The Wall Street Collapse and Its Implications for Europe and Asia

Beijing, Oct. 17, 2008

- …Or how some of us in global civil society are trying to make sense of this awful mess into which the global elites have gotten us and figuring out how to dig ourselves out of it.

Turmoil on

- *Flying into New York recently, I had the same feeling I had when I arrived in Beirut two years ago, at the height of the Israeli bombing of that city—that of entering a war zone. The immigration agent, upon learning I taught political economy, commented, "Well, I guess you folks will now be revising all those textbooks." The bus driver welcomed passengers with the words, "New York is still here, ladies and gentlemen, but Wall Street has disappeared, like the Twin Towers." Even the usually cheerful morning shows feel obligated to begin with the bad news, with one host attributing the bleak events to "the fatcats of Wall Street who turned into pigs."*

Last Week—the Worst Week ever in Wall Street Worst History

-$2.3 trillion dollars of investor wealth went up in smoke last week as the Dow Jones Industrial Average registered its worst week ever, plunging 18 percent as investors panicked and kept on unloading stock despite various US government plans to bail out the banks;

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

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

- *Over $8.4 trillion in total market capitalization has been wiped out since October of last year, with over a trillion of this accounted for by the unraveling of Wall Street's financial titans and now banks are beginning to totter in Europe as the "American financial virus" spreads.*
- *The usual explanations no longer suffice. Extraordinary events demand extraordinary explanations. But first…*

Is the worst over?

- No, if anything is clear from the contradictory moves of the last two weeks--allowing Lehman Brothers to collapse while taking over AIG, and engineering Bank of America's takeover of Merrill Lynch, proposing to buy up the banks' bad assets then advocating their partial nationalization--there is no strategy to deal with the crisis, just tactical responses, like the fire department's response to a conflagration. (Some say this description is an insult to the fire department.)

- The moves of the US and European governments amount to desperate efforts to shore up confidence in the system, to prevent the erosion of trust in the banks and other financial institutions and prevent a massive bank run such as the one that triggered the Great Depression of 1929.

- The financial crisis has now spread to Europe and Asia, and it is no longer something that only affects banks that hold subprime securities they bought from US institutions. It is now a question of fear overcoming trust. Banks don't want to lend to one another because they don't know who among them is overexposed to toxic subprime securities or because they want to hold on cash and other secure assets to defend themselves from an unpredictable conflagration, and depositors have growing fears about whether their money is safe in the bank. In this crisis, no bank, even the seemingly most impregnable, is safe from a run such as that which triggered the Great Depression in 1929. ***In a run, no bank is solvent.***

Causes of the Meltdown: Greed?

- So what caused the collapse of global capitalism's nerve center?

Was it Greed? Yes.

This is what *Klaus Schwab, the organizer of the World Economic Forum, the yearly global elite jamboree in the Swiss Alps, had in mind when he told his clientele in Davos earlier this year:*

"We have to pay for the sins of the past."

Wall Street Outsmarting Itself?

- Definitely. Financial speculators outsmarted themselves by creating more and more complex financial contracts like derivatives that would securitize and make money from all forms of risk. Derivatives might be labeled spectral contracts, that is, contracts that enable gambling and making money from the risk associated with an underlying asset—that is, on the price of that asset's rising or falling---without trading the asset itself. Derivatives include exotic futures instruments as "credit default swaps" that enable investors to bet on the odds that the banks' own corporate borrowers would not be able to pay their debts! This is the unregulated multi-trillion dollar trade that brought down AIG.

On December 17, 2005, when *International Financing Review* (*IFR*) announced its 2005 Annual Awards — one of the securities industry's most prestigious awards programs—it had this to say:

"[Lehman Brothers] not only maintained its overall market presence, but also led the charge into the preferred space by … developing new products and tailoring transactions to fit borrowers' needs… Lehman Brothers is the most innovative in the preferred space, just doing things you won't see elsewhere."

No comment. But Warren Buffett, the grand speculator who eliminated derivatives from his investment fund long before the recent crisis, called derivatives in 2003 “financial weapons of mass destruction” devised by “madmen” whom he recently defined as “geeks bearing formulas.” *The truth is that the top graduates of the US business schools like Harvard and Stanford brought us this crisis.*

Lack of Regulation?

