The Economic Collapse

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IN THE FALL of 2008, a little more than a year after the Bank for International Settlements (a Switzerland-based organization that fosters cooperation between central banks) warned that "years of loose monetary policy have fuelled a giant credit bubble, leaving us vulnerable to another 1930s slump," the combustive concoction of free market fundamentalism, corporate-dominated globalization, stagnant wages, growing inequality, greed, excessive leverage, and financial innovations such as securitization finally exploded.

Financial market conditions in the OECD countries sunk to their lowest levels in more than half a century, and the U.S. government made its most dramatic interventions in financial markets since the 1930s. The Federal Reserve and the Treasury nationalized the country's two mortgage giants, Fannie Mae and Freddie Mac; bailed out AIG, the world's largest insurance company; and, in effect, extended government deposit insurance to $3.4 trillion in money market funds.

Then, in the largest government rescue operation in history, Treasury Secretary Henry Paulson announced a plan to buy up to $700 billion of toxic securities from troubled banks. Incredibly, Paulson's original plan, only three typed pages, would have given Wall Street almost unrestrained access to public revenues at little cost. The Treasury plan was rejected by the House of Representatives and subsequently modified by the Senate. The version approved by Congress promises to make a larger share of any subsequent profits into public revenues.

The landscape of American finance has radically changed. The independent investment bank, a Wall Street animal that relied on high leverage, is now extinct. Lehman Brothers has gone bust, Bear Stearns and Merrill Lynch have been swallowed by commercial banks, and Goldman Sachs and Morgan Stanley have become commercial banks themselves. The "shadow banking system"—the securities dealers, hedge funds, and other non-bank financial institutions that defined deregulated American finance—is unraveling as I write.

The credit shock is reverberating across the world. In Europe, economies are unraveling after ten years of growth financed by borrowing. For much of the past year the emerging world watched the Western financial hurricane from afar. Their own banks held few of the mortgage-based assets that undid the rich world's financial firms. Commodity exporters were thriving, thanks to high prices for raw materials. Even as talk mounted of the rich world suffering its worst financial collapse since the Great Depression, emerging economies seemed a long way from the center of the storm.

No longer. As foreign capital has fled and confidence evaporated, the emerging world's stock markets have plummeted (in some cases losing half their value) and its currencies have tumbled. The seizing up of the credit market caused havoc, as foreign banks abruptly stopped lending and stepped back from the most basic banking services. Even China's economic juggernaut started to slow.

This is no ordinary business cycle downturn. It is a crisis of a failed thirty-year economic and social model. It started in the late 1970s, when a resurgent business community won support for the argument that inflation and low growth were the result of too much public spending, too much taxation, too much union power. Instead, we would rely on what Ronald Reagan once called "the magic of the market." In Newt Gingrich's Contract With America, that "magic" gave free license to the anti-tax, anti-government, pro-deregulation instincts of an increasingly fervent Republican Party. President Bill Clinton, triangulating the Gingrich revolution, declared that "the era of big government is over" and abolished the Glass-Steagall Act, which provided for regulatory firewalls between commercial banks, insurance companies, securities firms, and investment banks (see Timothy Canova's "Legacy of the Clinton Bubble," *Dissent*, Summer 2008). The Bush presidency sealed the market fundamentalist victory.

In this climate, banks, and especially the unregulated shadow banking system, developed fiendishly complex, sometimes outright fraudulent products and then generated huge purchases of these "assets" by other parts of the financial system through massive extensions of credit.

Wall Street executives made huge amounts of money as the real estate and other asset bubbles expanded. Chuck Prince, ex-CEO of Citigroup, expressed the outlook of the herd of independent minds that run our major financial institutions when, before the market burst, he told the *Financial Times*, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing you've got to get up and dance. We're still dancing." Eventually, the music stopped, Citigroup lost tens of billions of dollars, and Prince lost his job.

No one in the interconnected world of global finance knows who is holding the most toxic assets and who is on the hook for losses if and when borrowers default. The financial sector spread the huge risks it had created in such a way that few, if any, islands of security remain intact. For example, subprime mortgages were bundled together with other types of mortgages and corporate bonds. And, as Richard Bookstaber, author of *A Demon of Our Own Design*, put it, "Like a kid who brings his cold to a birthday party, the sickly subprime mortgages mingled with these other instruments. The result was contagion between markets."* No one can be certain about the staggering scale of the eventual financial losses, which the IMF now puts at $1.4 trillion, or whether they will precipitate not just a recession but a deep and protracted global slump, as happened in the 1930s.

