The Marxist, Vol. XXIII, No. 3, July to September, 2007

Growth and Crises in Contemporary Capitalism

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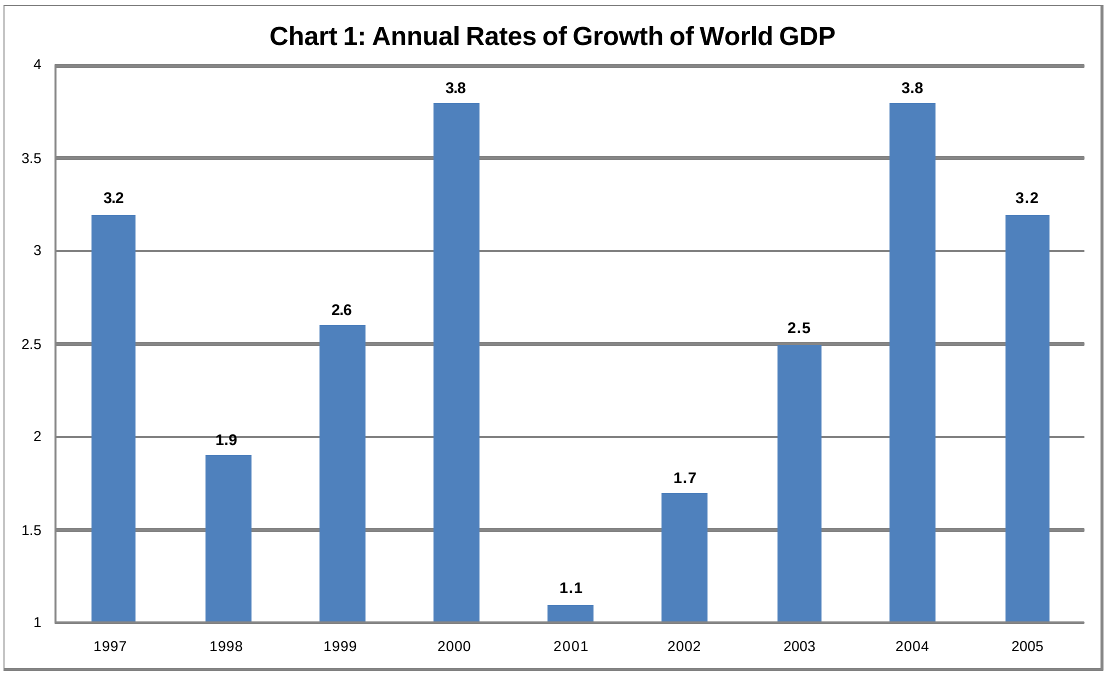
The world's leading capitalist economies, led by the United States, are gripped with fears of an imminent crisis, triggered by financial uncertainty. Financial markets are faced with a liquidity crunch, investors and consumers have turned cautious, and the dollar is on the decline.[1] Even if a recession does not follow, at least a slowdown in growth seems inevitable. This would be the third instance of an economic downturn within a decade, coming after the recessions that followed the East Asian financial crisis in 1997 and the bust of the dotcom bubble in 2000 (Chart 1). As in those instances, this time too, the proximate cause of the crisis is a speculative surge in the activities of poorly regulated, profit-hungry financial firms and entities that have come to dominate the global economic landscape in the neoliberal era.

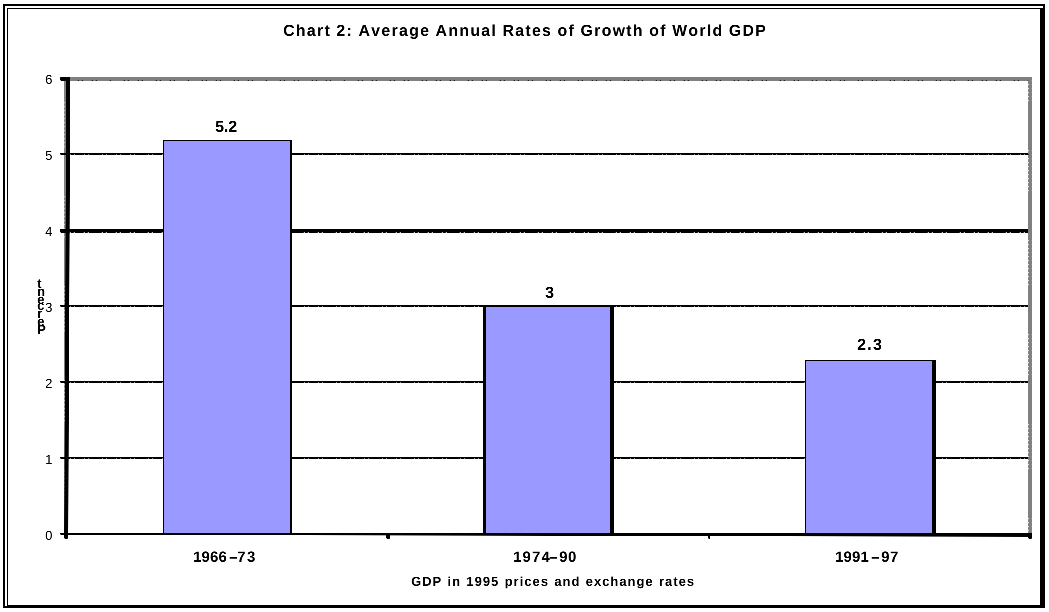


Source: World Bank, Global Economic Prospects and the Developing Countries (Annual), various issues.