Yes—everyone acknowledges by now that Wall Street's capacity to innovate and turn out more and more sophisticated financial instruments had run far ahead of government's regulatory capability, *not because government was not capable of regulating but because the dominant neoliberal, laissez-faire attitude prevented government from devising effective mechanisms with which to regulate*. The massive trading in derivatives helped precipitate this crisis, and the man who did the most to prevent the regulation of derivatives was Alan Greenspan, the former chairman of the Federal Reserve Board, who believed that the derivatives market would regulate itself.

The US Congress agreed with Greenspan and passed a law excluding derivatives from being regulated by the Securities Exchange Commission in 2000. Deregulation, it must be noted, was not just a Republican initiative. It was a bipartisan campaign. Led by Wall Streeter Robert Rubin, Bill Clinton's Treasury Secretary, the Clinton administration and Congressional Democrats were also strong supporters of another law that helped father the current crisis, the repeal of the Glass-Steagall Act, which prevented commercial banks from also being investment banks.

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

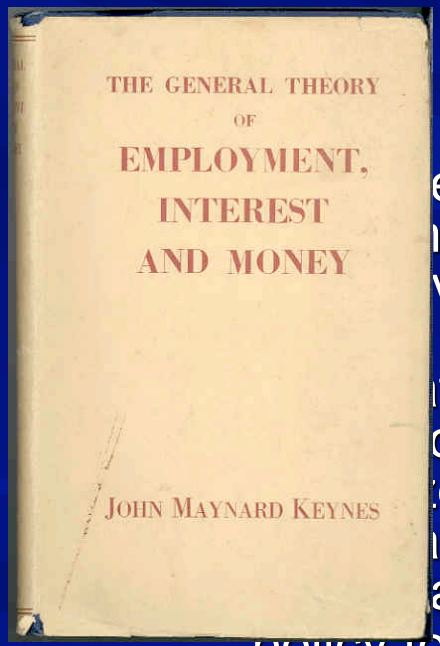
Well, another grand speculator, George Soros, who saw this coming, says what we are going through is the crisis of the "gigantic circulatory system" of a "global capitalist system that is… coming apart at the seams."

What do you mean?

- To elaborate on the arch-speculator's insight, what we are seeing is the intensification of one of the central crises or contradictions of global capitalism which is the crisis of *overproduction*, also known as *overaccumulation* or *overcapacity*.
- This is the tendency for capitalism to build up tremendous productive capacity that outruns the population's capacity to consume owing to social inequalities that limit popular purchasing power, thus eroding profitability.

But What Does Overproduction Have to Do with the Current Financial Meltdown?

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



This was a period of rapid growth both in the center economies and in erdeveloped nies—one that was partly triggered ve reconstruction of and East Asia after the tion of the Second World War, and partly by o-economic arrangements that were ed under the new Keynesian state. Key tter were strong state controls over activity, aggressive use of fiscal and monetary policy to minimize inflation and recession, and a regime of relatively high wages to stimulate and maintain demand.

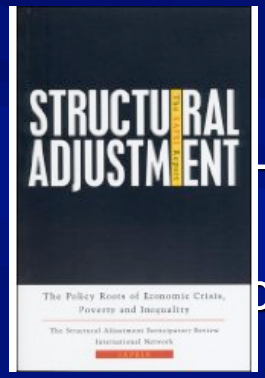
So what went wrong?

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

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

So how did capitalism try to solve the crisis of overproduction?

- Capital tried three escape routes from the conundrum of overproduction.



The first was neoliberal restructuring. This took the of Reaganism and Thatcherism in the North and ctural Adjustment in the South.

- The aim was to invigorate capital accumulation, and this was to be done by 1) removing state constraints on the growth, use, and flow of capital and wealth; and 2) redistributing income from the poor and middle classes to the rich on the theory that the rich would then be motivated to invest and reignite economic growth.

