The World Economic Crisis: 1991-2001

Part 2

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Below we are publishing the second part of a lecture given on January 16, 2002 by Nick Beams, national secretary of the Socialist Equality Party (Australia) and a member of the International Editorial Board of the World Socialist Web Site *. The lecture was delivered at an international school held in Sydney by the Socialist Equality Party of Australia. The* first part *was published on March 14 and the* conclusion *was published on March 16.*

The 1987 stock market crash ushered in the 1990s. While originating on Wall Street, the collapse was, in every sense, a global phenomenon. Conflicts between US government and financial authorities and German bankers over interest rates led to fears about a rapid fall in the value of the dollar, resulting in a withdrawal of funds from the US financial system.

Only through massive intervention by the US Federal Reserve Board and other central banks was a global financial crisis averted. These institutions injected large amounts of liquidity into the global financial system. But, in a pattern that was to be repeated throughout the decade, the very measures they used to combat the crisis created the conditions for even more serious problems to arise. In this case, the injection of liquidity helped further inflate the already growing Japanese financial bubble.

The Japanese bubble had its origins in the Plaza agreement of September 1985, under which the central banks agreed to revalue the world's major currencies against the US dollar. The dollar devaluation and yen revaluation had two immediate consequences. Firstly, Japanese exports became more expensive, leading to a shift of Japanese manufacturing to the East Asian region, where currencies stayed in line with the devalued US dollar. Secondly Japanese assets were revalued, leading to the escalation in Japanese property and land values, and the rise of the Tokyo stock market to unprecedented heights. Eventually, at the end of 1989, the Nikkei index reached over 40,000 (it is around 13,000 today). But the bubble could not continue indefinitely. Its collapse at the beginning of the 1990s was to send Japan into a debt deflation from which it has not recovered.

Indeed, this has been one of the central features of the 1990s: the inability of the world's second largest economy to escape from the vicious circle that was set in motion in the late 1980s. The fall in Japanese land and stock prices led to the increase in bad loans on the books of the Japanese banks and the erosion of their capital base. This, in turn, led to cutbacks in lending and investment and the collapse of financial institutions. The consequent economic downturn has seen further cuts in the value of stocks and property, precipitating a further weakening of the position of the banks and so on.

The first major crisis of the 1990s was the collapse of the European Exchange Rate Mechanism (ERM) in 1992. The British pound—under massive speculation from hedge funds—was withdrawn from the ERM and the Scandinavian banking system faced overnight interest rates of more than 100 percent.

This was followed at the end of 1994 by the collapse of the Mexican peso and the subsequent $50 billion Mexican bailout, organised by the Clinton administration at the beginning of 1995. "Mexican bailout" is something of a misnomer. It could, perhaps more accurately, be described as a bailout of those US financial interests with investments in Mexican bonds.

No sooner had the bailout been carried out than another crisis developed. The Plaza accord of 1985 had been aimed at lowering the value of the US dollar and boosting American exports. In the late 1980s and first half of the 1990s export growth had been responsible for about one third of the total increase in US GDP. But the low US dollar was putting great strains on the international financial system, and creating a crisis in US-Japan economic relations.

By April 1995, the US dollar had plunged to a record low of 79 yen to the dollar. The yen had risen by over 60 per cent against the dollar compared to its level at the start of 1991, and by 30 per cent compared to its level at the start of 1994. But the increase in the yen's value was playing havoc with the export-dependent Japanese economy. With the yen at these levels, Japanese exporters could not even cover their variable costs, let alone return a profit on sales in international markets. The Clinton administration, despite the fact that it had pursued an extremely aggressive policy towards Japan, could not ignore the impact of the rising yen-falling dollar. For the US, the danger was that if the continued fall in the dollar set off a financial crisis in Japan, Japanese funds could rapidly be withdrawn from US financial markets, setting off a rise in interest rates and plunging the US economy into recession. This was at the very moment it had just recovered from the recession of 1990-91 and several years of very low growth.

In April 1995, an agreement was made to drive down the value of the yen and push up the value of the dollar—a kind of reverse Plaza. But this agreement, which averted an immediate dollar-yen financial crisis, was to have longer-term consequences. The dollar's rise was to set in motion a US financial bubble, which continued until April 2000. The increase in the value of the dollar and of US assets resulted in a flow of liquidity into the US from the rest of the world. In 1995 the rest of the world bought US government securities worth $197.2 billion. This was two and a half times the average for the previous four years. In 1996 purchases of $312 billion were made, and in 1997, $189.6 billion. Altogether, a total of more than half a trillion dollars worth in just three years!

There was an immediate impact on the stock market. The S&P 500 index, which had increased by just 2 per cent in 1994, rose by 17.6 per cent in 1995 and a further 23 per cent in 1996. In December of that year, Greenspan made his warning of "irrational exuberance." In 1997, the S&P index rose by a further 30 per cent.