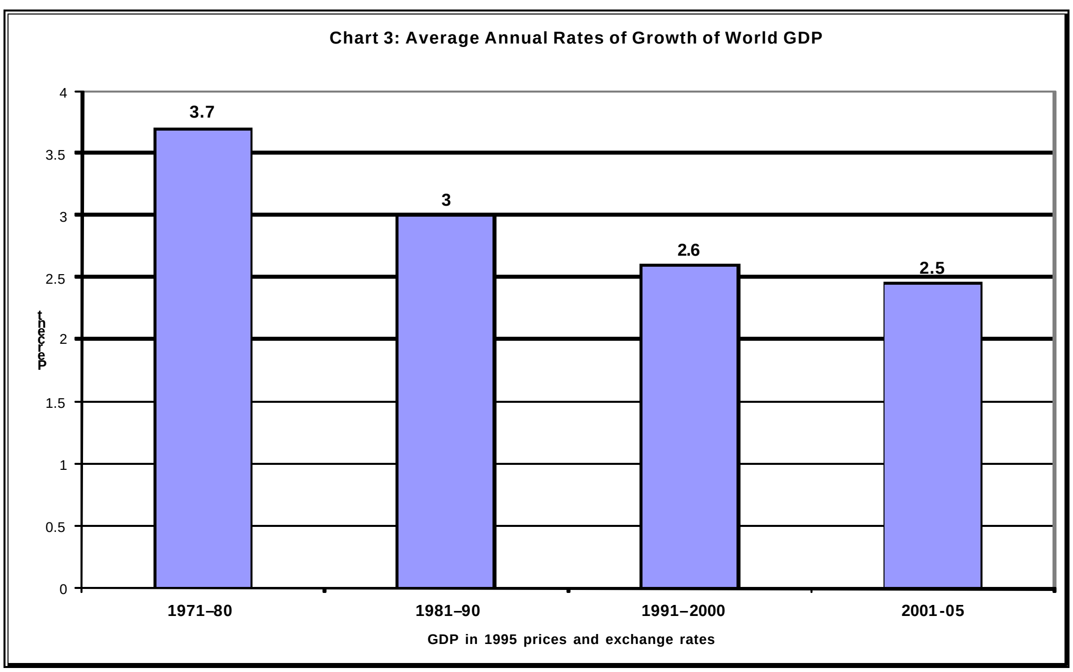
This proneness to periodic crisis is of special significance because it occurs in a global situation where booms of large amplitude are increasingly rare. An abiding feature of capitalism over the last three quarters of a century is a near continuous decline in its long-term rate of growth. The "Golden Age" of post-war capitalism — or the years of boom that followed the end of the Second World War — had come to an end by the late 1960s. By that time the belief in the ability of state-expenditure-led, Keynesian demand management policies to stall the periodic crisis that afflicts capitalism as a system had waned. The

[1] Liquidity crunch is shortage of cash in the market, which leads to default of payment commitements. Debtors cannot pay back their liabilities to the creditors.

resulting rejection of Keynesian policies led to a continuous decline in the average rate of growth of the world economy. According to the World Bank's annual analyses of *Global Economic Prospects*, world economic growth that stood at 5.2 per cent between the mid-1960s and 1973 (prior to the first oil shock) declined to 3 per cent during 1974-1990 and further to 2.3 per cent recorded during the years (1991-1997) preceding the East Asian financial crisis (Chart 2).



Source: (World Bank, 1998, p194)



Source: (World Bank, 2001, p. 234)

What is more if we compare the world economy's growth performance during the 1970s, 1980s, 1990s, and the first half of this decade, we observe a continuous decline in the rate of growth, leading up to a situation where growth of even 2.5 per cent per annum is considered creditable (Chart 3).

Apologetic case for Stability

Despite these medium-term trends, the performance of the US during the early to late 1990s and after 2002 is used to argue that global capitalism is now more stable with growth rates that are creditable even if not remarkable. Further, since the lower medium-term growth rates have associated with them lower rates of inflation than what prevailed in the past, it is argued that the world economy has entered a stage where it is capable of registering creditable GDP growth rates with low inflation. In the event, ideologues of a seemingly triumphant capitalism have for more than a decade now, argued that the system is characterised by a new resilience that comes from its late twentieth century transformation.

Two developments in particular are seen as making capitalism less crisis prone. First, contemporary capitalism's innate ability to deliver a stream of new inventions and innovations is seen as leading to periodic increases in productivity that permits relatively high growth without inflation. Productivity increases not only lead to increases in per capita income, but ensure that increases in real wages do not necessitate increases in prices. This innovative core of the new capitalism is seen as epitomised by the microprocessor and the information technology industry that have created a 'new economy', in which "knowledge is more important to economic success, than money or machinery". Since this opens all sectors of the economy to productivity gains, rapid productivity growth was no more "the province of manufacturing, a shrinking segment of the economy for four decades" (Cox & Alms, 2000: 4-5) These economy-wide technological changes are seen as having transformed the nature of capitalism, raised productivity across the board and made nonsense of arguments that a capitalist economy cannot sustain strong growth, a low unemployment rate and stable prices for long.

Second, the change in the financial scenario resulting from financial deregulation and financial innovation is seen as having developed in-built mechanisms that ensure that even temporary setbacks to or downturns in economic growth do not lead to recessions. An oft-quoted example of financial innovation that stabilizes capitalist growth is the practice of "securitization". This is the process by which credit assets created by banks, for example in the form of automobile, housing or personal loans, are bundled together in different combinations to create a new financial asset (securities) whose value is derived from that of the original assets that underlie it. These securities are then sold for a fee by the banks to other financial investors, who carry the risk of default associated with the underlying assets, but are also eligible for the returns that the original assets promise. Since assets with different kinds and levels of risk are bundled together in the security, the average risk for the investor in such securities is seen as low. On the other hand, the bank itself has reduced the volume of credit risk it carries, since it has transferred that risk to other investors through the process of securitization.

