

<https://internationalviewpoint.org/spip.php?article1581>



World Economy

# The Economic Crisis and its Effects

- IV Online magazine - 2008 - IV407 - December 2008 -

Publication date: Tuesday 30 December 2008

---

Copyright © International Viewpoint - online socialist magazine - All rights reserved

---

**The current economic crisis has broken the temporary solutions which have ruled the world economy since the mid-1980s. Profits had been created through production but, in contradiction, were realised through circulation and exchange. British is now exceptionally vulnerable to the crisis.**

## 1. Introduction

[<https://internationalviewpoint.org/IMG/jpg/p0054939.jpg>] **Andy Kilmister**

There are three important starting points for understanding the current economic crisis [1]. Firstly, what is happening at the moment represents the break-up of the interlocking set of arrangements by which the world economy has been governed since the mid-1980s. These arrangements represented a temporary "solution" for capital to the crises which emerged a decade earlier. Secondly, the crises of the 1970s and the attempts to resolve them of the 1980s arose from a central contradiction within capitalism between the creation of profits in the sphere of production and the realisation of those profits in the sphere of circulation and exchange. Thirdly, the historically weak situation of British capital, at least that section of British capital territorially located in Britain, has left Britain especially vulnerable to the crisis.

The crisis itself has a number of dimensions but three in particular are crucial. The first is the build-up of debt, both corporate and household debt, but especially household debt. Linked with this is the likelihood of a return to international monetary instability and of the refusal of the rest of the world to fund US (and UK) trade deficits. The third factor is the effect of the ecological crisis on the world economy, which brings with it the prospect of an end to two decades of low commodity prices. However, these should be seen as medium-term developments, determining the underlying tensions within which more immediate changes take place.

A Marxist analysis of the crisis needs to be based on an analysis which can both grasp these underlying structural factors, see how these play themselves out in surface phenomena and also understand the competing strategies of capital as it attempts to manage the crisis.

## 2. The Recent Financial Turmoil

The key development of the second half of 2008 has been a dramatic worsening of the first of the dimensions mentioned above; the financial crisis based on the accumulation of debt. The main cause of this has been growing recognition that the quantity of bad debt in the system was much larger than was previously thought. This in turn led to confusion amongst the US ruling class about the way to respond to the rising number of loan defaults. Unwillingly forced to nationalise the mortgage companies Fannie Mae and Freddie Mac (largely as a result of pressure from Chinese and Japanese investors in these companies) they then switched abruptly to allowing a leading investment bank, Lehman Brothers, to fold.

This threw the banking system into a deeper crisis in three ways. First, the rising tide of bad debt threatened the solvency of the banks. Second, the apparent change in Federal Reserve policy from the earlier rescue of Bear Sterns created a panic in the inter-bank lending market. Uncertain of which banks would survive banks ceased to lend to anyone at all in this market causing the system as a whole to seize up. Thirdly, stock market investors also panicked sending bank shares into freefall. Since bank regulation is based on the idea that loans can only be a certain multiple

of bank capital and since the decline in shares reduced capital significantly, this looked likely to lead to a massive decline in bank lending, which would have further threatened the stability of the system. While these problems were first apparent in the US and UK, where housing booms and bank deregulation had been especially strong, it quickly became clear that banks from many countries, particularly Continental Europe, had also made loans in these markets so that the banking crisis affected the major industrialised countries as a whole.

The result of this has been an abrupt change in policy towards bailing-out the banks. The form of this has varied across countries. The US response, led by Treasury Secretary Henry Paulson, who is rooted in Wall Street, has been particularly shameless (the original proposal by Paulson was simply that the US government, funded by taxpayers, would buy up the worthless debt from the banks "a straightforward subsidy with no control over future bank behaviour whatsoever). The UK government plan, which has effectively been adopted by the EU, provides some potential leverage for political debate in that it involves buying shares in the banks. This allows for discussion about the nature of state control over the banking system and about who should pay for the crisis. But it is clear that the initial aim of the government was to have the minimum amount of state involvement in the financial sector and to provide funds which would then be used to restore the banks to profitability in the hope of a quick sale of the governments' stake. The model was the Scandinavian restructuring of the banks following the financial crisis there in the early 1990s.

