Shades of 1929: the global implications of the US banking collapse

Part 1

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16 April 2008

The following is the first part of a report delivered by Nick Beams, national secretary of the Socialist Equality Party (SEP) in Australia and a member of the World Socialist Web Site *international editorial board, to public meetings in Sydney and Melbourne on April 9 and 15.* Part 2 *and* Part 3 *of the report will be published on April 17 and 18 respectively. Beams, an international authority on Marxist political economy, is the author of regular WSWS articles and analyses on globalisation and political economy.*

The SEP and the International Students for Social Equality called the public meetings to discuss the global significance of the deepening crisis wracking the US financial and banking system. Both meetings were well-attended, with the audiences including workers and university students, a number of whom were international students. Following Beams's report, there were animated discussions covering a wide range of issues about the causes and implications of the financial meltdown.

Audience members asked why mainstream economists had been unable to predict or explain the crisis, why the banks and finance houses had resorted to increasingly risky marginal lending, and what the financial failure meant for the world position of the US. Others raised the catastrophic impact of the economic breakdown on the jobs, homes, living standards and retirement funds of ordinary people. Questions also centred on the viability of a socialist perspective and how working people would take up the struggle for a socialist program.

March 14, 2008—the day it became public knowledge that Bear Stearns, the fifth largest investment bank in the US and one of the largest financial institutions in the world, had gone bankrupt—has already taken its place as one of the defining dates in the history of global capitalism.

On that day, the world changed in a fundamental way. The nostrums delivered day in day out by the various financial commentators, political leaders, academic economists and media pundits about the wonders and virtues of the "free market"—that it represented the highest, indeed the only possible form of social and economic organisation—were proven to be completely worthless.

Suddenly, not only was a crash on the scale of the Great Depression increasingly possible, it was on the verge of taking place.

Comments at the time and subsequent testimony by some of the major players involved in the Bear Stearns rescue operation make this clear.

For three days the US Federal Reserve Board, along with the US Treasury Department, worked round-the-clock to put together a rescue package. Time was of the essence, the fear being that if a package were not put in place by the time Asian markets opened for trading on Monday March 17, the world financial system would have gone into a meltdown that would have taken Wall Street with it when trading resumed there.

The key component of the rescue plan, which eventually saw Bear Stearns taken over by JP Morgan, was a guarantee that the Fed would assume responsibility for $30 billion worth of debts held by the failed bank—a decision without precedent in the annals of the US central bank.

As Wall Street economist Ed Yardeni commented in a note to his clients: "The Government of Last Resort is working with the Lender of Last Resort to shore up housing and credit markets to avoid Great Depression II."

In his testimony to the US Congress, Fed chairman Ben Bernanke used more restrained language, but the message was essentially the same.

"On March 13," he told the Congress, "Bear Stearns advised the Federal Reserve and other government agencies that its liquidity position had significantly deteriorated and that it would have to file for Chapter 11 bankruptcy the next day unless alternative sources of funds became available.

"This news raised difficult questions of public policy. Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability."

In other words, there was the real possibility of a global collapse.

The extent of the interconnections between Bear Stearns and the global financial system, and the impact its collapse could have had, is indicated by reports that the bank held trading contracts with an outstanding value of $2.5 trillion with firms around the world. That is, contracts whose value was equivalent to around one sixth of the gross domestic product (GDP) of the United States and one twentieth of total global GDP were at risk. As one participant in the rescue discussions put it: "It was much worse than anyone realized; the markets were on the precipice of a real crisis" ("Leveraged Planet", Andrew Ross Sorkin, *New York Times* April 2, 2008).

In the month since the crisis erupted, some stabilisation has taken place in financial markets as a result of the Fed's bailout and continuing interest rate cuts. But no one believes that the crisis is over. Rather, the question hanging over the financial markets is: when will the other shoes drop? And the consequences of the credit crisis are yet to be fully felt.

In its *Global Financial Stability Report* issued on April 9, the International Monetary Fund estimated that total losses in the US would be almost $1 trillion, a sum equivalent to about 7 percent of GDP.

The report warned that “macro economic feedback effects” were of growing concern as financial uncertainty was likely to “weigh heavily on household borrowing, business investment, and asset prices, in turn feeding back onto employment, output growth and balance sheets.”

These recessionary trends are already apparent. A report on April 4 revealed that the US economy shed 80,000 jobs in March, the third straight month that job numbers have been down, something that has not happened for five years. The unemployment rate went from 4.8 percent to 5.1 percent as job cuts were reported across a range of industries. In the crucial construction sector, some 51,000 building workers lost their jobs, bringing the total for the past 12 months to 350,000. Manufacturing industries have been losing jobs for the past 21 months.

The Economic Policy Institute pointed out that for “the fifth month in a row, fewer than half of industries have added jobs, demonstrating the pervasive nature of job loss.” It also noted that this was the first time on record that median family income had not recovered the ground lost in the last recession.

Growing perplexity

Among the more perceptive writers in the financial press there is recognition of some of the longer-term historical implications of this crisis. The chief economics writer for the *Financial Times*, Martin Wolf, began his remarks to a recent meeting as follows:

“For three decades now we have been promoting the joys of a liberalised financial system and what has it brought us? ‘One massive financial crisis after the other’ is the answer. This is not to say that liberalised finance brings no benefits. It has certainly made a substantial number of people extraordinarily rich.”