The growth of securitization is seen as having created a situation where credit does not dry up in a downturn, because lenders who are in a position to spread and share risk through securitization do not sharply cut back lending when the economy slows for fear of large losses. This according to *The Economist* (September 22nd 2007), for example, breaks "the rigid link between income and spending", since they can continue spending when income dips through resort to borrowing. Investment by firms is not restricted by their cash flow position and spending by households is not limited by current incomes. As a result, any short-term fall in incomes does not trigger a downward spiral in economic activity. The net result is more stable and therefore "better" income growth, even if as we have seen that growth is much lower than recorded during much of the post-war period.

Productivity and the New capitalism

It is indeed true that productivity growth in the US non-farm business sector has risen since the mid-1990s. But the level that average productivity growth has reached during the period between 1995 and 2006, while higher than that observed between 1973 and 1995, is still below that attained between 1947 and 1973 (Chart 4). Further, the 1995-2006 figures need to be interpreted with caution. An important reason for the improvement in productivity is the growing size of the information technology sector where productivity increases are higher than average, with the productivity-enhancing effects of the diffusion of information technology into other sectors contributing much less to the aggregate. Overall productivity has been rising because of high productivity increases in IT and IT-related industries, which have a significant share in aggregate output. On the other hand, investment spending in non-IT sectors on IT-hardware and software and in equipment incorporating information technology has been late in coming and much less than expected. Therefore, the productivity enhancing effects of IT in non-IT sectors has been less than in the IT industry itself. This is because the slower growth of recent decades has been associated with lower investment, resulting in the fact that new equipment has been installed and new software been adopted at a much slower pace that the innovation witnessed during the boom that followed the second world war.

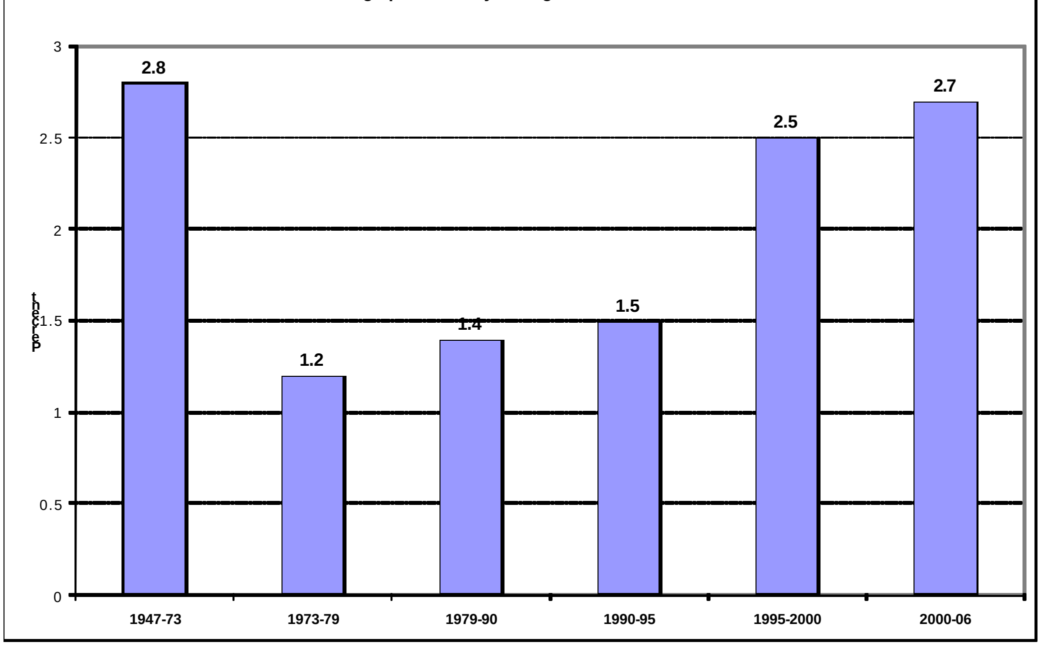


Chart 4: Annual average productivity change in the US nonfarm business sector

Source: United States Bureau of Labour Statistics, accessed from ftp://ftp.bls.gov/pub/special.requests/opt/lpr/nfbbardata.txt on 20 September 2007.

What is more, figures from the ILO's *Key Indicators of the Labour Market* database suggest that though the absolute level of per worker productivity was the highest in the US, long-term productivity gains during the period 1980-2005 were more marked in Western Europe and Japan than in the United States, which has a much higher share of IT and IT-related industries in its aggregate output. The average annual rate of American productivity growth was 1.7 percent during this period, whether measured in terms of output generated per worker (independent of total hours worked) or by hour. On the other hand, the annual rate of growth of output per worker over the same period in the UK was 2.1 percent, with the productivity growth figure rising to 2.4 percent if measured per hour. Labour productivity in France too rose 1.5 percent a year based on a per worker basis and 2.2 percent when calculated in terms of hourly output. Thus OECD countries other than the US performed better in terms of productivity growth than the US. The higher *absolute* level of per worker productivity in the US was largely due to the longer hours worked by each worker, because of its less regulated and more "flexible" labour markets.