### 3. Who Pays for the Crisis?

The starting point for Marxists in understanding these developments must be in terms of the devalorisation of capital. The immediate effect of the recognition of the bad debt in the housing market is that a large amount of capital which was valued at a certain amount, on the basis that the housing loans would be repaid in full, is no longer worth what was originally envisaged. This capital falls into two categories. Firstly, there is the capital directly tied up in providing housing linked to sub-prime mortgages, both the loan capital used to provide the mortgages and capital employed in construction and housing development. Secondly, there is the capital in other industries which has been invested in the expectation of demand originating from a booming housing market; in particular that which depends on high levels of demand resulting from homeowners borrowing against the equity in their houses "something now unlikely to happen in the foreseeable future.

Any devalorisation of capital of this kind raises the question of who will pay for the loss "capital or labour. The financial sector has been quite brazen about trying to shift the cost of the crisis onto labour "even to the extent of formulating plans to use taxpayers' money to maintain bonus payments. The mechanisms for ensuring this shift include the following:

- \* Direct subsidies for the banks funded by the taxpayer
  
- \* Rebuilding of the profit base by refusing to pass on interest rate cuts to borrowers. This may well be made easier by mergers like the Lloyds-HBOS merger, which will reduce competition and increase the dependence of households on a small number of large institutions
  
- \* An attack on the job security, wages and conditions of bank staff in order to cut costs. Again, state-sponsored mergers may help this process by providing the means to close branches.
  
- \*  
Reduction of the interest rate paid out to savers and depositors

To the extent that the state has attempted to act as something other than an agent of capital and to enforce terms on the banks, the banks have responded by threatening to bring the system down if they don't get their way. This has led to some conflict between the government and the banks, particularly with regard to the enforcement of cuts in interest rates. However, the cuts which have been achieved here have come at the expense of even larger cuts in rates paid to savers which have serious implications for both current and future pensioners. In addition, the bail-out as a whole has resulted in a considerable ideological cost both in terms of the reputation of the financial sector within society as a whole (which is probably now at an all time low) and in terms of the increased legitimacy of regulation and even state ownership.

## 4. Stabilising the Financial Sector

While it is difficult to predict events with any certainty, it appears most likely at present that the injections of funds made so far have restored a measure of stability to the banking system. While the housing boom in the US and a number of European countries was a significant speculative bubble, it did not represent sufficient lending in itself to bring down the financial systems of the industrialised world (The Economist of September 27 2008 reports a June Federal Deposit Insurance Corporation estimate of about \$500 billion worth of "seriously delinquent" residential mortgages in the US out of a total of \$10.6 trillion). It should also be remembered that even if mortgages are not repaid in full the houses on which they were secured are not entirely worthless.

In assessing the cost of this stabilisation we should be cautious about the headline figures such as the \$700 billion attached to the US bail-out. The bail outs comprise three different kinds of spending. First, there is direct financial assistance to the banks. This is a real cost. Second, there are loan guarantees. These will only become a real cost if the loans that are made from now on result in defaults. Basically they are confidence building measures and it is not expected that they will require much if any actual spending. Thirdly, there is direct government lending to get the money markets flowing again. Again this will only be a real cost if the interest rates at which the lending takes place are unrealistically low or if the loans made result in default.

The real cost of the UK bank bail-out at present appears to be around £37 billion; i.e. the actual financial assistance being given to the banks. Even this will not necessarily be a long-term cost if the stake taken in the banks can be resold at a higher price at a later date. Nonetheless, it is a significant amount of money and will lead to a record government budget deficit this year. The sums involved in other European countries appear rather similar "for example the Financial Times of 5 November reports that Italy is planning to allocate £24 billion to recapitalise its banks.

Here it is also important to recognise that the immediate impact of this government spending is only a small part of the projected increases in budget deficits in the medium term. More important is the loss of tax revenue and the extra expenditure resulting from the slowdown in growth arising from the crisis. Analysing Alistair Darling's pre-budget statement in the Financial Times, Martin Wolf points out that tax receipts are now expected to fall by 3 percentage points of GDP in 2009-10 and observes that "these changes are overwhelmingly due to revisions in the fiscal capacity and level of GDP; a permanent reduction in taxes on financial sector profits and housing transactions; and, more strikingly, a lasting loss of GDP. In 2010, the economy is now expected to be some 5.5 percent smaller than forecast in the budget" [2]. This raises serious questions about the ability of governments such as the British government to fund their increased deficits by issuing bonds without either a sharp fall in bond prices which will raise interest rates and worsen the crisis or an increase in public borrowing from abroad which will further weaken the value of the pound.

