

A lecture by Nick Beams

The World Economic Crisis: A Marxist Analysis—Part 4

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The following is Part 4 of a lecture *delivered 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, to audiences in Perth, Melbourne and Sydney in November and December, 2008. Part 1, Part 2 and Part 3 were published on December 19, 20 and 22, respectively. The final part will be published tomorrow, December 24.*

The collapse of the Bretton Woods Agreement in 1971 marked the end of the dollar's role as a stable anchor of the world monetary system. More than that, it signified that no national currency could take on that role.

Many here will never have experienced fixed exchange rates. But when I was a boy, my grandfather would send me one British pound every year for Christmas, and I could exchange that pound, each year, for exactly 25 Australian shillings. The rate never changed. The same was true of every currency. But in 1971 this certainty came to an end.

In the early 1970s, in the absence of a firm foundation for the international monetary system, new mechanisms were developed to cover the risks arising from the new currency movements. Consider an Australian importer of a piece of machinery. A deal that would have seemed very good, and potentially highly profitable, when the machine was ordered from, say, the United States, could result in a major loss if the Australian dollar had lost ground against the US dollar by the time full payment became due, on delivery, six months later.

It is from this period that we can trace the rise of financial derivatives.

A derivative is defined as a financial contract or financial instrument, the value of which is derived from the value of something else.

Derivatives have existed for a long time. The most well known are futures contracts, in which a contract is made to deliver a certain quantity of a commodity at a certain price at a certain time. These contracts were developed in the markets for agricultural products to try to eliminate the effect of movements in price between the time when a crop was sown and when it was brought to market. If the price at which the crops were to be sold could be fixed in a futures contract, then some degree of certainty could be brought into the production process.

Financial derivatives mark a new development. No longer do contracts relate to physical commodities, but to money and other financial assets. In 1972, the year after the demise of the Bretton Woods Agreement, a market in currency futures was launched on the Chicago Mercantile Exchange. This market enabled importers and exporters, as well as financial institutions, to hedge against currency fluctuations, under conditions where currency movements could effectively wipe out profits from business deals overnight.

The currency futures contract was only one of many new financial derivatives that were to develop in the next period.

In 1973 a major development occurred when two academics, Fischer Black and Myron Scholes, developed a formula for pricing options. While

a futures contract locks in participants to buying or selling, an option is a kind of insurance. In return for the payment of a premium, it gives the buyer the right to buy or sell an asset at a certain price within a specified period. If prices do not move in the way that was anticipated, then the option has no value and the buyer loses only the premium. In 1973 the Chicago Options Exchange was established for trading, and in 1975 the Chicago Board of Trade introduced the first interest rates futures contract.

Options provided the means for making big profits, as we can see from the following numerical example. A purchaser buys an option to buy a share for \$50 in six months time. The cost of the option is \$5. The outlay for an option on 100 shares will therefore be \$500. Suppose that after six months the price of the share has risen to \$60. The purchaser then exercises the option and makes a profit of \$5 on each share: \$60 minus \$50 minus the \$5 per option. This brings a total profit of \$500 on an outlay of \$500, that is, a profit rate of 100 percent.

Consider what would have happened if the purchaser instead simply bought 100 shares for \$50 each and held them for six months. The profit in that case would be \$1,000 (the \$10 increase in the share price multiplied by 100) on an outlay of \$5,000, that is, at a rate of 20 percent. The use of the option has yielded a much higher rate of profit.

By the same token, if the shares had fallen to say \$49, rather than risen to \$60, then the option purchaser would have lost \$500, a capital loss of 100 percent, whereas the share purchaser who held the shares for six months would have only lost \$100 or 2 percent of his or her original investment of \$5,000. Options offer greater rewards and also greater risks.

With increased trading in options after 1973, other types of derivatives were developed, including the currency swap, in which buyers could swap bonds issued in one currency with bonds in another, depending on their assessment of currency movements. Then came the interest rate swap, in which fixed interest rate payments could be swapped with variable rate payments and vice versa. In the last decade, the credit default swap has emerged, in which the holder can insure against the issuer of a bond defaulting on payment. These contracts can be made through an exchange, or, as has increasingly been the case, in arrangements between two parties in so-called over the counter (OTC) agreements.

While their origins lie in the attempt to protect against risk, derivatives become a source of speculation, in which vast profits can be made from correctly judging the movements of financial variables. Myriad statistics indicate the explosive growth of these financial instruments over the past three decades.

Foreign exchange transactions in the world economy increased from \$15 billion per day in 1973 to \$80 billion per day in 1980 and \$1.26 trillion by 1995. In 1973 world trade in goods and services constituted 15 percent of these transactions. In 1995 it constituted just 2 percent. This explosion in foreign currency dealings has been mainly the result of financial, not

trade, transactions.

The growth of derivatives has been even more spectacular. According to the Bank for International Settlements, the notional amount—the value of the underlying asset on which the derivative is based—for OTC contracts was \$683.7 trillion at the end of June 2008. This is an amount equivalent to more than ten times world output. Thirty-five years ago, in 1973, financial derivatives were virtually non-existent.