Expansion of Finance Capital

It is not just that the productivity arguments for a more resilient capitalism are not empirically valid. More importantly, the view that financial deregulation and financial innovation have helped to smooth capitalism's growth process is patently wrong. It is indeed true that the period since the mid 1970s has seen a substantial increase in the volume of liquidity in the world economy and a sharp rise in the number of financial transactions occurring within countries that have liberalised their financial sectors and across borders. But this has increased rather than dampened financial volatility and therefore the volatility in real economic growth.

Consider first the expansion of international financial capital and its implications for financial volatility. One obvious form it has taken ever since the international lending boom of the late 1970s and after is the expansion of banks based in the developed industrial countries into less developed countries, especially the so-called "emerging markets". The net result has been an increase in the international assets of the big banks based in the developed countries. This trend has only gained strength in recent years. At the time of the East Asian crisis (end of June 1997), 23 countries reporting to the Bank of International Settlements, reported that the international asset position of banks based in those countries stood at $9.95 trillion, involving $8.6 trillion in external assets after adjusting for local assets in international currencies. By December 2006, when 40 countries were reporting, this had risen to $29.38 trillion, with external assets totalling $26.1 trillion.[2] This expansion in international asset position was not only the result of the increase in the countries reporting. The trend was visible in countries that reported on both dates as well. Thus, the international assets of UK-based banks had increased from $1.5 trillion to $5.2 trillion, and that of US banks from $0.74 trillion to $2.3 trillion.

But this was not all. Increasingly non-bank financial firms — pension funds, insurance companies and mutual funds — have emerged as important intermediaries between savers and investors. According to the Committee on the Global Financial System, the total financial assets of institutional investors stood at $46 trillion in 2005. Of this, insurance firms accounted for close to $17 trillion, pension funds for $12.8 trillion and mutual funds)

[2] Data is from various issues of the *Quarterly Review*, Bank of International Settlements.

for $16.2 trillion.[3] The United States dominated, accounting for as much as $21.8 trillion of institutional investors' assets, while the United Kingdom was far behind at just $4 trillion. Here too, growth has been rapid with total assets more than doubling between 1995 and 2005 from $10.5 trillion in the US and $1.8 trillion in the case of the UK.[4] The assets of autonomous pension funds in the US rose from $786 billion in 1980, to $1.8 trillion in 1985, $2.7 trillion in 1990, $4.8 trillion in 1995, $7.4 trillion in 2000 and $8 trillion in 2004.[5]

Besides these institutions there are other less regulated and opaque institutions, particularly hedge funds and private equity firms that directly manage financial assets for high net worth individuals (super rich persons), besides the assets of other institutional investors. Hedge funds are like mutual funds, but with the right to mobilise capital only from large accredited investors. These funds have complex strategies to invest in the capital markets and are generally outside the ambit of regulatory bodies, functioning under a veil of secrecy. Private equity firms, broadly defined, are firms that mobilise money from rich investors to invest in equity that is not listed and therefore not publicly traded in stock markets. Both hedge funds and private equity firms add to the capital of their investors by borrowing heavily and use these funds to pursue unconventional, speculative and risky investment strategies. Assets managed by around 9000 surviving hedge funds are now placed at around $1.6 trillion.[6] And, according to one study, private equity assets under management are now nearing $400 billion in the United States and just under $200 billion in Europe. Private equity expansion is also reportedly strong with aggregate deal value growing at 51 percent annually from 2001 to 2005 in North America.[7] The largest private equity firms, such as Blackstone, the Texas Pacific Group, or Kohlberg Kravis Roberts & Co.,[8] each control companies with combined net revenues that exceed most US companies.

Transactions other than in debt and equity by these entities have also risen rapidly. In 1992, the daily volume of foreign exchange transactions in international financial markets stood at $820 billion, compared to the annual world merchandise exports of $3.8 trillion or a daily value of world merchandise trade of $10.3 billion. According to a recent BIS report the average **daily** turnover (adjusted for double-counting) in foreign exchange markets rose from $800 billion in 1992 to $1.5 trillion in 1998, before declining to $1.2 trillion in 2001.[9] It then rose to $1.9 trillion in 2004 and sharply to $3.2 trillion in 2007. With the average

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[3] Pension Funds are financial entities which invest accumulated pension contributions of employees in capital markets to finance current and future pension payments. Mutual Funds mobilise capital from small investors and invest in the capital markets on their behalf.

[4] Figures are from Report submitted by Working Group, *Committee on the Global Financial System*, 2007, p.5. This Committee monitors developments in global financial markets for the Central Bank Governors of the G10 countries.

[5] Data is from Organization for Economic Cooperation and Development, 2001 & 2003

[6] Financial Stability Forum, 2007, p. 8.

[7] Figures from Venture Economics; Private Equity; and Buyouts Magazine quoted in Bloomberg & Schumer (2006).

[8] Prominent private equity firms include: Kohlberg Kravis Roberts & Co., Blackstone Group, Texas Pacific Group, Bain Capital, Carlyle Group, Madison Dearborn, Clayton, Dubilier & Rice, TA Associates, Harvest Partners, and Warburg Pincus. Europe-based firms include: Apax Partners, BC Partners, Bridgepoint Capital, Candover, Cinven, CVC Capital Partners, Permira, Terra Firma Capital Partners and 3i

[9] Bank of International Settlements, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, Various Issues.

