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World Economy

Global Economic Turbulence - Blip or Crisis?

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Many newspapers have described the financial crisis of risky ("subprime") housing loans as being primarily the result of the manoeuvres of unscrupulous financial investors. According to them, what we are seeing is a crisis having essentially speculative roots and thus little impact on the real economy. The purpose of such a campaign is to "reassure" the markets and to support an economic system by "separating the wheat from the chaff".

[https://internationalviewpoint.org/IMG/jpg/northern_rock.jpg]
Northern Rock bank - technically bankrupt

Some people have up to now put the blame on the psychic weakness and the mentality of investors whoa are in the grip of panic and are incapable of understanding the marginal nature of the crisis. Today, whereas the crisis is by no means solved, there is even a certain competition to demonstrate that "the worst is behind us". Not claiming to be a specialist in finance and markets, I would like to limit myself here to drawing attention to some elements which shed light on the nature of this crisis, which emerged in August 2007. To put it another way, is the crisis the result of the "lies" of the financial world, which has taken the risk of implicating the real economy, or is just the opposite? Is the capitalist system as a whole solid and exterior to what has just happened?

It would be enough to list the establishments which have been implicated in the crisis to realize immediately that the story of the wheat and the chaff is just a fable. We can find in particular Deutsche Bank, Morgan Stanley, Merrill Lynch, Union des Banques Suisses, JP Morgan, BNP Paribas, Unicredit, Crédit Suisse, Goldman Sachs, Bank of America, Countrywide, Landesbank Sachsen, Bayerische Landesbank, in other words both top-ranking investment funds and wathcdogs of management. [1]

This list gets longer every day, because obviously both companies and banks are trying as far as possible to hide their direct involvement in the risky loan market and their indirect involvement through the acquisition of bonds which themselves serve as guarantee for these loans. We will undoubtedly know more between the end of September and the beginning of October when the principal investment banks publish their quarterly statements. To those which I have just enumerated it is obviously necessary to add the 87 small and medium-sized American financial enterprises which have already filed for bankruptcy .

The list of these big investment and pension funds, banks, the property investors and insurance companies really does not lead us to think of an "anomaly" but much more of a wide-ranging crisis concerning the heart of Western finance, primarily American and German. In the space of fourteen days these companies needed some $324 billion of short- or medium- term credit, obtained from the central banks, in particular from the European Central Bank (ECB). And we saw real rescue operations on companies, such as Countrywide, the principal supplier of credit in the United States, which controls 61 000 establishments.

And if we still had some doubts about the dimensions of the problem, it would be enough for us to remember the amount of these US credits: $6 500 billion. An amount which exceeds, and by quite a lot, that of the Treasury bills issued by the state ($4 300 billion) and also the amount of the bonds of private companies which come to only $5 300 billion.

"Subprime" credits

High-risk loans are relatively recent "financial products". Their rise started in 1996 and they subsequently experienced a rapid boom, so that their total amount came to exceed $1000 billion. They are loans granted by the banks and financial institutions to debtors who are "at risk", i.e. who do not have property to guarantee the loan and who have irregular incomes that come from precarious or intermittent work. The rise in the prices of real estate, which has been spectacular and uninterrupted for the 15 last years (between 10 and 20 per cent per annum between 2001 and 2006) thus served as a "solid" guarantee helped by the supply of "easy money" thanks to the very low lending rates of the central banks.

The risks and the profits were founded on these co-ordinates. We were witnessing a cycle that was apparently without end, where rising prices of real estate fed financial investments and facilitated new credits which in their turn made possible new construction and a further increase in real estate prices. Banks and financiers who had plenty of capital issued loans and bonds which were supposed to guarantee in due course profits for those who acquired them. These bonds multiplied and, taking advantage of the excellent evaluation of their reliability, were massively acquired by investment funds, pension funds, the insurances companies and other banks and companies. With the new liquidities, even riskier credits were issued, while competition became increasingly fierce.