The daily turnover of global currency markets has increased 50-fold since 1980, and now stands at about \$1.9 trillion per day. Of this, two thirds is transacted in derivatives markets and three quarters of this derivative trade, that is, half the overall market, is foreign exchange swaps.

The financialisation of the American economy

As we have seen, one impetus for the rise of derivatives came from the uncertainty generated by the collapse of the Bretton Woods system and the increased risk posed by currency fluctuations.

There is another, even more powerful force at work. This arose from changes in the mode of accumulation over the past three decades, above all in the United States.

When Nixon removed the gold backing from the US dollar in 1971 his intention was to maintain the financial dominance of American capitalism. But by the end of the 1970s, that was far from assured. The value of the dollar fell sharply, profits were declining, the stock market was down and the US economy was in the grip of stagflation.

In October 1979 Paul Volcker—who has recently been selected by President-elect Obama to be one of his key economic advisers—was appointed to the position of chairman of the US Federal Reserve Board. Volcker embarked on a program of interest rate hikes under the banner of anti-inflation.

The "Volcker shock," as it became known, sent interest rates to record highs and led to the deepest recession since the 1930s. It was accompanied by an offensive against the working class, starting with the Chrysler bailout in 1979 and the smashing of the air traffic controllers strike in 1981 and continuing right through the 1980s. Millions of jobs were destroyed and whole sections of industry wiped out.

The result was a transformation in the structure of American capitalism. From the end of the Civil War in 1865, American capitalism's rise to power had been based on its industrial prowess. American methods of production had proven to be the most efficient and the most profitable in the world.

That was no longer the case. Thus the essence of the Volcker measures was to put in place a new regime of accumulation based on the expansion of finance capital.

The road to this new mode of accumulation was by no means smooth. The recession of 1981-82 was followed by a slow recovery, and while the stock market started to rise from 1982 onwards, it crashed in October 1987. The decade finished with a crisis of the savings and loans banks, requiring a bailout of between \$150 and \$200 billion, and the onset of another recession.

The liquidation of the Soviet Union in 1991-92 and the decision by the Chinese Stalinist regime to open the way for the integration of the Chinese economy, and above all the multi-millioned Chinese working class, into the circuit of global capital, marked a major turning point. It was these events that made possible a mode of accumulation based on finance capital.

The opening up of China, with labour costs one thirtieth of those in the US and other major capitalist countries, provided the basis for an

expansion in the mass of surplus value extracted by capital from the working class. In a recent speech hailing the virtues of globalisation, European Commissioner Peter Mandelson noted that a Chinese manufacturing firm producing an iPod receives only \$4 for a device that retails for \$290 in the US.

Mandelson was pointing to a process in which surplus value extracted in China is then distributed to other sections of capital in the form of license fees, rents on shopping centres, and interest to banks and financial institutions.

This relationship with China formed a kind of virtuous economic circle. Cheap manufactured goods kept down the rate of inflation, allowing the Fed to lower interest rates in the US without worrying about inflation.

Cheaper credit fueled various asset bubbles—the share market bubble, the dot.com bubble and the housing bubble—that financed the debt, while helping to sustain US consumption levels in the absence of real wage increases. At the same time, Chinese authorities invested their trade surpluses in US financial assets, in order to keep down the value of the yuan against the dollar and ensure the maintenance of export markets. This also helped keep US interest rates low and sustain the supply of cheap credit, which, in turn, sustained the asset bubbles.

In 1982 the profits of finance companies amounted to 5 percent of total corporate profits after tax. By 2007 their share had risen to 41 percent. This transformation—the financialisation of the American economy—has had vast implications for the process of capital accumulation and the growth of debt in the US economy.

In previous periods, debt was incurred by industry in order to finance its expansion. But with the growing importance of the finance sector, debt has been increasingly incurred to finance further financial activity.

The buying and selling of securities based on assets became the new road to wealth accumulation. In 1995 the dollar value of asset-backed securities stood at \$108 billion. By the year 2000, at the height of the share market bubble, it was \$1.07 trillion. It reached \$1.1 trillion in 2005 and \$1.23 trillion in 2006. In other words, in the space of a decade, the value of these securities had increased ten-fold.

In other words, the financialisation of the economy, that is, the appropriation of surplus value rather than its extraction in the production process, became the other key factor in the explosive growth of derivatives.

In their valuable study *Capitalism and Derivatives*, the authors, Dick Bryan and Michael Rafferty from the University of Sydney, point to two essential functions performed by derivatives.

First, there is what they call a "binding" function, in which a derivative links assets in the present to assets in the future. The rise of these derivatives was bound up with the increased uncertainty and risk generated by the demise of the fixed currency regime. Under Bretton Woods, the national state kept its currency fixed, providing stability for capital involved in international financial transactions. When that was no longer the case, new mechanisms had to be developed to provide certainty and overcome risks.

Derivatives also have what these authors call a "blending" function. That is, they make possible the commensuration of different types of financial assets. For example, a contract may involve the swapping of shares for a company bond, or vice versa. This may or may not be exercised, depending on the relative movement of interest rates in the bond market and of the dividend paid in shares. Shares and debt both represent claims on future earnings, but interest and dividends may move in different directions and, depending on that movement, the holder of one or other asset may be disadvantaged. That risk can be countered by using derivatives.

