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*The Push for Recovery:  
Can a Divided Capitalism  
Reverse its Decline?*

As of May 2009, nearly two years since the financial crisis broke and a year-and-a-half after the onset of the global recession, the economic scenario remains uncertain, if not bleak. The rate of unemployment in the US, which stood at less than 5 per cent in the first quarter of 2008, had risen to 8.1 per cent in the first quarter of 2009 (Chart 1) and is estimated to have touched 9.4 per cent in May 2009—its highest rate for the last 26 years. This possibly explains US pessimism. It is true that the unemployment rate in the European Union had also risen from 6.8 to 8.1 per cent between the first quarters of 2008 and 2009. But the higher base level may be making the problem appear less alarming to ruling governments there than in the US, influencing their perceptions.

Output growth too gives no cause for optimism. Quarter-on-quarter growth rates of US GDP (as measured relative to the corresponding quarter of the previous year) had declined sharply in the last quarter of 2008 and first quarter of 2009 across the G7. This decline was even sharper in the UK and the EU, than the US (Chart 2). The crisis had clearly not gone away by the beginning of April, despite signs of recovery in the stock market.

Despite this evidence relating to the period till the last full quarter for which numbers are available, speculation that the downturn has bottomed out and the developed world is on the verge of recovery proliferates. This optimism is based on still tenuous evidence, including evidence that the rate of decline of economies is slowing. The most important of these is that the monthly decline in employment in the US is down sharply. In May 2009 nonfarm payroll employment fell by 345,000, which is around half the average monthly decline over the previous six months and well below the close to 750,000 fall in January this year. Associated with this fall in monthly employment declines is a fall in new unemployment claims. Economist Robert Gordon of Northwestern University in the US, a respected analyst of growth and productivity trends in the US, has found that past recessions came to an end four to six week after new unemployment claims peaked, which they have now done. So he conjectures that the business cycle will find its trough in May or June (*Financial Times*, June 3, 2009). While these developments are reassuring, we should view them in the light of the fact that the unemployment rate is at record levels and new unemployment claims are still above the figures they touched in the worst months of the last recession.

A second cause for optimism is that US producers may be reaching the phase of their inventory cycle where an increase in production is inevitable. By April, wholesale inventories had fallen for the eighth month running as firms cut back production to clear the excess inventories generated by falling demand. Having made those adjustments, it is argued, firms are now in a position where they would have to step up production, especially if demand begins to stabilise. In other words, the argument is that since things are so bad, they can only get better. But the figures do not support even this position. Thus, after seven months of decline, inventories in April fell 1.4 per cent relative to the year before and 6.4 per cent relative to the corresponding month of the previous year. That was because sales fell by 0.4 per cent in April, led by automobiles and parts. Sales of durable goods too were down 1.9 per cent during the month and 23.4 per cent over the year.

The third potential cause for comfort is the sign that relative to previous months the decline in production is slowing. As Chart 3

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shows the decline in GDP relative to the immediately preceding quarter, which was rising till the first quarter of 2009, seems to have bottomed out in the US and to a lesser extent in the EU. What is more, this trend seems to be reflected even in the month-on-month annual growth rates of industrial production, with the rate of decline in April 2009 relative to the corresponding month of the previous year showing signs of reversing its hitherto continuous increase in the US, UK and EU (Chart 4).

While this third factor may be adequate reason for optimism for some, there are two reasons why we should not read too much into this data. To start with, even if the downturn is touching bottom in terms of the stabilisation of the rate of decline, the decline could persist and the economy could “bounce along the bottom” as some analysts reportedly speculate. That is, there is no “statistical” reason why a stable rate of decline should automatically lead to lower rates of decline and positive rates of growth in the coming months or quarters.

The disconcerting element is that this situation prevails despite huge infusion of funds by G7 governments. According to one estimate, the US Federal Reserve had by April 2009 offered about \$12.7 trillion in guarantees and commitments to the US financial sector, and spent a little over \$4 trillion in combating the crisis. As a result the federal deficit has risen to more than 12 per cent of GDP, frightening fiscal conservatives who predict the onset of stagflation. The big thrust seems to be over and the recovery is still not in sight. What it has possibly done, and even that is not certain, is prevent the recession from turning into a depression.