Demand and prices increased so much that between 1995 and 2004 investments in new construction industries increased by 80 per cent in the United States and by between 20 and 40 per cent in Europe, except for Germany which was experiencing a period of spectacular growth. At the same time the property loans granted to households increased annually by 3.3 per cent in Germany, 11 per cent in the United States and up to 19.2 per cent in Italy, producing a real boom in the relationship between debt and disposable household income, which went from 31.1 per cent to 52.2 per cent in Italy, from 64.7 per cent to 75.3 per cent in France, from 99.7 per cent to 109.9 per cent in Germany, from 106.6 per cent to 155.5 per cent in England, which thus attained a ratio similar to that of the United States.

In 2006 in the United States, nearly 70 per cent of the population own their own houses, but two thirds them - that is to say, around 50 million Americans - are behind in repaying their loans. Just in the course of the last six years, the total amount of financing of new houses went from $5 100 billion to approximately $10 000 billion. These figures give an almost everyone takes part, directly or indirectly, in the banquet of the housing market, based on growing household debt.

And if at a certain moment the increase in prices were to stop, what would happen of all the calculations of risks and expected profits? Pretty well what has just happened. All it needed was a slight increase in the percentage of failure to pay by debtors with "subprime" loans, a fall in demand and consequently a deceleration of the increase in prices, to make the foundations of the great castle of the housing market tremble. A deceleration which started in 2007 and was recorded by the US indicators during July, which noted that the increase in the price of real estate was slowing, that the construction of new residences was reduced by 6.1 per cent and that the number of new building permits had fallen by 2.1 per cent. Figures confirmed it again on August 28: the price of residences showed an exceptional fall of 3.2 per cent on annual average annual, with high points reaching double figures in some large cities.

Many European analysts, especially those working for banks and property companies, sought to calm things down by underlining the diversity of the European market. We can understand them. But we have seen that the differences are not so enormous that it is not possible to imagine a structural crisis of the United States market which does not implicate the European market. The data that we have do not authorize excessive "optimism". In Italy for example, there is no lack of evidence of a deceleration of the rise in prices (+ 1.6 per cent in Milan in the first half of the year), and especially, the lengthening of the time necessary to sell or find a new tenant (indicators which record the fall in demand before that of prices). During the first half of 2007, in fact, in Italy the time necessary for the sale of a house was 37.2 per cent longer than in 2003. And it was necessary to await 53.1 per cent longer to conclude a rental agreement [2] . Standard & Poors mention that the index of non-repayment of credits at risk increased by 5 points during the second quarter of 2007 in England, and it envisages a further increase over the next six months. More than 10 % of customers are more than 90 days behind with their payments.

[https://internationalviewpoint.org/IMG/jpg/WallStBull.jpg]
Bull market stumbles

The selling price of houses cannot increase ad infinitum. When the level of repayment of loans – whose duration is constantly increasing - comes to eat up 60-70 per cent of the monthly wages of the household, it becomes difficult to go any further and to increase demand. All the more so as average wages are stagnating, job insecurity is increasing increases and that the most recent "subprime" loans have been based on low repayments during the first two years which then sharply increase. That is what explains the increase in payment defaults and the tendency for prices to fall.

Obviously the crisis is extending to all the companies which have invested in bonds based on "subprime" loans, because the promised profits are suddenly proving to be precarious. It is the risk of an insolvency-bankruptcy-insolvency spiral which obliged the central banks to inject billions in short and medium term loans to avoid the bankruptcy of companies short of liquidities. At the same time the Federal Reserve (Fed) reduced the lending rate by half a point, while the ECB has frozen the announcement of an increase in order to make new loans possible. Will that be enough? Will the banks and financial institutions manage to solve the crisis by taking advantage of the time that this imposing injection of "liquidities" gives them?

The crisis overcome?