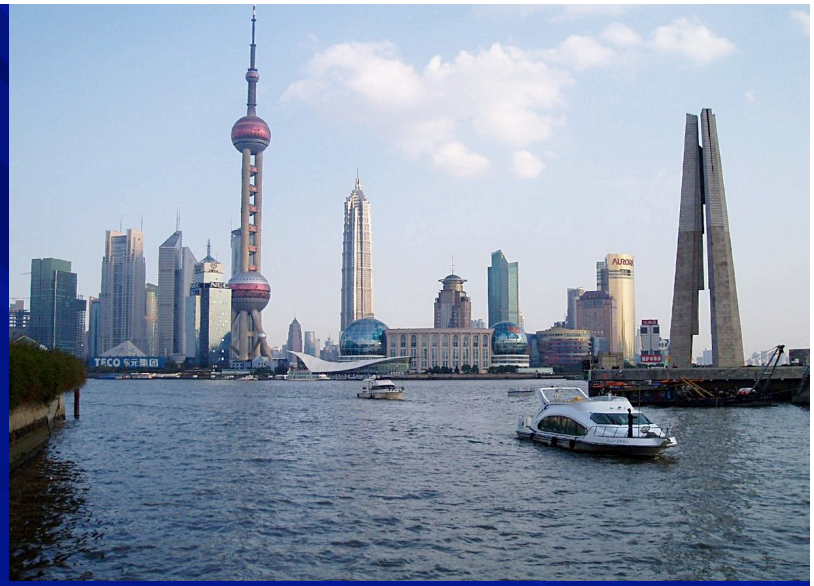
- The problem with this formula was that in redistributing income to the rich, you were gutting the incomes of the poor and middle classes, thus restricting demand, while not necessarily inducing the rich to invest more in production. In fact, it could be more profitable to invest in speculation.

- In fact, neoliberal restructuring, which was generalized in the North and south during the eighties and nineties, had a poor record in terms of growth: global growth averaged 1.1 per cent in the nineties and 1.4 in the eighties, whereas it averaged 3.5 per cent in the 1960's and 2.4 per cent in the seventies, when state interventionist policies were dominant. Neoliberal restructuring could not shake off stagnation.

How was globalization a response to the crisis?

- The second escape route global capital took to counter stagnation was “extensive accumulation” or globalization, or the rapid integration of semi-capitalist, non-capitalist, or precapitalist areas into the global market economy. Rosa Luxemburg, the famous German radical economist, saw this long ago as necessary to shore up the rate of profit in the metropolitan economies.

How? By gaining access to cheap labor, by gaining new, albeit limited, markets, by gaining new sources of cheap agricultural and raw material products, and by bringing into being new areas for investment in infrastructure. Integration is accomplished via trade liberalization, removing barriers to the mobility of global capital, and abolishing barriers to foreign investment



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

Shanghai

To counter their declining profits, a sizable number of the Fortune 500 corporations as well as Europe's largest corporations have moved a significant part of their operations to China to take advantage of the so-called "China Price"—the cost advantage deriving from China's seemingly inexhaustible cheap labor.

By the middle of the first decade of the 21st century, roughly 40 t0 50 per cent of the profits of US corporations were derived from their operations and sales abroad, especially China.

Why did globalization not surmount the crisis?