The blending function of derivatives enables the holder of a financial asset to hedge against adverse movements in one or another financial variable, or to take advantage of such movements. The risk to finance

capital is that once money is invested in a particular form of financial asset, any adverse movement in financial markets can see this asset receive a lesser rate of return than other financial assets, or even suffer a loss.

The use of derivatives has the effect of giving one asset the characteristics of another. In other words, finance capital is not tied to any particular form, but can develop a more universal character. And this becomes vitally important in conditions where the appropriation of profit—the basis for the accumulation of capital—is increasingly dependent on financial market operations.

Our examination of the rise of derivatives should dispel the notion that they were somehow developed purely as a vehicle for speculation, and that if only they were done away with, or somehow curbed, then economic and financial stability could be restored.

Of course, like every other financial asset, derivatives have certainly become a vehicle for speculation, with disastrous consequences. But simply to focus on this is to ignore the fact that they arose as a means to try to overcome objective contradictions in the capitalist economy, caused by the breakdown of the previous system of regulation—to which the would-be reformers of the capitalist system would now like to return.

The history of derivatives recalls comments made by Marx on the growth of credit, which likewise arose as an attempt to overcome objective contradictions within the capitalist economy, but whose development served to impart to these contradictions an even more explosive form.

"In its first stages," Marx wrote, "this system [credit] furtively creeps in as the humble assistant of accumulation ... but it soon becomes a new and terrible weapon in the battle of competition and is finally transformed into an enormous social mechanism for the centralisation of capitals" [Marx, *Capital* Volume I pp. 777-778].

If we were to adapt Marx's comments to the present day, we could say that derivatives first entered the scene as the humble servant of finance capital, offering to protect it against risk, but ended up creating the risk of the greatest financial disaster in history.

A turning point in the curve of capitalist development

There is another process we must examine to round out our review of financialisation. That is the phenomenon of securitisation, which has played such a crucial role in the mortgage crisis.

In the days of national regulation, US banks operated according to the so-called "3-6-3 model". Money borrowed at 3 percent was lent out at 6 percent, whereupon the bank manager could go to the golf course at 3 o'clock.

This model broke down under the impact of the rapid interest rate hikes at the beginning of the 1980s and the financialisation of the economy that followed. Banks now had to compete with other financial institutions for funds. But that was not possible on the basis of the old model, where loans were originated and then held by the bank, which then recouped the interest payments. The originate-and-hold model meant that large amounts of capital were tied up for long periods of time. Banks and other financial institutions could increase their profits and remain competitive only to the extent that they could turn over their capital at a faster rate.

The way forward lay in transforming the financial assets they held into bonds, and selling them off. This, though, presented another problem because, unlike the bonds issued by a company such as IBM or General Motors, the underlying asset, in this case mortgages, are not uniform. How then could the bank convert a pool of differentiated mortgages into a security that could be traded like a bond, so that investors would only

have to examine the interest rate and the maturity date, without being concerned with the security of the underlying asset?

The solution was to create a pool of mortgages and then issue a series of bonds on which interest was paid out of the money coming in from mortgage repayments. The pool was divided up in a series of tranches, with interest rates paid according to the level of risk of each tranche, the least secure paying the highest rates. Credit rating agencies supplied the risk assessment. These agencies developed various models of risk, on which they based the ratings. In many cases the investment banks issuing the bonds worked closely with the agencies to ensure that the bonds were structured in such a way as to receive the best rating. And investment banks like Lehman Brothers could, and did, sell these bonds around the world to German banks, British banks, or to Australian local councils seeking to boost their funds.

The process of securitisation replaced the "originate-and-hold" model with "originate-and-distribute". The originators had no need to undertake a risk assessment, because as soon as the mortgage was finalised it would be sold off as part of a securitised package. The bank would receive income in fees from the sale, enabling it to finance new mortgages and repeat the process. Capital could be turned over many times faster than before, with a resultant rise in profits.

Mortgages were increasingly financed without regard to capacity to pay, because the general assumption was that house prices would continue to rise—not since the 1930s had there been a uniform fall in home prices across the United States—so that mortgages could always be refinanced or, failing that, the house could be sold for a profit.

We have now examined the various components of this crisis. What then are its historical implications? The first point is that it is not merely a product of massive losses. That would be one thing. But here we have the collapse of a whole regime of accumulation, a regime that developed in response to the last crisis of accumulation in the 1970s.

The banks and financial institutions can no longer continue on the basis of the originate-and-distribute model. Nor can they return to the previous model.

We have arrived at a turning point in what Leon Trotsky called the "curve of capitalist development". Following the crisis of the 1970s and the downswing of the 1980s, a new upswing began in the 1990s, based on the integration of ultra-cheap labour into the global circuits of capital. This facilitated a new mode of accumulation—highly unstable as the financial crises of the past 20 years reveal—but an upswing, nonetheless. It has now come to a shattering end.

To be continued



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