THE GROWTH OF the financial sector relative to the real economy—to the point where it has recently accounted for one-third of U.S. corporate profits—was built on a now rapidly collapsing house of cards. An out-of-control financial sector also lies behind the destructive wave of private-equity buyouts that have has saddled productive companies with huge and perhaps unmanageable debts, and wild, speculation-driven gyrations in energy, food, and other commodity markets. These have had particularly devastating consequences for poor developing countries.

"The crisis," according to Nouriel Roubini, who along with a few others** has been predicting this catastrophe for several years, "was caused by the largest leveraged asset bubble and credit bubble in the history of humanity . . . a housing bubble, a mortgage bubble, an equity bubble, a bond bubble, a commodity bubble, a private equity bubble, a hedge funds bubble are all now bursting at once in the biggest real sector and financial sector deleveraging since the Great Depression."

U.S. policy has created a global market with no rules other than those designed to protect economic elites. American workers have been fully exposed to competition from low-wage economies. The resulting downward pressure on wages and the soaring trade deficit should have shrunk U.S. consumer spending. But debt-financed asset bubbles provided an illusory way for the economy to generate growth. Countries that run trade surpluses with the

*As recently as 2005, when talking about the housing bubble, Alan Greenspan said that "widespread securitization of mortgages make[s] it less likely" that price declines would "have substantial macroeconomic implications." The very thing Greenspan thought would reduce risk, in fact, spread risk.

**Dean Baker deserves special mention for sounding the alarm about our bubble economy for years. Eight years ago, he wrote in these pages, "It is hard to get a good view of the economic landscape from inside a bubble . . . There is likely to be a whole range of accounting and financial sins that will be exposed in the deflation of the bubble . . . .Many other forms of creative bookkeeping will come to light after a market crash has made them impossible to sustain. Only after the crash will it be possible to determine the extent to which the financial system is crippled." ("Holes in the 'New Economy,'" *Dissent*, Summer 2000).

United States, especially China, are re-lending the dollars they earn back to the United States in order to maintain the U.S. market for their exports. The Chinese and others, by pegging the value of their currency to the dollar, also do not allow their currencies to appreciate. In this way, our trading partners enabled us to keep purchasing from their factories even as our real economic capacity declined.

As economist Tom Palley explained, in a paper for the Economic Policy Institute's Agenda for Shared Prosperity,

> This new system has boosted profits by allowing companies to establish export-production platforms in low-wage countries and batter America's unions into submission. . . . The purpose of the new system has always been access to cheap, low-wage production; it has never been about expanded, balanced trade. The Federal Reserve and Wall Street have both supported the new international system. The Fed has supported globalization and a strong dollar because low-cost imports and fear of outsourcing help hold down inflation, which is the Federal Reserve's primary policy goal . . . Wall Street has supported it because it benefits from financing trade deficits. The strong dollar supports also make foreign assets cheap, enabling Wall Street and multi-national companies to buy foreign assets even as the United States has been falling deeper in debt . . . . This architecture suits the economic interests of the most powerful players—multi-national corporations, big retail, Wall Street, and the Federal Reserve. The problem is that it harms the interests of America's working families.

The Bush recovery, based on an unsustainable housing bubble, was the weakest economic expansion since the Second World War by almost all economic measures. For the first time ever, the median family income fell during an economic recovery. Wages continued to lag behind productivity growth. Pension and health care coverage for Americans shrank dramatically. Poverty rates have been rising since 1999 and are now again above where they were in 1973. And to an unprecedented degree the gains from economic growth after 2001 accrued to a narrow slice of the population at the top of the income distribution. Inequality reached levels not seen since the Gilded Age of robber barons.

There is one measure that did very well during the Bush years—corporate profits. While aggregate wages and salaries grew less than half as fast after 2001 as they did in the average postwar expansion, corporate profits grew almost 30 percent faster. The increased profitability in 2005-2007 relative to the late 1970s, according to calculations from the EPI, meant that a staggering $206 billion was transferred from labor to capital incomes.