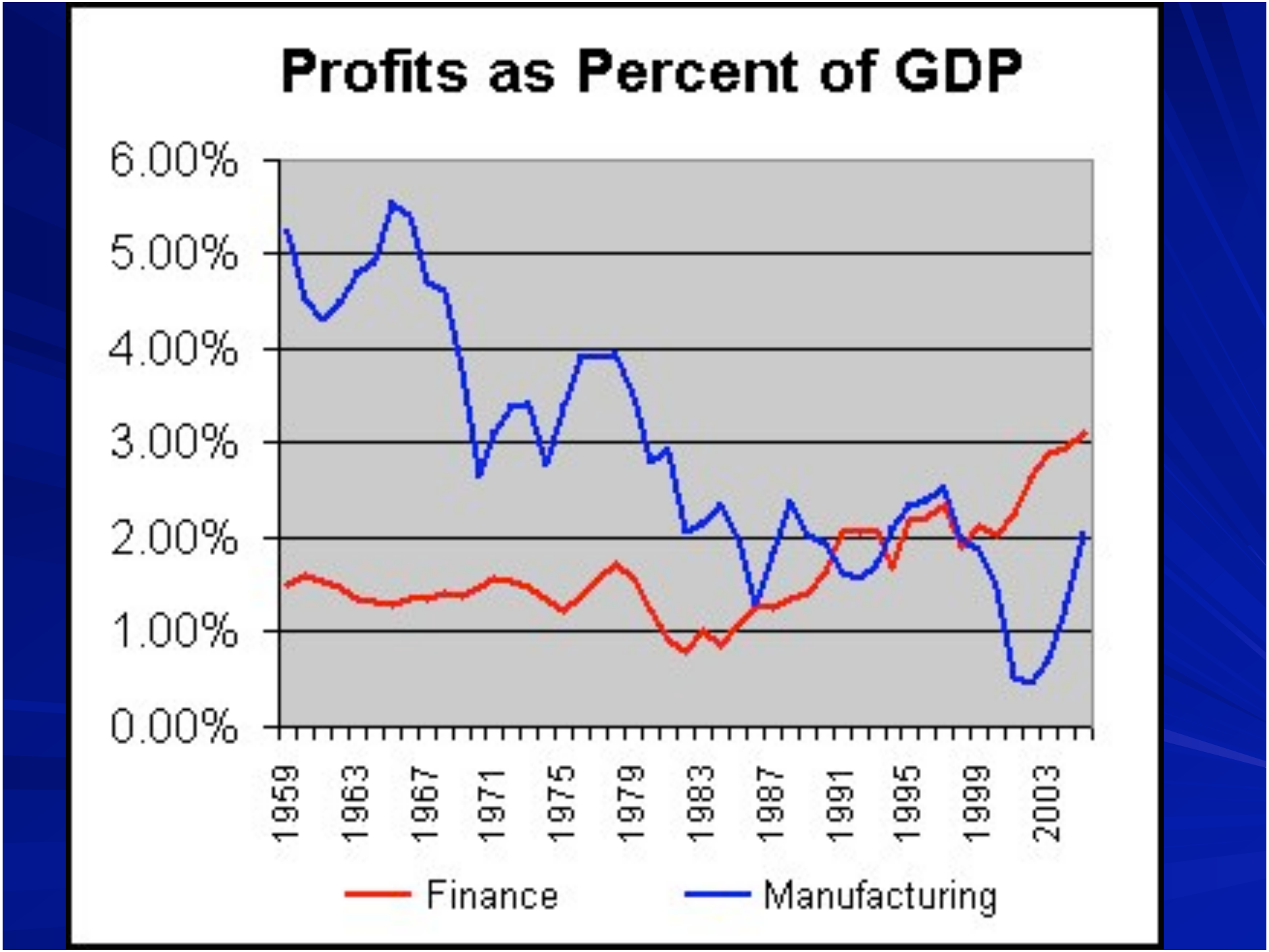
- The problem with this escape route from stagnation is that it exacerbates the problem of overproduction because it adds to productive capacity. A tremendous amount of manufacturing capacity has been added in China over the last 25 years, and this has had a depressing effect on prices and profits. Not surprisingly, by around 1997, the profits of US corporations stopped growing. According to one calculation, the profit rate of the Fortune 500 went from 7.15 in 1960-69 to 5.30 in 1980-90 to 2.29 in 1990-99 to 1.32 in 2000-2002. *By the end of the 1990's, with excess capacity in almost every industry, the gap between productive capacity and sales was the largest since the Great Depression.*

What about financialization?

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

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

- The result is an increased bifurcation between a hyperactive financial economy and a stagnant real economy. As one financial executive notes, “there has been an increasing disconnect between the real and financial economies in the last few years. The real economy has grown…but nothing like that of the financial economy—until it imploded.”
- What this observer does not tell us is that the disconnect between the real and the financial economy is not accidental—that the financial economy exploded precisely to make up for the stagnation owing to overproduction of the real economy.


Profits as Percent of GDP
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
1959
1963
1967
1971
1975
1979
1983
1987
1991
1995
1999
2003
Finance
Manufacturing

What were the problems with financialization as an escape route?

- The problem with investing in financial sector operations is that it is tantamount to squeezing value out of already created value. It may create profit, yes, but it does not create new value—only industry, agricultural, trade, and services create new value. Because profit is not based on value that is created, investment operations become very volatile and prices of stocks, bonds, and other forms of investment can depart very radically from their real value—for instance, the stock of Internet startups that keep on rising, driven mainly by upwardly spiraling financial valuations, that then crash.

