South Africa and the global economic downturn

Latief Parker 7 March 2008

In South Africa, we swing wildly between believing that everything is doomed or imagining that the financial sun will always shine. Because of our mineral resources, it often seems—for a short period at least—that whatever the financial agonies of the rest of the world, there will always be a silver—or to be more exact—a golden lining for us. In reality, it is easy to trace the political impact of the global economic crises within South Africa.

There is a clear and unambiguous link between the global downturn of the mid-1970s, provoked by the oil price hike of 1973, and the Soweto uprising in 1976. Mineral resources cushion us from the immediate impact of a global economic crisis, but they only delay the pain, they don't stop it. Young businessmen, who see post-apartheid South Africa as a licence to print money, implicitly trust the sages of global finance to protect them from the ravages of capitalism in crisis. If they knew their history, they would be substantially less trusting.

The 9th of August 2007 should always be remembered as "Debtonation Day"—to utilise the composite word forged by Ann Pettifor. On that particular day, an economic tidal wave created by the intensifying problems within the US sub-prime mortgage market swept across the Atlantic and the Pacific, flooding banks in France, the Netherlands, Switzerland, Germany and Australia with the realisation that the international credit system and globalised finance had finally imploded.

The terrified investment banks immediately ceased lending to each other, transforming the apparently unlimited financial liquidity of the previous five years into a crisis of illiquidity. This "strike of the banks" spread anxieties from the credit markets into the stock markets and produced a financial meltdown. Interventions by global leaders, including President George W. Bush, could not calm the markets. On 10 August, and again on 13 August, in an unprecedented development, the European Central Bank (ECB), swiftly followed by the Federal Reserve of the United States (the Fed), the Bank of Japan (BoJ) and other central banks injected more than half a trillion US dollars into the banking system. The central banks had decided that they had no choice but to act as the "lender of last resort" to the crippled banking system.

A financially cautious "lender of last resort" would usually require the following conditions: establishing that it was indeed a crisis of illiquidity rather than a crisis of insolvency; the imposition of penalty rates; the existence of good collateral; conditionality and limits to the amount of loan support. As commentators immediately observed, none of these criteria were employed by the central banks. The *Wall Street Journal* described the situation as a "moral hazard" because reckless investors could now expect to be bailed out by the central banks' injection of liquidity.

The reality was that the global financial system faced an insolvency problem, not a crisis of illiquidity. The banks had refused to lend for fear that US households, mortgage lenders, home builders, hedge funds and non-financial corporations would prove insolvent. As the *Financial Times* noted, the injection of liquidity was not accompanied by penalty rates and limits. The loans supplied by the central banks were not based upon solid collateral, but mortgage-backed securities that were the very core of the problem. Finally, there was no conditionality: banks that needed money could have access to it at a fixed rate.

Why had this violation of all the tried and trusted criteria of finance occurred? The answer is that the ECB, the Fed and the BoJ, the pillars of the world's financial system, had been confronted with something much more frightening than a "local difficulty" in the US; they had recognised that the global economy was facing a systemic threat. The intervention to stabilise the global economy had been on the principle of "by any means necessary." This was confirmed within a few days by the Fed's slashing of interest rates, a step that had initially been rejected. The turmoil has persisted in the global economy, taking different forms in different countries, throughout the last seven months.

There had been numerous signs of the impending crisis during the months before August 2007. In June, Bear Stearns, one of the biggest US banks, had shut down two imploding hedge funds that had become over-exposed to mortgage market-related non-performing loans. *The Nation* reported that Goldman Sachs had had "to rustle up \$3 billion to keep one of its hedge funds from collapse. Kohlberg Kravis Roberts ... the notorious takeover firm that has cannibalized so many corporations, experienced similar embarrassment."

The crisis had originated with the US sub-prime mortgage "bubble" which had burst in February 2007. But how had this "bubble" been formed?

During the previous four years (2002-2006), US interest rates were extremely low. This encouraged the housing market and the construction industry and eventually led to escalating house prices. Quite rapidly, it became apparent that purchasers could secure a cheap loan, buy property and see the investment immediately increase in value. The annual growth in the value of property could either support the payment of the loan or generate swift profit if the purchaser sold the building.

This was capitalist heaven: "win-win." But the market needed to expand beyond the usual purchasers of property. Rapidly, a market in mortgages for people who had previously been unable to secure conventional loans emerged. These "sub-prime" mortgages were nicknamed "liar" loans or "Ninja" (no income, no job, no assets)

loans. Robert Wade, professor of political economy at the London School of Economics, recalled in an article posted on *Open Democracy* that "the mortgagees were told that continuously rising house prices would allow them to 'extract equity' from the rising value of the house and in this way meet the higher payments when the repayment terms toughened in a year or two." If the sub-prime purchaser couldn't meet the higher payments, the houses were repossessed and sold in another lucrative "Ninja" operation.

