4. The Role of Finance in the Latest Capitalist Downturn

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The latest downturn of capitalism began as a financial crisis. The first signs of the financial crisis emerged in the US in the summer of 2007 with an increase in mortgage delinquencies followed by an effort by the central banks to inject liquidity[1] into the world financial system. March 2008 marked the beginning of the collapse with the major investment bank Bear Stearns facing failure and being acquired by JP Morgan Chase with backing from the Federal Reserve (Fed). This was followed by the takeover of Indymac Bank in July by the Federal Deposit Insurance Corporation (FDIC). Yet it was not until the government took over Fannie Mae and Freddie Mac and forced the sale of Merrill Lynch to Bank of America, Lehman Brothers collapsed and the Fed rescued the insurance giant AIG on September 17 that many realized that we were in the middle of a severe financial crisis.

From 2008 to 2009, the total market value of the financial assets and companies wiped out worldwide as a result of the financial crisis was estimated to be over 14 trillion dollars (Roxburgh et al. 2009). Governments all over the world- fearing a systemic collapse- rushed to bailout the failing financial institutions, provide liquidity to the financial markets, and negate the negative effects of the crisis on the economy through massive fiscal spending amounting to trillions of dollars. For example, in the US, by early 2009, the government had made commitments of about $12.2 trillion through various programs (*New York Times*, 02/04/2009). While the financial system came to a standstill, the world economy went into one of its biggest recessions, with most economies experiencing negative growth rates.

While some economists tried to defend capitalism by putting the blame for the crisis on government policies and arguing that state interventions via spending cannot pull the economy out of the present economic downturn (Fama et al. 2009), for some observers the crisis represented the "last nail in

[1] Liquidity here refers to direct loans made by the central banks to the banking system in order to encourage the banks to extend credit to the rest of the economy.

the coffin" of the neoliberal ideology that had reigned for three decades and stated that free, unregulated and self-correcting markets, combined with the institution of private property, could allocate resources efficiently and bring about the best possible outcome for society (Stiglitz 2008, Krugman 2009). Still, for others this crisis is a symptom of deeper problems with capitalism as a system that organizes the production of goods and services with the single goal of making more profit (McNally 2009, Resnick and Wolff 2010). What is not disputed is that millions of people are unemployed and those that have not lost their jobs are having to compromise for worse work conditions given the threat of losing their jobs. Many are also losing their homes while companies in every sector are filing for bankruptcy. In order to understand how troubles that emerged in a relatively small part of the US mortgage markets ended up with one of the most severe downturns of the capitalist system ever, a historical look at the structural features of the system since the early 1980s is needed.

Regulated Capitalism and Its Crisis

The period from World War II to the late 1970s was one in which the State played a significant role in the economy through regulations and interventions aimed at achieving high rates of growth and low unemployment, while constituting a 'welfare state' through various social programs. Increases in labor productivity were partly translated into improvements in wages, while weak foreign competition and oligopolistic markets led corporations to engage in 'friendly competition' and achieve high profit rates. Within this regime of accumulation the financial system was also strictly regulated and made to serve the needs of productive capital with the aim of promoting economic growth. By 1933 the government had already taken steps to control bank activity by passing the Glass-Steagall Act which inserted 'firewalls' between capital markets and depository institutions by separating banks according to the type of business activity that they did. Commercial banks were restricted to taking deposits and making loans while investment banks traded stocks and bonds. Commercial banks were also prohibited from holding assets that were deemed speculative, such as corporate stock. The Fed had the power to restrict competition among banks and to control interest rates in savings accounts.

All of the above interventions and policies, together with the role of the Keynesian[2] welfare state and a class compromise (Bowles et al. 1990) that

[2]Without getting into debates as to what it means to be Keynesian, we use this description in the broadly understood perspective that ascribes a role for the intervention by

guaranteed labor peace, led to the so-called "golden age," where we see the only period of sustained growth and declining inequality in terms of wealth and income distribution in the history of American capitalism. For example, workers enjoyed increasing material standards of living thanks to the institutional framework that facilitated mass production and mass consumption via higher wages and benefits. The emergence of this "golden age" was supported by the fact that the destruction of Europe and Japan during the war put the US in a very favorable position in world markets given the lack of competition. The US had a fundamental role in reconstructing these devastated countries via the Marshall Plan, which provided funds for the buying of US goods-as the US produced more than half of the world's industrial output- and also served an ideological function against the rise of socialism all over the world (Hobsbawm 1994).

However, this regulated capitalism ran into a multipronged crisis in the 1970s with declining profits, high inflation, and a stagnating economy. A variety of explanations have been offered in order to explain the reasons of this crisis, which ranged from tendency of the rate of profit to fall (Shaikh 1987), to increased foreign competition (Brenner 1998), a slowdown in productivity growth due to diminished worker effort (Bowles, Gordon and Weisskopf 1986), or profit squeeze due to increased wages (Glyn and Sutcliffe 1972). No matter which explanation is taken, the profitability crisis of the 1970s together with the collapse of the post-war Bretton Woods financial system, created new dynamics in the economy which involved a search for ways of increasing profitability and establishing a new financial architecture.