Further, it is unclear whether there would be adequate alternative stimuli to sustain the recovery when the effects of the already implemented fiscal stimulus wane. Governments could hold back on providing any fresh stimulus because of arguments of the kind espoused by conservative economists, representatives of the financial sector and even some European governments, which emphasise the dangers of inflation. If that happens, recovery would depend on the return of the consumer to the market.

But here too the prognosis is not all too happy. Fears generated by the recession and rising unemployment and the increased desire to save to make up for the decline in the values of accumulated housing and financial assets is encouraging savings and dampening consumption even in the US. According to a recent estimated of the

Federal Reserve, the net worth of US households had fallen 2.5 per cent or by \$1,300 billion in just the first three months of 2009. This comes on top of the 18 per cent fall in the previous year which was the worst since the Fed began estimating household wealth in 1946. The net result is that household savings rates in the US are rising and consumer spending was falling in March and April this year.

In the event many still remain sceptical. The *Financial Times* quotes Martin Feldstein as saying that “it is possible but unlikely” that the recession is over. “I think it is a more likely scenario that we are seeing the favourable effects of the fiscal stimulus,” he reportedly said. “That, for a while, will offset the general diminished trend we have seen over the past two quarters, but it is a one-shot thing.” Put otherwise, there could be more bad news ahead.

#### FINANCE AND THE REAL ECONOMY

Thus, part of the reason why the large expenditures undertaken by developed capitalist country governments has not reversed the decline is that much of the money has gone to save the banks and other financial institutions. The smaller share directed at providing a fiscal stimulus for recovery has been inadequate compensation for the decline in consumption spending that has resulted from the crisis—spending that had been crucial to sustaining the previous boom in the real economy.

The role of consumption spending in sustaining the pre-crisis regime of accumulation and growth under capitalism points to a close link between the speculative boom in financial and real estate markets and growth in the real economy. There were many ways in which the boom (and crisis) was transmitted from the financial and real estate sectors to the real economy. First, the expansion of finance had at different points in time triggered an asset market boom. Stock and housing market booms followed each other, making those exposed to these markets believe that they were wealthier than they had expected to be. This encouraged spending, resulting in a decline in the savings rate, most dramatically in the US. This much-discussed “wealth effect” had as its corollary a boom in the non-financial sector, since it expanded demand for products delivered by that sector.

Secondly, the transformation of finance from a “buy and hold” to an “originate and distribute” regime, wherein the originator of a credit

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asset did not carry the risk to maturity but transferred it on to investors for a fee, was also accompanied by a change in the nature of the accumulation regime in developed capitalism. Earlier capitalist growth, especially growth in manufacturing and services, was sustained by two drivers: the internal “external market” created by state expenditure for the private sector and the actual external market in the form of exports. The relative role of these varied, with state expenditure dominating in the US and exports playing an important role in Japan, for example. However, after the rise to dominance of the new finance the relative role of state expenditure declined in the US and countries like Japan (even if not always Japanese firms, which relocated capacities to low cost locations) lost their export competitiveness. In this environment, credit financed housing investment, automobile purchases and consumption and credit finance investment came to play an extremely important role in stimulating demand. Securitisation and credit risk transfer encouraged a proliferation of credit and fuelled demands of this kind.

These features answer the question as to why players outside the financial sector, especially players in the real, productive economy did not push for curbs on the speculative spiral driven by finance which was visible for long and was seen by many as damaging to productive investment. The answer lies in the “benefits” that the rise to dominance of finance delivered to the real economy. The first of these stems from the impact that financial proliferation had on the demand for manufactures. The increase in liquidity that accompanied that proliferation resulted in an expansion of credit at relatively low interest rates for housing investment, automobile purchases and consumption.

Offtake of this credit tended to be high because financial proliferation also triggered a speculative boom in stock and credit markets, to which households were directly or indirectly (through mutual funds and pension funds) exposed. Even though the stock market boom collapsed at the end of the 1990s, the housing boom followed. Thus for a long period the wealth-status of US households, defined by the value of their stock and housing equity, improved considerably, reducing the pressure to save and encouraging the desire to consume. Households were in fact willing to borrow to consume, often in excess of their incomes, resulting in a sharp fall in the average rate of saving. A credit-financed housing investment and consumption

boom followed with positive growth implications for the manufacturing sector.