What is more even important though than the immediate possibility of financial meltdown and the impact of the rescue of the banks on government spending is the longer-term impact of the financial crisis both on the financial

sector and on the economic situation more generally.

The banking crisis has also raised the issue of the kind of financial system which will emerge if and when the initial stabilisation has been achieved. It is very difficult for New Labour to avoid this debate now because by taking stakes in the banks they have inescapably raised the issue of how these stakes will be used to enforce control over the financiers. However, while this would seem to be a golden opportunity for social democracy to reassert ideas about regulation of the system the ideological hegemony of neo-liberalism over the last two decades has left it unable to articulate any very convincing vision of an alternative. The main ideas about regulating banks currently being discussed include strengthening the capital requirements for making loans (basically a stronger version of what already exists), regulating bank bonuses and banning certain kinds of market transaction (such as 'short-selling' Euros" where traders sell shares they do not actually own in the expectation that they can buy them up more cheaply before completing the transaction). None of these will lead to any significant differences between the financial system which emerges from the current turmoil and what we have seen in recent years.

However, if social democracy is unable to put forward a convincing alternative to neo-liberal financial deregulation that provides an opportunity for socialists to enter the debate. A space is opening up both for defence of public ownership and for arguments based on need rather than profit in a way which has not been the case for many years.

## 5. Recession and the Financial Crisis

The most important current development in the wake of the banking crisis is the transmission of that crisis to the rest of the economy and its interaction with the more general economic crisis now emerging. The most obvious issue here is the onset of recession. The central reason for the recession is the dependence of consumer demand in particular but also business investment on high levels of debt over the last two decades. Now that lending is contracting this debt-fuelled expansion is no longer possible and a sharp economic slowdown looks inevitable. The fall in house prices is also worsening the slowdown in consumer spending as households can no longer borrow against rising equity values.

There are two fundamental reasons for the reliance on debt. Consumption has come to depend on debt because of the contradiction between driving wages down to generate profits in production and needing to ensure demand in order to sell the goods produced and realise these profits. The most obvious manifestation of this is growing income inequality and it is no accident that the build-up of debt has been worst in countries with the greatest disparity in incomes, notably the UK and USA.

Linked to this is the way in which production in general, but especially investment, has come to rely on debt as a result of the weakness of profitability in the productive sector. As Robert Wade puts it 'the rate of profit of non-financial corporations fell steeply between 1950-73 and 2000-06' in the US, by roughly a quarter. In response firms 'invested' increasingly in financial speculation' [3]. Consequently, without debt being available to fund expansion recession appears inevitable.

The response of governments to the recession has been firstly to increase their own borrowing and secondly to encourage central banks to cut interest rates. But both of these create their own problems. Government borrowing is limited by the cost of the bank bail-outs. High levels of borrowing can also push up interest rates or reduce currency values as discussed above. Both of these effects lower household real incomes and decrease spending frustrating the original purpose of the borrowing. The strategy adopted by the British government in response to this is to make tax cuts explicitly temporary. But this risks making them ineffective since households will simply save any extra income in anticipation of future tax rises.

Cutting interest rates is also difficult. Central banks only directly control short-term interest rates and private banks have simply refused to cut long-term rates in response to central bank policies. Cuts in interest rates also have the effect of lowering both the actual returns of current pensioners living off savings and the prospective returns of future pensioners both of which may lower consumption.

More fundamentally, the room for government policy to boost the economy is limited so long as spending depends on debt because of low wages and inequality and so long as new debt is not forthcoming. Consequently, the slowdown is likely to be protracted and severe.

## 6. The Internationalisation of the Crisis

The growth of debt over the last two decades in countries like the USA and UK has been dependent on international flows of capital which in turn have resulted from a significant degree of exchange rate stability compared to the turbulence of the early 1980s. Conversely, a move towards a different pattern of accumulation will inevitably put great strain on global monetary arrangements.

So far the crisis has mainly manifested itself in domestic monetary developments in the largest economies, although countries like Iceland, Ukraine, Hungary and the Baltic States have been driven to seek IMF or EU help. But this is now changing and the crisis is being internationalised in three ways.