GDP generated globally in a day standing at close to $100 trillion in 2003, this appears to be a small 3 per cent relative to real economic activity across the globe. But the sum involved is huge relative the daily value of world trade. In 2006, the value of world merchandise exports touched $11.8 trillion, while that of commercial services trade rose to $2.7 trillion. Thus the **daily** volume of transactions in foreign exchange markets at over $3 trillion in 2007 exceeded the **annual** value of trade in commercial services and was close to a third of the annual merchandise trade in 2006. The daily volume of foreign exchange transactions is around **80 times** more than the daily volume of trade in goods and services taken together.

More significant is the trade in derivatives, which are financial instruments with no intrinsic or independent value, but "derive" their value from the performance of other assets (be they financial assets, commodities, gold or something else) or indices to which they are linked. They are investments that are expected to yield returns from expected movements (in terms of both direction and magnitude) in the values of these assets or indices or protect investors from unexpected movements in the same values. They take many forms, including *futures* (binding contracts to buy or sell the underlying assets at a future date) or *options* (contracts that give the holder the right but not the obligation to buy or sell the underlying asset during some specified period or on some specified future date). Some of these derivatives are traded in official commodity or stock exchanges or specialized exchanges for derivatives. Others are traded directly through contracts negotiated privately between agents and are referred to as over-the-counter (OTC) derivatives.

The BIS estimates that the average daily turnover of exchange-traded derivatives amounted to $6.2 trillion in April 2007, as compared with $4.5 trillion in 2004, $2.2 trillion in 2001 and $1.4 trillion in 1998. In the over-the-counter (OTC) derivatives market, average daily turnover amounted to another $2 trillion in 2007 at current exchange rates as compared with $1.2 trillion, $575 billion and $375 billion respectively in 2004, 2001, and 1998.[10] Thus total derivatives trading stood at $8.2 trillion a day, which together with the $3.2 trillion daily turnover in foreign exchange markets adds up to $11.4 trillion. This almost equals the annual value of world merchandise exports and amounts to over **290 times** the daily volume of trade in goods and services.

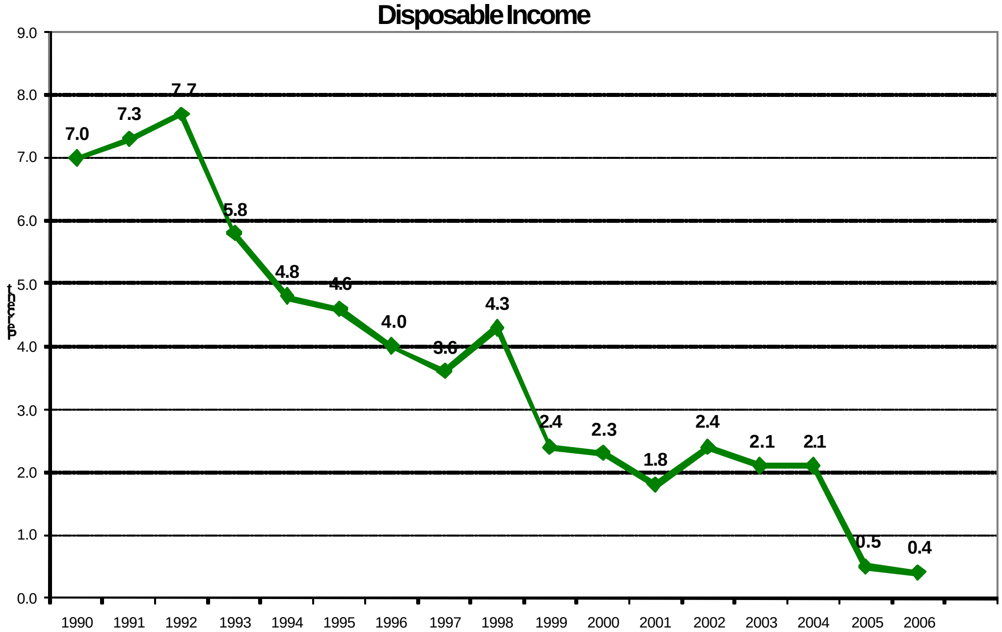
All of this has meant that liquidity in the international financial system, or the ability to quickly buy or sell assets or immediately access credit and use the proceeds to purchase commodities or assets, has reached unprecedented levels. When liquidity is easy, the incentive to "discover" and acquire assets that promise quick and high returns is also great. From the point of view of this discussion what is important is that the massive increase in liquidity in global financial markets in recent years has ensured that the pressures to push funds into emerging markets that prevailed at the time of the debt crisis in the 1980s and the East Asian crisis in 1997 has intensified manifold. Banks and non-bank financial institutions desperately searching for means to keep capital moving have discovered a range of new investments including investments in the so-called "emerging markets" in the less developed world.

[10] Bank of International Settlements, Monetary and Economic Department, 2007, p. 10.

Finance and the Real Economy

What needs to be noted is that this liquidity has been crucial for whatever growth has occurred in the developed industrialised countries in recent times. There are two important ways in which the expansion of finance capital has contributed to growth in the US, and through its external effects, to growth in the OECD in general. To start with, this expansion has been responsible for speculative surges in asset markets that have through the operation of what is termed the "wealth effect", contributed to a consumption splurge. A speculative surge in stock or real estate market prices increases the value of the equity or assets currently being held by individuals and make individuals feel that much wealthier. To the extent that individuals have some assessment of how much wealth they should hold to secure their future, any windfall increase in wealth reduces the desire or the pressure to save for the future. Hence, individuals are willing to save less and spend more out of current incomes or even borrow to spend more than their current income warrants. Growth in the US during the 1990s, which was far better than in developed capitalist Europe and Japan, was seen as the result of a sharp increase in personal consumption expenditures driven by this factor. The consumption fest was not determined by real incomes. What had been more crucial was the willingness of the average American, who had benefited from an increase in asset values, to dip into potential savings to finance consumption, resulting in a collapse in the household savings rates in the US to (Chart 5). Credit, equal to net dissaving, was the trigger for the consumption boom that drove growth. Credit could be easily accessed because the increase in individual wealth served as real or virtual collateral for that debt. Credit was also easily available because of the excess liquidity in the system and the easy monetary policy adopted by the Federal Reserve, the Central Bank of the US.