Recognising the crucial role of credit in sustaining real economy growth, the government and the Federal Reserve in the US encouraged credit growth, even when its effects in terms of speculative asset price inflation were obvious. From late 2002 to the middle of 2005, the US Federal Reserve's federal funds rate stood at levels which implied that when adjusted for inflation the "real" interest rate was negative. This was the result of policy. Further, by the middle of 2003, the fed funds rate had been reduced to 1 per cent, where it remained for more than a year. Easy access to credit at low interest rates triggered a housing boom, which in turn triggered inflation in housing prices that encouraged more housing investment.

Finally, the speculative boom in the stock markets resulted in a sharp increase in the market capitalization of firms, exploiting which they resorted to leveraged takeovers or mergers. Managers and shareholders were beguiled by the increase in their paper wealth, which appeared to have substantially increased their command over real resources. In the event it is not the profits from productive activity alone which came to define corporate success, but the returns implicit in the appreciation in equity values as well. Firms increasingly strengthened their Treasury departments and some indulged in fraud and manipulated their accounts to drive up stock prices.

For all of these reasons the expectation that the rise to dominance of finance would result in a contradiction between finance and industrial capital remained unrealised. There was no corrective to the speculative spiral, till the bubble itself went bust. The crisis had a number of consequences. It made households whose homes were now worth much less more cautious in their spending and borrowing behavior, resulting in a collapse of consumption spending and housing investment. It made banks and financial institutions hit by default more cautious in their lending, resulting in a credit crunch that bankrupted businesses and reduced debt-financed consumption. It resulted in a collapse in the value of the assets held by banks and financial institutions, pushing them into insolvency. All of these effects soon translated into a collapse of demand and a crisis in the real economy with falling output and rising unemployment. This is only worsening the financial crisis even further.

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Thus, once the financial collapse occurred because the doubtful assets on which the financial boom was built undermined the process, there were a number of ways in which real economy growth was affected. When the financial and housing boom collapsed, the “wealth effect” operated in reverse, discouraging spending and contracting demand and production. When crisis afflicted the financial sector, the willingness of banks and other financial institutions to lend evaporated and the ability of borrowers affected by the crisis to take on new debt also declined. This was a second contributor to the crisis that afflicted the real economy. The third route through which the financial crisis was transmitted to the real economy was through the freezing of credit to firms in the real economy when they were faced with rising inventories and declining utilization, resulting often in bankruptcies and real contraction.

A crisis of this nature requires holes to be plugged at many places simultaneously. Governments must adopt immediate measures that can ensure recovery from the crisis. This requires saving from insolvency financial institutions that underpin the system, for if they fail the crisis would be systemic. It also requires a globally coordinated fiscal stimulus, that can substitute government demand for the now sharply reduced demand from the private sector. Governments must also collaborate to reform, in the medium and long term, their monetary and financial systems and the economic structures that underlie them. And finally they must do these in ways that do not exacerbate global imbalances which could lead to excessive protectionism, and which promote the “global good”, with equitable and sustainable growth, protection for the poor and the long term redistribution of global surpluses to strengthen the less and least developed countries.

However, given the uneven and differential development and the inter-imperialist rivalry that characterises capitalism, the global coordination needed to pursue such a strategy is not forthcoming. Views in France and Germany diverge from those in the US and the UK, and whatever efforts are underway to halt the downturn and stimulate a recovery are national in character. In some contexts like the US the effort at stalling a financial meltdown, halting the downward slide of the economy and stimulating a recovery are substantial. There are broadly three features that characterise the US

effort. The first is to ensure adequate cheap liquidity, so that as and when confidence is restored and the demand for credit increases, such credit is available at reasonable interest rates. The second is an effort at injecting capital into banks, other financial firms (like AIG) and manufacturing enterprises like the automobile companies to preempt failure. This has resulted in the boundary between public and private ownership being redrawn in the US, UK and elsewhere in the developed industrial world. The third is a significant step up in government expenditure financed by borrowing, resulting in aggregate debt to GDP rising with a shift in proportions in favour of public debt.