The crisis of this regulated capitalism during the 1970s paved the way for neoliberalism, the latest variant of the *laissez-faire* ideology which celebrates unregulated markets that facilitate the mobility of capital. Since the crisis of the 1970s, a series of attempts have been made by the corporations and the governments to restore profitability. Corporations engaged in cutthroat competition with each other, began relocating their production activities around the globe in order to take advantage of lower labor costs and expand into new markets. Coupled with the new anti-labor stances of the governments and the shift of focus of economic policy from lowering unemployment to lowering inflation—and the emergence of flexible labor markets, subcontracting and outsourcing—a decline in the overall share of labor began. A process of deregulation of trade and finance, privatization of most public services, reduction of taxes on corporations and the wealthy aimed to secure new conditions of profitability for the corporations under a

the State in the economy, especially in moments of market imbalances and economic crisis.

so-called "free market" economy. While these developments led to the global expansion of the capitalist system and periods of economic expansions, at the same time it has more clearly exposed fundamental contradictions within the modern capitalist system. Five of them are central to a proper understanding of the crisis of late 2000s:

Financial Deregulation

With the elimination of most of the financial regulations designed to curb excessive risk-taking by the financial system and with the effect of the unrestrained competition in the financial sector, banks and other financial institutions began engaging in increasingly risky activities in order to acquire profits. This was marked by a shift from traditional financial activities such as mortgage lending towards speculative activities -enabled by financial innovations such as securitization- and resulted in the emergence of asset bubbles both in the US and in the rest of the world. Starting in 1980, the government began to deregulate the financial sector and as a result created an environment in which banks could decide which strategies to pursue to obtain more profits given that taking deposits and lending money were not as profitable as speculative investment.

Among these regulatory changes, the infamous Gramm-Leach-Bliley Act of 1999 repealed the Glass-Steagall Act and removed the barriers between investment and commercial banking. In 2000, the Commodity Futures Modernization Act replaced the 1982 Shad-Johnson Act and provided regulatory exemptions to certain financial innovations, among others to credit default insurance and permitted financial institutions to invest large sums in the credit default swaps. The Sarbanes-Oxley Act allowed the banks' off-balance-sheet activities as long as the risk and rewards of these activities were held by other entities. In 2004, investment banks were allowed to increase their leverage. All these regulatory changes contributed to the latest financial crisis by allowing increased leverage, securitization, and speculation in the financial markets and by creating an environment prone to speculative asset bubbles and fragility.

The monetary policy of the Fed only contributed to this by a lowering of the federal funds rate in order to stave off slowdowns of the economy in the early 1990s and then again the early 2000s. The Fed aimed to maintain consumption at high levels through increased credit at low interest rates while allowing the emergence of speculative asset bubbles, in the stock market in the 1990s and in the housing market in the 2000s.

Stagnant Wages and Household Borrowing

The internationalization of production and the concomitant increase in the reserve army of labor both domestically and globally together with flexible labor markets and declining unionization rates led to stagnant wages throughout the new era. Relocation of production to sites with lower labor costs put US workers in direct competition with the global reserve army of labor whose size grew immensely because, among other things, of the increased participation of China in world industrial production. At the same time, the domestic balance of power moved against labor. The declining power of labor organizations and deunionization together with the decline of the social wage through cuts in or eliminations of social programs such as guaranteed retirement pensions, unemployment benefits and so on reduced the power of workers in the workplace and in the political arena. Flexible labor markets involved the widespread use of temporary and contingent workers, leading to decreased job security, lessened bargaining power and declining wages (Rosenberg 2010).

In terms of economic policy, we see a shift from the full employment targeting of the "golden age" to inflation targeting and a reduction in social programs which brought down the social wage and decreased the bargaining power of labor. While average productivity in the manufacturing sector between 1978 and 2007 increased 3.26 percent per year, real wages paid to the workers in this sector remained stagnant and even decreased by -0.37 percent per year in the same period.[3]

Faced with stagnant wages, American households devised new strategies to keep their consumption up, including increased participation in the labor force (more household member entering the workforce), working longer hours or having more than one job, and heavy borrowing (Wolff 2010). Total outstanding household debt as a percentage of disposable personal income was around 70 percent in early 1980s, approached to 100 percent by late 1990s and was more than 130 percent by the time the financial crisis hit in 2007.[4] Households also began using their houses as ATM machines in order to sustain their consumption. One measure of this, gross equity extracted from housing, shows that funds acquired by households through their houses constituted close to 10 percent of disposable income in the 2000s (Greenspan and Kennedy 2007, Kotz 2009).

[3] Authors' calculations from the Economic Report of the President, 2010, Table B-47 and B-49.

[4] Authors' calculations from the US Bureau of Economic Analysis, National Income and Product Accounts Table 2.1 and Federal Reserve Flow of Funds Accounts Table D.3.