This form of deceptive capitalism was complemented by techniques of "structured finance" developed by the hedge funds, private equity companies and investment banks "securitizing" the "Ninja" loans. Wade continues: "Combinations of highly risky mortgages would be packaged and sold—and given AAA ratings by the rating agencies on the pretext that the risk was widely dispersed ... this mechanism constituted a turbo-charger on the US house market. House prices escalated, the bubble intensified."

Securitization: the multiplication of securities to disperse the risk became the generator of all kinds of exotic derivative instruments. Collatorized Debt Obligations (CDOs) could give rise to CDOs of CDOs (or squared CDOs) and then to CDOs of CDOs of CDOs (or cubed CDOs) ad infinitum, or rather into a "bad infinity" as old Hegel could have said.

Nouriel Roubani portrayed the expanding bubble as follows: "[A] wealthy individual can take \$1 million and go to a prime broker and leverage this amount three times: then the resulting \$4 million (\$1 million equity, and \$3 million debt) can be invested in a fund of funds that will in turn leverage these \$4 millions three or four times and invest them in a hedge fund; then the hedge fund will take these funds and leverage them three or four times and buy some very junior tranche of a CDO that is itself levered nine or ten times. At the end of this credit chain, the initial \$1 million of equity becomes a \$100 million investment ... Then, only a small 1% fall in the price of the final investment (CDO) wipes out the initial capital and creates a chain of margin calls that unravel this debt house of cards."

Who is responsible for the credit bubble, the credit squeeze and the international slowdown that is currently occurring? Wolfgang Munchau informed the readers of the *Financial Times* that "the explosive growth in credit derivatives and the collateralized debt obligations between 2004 and 2006 was caused by global monetary policy between 2002 and 2004. In parts of 2002-04, both the US and Europe experienced negative real interest rates—nominal rates adjusted for expectations of future inflation. From 2003 until 2004, the Fed funds rate stood at 1 percent. In Europe, short-term nominal interest rates reached a low of 2 per cent between 2003 and 2005."

The low interest rates were a reaction to the previous systemic crisis which had started in 1997 with the crash in the Asian-Pacific region. It expanded worldwide in 1998 with the default in Russia, the collapse of the Long Term Capital Management hedge fund and the crises in Brazil and Turkey. It then spread into the US with the bursting of the "dot-com" bubble and the Enron debacle, climaxing in 2001 with the bankruptcy of the "jewel in the crown" of international neoliberalism, Argentina. In this context, credit expansion was not a choice but a financial necessity in order to contain a global crisis.

The relative upturn in the global economy between 2002 and 2006 was based on the credit-sponsored US consumers' boom, the huge US deficit and the trade surpluses in Asia, particularly China, which is now the industrial workshop of the world. During the last few years, the Chinese have propped up the US economy by purchasing US Treasury bonds and pegging the yuan to the shrinking dollar. The

never-ending flow of cheap commodities and manufactures helped counteract the inflationary pressures in America.

We can now see that the methods used to temper the crisis of 1997-2001 provided only temporary relief. The global economy has now accumulated fresh problems and the systemic contradictions have intensified. It is not a coincidence that the emergence of the US subprime crisis between February and May last year was book-ended by stock market plunges in Shanghai. And it is no good looking to China for salvation. As Stratfor's Global Market Brief explained: "In China, growth rates regularly top 10 percent annually. But this growth is not healthy, as it is predicated on throughput and exports, not profit and local demand." Put simply, since China's growth is export-led, it cannot trigger a resurgence elsewhere. China is not the solution; it is an inseparable part of the global crisis.

There is a significant difference between the crisis of 1997-2001 and the financial upheaval now—the United States of America is no longer the world's financial sheriff, it is now the central villain.

The exposure of the sub-prime delusion in the US "triggered a sequence in which ... banking and financial operators became aware that the foundation of the debt problem was quicksand."

But sub-prime mortgages and an over-inflated US housing market were only the most prominent tips of the iceberg that is sustained by US debt. Loren Goldner's inventory of total US debt demonstrates the scale of the problem and the speed with which Americans are wasting their treasure: "As of the end of 2005, there was \$33 trillion in outstanding debt (Federal, state, local, corporate, personal) in the US economy, three times GDP. (No one knows how much is tied up in the international hedge funds and derivatives, and the estimated \$7-8 trillion in Federal debt does not include trillions more in commitments for Social Security and Medicare.) The state (including Federal, state and local levels) consumes 40% of GDP. The net US debt abroad is between \$3 and \$4 trillion (at least \$11 trillion held by foreigners minus \$8 trillion in US assets abroad) i.e. it is comparable (at 30 percent of GDP) to the situation of crisis-ridden Third World countries. That amount is growing by \$800 billion a year at current rates. Ominously, in late 2005, foreign income from investment in the US exceeded US income from overseas investment (the one remaining strong pillar of the US international position) for the first time."

Globalized finance is incapable of eliminating the systemic contradictions in the global economy; in fact, it globalizes and intensifies the crisis.



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