#### NEED FOR COORDINATED STIMULUS

The difficulty is that the US has not been able to encourage other countries to contribute in full measure to the effort at stimulating the global economy in coordinated fashion. Nor has it been able to create the kind of cooperation needed to ensure that its own efforts at stimulating the economy does not merely exaggerate global imbalance with deficits and slow growth in the US and surpluses and reasonable growth in countries like China and India. In fact, as the Stiglitz Commission appointed by the President of the General Assembly makes clear, any coordinated stimulus must be part of a path of global development substantially different from the inequalising growth trajectory characteristic of the years of finance-driven globalisation. The Commission's prescriptions for recovery are influenced by the recognition that the crisis is in substantial part the result of market failure and that real economy growth that rides on a credit-financed bubble is unsustainable. Hence, recovery from the crisis requires the restoration of balance in the relative roles of the market and the state and a greater dependence on a state-financed stimulus as the basis for growth. This leads to the plea for coordinated and strong stimulus packages in all countries, that are framed in ways in which the downstream, "multiplier" effects are large, the impact on the poor significant, and the global fall-out large and positive. To enhance the global effects of the stimulus, given the limited manoeuvrability of poor countries and the decline in world trade and financial flows, the Commission suggests that at least one per cent of the spending on the



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stimulus packages of the developed countries should occur in developing countries. This would avoid also pre-empt the tendency towards deflation in developing countries aimed at generating surpluses on their balance of payments, either because they cannot access foreign capital to finance deficits or because of conditions imposed when they turn to the IMF for financing their deficits.

Needless to say, the problem the Commission grapples with is complex. For example, the difficulty in opting for a coordinated fiscal stimulus is that it could aggravate global imbalances in two ways. First, it could enlarge current account surpluses in countries like China while worsening current account deficits in the US. Second, the benefits of expansion in poorer countries may leak out abroad resulting in a widening of their current account deficits. If in response to the first of these imbalances developed countries like the US opt for protectionism, the benefits of the coordinated stimulus would be far less and far more unequally distributed than would otherwise be the case. Hence, “advanced industrial countries should observe their pledges not to undertake protectionist actions”, while allowing poor countries to adopt measures that give them the space to opt for counter-cyclical policies. The transfer of around one per cent of spending out of global stimulus packages to poorer developing countries can help here as well. Spending a part of the money in developing countries not only ensures global coherence and reinforces the stimulus, but could through import demands reduce the deficit in developed countries such as the US. In fact, in addition to this one per cent, it is necessary to identify and operationalise new and stable sources of funding for developing countries that could be disbursed quickly without inappropriate conditionality.

The crisis has not transformed capitalism to a degree where measures like these that could render a globally coordinated stimulus feasible would be taken up. In the event, much of the so-called stimulus is really the provision of support in various forms to the firms and agents in the financial sector who were responsible for the crisis in the first place. An example of this is the now infamous back-door nationalisation of banks, which even the most conservative right-wing economists and policy makers support. The US has used much of the hundreds of billions of bailout money to acquire a stake in a large number of banks. Much of that money went to the nine largest banks,

such as Bank of America, Citigroup, Wachovia and Morgan Stanley.

However, Wall Street's influence has ensured that this intervention is biased in favour of Big Finance. The support comes cheap: banks will pay a dividend of just 5 per cent for the first five years, only after which the rate jumps to 9 per cent. During that time, they have the option of mobilising private capital and buying out the government. Interestingly, the government is not taking voting rights and would be able to appoint directors only if the bank misses dividend payments for six quarters. While there are restrictions on payment of dividends to ordinary shareholders before clearing the government's claims and limits on executive compensation, the government only reserves the right to convert 15 per cent of its investments into common stock.

Whether it occurs in part-punitive fashion or as a sop, the back-door takeover of major private banks is a desperate attempt to stall the financial meltdown in the advanced economies resulting from the decision to allow private financial players unfettered freedom to pursue profits at the expense of all else. That threat has forced governments to drop their neo-conservative bias against State ownership and markets that hollered at government intervention in the past have now applauded such action.

