ON THE MARKET AND POLICY ORIGINS OF THE INTERNATIONAL FINANCIAL CRISIS

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At the heart of the crisis:

A massive overextension of credit to individual households in the US

Catalysed by a speculative real estate bubble
US Household Debt and Borrowing, 1970Q1 - 2008Q2
Calculated from Flow of Funds of the United States, Board of Governors of the Federal Reserve System
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- Stock of Debt (left scale)
- Flow of Net Borrowing (right scale)
PROXIMATE CAUSES

1. NEW INSTRUMENTS
2. LAX REGULATION
3. LEVERAGE
4. LOW INTEREST RATES
“As in all periods of speculation... men sought not to be persuaded of the reality of things but to find excuses for escaping into the new world of fantasy”

-- JK Galbraith, The Great Crash
TWO KEY RELATED DEVELOPMENTS CONDITIONED BY LIBERALISATION, RISING INEQUALITY IN PAST 30 YEARS

1. TURN BY BANKS AND OTHER FINANCIAL FIRMS TO WAGES AS A SOURCE OF PROFITS

2. INIQUITOUS KEYNESIANISM
Gave rise to a Regime of Rising Consumption, Personal Debt, and Financial Profits in the US, exported to many advanced economies...
GAVE RISE TO A REGIME OF RISING CONSUMPTION, PERSONAL DEBT, AND FINANCIAL PROFITS IN THE US, EXPORTED TO MANY ADVANCED ECONOMIES...

...AND TO MIDDLE-INCOME COUNTRIES, WITH THE WORLD BANK AND THE IFC CENTRALLY RESPONSIBLE.
THE CRISIS REPRESENTS THE UNRAVELLING OF THIS REGIME, IN THE FIRST INSTANCE IN THE US, AT ITS WEAKEST LINK, HISTORICALLY OPPRESSED LAYERS OF POPULATION SPREADING TO ADVANCED AND MIDDLE-INCOME COUNTRIES
TURN BY FINANCIAL FIRMS TO WAGES

PRIVATISATION, STAGNANT WAGES FORCED
ORDINARY PEOPLE TO:

* BORROW TO ACCESS NECESSITIES
  (HOUSING, EDUCATION, HEALTH)

* MANAGE RISKS, NOW BORNE INDIVIDUALLY
  (PENSIONS, INSURANCE, HEALTH)
HIGHLY PROFITABLE BUSINESS INCENTIVES TO INCREASE MARKETS AND MARKET SHARES

In 2006, Consumer segments

56%, 42.9% of Profits of Citi and HSBC

65.6% of Net Interest Income for B of A
THIS DOES NOT TAKE INTO ACCOUNT FEES AND GAINS FROM UNDERWRITING AND DEALING IN COLLATERALISED CLAIMS ON HOUSEHOLDS
First Aspect of the Financial Crisis

A Result of Financial-Market Agents Pushing this New, Profitable Business to Its Limits
POST dot.com setting

BOOM IN MORTGAGE LENDING
SPECULATIVE PRICE BUBBLES
LENDING TO POSITIONS ONLY VAILABLE IN BUBBLE
(SUBPRIME, BUY-TO-LET, FOREX)

FINANCIAL INNOVATION, CDOs, ENDOGENOUS
‘SCIENTIFIC’ EXCUSE TO ESCAPE INTO WORLD OF FANTASY

PROFITABLE WHILE MONEY KEPT COMING IN, INFERENCE-BASED INSTRUMENTS, DEFY GRAVITY...
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'Scientific' EXCUSE TO ESCAPE INTO WORLD OF FANTASY

PROFITABLE WHILE MONEY KEPT COMING IN, INFERENCE-

BASED INSTRUMENTS, DEFY GRAVITY...
SECOND ASPECT OF THE CRISIS
THE RISE OF INIQUITOUS KEYNESIANISM
POLICY MAKERS:

BOOSTED DEMAND THROUGH PERSONAL
CONSUMPTION AND DEBT

SAW REAL ESTATE BOOM AS PERPETUAL MOTION
MACHINE

SUPPORTED (AND DENIED) BUBBLES
“Consumer spending carried the economy through the post-9/11 malaise, and what carried consumer spending was housing.... This boom provided a big lift in morale”

-- Alan Greenspan (2007)
Greenspan (2007) traces rise of this ‘Keynesianism’ to his agreement with Bill Clinton in late 1992 about how to enhance growth after recession

- Low fiscal deficits
- Low interest rates
- Rising homeownership
- Boost to consumption, demand
The Perpetual Motion Machine
“Household debt increased 10\(\frac{3}{4}\) percent last year, in large part because of the surge in mortgage borrowing.... Even with the rapid expansion of debt, net worth... increased as the value of household assets rose noticeably.... Although prices of existing homes climbed more slowly than they had in the previous year, the rate of increase remained sizeable.”

-- Federal Reserve, Monetary Report to Congress (2004)
“The end of boom-and-bust”

“the lowest mortgage rates in living memory”

“Widen the circle of opportunity by low mortgage rates”
Policy Support for Increased Mortgage Lending and Bubble
US Household Consumption to GDP
Calculated from Flow of Funds of the United States, Board of Governors of the Federal Reserve System
US Declared Income to GDP, Selected Income Percentiles
Calculated from Individual Income Tax Returns with Positive AGI, US Internal Revenue Service
US Household Consumption, Percent of Personal Disposable Income - 1952-2008
Calculated from Flow of Funds of the United States - Board of Governors of the Federal Reserve System
And This Meant More Borrowing
US Household Debt and Borrowing, 1970Q1 - 2008Q2
Calculated from Flow of Funds of the United States, Board of Governors of the Federal Reserve System
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On the Other Side of the Same Coin...
US Declared Income to GDP, Selected Income Percentiles
Calculated from Individual Income Tax Returns with Positive AGI, US Internal Revenue Service

Bottom 90 Percent (left scale)  Top 1 Percent (right scale)
And This Meant More Funds Looking for Investment Opportunities
And This Meant More Funds
Looking for Investment Opportunities
Including in Lending to Those with Falling Income Shares
Ideology and Politics Also led to Policy Support to Increased Homeownership and Bubble
Markets for Housing Policy

“When homes are doubling in price every six years and incomes are increasing by a mere one per cent per year... Fannie and Freddie can do more, a lot more”

-- Sen Jack Reed (D), RI (2006)
By 2006, nearly 69 percent of households owned their own home.... The gains were especially dramatic among Hispanics and blacks, as increasing affluence as well as government encouragement of subprime mortgage programs enabled many members of minority groups to become... home buyers. This expansion of ownership gave more people a stake in the future of our country and boded well for the cohesion of the nation.

-- Alan Greenspan (2007)
Regulation Followed Quite Naturally from This Stance

“We don’t want to stifle financial innovation”

-- Steve Fritts, Associate Director for risk-management policy, FDIC (2005)
Subprime crisis also signals exhaustion of policy of mass personal indebtedness, backed by real estate bubbles, to sustain macroeconomy.
Now What?

Three Underlying Changes that May Help Dig Economy from Likely Big Hole by Addressing Broad Determinants of the Crisis
Improve Distribution of Income

Rising Inequality Conditioned Development of Crisis

Unsustainable Levels of Household Debt at Heart of Crisis (poorer, younger)
Replace Private Provision of Social Necessities through Capital Markets with Quality Public Provision
Instead of fleecing ‘Keynesianism’

Conscious State Productive Investment to Counter Economic Downturn
Most Importantly, these point to

Re-strengthening of trade union and broader social movements

Need to put back on the agenda democratic economic management