The global financial crisis will make a weak U.S. economy much worse. As I write in November, the U.S. economy has lost 1.2 million jobs since December 2007 and 651,000 jobs in the last three months alone. Over the past 18 months 3.3 million workers have been added to the jobless rolls, and there are over 10 million unemployed workers in the country. The official unemployment rate has risen to 6.5 percent. But the official rate understates the problem. Taking account of those who are working part time but who want full-time work and those who want work but have given up looking, the real underemployment rate is just under 12 percent.

As bad as the economy is, the U.S. downturn is just beginning. General Motors is hemorrhaging $2 billion a month and is on the verge of bankruptcy. The global economy will not provide a lifeline for the United States. The IMF forecasts a global recession for 2009, and for the first time since 1945, it predicts that the advanced countries of the world will experience an economic contraction.

The housing market is suffering its biggest slump since the 1930s. Distressed sellers have seen property prices fall by up to 50 percent in some areas. More than three million families are likely to lose their homes by the end of 2009. And if housing prices continue to drop as expected, twenty-three million mortgage holders will have mortgages worth more than their houses.

In addition to the impact of the shrinking construction and housing-related sectors, an even more important problem of the bursting housing bubble is that U.S. households typically borrow against the equity in their homes. The expansion of the U.S. economy from the bottom of the 2001 recession to last year was largely driven by this borrowing. At the peak of the bubble in 2006, consumers were cashing out some $780 billion a year from (then rapidly rising) home equity. Much of this borrowing and spending has come to an end, and the third-quarter 2008 report saw the largest drop in consumer spending in twenty-eight years. Consumer spending represents two-thirds of the nation's economic activity, and this kind of severe decline portends an extended recession.

Treasury Secretary Paulson's plan has been, like so much else in the Bush administration, a disaster. In mid November, Alan Blinder, a professor of economics at Princeton, former member of President Clinton's Council of Economic Advisers, and former vice chairman of the Board of Governors of the Federal Reserve, testified before the House Committee on Financial Services on the administration's pathetic response to the greatest economic crisis in seventy years.

Since the financial crisis has grown to be so complex and multi-faceted, it is worth recalling that it all began with falling house prices and defaults on mortgages—or, rather, fears that defaults would become rampant. (Those fears depressed the values of securities based on mortgages, and made them "troubled.") Foreclosures are personally painful and economically costly; they undermine property values; and they lead to fire sales of homes, which depress house prices further, thereby continuing the vicious cycle. It is difficult to see a way out of this mess without reducing the coming tsunami of defaults and foreclosures. Congress wrote legislation that, at numerous points, exhorts, encourages, and even directs the Secretary of the Treasury to use TARP [Troubled Assets Relief Program] funds to acquire mortgages and get them refinanced. But he has not done so. Nor has he purchased any mortgage-related assets. . .

I fault the Treasury on at least six dimensions: First, while I understand the need to keep proprietary information confidential, the program is enshrouded in too much secrecy. It is, after all, the taxpayers' money being put at risk. Second, Secretary Paulson decided to purchase preferred stock with no voting, or other control, rights. So the government provides money, but acquires virtually no influence over the recipient banks' behavior. Third, taxpayers will receive only a 5% dividend on their investment (for the first five years). Curiously, just days before the legislation was passed, Warren Buffett concluded a deal with Goldman Sachs (a major recipient of TARP money) that included both preferred stock with a *10%* dividend yield and more attractive warrants. . . . Fourth, participating banks are allowed to continue to pay dividends to their shareholders. This raises the spectacle of banks borrowing money (cheaply) from taxpayers in order to maintain their common stock dividends. Fifth, contrary to many suggestions, Secretary Paulson did not require participating banks to raise private capital *parri passu* with the government's capital injections, which would at least have provided a valuable market test of viability. Sixth, the capital injections are being made with no public-purpose *quid pro quos* at all—e.g., a minimal lending requirement, or a pledge to refinance more mortgages.

Frankly, I find it all breathtaking.

A Recovery Program

Because of the collapse of finance, consumption, and investment, the only way to mitigate the effects of the recession will be a massive, expansionary fiscal policy—in the range of 4 percent of GDP or $600 billion and perhaps even more. The Fed has already cut the Federal Funds rate from 5.25 percent to 1.0 percent. There is not much more to cut, so monetary policy cannot have even a small fraction of the expansionary effect that it had on the last recession, when it contributed to the expansion of the housing bubble.