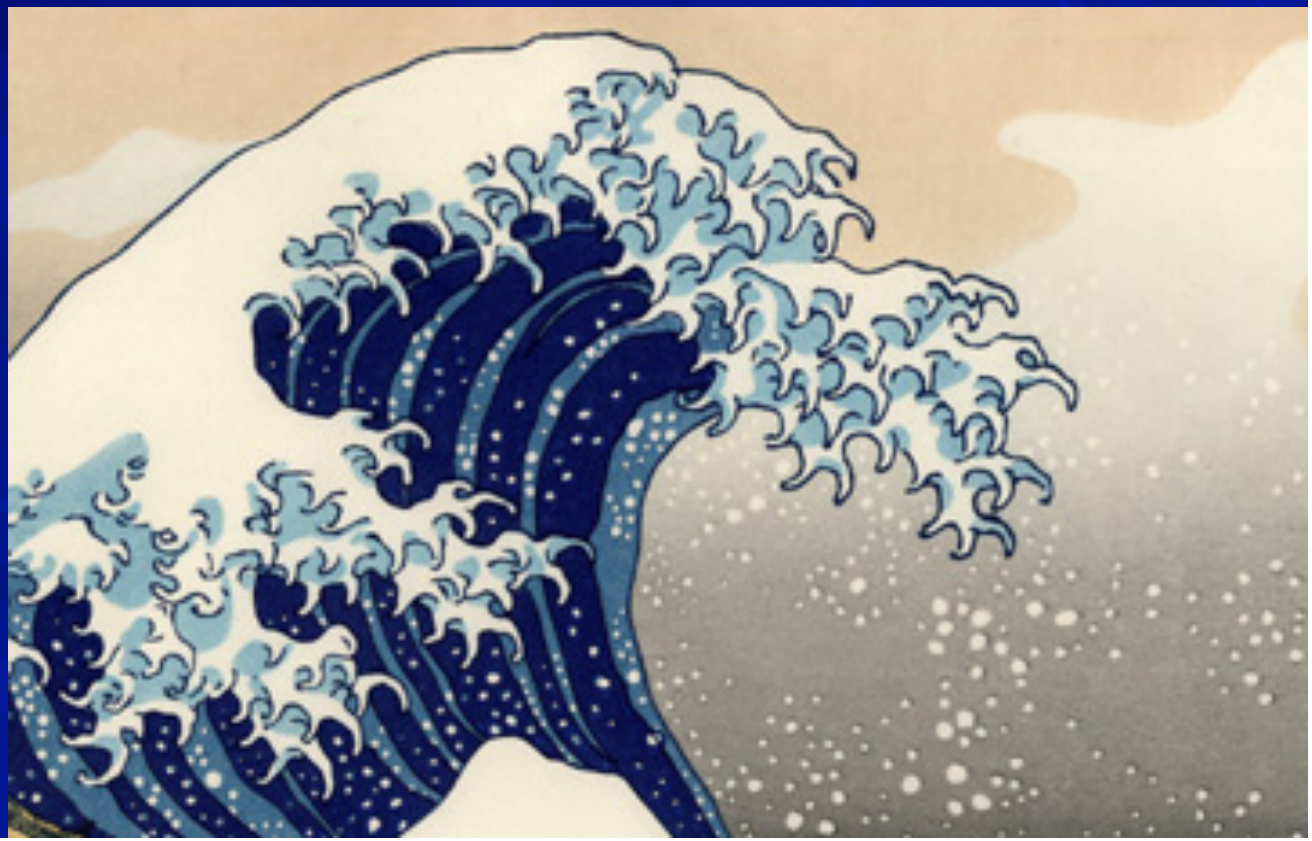
- Profits then depend on taking advantage of upward price departures from the value of commodities, then selling before reality enforces a "correction," that is a crash back to real values. The radical rise of prices of an asset far beyond real values is what is called the formation of a bubble.

Why is financialization so volatile?

- Profitability being dependent on speculative coups, it is not surprising that the finance sector lurches from one bubble to another, or from one speculative mania to another.
- Because it is driven by speculative mania, finance driven capitalism has experienced about 100 financial crises since capital markets were deregulated and liberalized in the 1980's.
- Prior to the current Wall Street meltdown, the most explosive of these were the Mexican Financial Crisis of 1994-95, the Asian Financial Crisis of 1997-1998, the Russian Financial Crisis of 1998, the Wall Street Stock Market Collapse of 2001, and the Argentine Financial Collapse of 2002.
- Bill Clinton's Treasury Secretary, Wall Streeter Robert Rubin, predicted five years ago that "future financial crises are almost surely inevitable and could be even more severe."