Chart 5: Annual US Personal Savings as a percentage of Annual Disposable Income



Source: US Department of Commerce, Bureau of Economic Analysis, at http://www.bea.gov/national/index.htm#gdp , accessed 20 September 2007

This debt-financed consumer boom in the US was attributed to the wealth gains which American households had registered because of the boom in US stock markets. It is widely known that the US is unique in terms of the width and depth of the equity (share) culture in the country. According to surveys of Consumer Finances, conducted by the US Federal Reserve Board (the Fed), the number of shareowners in the US increased by approximately 32 million between 1989 and 1998, when it touched 84 million (New York Stock Exchange, 2000). While stock ownership through self-directed retirement accounts and through equity mutual funds were the two largest contributors to the growth in share ownership, even direct share ownership increased between 1995 and 1998. By 1998, the probability that an individual between the age of 35 and 64 owned some shares stood at above 50 per cent, with the figure standing at 62.4 per cent in the 35 to 44 age group. During the years of the stock market boom, which began at the end of 1994 and lasted till the end of 1990s (with one major glitch at the time of the financial crises of 1997-98), this wide prevalence of stock ownership resulted in a substantial increase in the wealth of American citizens. The consequent "wealth-effect", which encouraged individuals to spend because they saw their accumulated wealth as being adequate to finance their retirement plans, was seen as a major factor underlying the consumer boom and the fall in household savings to zero or negative levels.

The end of the stock market boom in 2000, in the wake of the dotcom bust, was expected to reverse this process. It initially did, forcing the Fed to intervene by reducing interest rates. But these reduced interest rates and the persistence of excess liquidity triggered in time the housing boom. As economist Rick Wolff put it (Wolff, 24 July 2006): "People borrowed to buy or expand a home. Housing prices (home values) were bid up. With more value in their now higher-priced homes, American workers had more collateral with which to borrow more. The boom in building and improving homes generated a huge portion of the rising consumer spending that kept the US economy afloat. This cycle of borrowing-building-and borrowing more-and building more produced a historic run-up in home prices alongside a historic rise in consumer debt. The rapidly increased borrowing allowed all kinds of consumer spending to rise, not only spending on housing." House sales, which peaked at just under 10 per cent of GDP in 1979, surpassed that level in 2002, and rose to over 13 per cent by 2005. Thus, easy money that financed the housing boom has been crucial to the economic recovery since 2001. According to one estimate, housing has contributed over 40 per cent of employment growth between 2001 and 2005. And housing expansion plus real estate inflation are estimated to have accounted for 70 per cent of the increase in household wealth over this period. With the value of their housing assets having risen, individuals found that their net worth had increased substantially. This too triggered a splurge in consumption.

Capital Flows from the Developing Countries

A second factor that contributed to the boom in asset markets and, therefore, to consumption and income growth in the US and other OECD countries, was the reverse flow of finance from the developing countries to the developed ones. A consequence of the rise to dominance of finance and the associated global liquidity overhang (i.e. excess cash) was a sharp increase in the cross-border flow of capital. This began in the 1980s itself. And despite periodic shrinkage in certain kinds of financial flows, such as debt after the Asian crisis, private capital has continued to flow to emerging markets in search of high profits. Recently this trend has only accelerated. Total (gross) flows touched a record $571 billion n 2006, having risen by 19 per cent on top of an average growth of 40 per cent during the three previous years. Relative to the GDP of these countries, total flows, at 5.1 per cent, are at levels they touched at the time of the East Asian financial crisis in 1997. Net private debt and equity flows to developing countries have risen from a little less that $170 billion in 2002 to close to $647 billion in 2006, an almost four-fold increase over a four-year period. This has more than matched the reverse flow to official bilateral and multilateral sources. (World Bank, 2007) This large inflow was not warranted by the financing needs of the developing countries, which have been running small deficits or even significant surpluses on the current account of their balance of payments. Taking developing countries as a group, the period since the mid-1990s has seen a transformation of their current account deficits into surpluses. While this was true initially for a set of countries in Asia, they have since been joined by countries in West Asia, the Commonwealth of Independent States (included by the IMF in the developing countries and emerging markets group) and Latin America, though not Africa and Central and Eastern Europe. However, developing and emerging market countries outside Developing Asia have also been recording a surplus as a group.