#### FALL-OUT FOR THE REAL ECONOMY

However, while this has saved the financial system from collapse, the recession has not receded. Even if the banks are safe, the effects of that wealth erosion on investment and consumption demand are only now unravelling, indicating that there is much to be told in this story as yet. And the limited fiscal stimulus offered globally has meant that the figures do not point to a recovery as yet, though much money has been pumped into the system as discussed at the beginning of this article.

In fact, with finance gaining in confidence based on support from the State, the backlash against the State to prevent it from extending its influence any further has begun. Finance Ministers of the G8, meeting at Lecce in Italy during the latter part of week ending June 14, 2009 were cautiously optimistic. The final communiqué noted that in the aftermath of efforts at financial stabilisation and

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fiscal stimulation “there are signs of stabilization in our economies, including a recovery of stock markets, a decline in interest rate spreads, (and) improved business and consumer confidence”. But, the ministers cautioned “the situation remains uncertain and significant risks remain to economic and financial stability”.

There were two elements of the communiqué that pointed to a compromise between the differing perceptions of the US and UK, on the one hand, and Germany and France, on the other, regarding the principal problems and tasks at hand. The first of these elements was the reference to the persistence of “significant risks” which was not there in the original draft of the communiqué, and was ostensibly inserted by those countries (UK and US) who feel that it is not yet time to decide that the recovery is here and the stimulus provided thus far has been adequate. Moreover, the mention of “encouraging figures in the manufacturing sector” that figured in the draft was dropped, since it went against the evidence that industrial production in the eurozone area had fallen by 21 per cent in April, relative to the corresponding month of the previous year.

The second element of the communiqué of interest is that it pushes for going beyond thinking of recovery and formulating national level “exit strategies” “for unwinding the extraordinary policy measures taken to respond to the crisis.” The reference here is to the huge budget deficits and high levels of public debt that many countries, especially the US, have accumulated in the wake of the bail-outs and the stimulus packages they have put in place. Though the US and UK have played down this aspect of the discussions, there is clearly a difference in emphasis among the leading powers on where the world economy stands and what is the immediate priority in terms of action. If this leads to an effort to hold back on any further fiscal stimuli and an attempt to reduce government debt in the developed industrial countries over time, the recession could persist and perhaps even worsen, even if the financial meltdown is halted.

## THE AGENDA FOR FINANCIAL REFORM

The strength of finance is also reflected in the financial reform package announced by the Obama administration on June 17, 2009. Ever since President Barack came to office he has been preoccupied with

efforts to resolve the financial collapse and reverse the economic downturn that the US has been experiencing for a year and a half now. But the big economic policy thrust everyone was awaiting was his administration's medium- and long-term response to the crisis in the form of a financial re-regulation package that would seek to prevent recurrence of crises of this kind.

There has been a considerable degree of consensus on the role that financial deregulation since the early 1980s had in generating the current and earlier financial crisis. This liberalisation involved dismantling the framework of structural regulation put in place with the Glass-Steagall Act of 1933. That framework created a system in which banks dominated, deposit rates were controlled, small and medium deposits were guaranteed, bank profits were determined by the net interest margin or the difference between deposit and lending rates adjusted for intermediation costs, and banks were restrained from straying into other areas like securities trading and the provision of insurance. To quote one apt description (OECD 2000), that was a time when banks that lent to a business or provided a mortgage, "would take the asset and put it on their books much the way a museum would place a piece of art on the wall or under glass – to be admired and valued for its security and constant return." This was the "lend and hold" model. This was a comfortable world in which banks were almost guaranteed a profit: but that rate of profit was relatively low.