Charting the overall rise of the market, Robert Shiller notes in his book *Irrational Exuberance*: "The Dow Jones Industrial Average ... stood at around 3,600 in early 1994. By 1999, it had passed 11,000, more than tripling in five years, a total increase in stock market prices of over 200 per cent. At the start of 2000, the Dow passed 11,700. However, over the same period, basic economic indicators did not come close to tripling. US

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personal income and gross domestic product rose less than 30 per cent and almost half of this increase was due to inflation. Corporate profits rose less than 60 per cent, and that from a temporary recession-depressed base" [Shiller, *Irrational Exuberance*, p. 4].

There was a direct connection between the growth of indebtedness, the rise of the stock market and the increase in the value of the dollar. Indeed, they formed a kind of virtuous circle, which kept on expanding the US financial bubble. The inflow of capital, attracted by the rising dollar, financed the growth of debt, much of which was, in turn, used to finance purchases of stocks. The increase in stock market prices attracted more capital into the US to take account of the higher rates of return on financial investments—rates of return determined not so much by income streams, but by the increase in the value of assets, the classic form of a financial bubble.

Some figures illustrate the process. By 1999, the corporate debt to equity ratio of S&P 500 companies was 116 per cent, compared to 84 per cent at the end of the 1980s. Borrowing by non-financial corporations in the period 1994-99 was $1.22 trillion. Of this, only 15.3 per cent was used to finance capital expenditures, while no less than 57 per cent or $694.7 billion was used to buy back stocks.

By the first quarter of 2000—the peak of the market—the value of corporate equities, their market capitalization, had risen to $19.6 trillion, up from $6.3 trillion in 1994. But there was no connection with the underlying economy. Market capitalization as a percentage of GDP had needed only five years—between 1995 and 2000—to triple from 50 per cent to 150 per cent. In the same period, after-tax corporate profits rose by 41.2 per cent. By contrast, it had taken 13 years—between 1982 and 1995—for market capitalization to double from 25 to 50 per cent of GDP, while corporate profits rose 160 per cent over the same period.

There were other consequences of the dollar revaluation. With the Plaza agreement of 1985 and the revaluation of the Japanese yen, the so-called East Asian Tigers—South Korea, Thailand, Malaysia, Singapore, Indonesia and, to some extent, the Philippines—had become the focus of Japanese investment. Then, from the early 1990s, US funds began targeting them for investment, looking for new profitable outlets, given the sluggish growth in the US at the time. The so-called "Asian miracle" resulted from the flow of these funds and the establishment of new production facilities by corporations seeking to take advantage of the region's cheaper labour.

This was not simply an Asian question. The region began playing an increasingly important role in the world economy. During the period from 1990 to 1997, the East Asian region accounted for some two-thirds of new global investment and about half of the increase in world GDP. It was increasingly important as a stimulator of the US and European economies.

The following figures demonstrate the significance of the region in terms of investment flows. At the end of 1996, three of the region's countries were among the top recipients of private foreign capital flows. Indonesia received the world's third largest share ($17.9 billion), Malaysia the fourth ($16 billion) and Thailand the sixth ($14.7 billion).

The "miracle" rested on two foundations: the region's ability to compete in export markets and the continued inflow of foreign capital. But these foundations came under pressure with the reverse Plaza agreement of 1995, where the dollar was revalued against the yen. The East Asian economies, whose currencies were tied to the US dollar, suffered an immediate squeeze. Their problems were compounded by the fact that the Chinese currency— the yuan—had been devalued in 1994, and China was becoming an ever-more attractive target for investment funds and offshore production. Removing their link with the dollar, while it might have cheapened exports, was not really an option for the East Asian tigers, because it would have led to a cutback in investment funds. One of the reasons for the region's attractiveness was its currency stability vis-à-vis the dollar.

By 1996, the export growth of the region had begun to fall off and there were growing problems of indebtedness. Then, in 1997, the crisis was sparked by a devaluation of the Thai baht and the collapse of the country's real estate boom.

Between 1994 and 1996 capital inflows to the four most affected countries had more than doubled from around $40 billion to $93 billion. In 1997, however, there was a net *outflow* of $12 billion. This $105 billion turnaround was equivalent to 10 per cent of the GDP of the affected countries.

"The 1997-98 crisis ... meant by the year 2000 a short-term loss of 10-20 per cent of GDP for Thailand, Indonesia, Korea and Malaysia (assuming that the growth of 1996-97 would have continued otherwise). The long-term cumulative loss is bigger. The Asian crisis was deeper and more severe than financial crises usually are. ... It has been estimated ... that the Asian crisis and its global repercussions cut global output by US$2 trillion in 1998-2000. This was perhaps 6 per cent of the global GDP; by far, the worst crisis thus far. It has also been estimated that the Asian crisis made 10 million people officially unemployed. Moreover, some 50 million people in Asia alone fell under the poverty line" [*Democratising Globalisation*, p. 31].