How do bubbles form, grow, and burst?

- Let's take the Asian financial crisis of 1997 as a case study.



The key ingredients of a speculative bubble were on display during the Asian Financial Crisis of 1997-98:

- Capital account and financial liberalization at the urging of the IMF and the US Treasury Dept.
- Entry of foreign funds seeking quick and high returns, meaning they went to real estate and the stock market
- Overinvestment, leading to fall in stock and real estate prices, leading to panicky withdrawal of funds—in 1997, $100 billion left the East Asian economies in a few weeks
- Bailout of foreign speculators by the IMF
- Collapse of the real economy—recession throughout East Asia in 1998

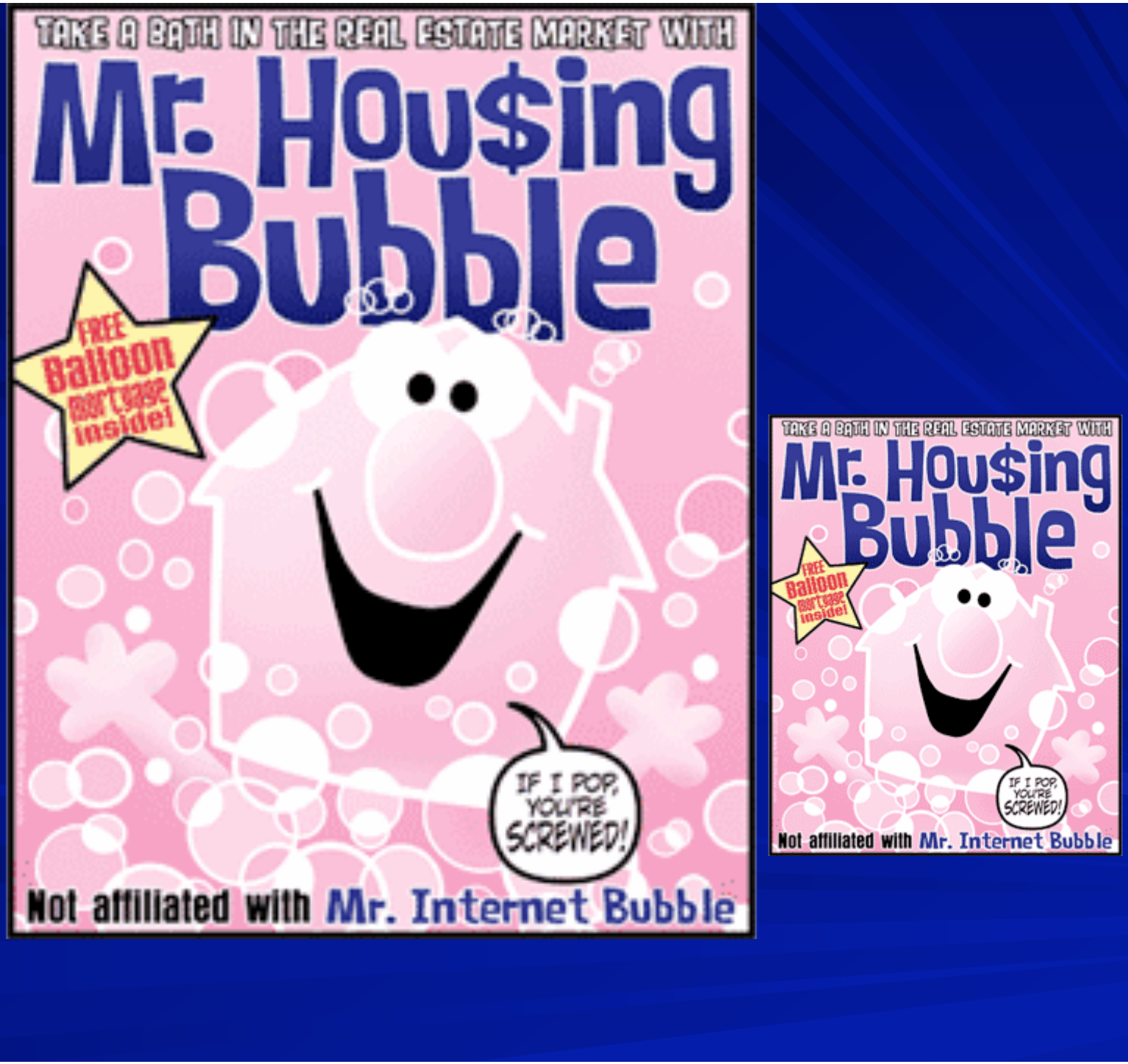
Self-regulation—the fruit of the Asian Financial Crisis

Despite massive destabilization, efforts to impose both national and global regulation of financial system were opposed on ideological grounds. The rhetoric about creating a new global financial architecture degenerated into “financial self regulation.”