Inequality and Finance

While the average wages of non-supervisory workers have been stagnant, inequality widened as the wealthier began earning more and more. For example, CEO pay skyrocketed from 42 times the pay of an average worker in 1982 to more than 400 times in the 2000's. In fact, "after decades of stability in the post-war period, the top decile share has increased dramatically over the last twenty-five years and has now regained its pre-war level. Indeed, the top decile's[5] share of income is 49.7 percent in 2007, a level higher than any other year since 1917, even surpassing 1928, the peak of the stock market bubble in the 'roaring' twenties" (Saez 2009: 2). This increase in the concentration of income has been matched by an increase in the concentration of wealth, especially financial assets (Wolff, et al. 2009).

Coupled with the financially deregulated environment, institutional investors such as hedge funds or private equity funds would put this increased wealth into more financial speculation and create an ever growing supply of speculative finance. At the same time, increased wealth at the top and the consequent rise of money management forced banks and other financial institutions into intense competition with each other in order to capture this business. Exotic new financial instruments were created in order to provide higher yields and capture niche markets (Crotty 2007).

While the rise of profits and financial incomes relative to wages was a major factor leading to a concentration of income and wealth at the top, profits made from managing this increasingly concentrated wealth further contributed to these inequalities. Also, while the regulatory framework allowed increasingly complex financial innovations, institutional investors and the wealthy provided the demand for these complex financial assets. The large amount of wealth accumulated sought professional management through institutional investors as a substantial amount of investable funds were produced relative to existing available investment opportunities.

Chronic Excess Capacity

Heightened competition in product markets created chronic excess capacity in many industries, which led to a double problem with the lack of effective demand. While during the "golden age" limited competition placed lower limits on the price and upper limits on capacity, the cutthroat nature of competition in the current era, intensified thanks to deregulation and liberalization of trade flows, led to overinvestment relative to demand, leading

[5] Top decile refers to families with an income of more than $109,600.

to excess capacity. In the face of increasing international competition and price wars, corporations attempted to defend their illiquid capital assets and keep their position through further investment in cost-cutting technology. This led to growing idle capacity, which in turn led to downturns in investment spending as well. Hence the slow growth of aggregate demand and the problem of excess capacity reinforced each other. Increased competitive pressures forced firms to further cut wages and relocate production in an attempt to lower labor costs, further contributing to the slow growth of aggregate demand (Crotty 2005).

Non-financial corporations facing profitability problems also began engaging in financial investments. Asset bubbles worsened the chronic excess capacity problem by directing excess investment into booming sectors, as seen in the 1990s tech bubble in which overinvestment created excess capacity in many high-tech industries which led to a collapse of prices, profitability and eventually many firms in the early 2000s (Orhangazi 2008, 2009).

Global Imbalances

Finally, in the last decade imbalances in global trade and financial flows have been more pronounced. As the US current account (trade) deficit widened in the 1990s, this was mirrored in the increasing flow of capital into the country. The structural reasons behind this trend included increased relocation of production to lower labor cost countries through outsourcing and subcontracting and the fast growth of export oriented countries, especially in Asia. While relocation of production outside the US was a significant contributor to the decline of high-paying jobs and investment, low-priced imports became an enabling factor in sustaining the stagnant wages of the era. In the process, US consumption, heavily dependent on credit, became an outlet for many export oriented economies in the world. While the size of the trade deficit that the US had for years would be unsustainable for any other country, whose currency would be devalued, automatically reducing imports. But the US dollar's role as the international reserve currency enabled the continuation of these imbalances by maintaining high demand for US currency. The inflow of international capital into the US involved both private and public savings. The liquidity and perceived soundness of the US financial markets and institutions drew global savings into the American financial markets. Securitization and financial innovation in the US contributed to attracting the excess savings of the world to the US. In addition, the public savings, export-oriented policies of the Asian economies together with their need to hold dollar reserves against financial instability,

especially exchange rate instability (a lesson of the Asian financial crisis of the late 1990s), led to a growing amount of surplus flowing to the US economy from these economies. In this setup, while the US dollar played the role of international currency, serving as the basis for the international accounting and payments system, US Treasury bonds played a key role as a store of value.

Concluding Remarks

The disturbances that began in the mortgage market led to an unraveling of the contradictions discussed above. Securitization and the deregulated financial environment caused a rapid spread of the financial crisis, while households faced with a decline in their net worth and tightening lending conditions cut their spending and firms began rapidly cutting back on their investments leading to a severe downturn in the world economy. One thing that this downturn reminds us of again is that capitalism periodically runs into crisis. All the risk management innovations made in the recent years, instead of preventing this from happening, exacerbated it. As Minsky had put it, *stability is destabilizing* in capitalism and there are various sources for this instability. In this sense, any type of policy that aims at reviving and fixing the dynamics of an inherently unstable capitalism will most probably prepare the ground for future crises, especially when the main structures, relations and incentives of the system remain in place. Apart from the current economic crisis that the world is experiencing, other crises related to the environment, energy, and food can all be understood in relation to how capitalism works, irrespective of the shape the system takes and where in the business cycle we are located. This crisis is a strong reminder that we should be looking for alternative ways of organizing the economy if we want to avoid the destructive impact of capitalism on our lives.

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