He noted that since the late 1970s there had been no fewer than 117 systemic banking crises in 93 countries, half the world, and in 27 of these the fiscal cost of the bailout was 10 per cent of GDP and sometimes more. But the crisis of 2007-2008, he continued, was “far and away the most significant of all the crises of the last three decades.”

“What makes this crisis so significant? It tests the most evolved financial system we have. It emanates from the core of the world’s most advanced financial system and from transactions entered into by the most sophisticated financial institutions, which use the cleverest tools of securitisation and rely on the most sophisticated risk management. Even so, the financial system blew up: both the commercial paper and inter-bank markets froze for months; the securitised paper turned out to be radioactive and the ratings proffered by ratings agencies to be fantasy; central banks had to pump in vast quantities of liquidity; and the panic-stricken Federal Reserve was forced to make unprecedented cuts in interest rates.”

What will be the eventual consequences? According to Nouriel Roubini of New York University’s Stern School of Business the hit to the financial system may be as much as $3 trillion, equivalent to around 20 percent of GDP.

Wolf summed up the perplexity gripping those supposedly in charge of the financial system.

“I no longer know what I used to think I knew. But I also do not know what I think now.”

Emphasising the need to learn from history, he continued: “A fundamental lesson concerns the way the financial system works. Outsiders were aware it had become a gigantic black box. But they were prepared to assume that those inside it at least knew what was going on. This can hardly be true now” (Martin Wolf, *Financial Globalisation, Growth and Asset Prices*, paper prepared for Colloque International de la Banque de France on Globalisation, Inflation and Monetary Policy, Paris, March 7, 2008).

This is a rather startling admission, not from an opponent of the capitalist order and the free market, but from one of its foremost international public defenders.

The same picture emerges from a report issued in early March, just before the Bear Stearns crisis broke, by The President’s Working Group on Financial Markets, a body comprising representatives from the Department of the Treasury, Board of Governors of the Federal Reserve System, Securities and Exchange Commission and the Commodities Futures Trading Commission.

According to this report the reasons for the turmoil in financial markets were:

“A breakdown in underwriting standards for subprime mortgages;

“A significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures;

“Flaws in credit rating agencies’ assessments of subprime residential mortgage-backed securities (RMBS) and other complex structured credit products, especially collateralized debt obligations (CDOs) that held RMBS and other asset-backed securities (CDOs of ABS);

“Risk management weaknesses at some large US and European financial institutions; and

“Regulatory policies, including capital and disclosure requirements, that failed to mitigate risk management weaknesses.”

In short everyone was involved ... from those who issued the mortgages in the first place, to those institutions that then sliced and diced them, to the credit rating agencies who gave top ratings to the resulting packages, to US and European financial institutions that did not adequately assess risk, right through to those who were in charge of regulatory polices.

There was a considerable element of what can only be described as criminality—deriving not from the particular characteristics of the individuals involved, but from the nature of the capitalist system itself.

When the market was on the rise, when there was money to be made from subprime mortgages, based on so-called liar loans with teaser rates to pull in the unwary; if money could be made by packaging these loans and then selling them off; if it could be made by giving these dubious packages a top credit rating, then who wants to know about issues concerning the long-term unviability of the whole process. There were no profits to be made there and, as one financial executive recently put it, so long as the music’s still playing you have to keep on dancing.

The British economist John Maynard Keynes, who knew a thing or two about speculation, once wrote: “A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him.” And when a crisis does erupt, he can always call for a government rescue package.

I draw attention to these issues because of their political significance. One of the most powerful ideological forces generated by capitalist society is the conception that working people could not possibly undertake the organization and control of society, and, above all, of its economy, because they do not have the necessary knowledge. Socialism is therefore out of the question and society’s economic organization must be left to the market and to those who supervise its operations.

In the first half of the twentieth century, millions of people all over the world entered the struggle for socialism based on their understanding, born of the experiences of war, fascism, depression and mass unemployment, that the operations of the free market and the capitalist system led to barbarism.

Over the past 60 years one of the most essential ideological props of the capitalist order has been the conception, assiduously promoted in the schools, universities, mass media and from the political platform, that such conditions could not possibly return. Those in charge—wherever they are located—have learned the lessons of past disasters and know how to prevent their recurrence.

After all, we are told repeatedly, Ben Bernanke, the chairman of the US Federal Reserve Board, made his name in the academic world through a study of the causes of the 1930s Depression and is determined not to let it happen again. So, despite some problems, all is really for the best in the best of all possible worlds.

If the events of the past weeks have done nothing else they have surely shattered that myth. As official reports openly acknowledge, all the control mechanisms that were supposed to prevent a financial crisis failed. And what is more, those in charge cannot even say why.

Bear Stearns operated under the regulation of the US Securities and Exchange Commission. But as its chairman, Christopher Cox, wrote in the wake of the bank's collapse: "At all times the firm had a capital cushion well above what is required to meet supervisory standards." Bear Stearns, according to Cox, was, under the SEC's rules "well capitalized." In other words, as the surgeon put it, the operation was a success, but unfortunately the patient died on the table.

While the representatives of the capitalist economy voice their bewilderment over what has taken place, the events of the past weeks serve as the most powerful confirmation of Marx's analysis of the capitalist mode of production, revealing that its motion is governed by objective laws that assert themselves in the same way that the law of gravity does when a house falls about our ears.

And as the collapse of the house is the outcome of processes stretching back over a long period, so the breakdown of the financial system, and the political issues arising from it, can only be understood through an historical analysis of the global capitalist economy.

To be continued