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

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

- The loose money policies of the Fed under Alan Greenspan had encouraged the Technology Bubble, and when it collapsed into a recession Greenspan, to try to counter a long recession, cut the prime rate to a 45-year-low of 1 per cent in June 2003 and kept it there for over a year. This had the effect of encouraging another bubble—the real estate bubble.


TAKE A BATH IN THE REAL ESTATE MARKET WITH
Mr. Hou$ing Bubble
FREE Balloon Mortgage inside!
IF I POP, YOU'RE SCREWED!
Not affiliated with Mr. Internet Bubble

TAKE A BATH IN THE REAL ESTATE MARKET WITH
Mr. Hou$ing Bubble
FREE Balloon Mortgage inside!
IF I POP, YOU'RE SCREWED!
Not affiliated with Mr. Internet Bubble

- As early as 2002, progressive economists were warning about the real estate bubble. However, as late as 2005, then Council of Economic Advisers Chairman and now Federal Reserve Board Chairman Ben Bernanke attributed the rise in US housing prices to “strong economic fundamentals” instead of speculative activity. Is it any wonder that the great Princetonian was caught completely off guard when the Subprime Crisis broke in the summer of 2007?

And how did it grow?

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

- Let's translate this Wall Street jargon into lay language: the subprime mortgage crisis was not a case of supply outrunning real demand. The "demand" was largely fabricated by speculative mania on the part of developers and financiers that wanted to make great profits from their access to foreign money—most of it Asian and Chinese in origin--that flooded the US in the last decade. Big ticket mortgages were aggressively sold to millions who could not normally afford them by offering low "teaser" interest rates that would later be readjusted to jack up payments from the new homeowners.

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

- Because these assets were then “securitized”—that is converted into spectral commodities called “collateralized debt obligations” (CDO’s) that enabled speculation on the odds that the mortgage would not be paid. These were then traded by the mortgage originators working with different layers of middlemen who understated risk so as to offload them as quickly as possible to other banks and institutional investors. These institutions in turn offloaded these securities onto other banks and foreign financial institutions. The idea was to make a sale quickly, make a tidy profit, while foisting the risk on the suckers down the line.

- Essentially, the process was to offer a mortgage to subprime borrowers, securitize the mortgage, offload the securities as quickly as possible, get your money upfront, and get others—in this case, the hundreds of thousands of institutional and individual investors who brought these securities—to bear the risk.

Game's Up…

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

- …and five million more defaults from adjustable rate mortgages and other “flexible loans” geared to snag the most reluctant potential homebuyer will occur over the next several years. *But securities whose value run into trillions of dollars have already been injected, like virus, into the global financial system. Global capitalism’s gigantic circulatory system has been fatally infected. And, as with a plague, we don’t know who and how many are fatally infected until they keel over because the whole financial system has become so non-transparent owing to lack of regulation.*

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

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

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


AIG
American International
PHILAM
1006
MONTH/YEAR
VALID FROM 12/06
MONTH/YEAR
VALID THRU 12/08
ARBET W BERNARDO
MEMBER SINCE 06
VISA

What's going to happen now?

- *We can safely say then that there will be more bankruptcies and government takeovers, with some European and Asian banks and institutions joining their troubled US counterparts in being either allowed to fail, propped or taken over by government, that Wall Street's collapse will deepen and prolong the US recession, and that in Asia, Europe, and elsewhere, a US recession will translate into a recession, if not worse. Asia will definitely suffer, and not only because most countries are greatly dependent on the US market for their exports. China's capacity to counteract the recessionary impact is limited since China's main foreign market is the US and it imports raw materials and intermediate goods that it uses for its exports to the US from Japan, Korea, and Southeast Asia. Globalization has made "decoupling" impossible. The US, China, and East Asia are like three prisoners bound together in a chain-gang.*

In a nutshell…

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

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

- The key questions in everyone's mind now are: How deep and long will this recession be? Will this recession tip into a depression? And of course, how do we get out of this mess?