Starting in the 1980s and culminating in legislation in 1999, the Glass-Steagall framework was dismantled. This led to a remarkable transformation of the financial sector in the Anglo-Saxon world. To start with, banks extended their activity beyond conventional commercial banking into merchant banking and insurance, either through the route where a holding company invested in different kinds of financial firms or by transforming themselves into universal banks offering multiple services, often as agents of other non-banking financial firms. Second, within banking, there was a gradual shift in focus from generating incomes from net interest margins to obtaining them in the form of fees and commissions charged for various financial services, permitting them to increase their profits and move returns closer to that earned by non-bank or quasi-banking financial entities. Third, related to this was a change in the focus of banking activity as well. While banks did provide credit and create assets that promised

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a stream of incomes into the future, they did not hold those assets any more. Rather they structured them into pools, “securitized” those pools, and sold these securities for a fee to institutional investors and portfolio managers. Banks transferred the risk for a fee, and those who bought into the risk looked to the returns they would earn in the long term. This “originate and distribute” model of banking meant, in the words of the OECD Secretariat (OECD 2000), that banks were no longer museums, but parking lots which served as temporary holding spaces to bundle up assets and sell them to investors looking for long-term instruments. This meant that those who originated the credit assets tended to understate or discount the risks associated with them. Moreover, since many of the structured products created on the basis of these credit assets were complex derivatives, the risk associated with them was difficult to assess. The role of assessing risk was given to private rating agencies, which were paid to grade these instruments according to their level of risk and monitor them regularly for changes in risk profile. Fourth, the ability of the banking system to “produce” credit assets or financial products meant that the ultimate limit to credit was the state of liquidity in the system and the willingness of those with access to that liquidity to buy these assets off the banks. Within a structure of this kind periods of easy money and low interest rates increased the pressure to create credit assets and proliferate risk. Fifth, financial liberalisation increased the number of layers in an increasingly universalised financial system, with the extent of regulation varying across the layers. Where regulation was light, as in the case of investment banks, hedge funds and private equity firms, financial companies could borrow huge amounts based on a small amount of own capital and undertake leveraged investments to create complex products that were often traded over the counter rather than through exchanges. Finally, while the many layers of the financial structure were seen as independent and were differentially regulated depending on how and from whom they obtained their capital (such as small depositors, pension funds or high net worth individuals), they were in the final analysis integrated in ways that were not always transparent. Banks that sold credit assets to investment banks and claimed to have transferred the risk, lent to or invested in these investment banks in order to earn higher returns from their less regulated activities. Investment banks that sold derivatives to hedge

funds, served as prime brokers for these funds and therefore provided them credit. Since securitised credit assets could not be always be sold immediately banks had an inventory of them in their vaults as well, waiting to be disposed off. And, finally, when it appeared that non-bank institutions were earning high returns from investing in these assets, the banks too decided to retain some of them, . Credit risk transfer neither meant that the risk disappeared nor that some segments were absolved from exposure to such risk.

In the event, a less regulated and more complex financial structure than existed for more than four decades after Glass-Steagall was enacted, was in place by the late 1990s. In an integrated system of this kind, which is capable of building its own speculative pyramid of assets, any increase in the liquidity it commands or any expansion of its universe of borrowers (or both) provide the fuel for a speculative boom. As has been convincingly argued by many, this is what led up to the many crises the US financial system has experienced starting with the savings and loans crisis and culminating in the current collapse. The consequences of the savings and loans crisis, the dotcom bust and the financial manipulations at Enron and WorldCom (among others) were bad enough, but the financial collapse triggered by the sub-prime crisis was too close to the 1930s to brook further delay in rethinking the deregulation that is now widely seen as having contributed to these developments. A Roosevelt moment had come, and it needed a response that equalled the framework epitomised by the Glass-Steagall Act of 1933 in significance.

The Obama administration announced the much awaited package on 17 June, 2009 led by a statement by the President. But implicit in that statement were indications of the compromises that the regulatory package would include—compromises that could make it inadequate to the task it seeks to address. While admitting that the economic downturn was a result of “an unravelling of major financial institutions and the lack of adequate regulatory structures to prevent abuse and excess,” Obama did not blame the dismantling of the regulatory regime that was put in place in the years starting 1933 for these developments. He attributed them to the fact that “a regulatory regime basically crafted in the wake of a 20th century economic crisis—the Great Depression—was overwhelmed by the speed, scope, and sophistication of a 21st century global economy.”

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Glass-Steagall was not the model for reregulation but the outdated 'other' which needed to be substituted with a new regime. It was not the dismantling of the structural regulation that Glass-Steagall epitomised but the vestiges of that framework which remained that mattered.