Despite this, these countries have been receiving large inflows of capital on the capital account of their balance of payments. Since this capital is not needed to finance their current foreign exchange needs they are either accompanied by capital outflows from these countries or accumulate as foreign exchange reserves. Much of these reserves too have been flowing back to the US, to be invested in Treasury Bills that are considered safe and can be quickly encashed in case of need. Since the interest rate on US Treasury bills is low, the interest paid on the flow of capital from the developing countries is low. This is convenient for the US, which has been living beyond its means, as reflected in the large deficit in its balance of trade and the overall current account of its balance of payments. The inflow of 'cheap' capital from the developing countries helps finance this deficit. If cheap finance of this kind had not been available, the trade and current account deficit of the US would have resulted in a much faster depreciation of the dollar. Since this would have fed inflation by increasing the dollar values of imports into the US as well as eroded the confidence that investors have with regard to dollar denominated financial assets, the US Federal reserve and government would have been forced to intervene by raising interest rates, restricting credit and cutting government deficits, in order to curtail income growth and reduce the trade deficit. This would have put an end to the easy credit and low interest rate situation that underlay the asset market booms in the US and capped the consumption splurge that keeps the US economy going. Capital flows from the developing countries has thus been a second finance-linked factor driving growth in the US and the OECD.

This finance-driven process of growth in the US, however, has had two apparently contradictory consequences. The first is that for almost a decade after the mid-1990s, there appeared to be a lack of synchrony and a substantial degree of unevenness in the growth within the developed capitalist world. Between 1991 and 1994, while the US and UK recorded sharp recoveries in annual rates of GDP growth, Germany, France and Japan witnessed a downturn. In the subsequent five years, only the US managed to maintain remarkably high rates of growth; performance in Germany, France and the UK ranged from moderate to good and that in Japan was dismal in almost all these years excepting 1996. More recently, while unevenness had reduced, the US continued to lead in terms of growth and employment performance. The second consequence is that the US was clearly playing the role of locomotive in the global economy. Its huge trade deficit meant that it was sucking in goods from the rest of the world, sustaining growth in some (like in Europe) and contributing to an acceleration of growth in others (such as China). Thus finance appeared to be indirectly contributing to sustaining global growth, however creditable or indifferent that growth was seen to be.

Vulnerabilities of Finance-led Growth

This crucial role of finance in sustaining the process of growth has meant that the volatility in the process of growth noted earlier in this analysis also arises from the disruptions in the world of finance. Such disruptions were inevitable given the speculative nature of financial expansion and proliferation. Thus the downturn at the end of the 1990s followed a financial slump that came when it became clear that: (i) financial speculators had hugely overvalued technology firms, whose equity values presumed levels of future earnings which were not just unwarranted given past experience but clearly impossible to achieve; and (ii) many firms within and outside the technology sector had inflated their profit and performance figures to help inflate stock values with substantial gains for insiders in some cases. More recently, the US is threatened with a recession because of similar developments in the speculative finance-driven housing and real estate boom. The housing market in the US has been crucial to sustaining growth in the US ever since the dotcom bust of 2000. Galloping housing purchases stimulated residential investment and rising housing asset values encouraged a consumption splurge, keeping aggregate investment and consumption growing.

The problem lies in the way in which the boom was triggered and kept going. Keen to profit from the liquidity available in the system, a variety of financial firms hindered by the stock market downturn turned to housing finance as an alternative. However, expanding the housing and real estate finance market required expanding the credit-financed purchases of housing. This in turn required bringing into the market a range of clients who would earlier not have been offered access to credit. A number of players contributed to realizing this outcome. Utilizing the environment of easy liquidity and lower interest rates, mortgage brokers attracted clients with low creditworthiness scores who would otherwise be considered incapable of servicing debt. These *sub-prime* borrowers were offered credit at higher rates of interest, which were sweetened by special treatment and unusual financing arrangements — little documentation or mere self-certification of income, no or little down payment, extended repayment periods and structured payment schedules involving low interest rates in the initial phases which were "adjustable" and move sharply upwards when they are "reset" to reflect premia on market interest rates. All of these encouraged or even tempted high-risk borrowers to take on loans they could ill afford, either because they had not fully understood the repayment burden they were taking on or because they chose to conceal their actual incomes and take a bet on building wealth with debt in a market that was booming.

Mortgage lending companies were encouraged to do this because they could easily sell their mortgages to banks, especially the investment banks in Wall Street, to finance their activity and make a neat profit. And the investment banks themselves were keen to buy into the business because of the huge profits that could be made by "securitizing" these mortgages. Firms such as Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, and others bought into mortgages, pooled them, packaged them into securities and sold them for huge fees and commissions. Among the investors in these collateralized debt obligations (CDOs) are European banks and pension funds and Asian institutional investors. With high returns on creating these products and facilitating trade in them, the investment banks were hardly concerned with due diligence about the underlying risk associated with these securities. That risk mattered little to them since they were transferred to the purchasers of those securities. The risks in the final analysis are shared with pension funds and institutional investors, which were buying into these securities, looking for high returns in an environment of low interest rates. The net result was a sharp rise in the volume and proportion of sub-prime mortgages. Estimates vary, but according to one by Inside Mortgage Finance quoted by *The New York Times*, sub-prime loans touched $600 billion in 2006 or 20 per cent of the total mortgages, as compared with just 5 per cent in 2001.

This structure was relatively stable so long as defaults were a small proportion of the total. But once the share of sub-prime mortgages in the total mortgages rose, the proportion of defaults also increased. Rising foreclosures affected property prices and their saleability adversely as foreclosed assets were put up for sale at a time when credit got squeezed because lenders turned wary. And securities built on these mortgages turned worthless because there were few buyers for assets whose values were opaque since there was no ready market for them. The net result was a situation where a leading Wall Street bank like Bear Stearns had to declare that investments in two funds it created linked to mortgage-backed securities were worthless. The investors themselves had to sell-off other assets to rebalance their portfolios, sending ripples into markets such as those in developing countries that have little to do with the US sub-prime market.

