization in the wake of resistance to neoliberal reforms are out of the question. These calls are rooted in a childlike faith that, in the long run, these measures will lead to the best of all possible worlds. The way forward, it is increasingly clear, will be largely determined by the outcome of a political struggle between two post-globalization camps.

The first espouses a defensive program that involves state management of the economy but leaves the capitalist mode of production largely intact (along with its class inequalities), though with discriminatory privileges for whole communities based on ethnicity, blood, and race (i.e., whitedom) and with borders sealed to migrants.

The second espouses stronger state and civil society management of the economy, one that moves it beyond capitalism, with a strong dose of radical income and wealth redistribution, while welcoming migrants and protecting democratic processes.

One would not be far off in characterizing this confrontation as between fascism and social democracy.

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