Despite this important compromise, there are a number of important regulatory advances that the new package incorporates. To start with, recognising that there are in the current financial scenario a number of institutions—banks and non-banks—that are too big to fail, because their failure can have systemic effects, the package gives a new role for the Federal Reserve in overseeing and regulating these entities. This implies that institutions other than banks, which constitute the shadow banking sector that both mobilised investments and borrowed many multiples of that to finance its activities, would come under Fed scrutiny and influence. It is unclear what the criteria for identifying these “too big to fail” entities would be, but once identified they would be regulated with the intent of pre-empting fragility.

It hardly bears emphasising that these entities are not just large in size, but because the walls between different segments of the financial sector (conventional banking, investment banking, insurance, etc) were completely dismantled by 1999, they are diversified as well. To assist the Fed in monitoring and regulating these diversified firms, the administration plans to establish a Financial Services Oversight Council, which would “bring together regulators from across markets to coordinate and share information; to identify gaps in regulation; and to tackle issues that don't fit neatly in an organizational chart.” Moreover these entities would be subject to more stringent regulations with regard to capital adequacy and liquidity. Note, however, that the effort here is not to limit size to prevent the emergence of institutions that are too big to fail, as has been suggested by some, but to attempt to prevent failure of large firms.

Since it is impossible to guarantee that this would work at all times, the package promises to devise a system that would allow firms to be unwound without damage to the system and excessive burdens on the tax payer. The proposed “resolution authority” would work out “a set of orderly procedures” for breaking up or liquidating large and interconnected financial firms without overly damaging the economy.

A second major lesson from the crisis was that a deregulated system which allows for securitisation and the transfer of risk, significantly discounts risk when credit assets are first originated. This is inevitable since the originator does not herself carry that risk after transfer. In addition, experience shows that securitisation aimed at transferring credit risk and deriving revenues from fee and commission incomes, also leads to the sequential creation of composite derivative assets whose complexity precludes proper assessment of risk. This experience led to suggestions that such opaque instruments should be banned, and more transparent, simple and standardised instruments that are traded in exchanges should be the norm. This is a suggestion that the Obama administration has largely sidestepped, though it wants to limit over-the-counter transactions. According to Treasury Secretary Tim Geithner's statement to the Senate Banking Committee, the new package is based on the belief that you cannot "build a system based on banning individual products because the risks will simply emerge in new forms." So the focus is on making instruments more transparent as well as changing the incentive structure by getting firms to hold a minimum material interest in the instruments they create. Their own exposure is expected to limit risk. However, there is no clear indication how riskiness is to be assessed and by whom. Nor is there clarity on whether and how institutions like the rating agencies, that failed miserably when assessing risks, would be made to function better.

The result of this liberal approach is that controls on the kind of "financial products" the system can generate would be restricted to areas where they directly affect the retail consumer. A new institution—the Consumer Financial Protection Agency—would have powers to regulate any institution that provides financial products or services to retail consumers, whether they be banking or non-bank entities. This would, for example, clamp down on the kind of risky and complex mortgages offered by mortgage brokers, the implications of which were not often fully understood by borrowers.

Having decided not to go in for structural regulation, the new package talks of new guidelines with respect to capital requirements ("adequacy") and prudential norms, which are expected to reduce the degree of leverage in the system, raise the cost of credit and possibly affect profitability. According to an administration official quoted by



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the Financial Times, the new guidelines would be aimed at delivering “more”, “better” and “less pro-cyclical” capital.

While these are the core elements included in the new package, there are many features that were expected to be dealt with but have been missed out. There are two in particular that stand out. One is the unwillingness to substantially reduce the multiple agencies at the national and state levels, with overlapping jurisdictions, that currently define the regulatory framework in the US. Expectations were that the reregulation would deliver a leaner framework with less agencies that have stronger and well defined powers and clear cut jurisdictions of their own. In the effort not to rock the boat by treading on powerful interests the current reform package dumps just one agency, the Office of Thrift Supervision, and balances that with the new consumer protection agency.

Multiple regulators work reasonably well in a world where segments of the financial system are separated. That has changed over the last three decades and there is no intent here to return to the past. In the event, multiple regulators encourage efforts at regulatory arbitrage, with institutions seeking the least obtrusive regulator to register with. It is unclear how the current reform would deal with this issue.