The national debt is already more than 69 percent of GDP; the current bailout will push this over 72 percent, and there will probably be more bailouts as well as further deficit increases due to automatic spending increases and revenue declines as the economy weakens. These are levels of public debt that have not been seen since the early 1950s, when the debt was still winding down from its explosive growth during the Second World War. Even with these debt levels, it is crucial that Barack Obama proceed with a large fiscal stimulus package that includes the following elements.

Public Investment. There is a huge public investment deficit in many areas: physical infrastructure, such as roads, bridges, and mass transit; schools; energy-producing technology, such as improved solar and wind generation; electrical grids; and energy conservation technologies, such as advanced building materials. Investing in these areas is not only necessary for economic recovery, it is the way to create a competitive and decent society. Other countries have already announced stimulus packages that include public investment: China, $586 billion; Japan, $51 billion; and Korea, $11 billion.

Relief to State and Local Governments. The weak economy is generating great fiscal distress in the states. Because states cannot run deficits, they must close their shortfalls by cutting spending or raising taxes. Both approaches take money out of the economy, making the downturn worse. Collectively, the state budget shortfalls will be around $100 billion in 2009. Congress should immediately provide $100 billion in relief. This will preserve thousands of jobs and help stabilize the economy.

Fix the Safety Net. We need to respond to the unmet needs made worse by the recession. For example, our unemployment insurance system has not kept up with changes in the labor market. As a result, many of the female, low-income, and part-time workers who now make up a significant portion of the labor force do not qualify for UI benefits when they are laid off. Expanding unemployment insurance is long overdue and is particularly needed now.

The basic cash assistance safety net for jobless families and individuals that do *not* qualify for UI benefits is far weaker than in past recessions. Only about 40 percent of families that qualify for cash assistance under Temporary Assistance For Needy Families (TANF) actually receive that aid (and the help in preparing for and finding jobs that should come with it), while in the recessions of the early 1980s and early 1990s, about 80 percent of poor families eligible for cash assistance received it. In addition, the safety net of last resort for jobless individuals without children—state general assistance programs—has essentially disappeared.

Relief for Homeowners. Too many homeowners are being needlessly thrown out of their homes. James Galbraith has proposed a foreclosure moratorium that would buy time while a Homeowner Loan Corporation is established to rewrite millions of unsustainable mortgages.

Regulation. In testimony before the House Financial Services Committee, Robert Kuttner described the financial abuses of the 1920s, the effort in the 1930s to create a financial system that would prevent repetition of those abuses, and the steady dismantling of those safeguards over the last three decades in the name of free markets. According to Kuttner, "Although the particulars are different, my reading of financial history suggests that the abuses and risks are all too similar and enduring. When you strip them down to their essence, they are variations on a few hardy perennials—excessive leveraging, misrepresentation, insider conflicts of interest, non-transparency, and the triumph of engineered euphoria over evidence."

In an important speech during the primary campaign, Obama demonstrated that he clearly understands the need to re-regulate.

> We need to regulate institutions for what they do, not what they are. Over the last few years, commercial banks and thrift institutions were subject to guidelines on subprime mortgages that did not apply to mortgage brokers and companies. It makes no sense for the Fed to tighten mortgage guidelines for banks when two-thirds of subprime mortgages don't originate from banks. This regulatory framework has failed to protect homeowners, and it is now clear that it made no sense for our financial system.

We are finally emerging from Ronald Reagan's shadow. The market has lost its "magic," but the cost has been great. We confront a recession that is going to get much worse at a time when the problems in American society—inadequate health care, lack of retirement security, poverty, inequality, stagnant wages—are increasing.

Once the financial mess gets straightened out, we need to build an economy whose benefits are more broadly shared. That means growth should result from rising wages rather than unsustainable borrowing. It also means health care for all Americans, a fairer and more progressive tax system, and an international economy without today's untenable imbalances.

This is a terrifying moment. But it also provides us with a once-in-a-lifetime chance to create a more equitable U.S. economy. ●

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CREATING A *DISSENT* ARCHIVE

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