The problem is not restricted to the Wall Street banks. For example, in early August, the French bank BNP Paribas suspended withdrawals from three of its funds exposed to the mortgage-backed securities market. The bank reportedly attributed its decision to “the complete evaporation of liquidity in certain market segments”, which constrained it from meeting withdrawal demands that could have turned into a run on the fund. In some cases like the Düsseldorf-based IKB bank, which through an offshore front company Rhineland Funding had invested as much as $17.5 billion in asset-backed securities, a bailout became necessary. As the value of its assets fell, Rhineland had to call on a €12 billion line of credit that it had negotiated with a group of banks, including Deutsche Bank, besides IKB itself. Deutsche Bank decided to opt out of its promise to lend, resulting in the discovery that the Fund had suffered huge losses and needed a bail-out led by state owned KfW. And in the UK, Northern Rock, a top mortgage lender that is a bank that began as a hosing society, incurred losses in the sub-prime market and became the target of a bank run. Worried depositors began pulling out their money, forcing the Bank of England to intervene because of fears that the disease may spread to other banks. It offered Northern Rock funds to tide over the crisis and depositors a guarantee that their deposits were safe.

In sum, the effects of the sub-prime crisis are weakening distant segments of the global financial system, and threatening to precipitate a global financial crisis of sorts. If that happens, financial firms would either not have the money or not have the confidence to lend and invest. This would imply a liquidity crunch that cuts off access to finance, aggravates the slowdown and precipitates a recession. All this has occurred also because of the regulatory forbearance that has characterized the ostensibly “transparent” but actually opaque markets that are typical of modern finance. Investment banks did not reveal the weak credit base on which the mortgage securities business was built, investment analysts routinely issued reports assuaging fears of a meltdown, credit rating agencies did not downgrade dicey bonds soon enough, and the market regulators chose to look the other way when the speculative spiral was built.

The capital to finance the activities of these entities originates in the transformation of capitalism that has occurred under the tutelage of neoliberal and neoconservative ideologies. The growing inequality characterizing an unregulated capitalism in which wages stagnate while productivity and profits rise, has resulted in the accumulation of vast sums of capital in the hands of a few investors in the metropolitan centres of global capitalism. The wealthiest 1 per cent of Americans reportedly earned 21.2 per cent of all income in 2005, according to data from the Internal Revenue Service. This share was 19 per cent in 2004, and exceeded the previous high of 20.8 per cent set in 2000, at the peak of the previous bull market in stocks. As compared with this, the bottom 50 per cent earned 12.8 per cent of all income, which was less than the 13.4 per cent and 13 per cent recorded in 2004 and 2000 respectively. (Ip, 12 October 2007).

These gains are lightly taxed by governments, like the neoconservative Bush administration, which are not committed to appropriating a part of the surpluses of the rich to improve the welfare of the poor. Lower down the ladder, investment capital accumulates with mutual and pension funds in which less protected populations deposit the savings they put aside to insure their future. The lack of state-funded welfare in today's more liberalized and open capitalism is forcing the middle classes in the developed countries to save by subscribing to these funds that have become important sources of financial capital. Financial firms in the developed countries leverage capital from these sources by borrowing huge sums and use the resulting corpus to indulge in financial speculation.

The Consequences

The consequence of this process of financial expansion and globalisation is that the policy space available to governments is substantially reduced. If the government in any one country chooses to accelerate employment and output growth by expanding expenditures, any inflation that this might spur would by worsening the trade deficit and eroding the value of financial assets result in an outflow of capital and trigger a collapse of the currency. As a result governments learn to limit their expenditures and curtail their deficits, resulting in chronic deflation and slow growth. Whatever growth occurs is triggered by private expenditures, which are increasingly financed by the excess liquidity that financial deregulation and openness deliver. As we have seen above, this dependence on debt-financed consumption, stock market or housing booms makes economies prone to crises resulting from speculation. As a result relatively slower growth is accompanied by greater volatility.

Thus far, however, periodic crises have been followed by early recoveries. But there is no guarantee that these would always occur and that too in a short period of time. In fact the fear today is that if the uncertainties generated by the sub-prime housing loan crisis were to persist, the dollar could collapse and the global economy could be faced with a prolonged crisis. It is for this reason that there is much talk of the need to ensure a soft-landing of the dollar. There is a perception that this is quintessentially a crisis afflicting the US and UK, and to a lesser extent Germany and Japan, but is no threat to the more successful developing countries like India and China. The latter are not exposed to these markets it is argued and their economies are buoyant. What is missed in this argument is the fact that growth in countries like India and China depends on growth in the OECD countries, especially the US. The latter account for a large share of the exports of manufactures from China and services from India. Slow growth in the OECD would directly affect exports, which would be further hit by the depreciation of the dollar.

There are also other indirect ways in which these countries, which are now more integrated with global financial markets, can be affected. Financial investors in the developed countries required to sell-off assets to rebalance their portfolios, may choose to exit markets such as those in developing countries. This could affect liquidity in these markets as well and the effects of the financial crisis could spread from the centres of global capitalism to the rest of the world. Developing countries would also be losers and a global recession is a real danger. Once more the benefits of limited integration that partially insulates countries from the vagaries of speculative global finance is being driven home. However, unwilling to impose some controls on capital inflows and unable to manage the huge inflows into the country, the Indian government has chosen to dilute or dismantle capital controls and encourage foreign exchange outflows, increasing economic vulnerability and undermining policy sovereignty even further.

This, however, is not a problem for developing countries alone. It is a problem of global capitalism, which is looking to developing countries such as China and India to serve as buffers that can soften the crash that threatens to overwhelm them.

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