- **Well, there is one thing that we can be certain of: that neoliberal free-market policies and globalization, which got us into this mess in the first place, will not provide the answer. In fact, the silver lining in all this is the discrediting and delegitimizing of free market ideology, the globalist paradigm, and ivory tower neoclassical economics, which was blind to the developments in the real world.**

- *Adios companeros*

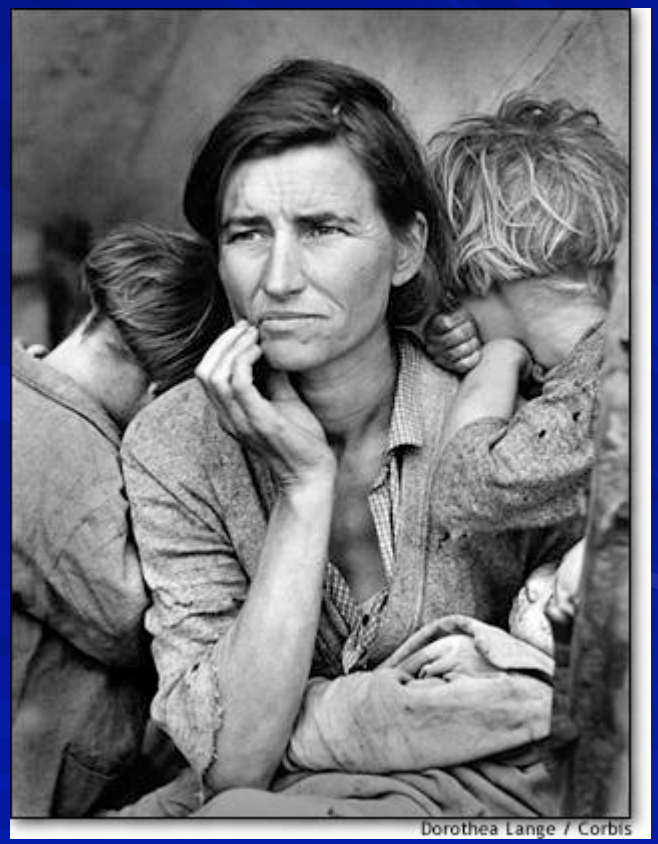
- The reaction of civil society groups throughout the world to the crisis has been a volatile one where outrage and frustration are mixed with hope. Outrage at the greed of Wall Street, frustration at the fact that we had been warning for so long about the dangers of globalization and deregulation and this would not have happened had people listened to us, and hope because we are being presented with an opportunity to push for a transformation of a dysfunctional global economic system.

Alternatives are now being proposed to the unpopular bailout plans in Washington and Europe. At the recently concluded Asia-Europe Peoples Forum (AEPF), for instance, scores of participants drafted an alternative program, some elements of which are the following:

- Introduce full-scale socialization of banks, not just nationalization of bad assets.
- Institutionalize full transparency within the financial system through the opening of the books to the public, to be facilitated by citizen and worker oversight bodies.
- Introduce parliamentary and citizens' oversight of the existing banking system.
- Apply social and environmental criteria to all lending, including for business purposes.
- Prioritize lending to meet social and environmental needs, at minimum rates of interest.

- Safeguard migrant remittances to their families and introduce legislation to restrict charges and taxes on transfers
- Overhaul central banks and make them autonomous but publicly accountable institutions.
- Create people-based banking institutions
- Reintroduce stringent capital controls as well as currency transactions taxes
- Cancel the debt of all developing countries to enable them to have resources to protect their populations from the developing recession or depression.

In other words, bail out the people, not the banks!



The past… and the future?

- Civil society organizations, of course, know that these demands will not be granted merely by demanding them from governments. But they see politics as being unfrozen by the recent events and are hopeful that people will become more and more susceptible to mobilization around radical programs as the crisis of legitimacy of neoliberalism, globalization, and capitalism deepens. They sense that we are entering an era of great danger mixed with great possibilities for progressive change.

- At no other period have the words of the great Italian thinker Antonio Gramsci been more relevant than today: “We have to balance the pessimism of the intellect with the optimism of the will.”

Having said this, we are in uncharted territory, and we don't know how this story is going to end…

Thank you!