The Global Financial System in Crisis

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I have been asked to address the issue of the international financial architecture that provides the context for aid flows.

My response is what architecture? In fact, we now stand on the brink of what former US Federal Reserve Chairman Alan Greenspan has called possibly the worst economic crisis since the Second World War because of the lack of architecture to govern global capital flows. The so-called subprime mortgage crisis that has resulted so far in losses of some $400 billion and threatens a chain reaction of collapsing financial institutions globally is the end product of a process of deregulation of financial markets that began during the Reagan-Thatcher era. This is the latest of some 100 financial crises in the last 30 years, according to the count of the Brookings Institution.

Owing to the devastating impact of uncontrolled gyrations and permutations of speculative capital, there were calls for capital controls and a return to strong financial regulation following two of these crises: the Asian financial crisis in 1997 and the dot.com craze of the late 1990s. The first event led to the economic collapse of all the so-called Asian tiger economies that did not impose capital controls, the second to the wiping out of $7 trillion in investor wealth and the US recession of 2001. I am sure we all still remember how during the Ramos years, some $19.4 billion entered the country between 1994 and 1997 and left in a flash in July and August of 1997, dragging down the peso from 25:1 to 54:1 in the course of the next few months and bringing us to recession in 1998.

Nothing came of these demands for capital controls as the global financial elite refused even the weakest regulatory mechanisms that were proposed. Instead, "self-surveillance" and "self-policing" was the alternative pushed by the private sector, even as it removed the last remaining barriers to capital flows across borders and devised ever more sophisticated financial instruments such as derivatives. In this connection, just as they said they would be model debtors and pay off all the country's debt according to the terms of the creditors during the Aquino period, so did our financial authorities dutifully repeat international financial capital's mantra against the imposition of capital controls during the Ramos presidency and afterwards.

What happens when you eliminate or water down state regulation of financial activity is provided by the *Wall Street Journal's* summary of a recent report on the subprime crisis by the G7's Financial Stability Forum:

> [T]here is plenty of blame to go around for the financial chaos: The US subprime mortgage market was marked by poor underwriting standards and 'some fraudulent practices.' Investors didn't carry out sufficient due diligence when they bought mortgage-backed securities. Banks and other firms managed their financial risks poorly and failed to disclose to the public the dangers on and off their balance sheets. Credit-rating companies did an inadequate job of evaluating the risk of complex securities. And the financial institutions compensated their employees in ways that encouraged excessive risk-taking and insufficient regard to long-term risks.

Deregulation of financial markets is the immediate cause of the current financial crisis. However, we cannot have a comprehensive understanding of the crisis unless we ask why radical deregulation of financial markets occurred in the first place.

One chieftain of a financial corporation chief writing in the *Financial Times* captured the basic reason behind financial liberalization, perhaps unwittingly, when he claimed that "there has been an increasing disconnection between the real and financial economies in the past few years. The real economy has grown…but nothing like that of the financial economy, which grew even more rapidly—until it imploded." *What his statement does not tell us is that the disconnect between the real and the financial is not accidental, that the financial economy expanded precisely to make up for the stagnation of the real economy.*

This growing gap between the financial and the real cannot be comprehensively understood without referring to the crisis of overaccumulation that overtook the center economies in the late seventies and 1980's, a phenomenon that is also referred to as overproduction or overcapacity.

The golden period of postwar growth globally that skirted major crises for nearly 25 years was due to the massive creation of effective demand via rising wages for labor in the North, the reconstruction of Europe and Japan, and the import-substituting industrialization in Latin America and other parts of the South. This was done principally via state intervention in the economy. This dynamic period came to a close in the mid-seventies, with stagnation setting in, owing to global productive capacity outrunning global demand, which was constrained by continuing deep inequalities in income distribution. According to the calculations of Angus Maddison, the premier expert on historical statistical trends, the annual rate of growth of global gross domestic product (GDP) fell from 4.9 per cent in what is now regarded as the golden age of the post-World War II Bretton Woods system, 1950-73, to 3 per cent in 1973-89, a drop of 39 per cent. These figures reflected the wrenching combination of stagnation and inflation in the North, the crisis of import substitution industrialization in the South, and erosion of profit margins all around.

In the eighties and nineties, global capital blazed three escape routes from the specter of stagnation. One was neoliberal restructuring, which included redistribution of income towards the top via tax cuts for the rich, deregulation, and an assault on organized labor. Neoliberalism took the form of Thatcherism and Reaganism in the developed North and World Bank and International Monetary Fund (IMF)-imposed structural adjustment in the global South.

Another was corporate-driven globalization or "extensive accumulation," which opened up markets in the developing world and moved capital from high-wage to low-wage areas. As Rosa Luxemburg long ago pointed out in her classic *The Accumulation of Capital,* capital needs to constantly integrate precapitalist societies to the capitalist system to shore up the fall in the rate of profit. In the last two decades, the most spectacular case of incorporating a precapitalist society into the global capitalist system was China, which became both the world's second biggest exporter and the primary destination of foreign investment. This was, however, a double edged sword for capitalism, as we shall later see.

A third was the process we are mainly concerned with here: "intensive accumulation or "financialization," that is, the channeling of investment towards financial speculation, where much greater returns were to be derived than in industry, where profits were largely stagnant. Finance capital forced the elimination of capital controls, the result being the rapid globalization of speculative capital to take advantage of differentials in interest and foreign exchange rates in different capital markets. These volatile movements, the result of capital's liberation from the fetters of the post-war Bretton Woods financial system, was one source of instability. Another was the proliferation of novel sophisticated speculative instruments like derivatives that escaped monitoring and regulation. Instability derived ultimately from the fact that speculative finance boiled down to an effort to squeeze more "value" out of already created value instead of creating new value since the latter option was precluded by the problem of overproduction in the real economy.