So the crisis of the housing market now seems to be certain. During preceding decelerations of real estate prices in the United States - at the end of the 1970s and the beginning of the 1980s - prices stagnated, but they never actually fell, especially because of the high rate of inflation. The current fall could be much more sudden, just as the rise was more rapid and longer, thereby contributing to reignite the panic effect in sales of property and accelerating the fall in prices. If that happened, bankruptcies could prove to be more numerous than in 1987, and especially they could reach some giants of the financial world. The crisis would be propagated not only via the bonds issued on the basis of credits, as described previously, but also by its effects on the fundamental elements of the US economy. We have already seen 20 000 lay-offs in the financial sector (6 550 at American Home Montgage, 2 000 at Countrywide, 1 900 at Capital One...) during the first twenty days, a figure destined to grow and to which must be added the foreseeable reduction of the number of jobs in the building industry. To that must also be added the future reductions of stock exchange profits and of those derived from investment and pension funds of pensions and the effects of these reductions. As if that were not enough, in the course of the last six months the United States recorded an increase of 30 per cent of unpaid overdrafts originating from the use of credit cards. [3] . All these elements then act to reduce the indicators of consumer confidence and the propensity of US households to consume.

They also immediately set the alarm bells ringing in the sectors producing the durable consumer goods, in the first place the automobile sector. General Motors and Ford have already implemented the first reductions in production ,envisaging a drop in sales of 10 per cent and estimating the increase in stock at 116 days of autonomy. The same economists who had been accused of having been too late in warning of the risks of investments related to "subprime" loans, today confirm the danger: the probability of an economic recession increased in August, going from 15 per cent to 35 per cent, whereas the forecasts for growth were reduced by a point for the North American economy and by several decimals for Europe. So if the spiral effect of is not foreseeable today, it is no longer completely excluded, especially if the crisis of loans at risk ("subprime", which represents 10 per cent of the credit market) were to extend to "normal" credits (90 per cent of the market). If the chain of the bankruptcies reached the giants of the financial sector, the forecasts concerning growth could prove to be still too optimistic.

Property speculation and overproduction

Just as Joseph Halevi wrote [4] , the crisis of the United States housing market is a crisis which was largely announced in advance. Two years ago economists were divided between those who announced a controlled landing from the period of growth and those who put forward the hypothesis of a crash... Today the second hypothesis seems to have gained in probability, even if nobody can sell certainties on how it will finish. The question that is essential today is why were there no interventions earlier, although everyone recognized that the growth of the housing market was an anomaly? The answer it is that it was not possible.

"The reality" - Halevi has written- "is that since 1970 during each decade the cumulative growth of the world economy (...) has been weaker than it was it during the previous decade, and that is still valid for 2000-2005. (...) Today, for capital, the best fruit of the present period is the compression of wages and of the pensions" One can only approve. We are still in the long wave of stagnation, caused by the crisis of 1973-1974 and the fall I the rate of profit, that is to say by the fall in the percentage of capital gained compared to that invested. The history of the following thirty years is the history of a capitalism which has been trying to increase its profits by a short-term strategy: reduction of wages to increase surplus value, reduction of the cots of raw materials in order to reduce the capital invested, increase in financial activities in search of easy money. The financial storms in South-East Asia at the end of the 1990s, the Argentinian crash of 2001 and the crisis of the so-called "new economy" are separate phenomena, but they are of the same nature as the crisis of the housing market. There is a latent crisis of the system, intrinsically related to the laws of capitalist accumulation.

Since the crisis of 1973-1974 the capitalist economy has been marked by a strong tendency to overproduction, in other words by productive forces that are in excess compared to the market available. When you tend to produce too much, the rate of profit in relation to the capital invested decreases and thus productive investments are discouraged. If for example the existing factories of FIAT are able to produce more cars than they manage to sell on the market, then why should FIAT invest in creating new factories? We are certainly seeing the appearance of new products and of expanding economies, where it is possible to invest capital and hope for a profit, but that is not enough to guarantee a worldwide relaunch of capitalist accumulation comparable to that of the thirty years which followed the Second World War.