When the Asian crisis broke, Clinton wrote it off as a "glitch". Not long after, however, with the default of Russia in August 1998 and the $3 billion collapse of the US hedge fund Long Term Capital Management (LTCM), the Clinton administration was describing the financial situation as the most serious in the post-war period.

Intervention by the Federal Reserve Board, through the LTCM bailout, prevented a "systemic failure" of the banking and financial system. But not without consequences. Interest rate cuts at the end of 1998 and in the lead-up to 2000 helped inflate the US financial bubble even further, until it reached its peak in April 2000. A year later the US economy had entered a recession.

The most significant feature of the recession is that it is unlike any other in the post-war period. It has not been induced by the Federal Reserve lifting interest rates in response to rising inflation. On the contrary, the general tendency in the recent period has been one of lower prices, if not actual deflation—that is, falling prices.

The root cause of the recession is the fall in investment in the wake of the collapse of the share market boom. This has led to growing fears that, with 11 interest rate cuts in 2001 failing to bring about an upturn, the US economy could be in a situation akin to that of Japan, where monetary policy has no impact because deflationary conditions have developed. These conditions, in turn, are an expression of the over-accumulation of capital.

The extent of this over-accumulation can be seen in the telecommunications industry. The telecom bubble was, in fact, far more significant than the dotcom bubble. An article in the *Financial Times* last September 4 pointed to the extent of the telecom debacle and its impact.

"Failed websites and internet retailers may each have wasted a few tens of millions of dollars before going bust but, according to the European Information Technology Observatory, spending on telecoms equipment and services in Europe and the US amounted to more than $4,000 billion between 1997 and 2001.

"Between 1996 and 2001, banks lent $890 billion in syndicated loans, according to Thomson Financial. Another $415 billion of debt was provided by the bond markets and $500 billion was raised from private equity and stock market issues. Still more came from profitable blue-chips that drive themselves to the brink of bankruptcy or beyond, in the belief that an explosive expansion of internet use would create almost infinite demand for telecoms capacity.

"The global financial system became addicted to fuelling this bonfire. Nearly half of European bank lending in 1999 was to telecoms companies. Moody's, the credit agency, estimates that about 80 percent of all the high-yield, or 'junk', bonds issued in the US at the height of the boom were to

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telecoms operators. Five of the 10 largest mergers or acquisitions in history involved telecoms companies during the boom.

"The enduring legacy of all this money is a glut of 'bandwidth'—the capacity to transmit volumes of data and the basic raw material of all communications networks. This glut is so great that if the world's 6 billion people were to talk solidly on the telephone for the next year, their words could be transmitted over the potential capacity within a few hours."

The article went on to point out that the collapse in the telecom bubble had been felt in numerous ways. Telecoms loan defaults totalled $60 billion; there were redundancies in the thousands at investment banks; more than 300,000 jobs were destroyed in six months at telecoms equipment manufacturers and as many as 200,000 jobs in components suppliers and associated industries.

"The stock market value of all telecoms operators and manufacturers has fallen by $3800 billion since its peak of $6300 billion in March 2000. To put this into context, the combined loss in value on all of Asia's stock exchanges during the Asian financial crisis of the late 1990s was only $813 billion" [Dan Roberts, "Glorious hopes on a trillion-dollar scrapheap," *Financial Times*, September 4, 2001].

This is only the most graphic expression of the general over-accumulation of capital throughout the world economy. Back in February 1999, the British magazine *The Economist* warned that "thanks to enormous over-capacity" the world was "awash with excess capacity in computer chips, steel, cars, textiles, and chemicals." It concluded that the world output gap—between industrial capacity and usage—was close to its highest levels since the 1930s.

These sentiments were reflected in the annual report of the Bank for International Settlements, issued in June 1999: "The overhang of excess capacity in many countries and sectors continues to be a serious threat to financial stability. Without an orderly reduction or take up of excess capacity, rates of return on capital will continue to disappoint, with potentially debilitating and long-lasting effects on confidence and investment spending. Moreover, the solvency of institutions that financed this capital expansion becomes increasingly questionable."

One could go on listing indices of the depth of the recessionary and deflationary tendencies within the global economy. We should also note that considerable doubt is being cast on the claims of expanding profits in the "new economy." The latest figures show that profits, as a share of income, have been falling in every year since 1997. The collapse of Enron was symptomatic of the "new economy" as a whole.

The important point is not just that a recession has emerged, but the nature of the recession. It constitutes, not a transition to a more stable situation within the world economy, but the latest expression of a mounting disequilibrium that has been developing since the beginning of the 1990s.

Let us recall: the decade began with a surge of investment flows into the East Asian region—hailed by the World Bank in 1993 as "miracle economies." The Asian expansion accounted for a considerable proportion of world economic growth and investment. Then, in the second half of the decade, the US financial bubble and investment boom largely supported the world economy. Between 1996 and 2000, it is estimated that the US alone generated just under half of total world incremental demand. But it only did so through the creation of what must rank as one of the biggest financial bubbles in the history of capitalism.

To be continued

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