A second area which the new package leaves untouched is the much discussed and highly controversial area of executive compensation in the financial sector. The issue is not just that some executives were being paid unjustifiably high salaries and bonuses even in companies that were not that successful. The real problem was that the compensation system incentivised risky behaviour and encouraged speculative investments. In the process it was not talent or experience that was being rewarded but the ability to exploit legal loopholes to expand the business even at the cost of courting excessive risk. Expectations were that this would be curbed, but there appears to be no mention of regulation in this area.

Thus, at the centre of the new financial framework are a set of unchanged beliefs on how financial markets function and therefore should be regulated. The first is that if norms with regard to accounting standards and disclosure were adhered to, capital provisioning, in the form of a capital adequacy ratio, is an adequate means of insuring against financial failure. The second is that financial innovation should

be encouraged. In the words of Geithner: “The United States is the world’s most vibrant and flexible economy, in large measure because our financial markets and our institutions create a continuous flow of new products, services and capital. That makes it easier to turn a new idea into the next big company.” The third is that this whole system can be partly secured by allowing the market to generate instruments that helped, spread, insure or hedge against risks. These included derivatives of various kinds. By sticking to these beliefs the Obama administration has ensured that it does not return to the structural regulation that Glass-Steagall epitomised, but continues with the more liberal regime that was fashioned in the years since the late 1970s. Unfortunately, those were also the years when bank closures, bankruptcies and financial crises increased in number, scale and scope.

This is indeed unfortunate because the significance of the Obama package not only rests in its likely impact on the world’s leading financial firms that operate out of the US, but in the fact that the US provides the

model for financial systems elsewhere in this globalised world. If implemented in the US, the Obama administration’s blueprint for 21st Century Financial Regulatory Reform could serve as the road map for other developed and developing countries as well. Past experience suggests that the problem here is not just that President Obama has not gone far enough. He has left the system vulnerable to crises of the kind that it even now battling.

#### IGNORING IMPORTANT LESSONS

How then does this financial reform package tally with the lessons learnt from the crisis? To start with, the crisis made clear that when private players make financial decisions, limited interventions such as accounting standards, disclosure norms, behavioural guidelines and capital adequacy requirements, are inadequate restraints on the extent of risk accumulation in the system. The financial meltdown triggered by the sub-prime mortgage crisis had changed the terms of the debate over financial regulation, offering an opportunity for major, even radical, reform. But the Obama administration is unwilling to seize this opportunity.

## THE MARXIST

The lessons from the ongoing financial crisis make clear that the accumulation of risk and the manufacture of crisis are inevitable in a private-led, deregulated financial system that makes short term profits the prime objective. Limited intervention cannot fundamentally alter financial behaviour to avoid such an outcome. When financial markets are left unfettered, the system goes through a sequence of events that inevitably generate a financial and real economy boom that soon goes bust. Strong regulation is called for. One form that such regulation can take is that put in place since the passing of the Glass-Steagall Act.

If Obama explicitly chose not to opt for that route, it can only be because he feels that it is possible to sustain growth by triggering another speculative bubble, but where that bubble is managed through “innovative” regulation so as to prevent it from bursting. That is the new utopia that the new messiah of US capitalism is promising his people. But if past experience is any guide this is unlikely to work.

In sum, as of now rivalry within capitalism, especially its developed core, is undermining the prospects of recovery. First, it is unclear whether the G8 would be able to agree on a coordinated and sustained stimulus to boost the global economy. While much was expected of the last G20 summit on this count, little came out of that meeting. Second, even in countries like the US where initial support for a fiscal stimulus is strong, conservative opposition to rising budget deficits and debt to GDP ratios is likely to constrain any further effort on this count, though much of the expenditure till now has been aimed at saving financial institutions rather reviving the real economy. Third, there appears to be no commitment to undertaking measures of the kind that can reduce speculative tendencies and financial fragility. Finally, the unwillingness to opt for structural regulation of finance points to a tendency to rely once again on an engineered financial boom to trigger real economic growth. This can, if at all, only yield another episode of unstable growth, which is likely to be much less strong than before. All of this suggests that capitalism is yet to find a way of reversing the decline it is currently still experiencing.