The first of these is the effect of current developments on so-called 'emerging market economies'. Nobel Prize winning economist Paul Krugman gives the example of Russia where 'while the Russian government was accumulating an impressive \$560bn hoard of foreign exchange, Russian corporations and banks were running up an almost equally impressive \$460bn foreign debt... This truly is the mother of all currency crises and it represents a fresh disaster for the world's financial system' [4]. The unwinding of the 'carry trade' (where financiers borrow in markets with low interest rates such as Japan and lend abroad) is beginning to have a devastating effect on such currencies.

Secondly, countries like the UK and USA which have been at the centre of the crisis see their currencies in danger of sliding, both because their governments need to borrow abroad and because of a general lack of confidence. At the time of writing the dollar remains relatively strong simply because of the weakness of other currencies, but sterling has fallen dramatically against both the dollar and the euro.

The third factor is increasing pressure on countries to devalue their currencies in order to boost exports at a time of falling demand. Even the Chinese government is now considering this to American consternation [5].

All of these developments are likely to herald a period of much greater turbulence for exchange rates and capital flows. Yet underlying the immediate changes in currency values is a deeper disagreement about future strategies amongst the international capitalist class.

The central long-run task for capital is to develop a strategy of accumulation which does not depend on the build-up of unsustainable debt (Martin Wolf's article in the Financial Times of November 5 entitled 'Why agreeing a new Bretton Woods is vital and so hard' is in many ways a manifesto for this process). This process involves a wide range of different potential conflicts but one issue in particular is seen as increasingly central. This is the rebalancing of world economic growth away from the USA (and UK) towards the surplus economies of Asia and elsewhere, especially China.

The more far-seeing representatives of capital, such as Wolf, are very clear that if the current pattern of global imbalances persists, so will recurrent financial crises of the kind we have seen recently. Large flows of funds into the US and UK will result in risky lending whatever the regulatory structures created. The only way this can be avoided is through a shift towards domestic consumption in countries like China and a move away from consumption towards investment and, especially, exports in the US.

This kind of strategy is extremely difficult to implement in practice because the unplanned, spontaneous nature of capitalism makes this kind of rebalancing very destabilising and risky. This was shown in the mid-1980s when the decision to co-ordinate a rise in the value of the yen and shift the Japanese economy towards domestic demand and away from exports triggered a speculative frenzy of lending resulting in a slump lasting almost two decades.

Yet, an even more serious problem today is that there is no clear agreement on the way forward between the representatives of different national capitals. That has been shown within Europe with regard to the arguments between the German and British governments over the degree to which government spending and fiscal deficits are an appropriate response to the crisis. More serious, however, are the underlying tensions between the US and Asian governments [6]. These tensions reflect not just economic concerns, but also shifts in the balance of power within international capitalism.

## 7. Commodities and the Ecological Crisis

The third aspect of the crisis of capitalism raised at the outset of this article is the question of commodity prices and the constraints on production arising from ecological factors. There is a strong temptation at present to downplay this issue as oil prices in particular fall. There are four reasons why this would be a serious mistake.

Firstly, oil prices remain at high levels compared to five or ten years ago, as do food prices in much of the world. Even in countries like Britain rising energy costs are seriously affecting working class living standards while for the poor in developing economies food costs are still devastating.

Secondly, to the extent that energy and food prices have declined it has only been because of the severity of the recession. Any sustained upturn in growth that does take place, in particular one based on a shift towards domestic consumption in countries like China, is likely to lead to renewed price rises. Here it is important not to assume that all the commodity price inflation of 2006 and 2007 was due to speculation. This did play a role, especially as speculators moved away from the dollar during this period, but it was by no means the only factor. The price rises of those years also indicated a genuine constraint on global capitalist growth arising from ecological limits.

Thirdly, given the irrationalities of capitalist decision-making any sharp decline in commodity and fuel prices which does take place over the next few years is likely to stop the development of new sources of supply and worsen the price rises that will occur if growth restarts.

Fourthly, the current recession is not slowing down the process of international environmental degradation, especially climate change. The impact of this on food supplies in particular represents a long-run trend which will assert itself increasingly sharply in future years whatever the level of global output.

All this means that, while at present governments and central banks are not worrying about inflation when trying desperately to restart production, any sustained recovery from the crisis is likely to reawaken inflationary fears. This will constitute a severe constraint on the economic options available to them in the longer term.