It is in the course of this long wave of thirty years of limited expansion and of weak increases in productivity that capital has implemented short-term strategies to obtain high profits:

1. By directly acting on direct and indirect wages and by operating the greatest reduction of wealth redistribution to the advantage of capital in the entire history of capitalism [5];

2. By trying to reduce the cost of energy and raw materials in order to lower the cost of investments;

3. By increasing through financial, technological, political and military means unequal exchange, to the advantage of the economies having a strong organic composition of capital;

4. By reinforcing fusions, concentration of capital and monopolies, including by the use of legal instruments, such as copyright;

5. By multiplying short-term speculative activities. [6]

The incredible rise of in the price of housing can be explained by the same causes. On average their selling price is 80 per cent higher than the cost of their construction. What we have here is clearly of a price very greatly superior to the actual value of the commodity that is housing. In Italy, from 1986 to 2004, the relationship between the value of housing and annual income increased by 98 per cent in the large cities [7]. The added value of real estate was higher than 10 per cent per annum, to which it is necessary to add the profits obtained from renting. The obvious speculation on the housing market was a safety valve for surplus capital in search of short and medium term profits, with risks that were apparently limited compared to other types of investment. And it is no accident that the spectacular increase in real estate prices took place after the three crises previously cited (South-East Asia, Argentina, "New economy" and stock exchange indicators).

Moreover, "the positive contribution that the real estate sector offered to the business cycle, by supporting the demand for investments during the recessive phase which followed the crisis of the financial markets at the beginning of the decade, is largely recognized" [8]. According to the Economist the share market increased during the second half of the 1990s by only 80 per cent of the global revenue of this period, whereas housing property prices of exceeded 100 per cent in 2001. Moreover the relationship between the price of rents and prices as a whole gradually widened to ore than 35 per cent in Europe as well as the United States. Finally, the negative effects of the bursting of the housing bubble could be more devastatoing than those of the stock exchange bubble, because it is more directly clinked to the level of possible household consumption.

We do not know if the crisis of the "subprime" loans will lead to an abrupt economic recession, even though it seems probable. But we can answer the question put at the beginning of this article What is involved is not a speculative crisis, because speculation is the consequence and not the cause of a productive crisis. Capitalism is confronted with a systemic crisis related to the permanent tension between the immensity of the productive forces at its disposal and the limits of the market, both being the product of the law of profit. Fundamentally, as Joseph Halevi explained it well [9], the central banks, and in particular the Fed, actually tried to reactivate the speculative bubble by intervening on the lending rate: another question concerned with morality, the wheat and the chaff.

Rome, September 7, 2007

This article was first published on the web site ofSinistra Critica

1. I quote here only the companies mentioned in the data published between August 17 and 23.
2. According to Thomson Financial and the (Italian) Association of the financial and industrial markets.
3. Figures from www.internationalhouses.net.
4. Data from Nomisma, quoted by the supplement “Plus 24” of the daily newspaper Il Sole 24 ore of September 1, 2007.
5. Quoted by Il Sole 24 ore of August 30, 2007, p.2.
6. Joseph Halevi, writer and journalist, is a longtime collaborator of the left-wing Italian daily newspaper Il Manifesto. The quotation comes from his article in Il Manifesto of August 19, 2007.
7. According to the UN the relationship between the incomes of the richest 20 per cent of the population and the poorest 20 per cent went from 30/1 duringthe 1960s to 86/1 at the end of the 1990s.
8. "(...) in 1979 71 per cent of the resources of French companies were intended for productive investment internal or external to the company, and only 2,9 per cent for financial activities; ten years later the ratio was 48 per cent to 35 per cent ". M. Bertorello, Per una nuovo movimento operaio (“For a new workers’movement”), Alegre editions, Rome 2004, p. 57.
9. Data from the Bank of Italy, quoted by the supplement “Plus 24” of Il Sole 24 ore of September 1, 2007.
10. www.internationalhouses.net.

11 Il Manifesto of August 29, 2007, op. cit.

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[8] www.internationalhouses.net

[9] Il Manifesto of August 29, 2007, op. cit.