The disconnect between the real economy and the virtual economy of finance was evident in dot.com bubble of the 1990's. With profits in the real economy stagnating, the smart money flocked to the financial sector. The workings of this virtual economy were exemplified by the rapid rise in the stock values of Internet firms which, like Amazon.com, still had to turn a profit. The dot.com phenomenon probably extended the boom of the 1990's by about two years. "Never before in US history," Robert Brenner wrote, "had the stock market played such a direct, and decisive, role in financing non-financial corporations, thereby powering the growth of capital expenditures and in this way the real economy. Never before had a US economic expansion become so dependent upon the stock market's ascent." But the divergence between momentary financial indicators like stock prices and real values could only proceed to a point before reality bit back and enforced a "correction." And the correction came savagely in the dot.com collapse of 2002, in the form of the wiping out of $7 trillion in investor wealth.

A long recession was avoided, but it was only by encouraging another bubble, the housing bubble, and here, Alan Greenspan played a key role by cutting the federal funds rate to a 45-year low of 1 per cent in June 2003, holding it there for a year, then raising it only gradually, in quarter-percentage-increments. As Dean Baker put it, "an unprecedented run-up in the stock market propelled the US economy in the late nineties and now an unprecedented run-up in house prices is propelling the current recovery."

The result was that real estate prices rose by 50 per cent in real terms, with the run-ups, according to Baker, being close to 80 per cent in the key bubble areas of the West Coast, the East Coast, North of Washington, DC, and Florida. How big was the bubble created? It is estimated by Baker that the run-up in house prices "created more than $5 trillion in real estate wealth compared to a scenario where prices follow their normal trend growth path. The wealth effect from house prices is conventionally estimated at five cents to the dollar, which means that annual consumption is approximately $250 billion (2 per cent of gross domestic product [GDP]) higher than it would be in the absence of the housing bubble."

The succession of speculative manias in the US have had the function of absorbing investment that did not find profitable returns in the real economy, thus not only artificially propping up the US economy but also "holding up the world economy," as one IMF document put it, owing to the stimulus to global production triggered by US middle class spending. Thus, with the bursting of the housing bubble and the seizing up of credit in almost the whole US financial sector, we face not only a US recession but a global recession that will impact on, among other places, China, whose economic growth depends largely on the US and European markets and the Southeast and East Asian economies, including the Philippines, that supply China with the resources and components that it puts together as finished goods for export to the US and Europe. In this connection, it was demand from China's export-led industries that pulled us out of the doldrums of the financial crisis and became the main driver of growth in the early part of this decade.

One must not, however, overestimate the resiliency of capitalism. Many are now asking: After the collapse of the dot.com boom and the housing boom, is there a third line of defense against stagnation owing to overcapacity? One theory is that military spending could be a way that the government might pull the US out of the jaws of recession. And, indeed, the military economy did play a role in bringing the US out of the 2002 recession, with defense spending in 2003 accounting for 14 per cent of GDP growth while representing only four per cent of the GDP of the US. According to estimates cited by Chalmers Johnson, defense-related expenditures will exceed $1 trillion for the first time in history in 2008.

Stimulus could also come from the related "disaster capitalism complex" so well studied by Naomi Klein--that "full fledged new economy in home land security, privatized war and disaster reconstruction tasked with nothing less than building and running a privatized security state both at home and abroad." Klein says that, in fact, "the economic stimulus of this sweeping initiative proved enough to pick up the slack where globalization and the dot.com booms had left off. Just as the Internet had launched the dot.-com bubble, 9/11 launched the disaster capitalism bubble." This subsidiary bubble to the real estate bubble appears to have been relatively unharmed so far by the collapse of the latter.

Whether or not “military Keynesianism” and the disaster capitalism complex can in fact play the role played by financial bubbles is open to question. A critical limit to military Keynesianism and disaster capitalism is that the military engagements to which they are bound to lead are likely to create quagmires such as Iraq and Afghanistan that could trigger a backlash both abroad and at home. This would eventually erode the legitimacy of these enterprises, reduce their access to tax dollars, and erode their viability as sources of economic expansion in a contracting economy.

Yes, global capitalism may be resilient, but it looks like its options are increasingly limited. The forces making for the long term stagnation of the global capitalist economy are now too heavy to be easily shaken off by the economic equivalent of mouth-to-mouth resuscitation. Let me just say that I agree with those who say that the global economic crisis before us might rival the Great Depression. The accumulated pressures since the end of easy post-war growth in the mid-seventies have simply been too great to be warded off by another speculative mania. We may in fact be on the way down to the trough of the latest Kondratieff Wave, those fifty-year supercycles of long-term-expansion and long-term contraction that have marked capitalism’s history. While there will be great dislocations, this crisis may also provide the opportunity for a transition to a more progressive global economic system where markets are brought under control and are disciplined by the public interest. Indeed, since the 1980’s, there has been great disaffection that has built up globally over unfettered capital that is going to explode in the public arena, marking what the great Hungarian economist Karl

Polanyi described as the second phase of the "double movement" under capitalism: an era following a period of uncontrolled market gyrations when, forced by a civil society that is up in arms, governments again intervene, this time to stabilize the economy, bring about a just income distribution, eliminate poverty and—a critical goal in this era of global warming—promote environmental sustainability.

Thank you.

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