## 8. An end to Neo-Liberalism?

An important question here is that of the extent to which the current crisis represents an end to the political hegemony of neo-liberalism. Linked to this is the issue of the revival of Keynesianism. Here it is important to recognise that state expenditure is by no means incompatible with neo-liberalism provided such expenditure is in the interests of capital [7]. The initial aim of New Labour in rescuing the banks was very much within this framework, as discussed above.

However, this does not mean that the resolution of the crisis will remain within the bounds of neo-liberalism. A neo-liberal outcome in which the banks are restructured and re-privatised while accumulation is restarted on a free-market basis remains one possible outcome but by no means the only one. Already, in the UK the government has been driven to be more interventionist with regard to management of the banks than it had originally intended and to adopt fiscal policy measures which were also not planned even a few months ago. So, far such measures "pressuring interest rate reductions and raising income tax to 45 percent for higher earners" do not represent a significant break with past policies. But they do indicate a space for debate around political alternatives which is opening up. The way in which this space will be occupied will depend partly on how the crisis develops but also on the ability of socialists to articulate alternative responses to what is happening to that proposed by capital.

More generally, the way in which the crisis has thrown into question the way in which the world economy has functioned since the mid-1980s indicates that even if neo-liberalism is able temporarily to resolve the situation on its terms the way in which it will do this will differ significantly from what has been seen in recent years. It will also involve turbulent and difficult adjustments which in turn will open up further opportunities for socialists to present alternatives.

## 9. What should socialists demand?

In raising demands in response to the crisis it is important that socialists emphasise the nature of the crisis as a general crisis of capitalism, which has its roots in the contradictions of productive capital as much as in the financial sector and which is caused by global factors, not the economic policies followed by a particular national capital. In this context the following demands seem especially important:

- \* Nationalisation of the banks coupled with popular control over the allocation of credit and use of savings.
- \* A massive programme of public works to combat the recession with particular emphasis on ecological production and a shift in the economy towards "green" technologies. Investment in alternative forms of transport and energy.
- \* Taxation of the income and wealth of the rich and limits on higher earnings to remove the reliance on debt to maintain consumption.
- \* Opening of the books of both the financial institutions and industrial companies to public scrutiny in order to prevent any use of the crisis as an excuse to force through cost-cutting and redundancies
- \* Indexation of wages, pensions and benefits to protect workers against rises in food and energy prices.



- \* An extensive programme of publicly-owned and financed house building to avoid another housing bubble. A moratorium on any re-possession for mortgage arrears.
- \* A government guarantee for pensions. Future pensions to be paid for from taxation of the rich and not to be reliant on returns from shares and bonds. Current pensioners to be compensated for loss of income resulting from interest rate reductions.
- \* Control over international financial speculation both through controls on capital movements and through taxation.

## 10. Conclusion

The current crisis represents the most significant set of economic events internationally since the decade spanning the mid-1970s and the mid-1980s. The economic order created following that turbulent decade is now breaking down. What replaces it will depend not just on "objective" circumstances but on the ability of the left to put forward its own vision of an economy based on need rather than profit as a replacement for the finance-driven accumulation of the last twenty years.

*This is the opening chapter of a forthcoming book on the crisis being published by Socialist Resistance next month.*

---

[1] For a more detailed account of the following argument see A Kilmister "What's happening to the economy?" (Socialist Outlook no.14, February 2008), A Kilmister "The world economy and the credit crisis" (Socialist Resistance no.51, Summer 2008)

[2] M Wolf "How Britain flirts with disaster" (Financial Times November 28 2008, p.11)

[3] R Wade "Financial regime change?" (New Left Review Second Series no.53 September/October 2008 p.11). There is a lively debate amongst Marxist economists about the extent to which the crisis can be seen as the result of falling profitability, which in large measure centres on different ways of measuring the profit rate. However, even those who see profits as being to some extent maintained (and who point to the fact that the share of profits in national income has risen) accept that the link between profits and productive investment has weakened significantly in recent years "presumably because of a change in expectations of future profits.

[4] P Krugman "We all go together when we go" (The Guardian Weekend December 6 2008 p.31)

[5] G Dyer "Paulson in last stand against weaker renminbi" (Financial Times December 4 2008 p.11)

[6] D Pilling "Prudent Asia is unlikely to bail out the west" (Financial Times December 11 2008) p.13)

[7] For a development of this argument see A Kilmister "Understanding neo-liberalism" (Socialist Outlook no.3 Spring 2004)