What's happening in the finance sector – why market mechanisms failed

John Edmundson and **Philip Ferguson** look at the crashes on Wall Street, the US government bailout and what these tell us about the state of contemporary capitalism

Go figure. . .

"The market is not functioning properly"
- George Bush, September 25

Actually, it's the normal – 'proper' – functioning of the market which regularly produces crises

Virtually everywhere you turn there is panic in the media. The spectre of 1929 has been summoned as commentators predict economic catastrophe. The US administration has been panicked into approving a bailout of the US financial sector with close to a trillion dollars in governmental assistance. Are we facing another '29 crash? Are we facing another Great Depression in the mould of the 1930s?

Following the 1929 crash, the USA and other capitalist countries enacted new legislation with the aim of preventing a repeat of the Wall Street Crash and the Great Depression that followed – a depression that was not finally overcome until after six years of the bloodiest war the planet has ever experienced. While high profits were the order of the day during the long postwar boom, the system ran quite smoothly. However the end of that boom, the oil shock and prolonged stagflation of the 1970s revealed that the postwar economic prosperity had not seen the much-trumpeted end of the boom/bust cycle. Despite this, over the years, most notably after the election of Ronald Reagan as US president and the triumph of neo-liberal economics over the struggling Keynesian orthodoxy, those controls were gradually relaxed or withdrawn. This set the scene for the financial turmoil that has characterised the last few years, particularly the period following the onset of the sub-prime mortgage crisis.

Sub-prime crisis

The sub-prime crisis occurred when banks discovered what they saw as low-risk ways of lending out increasingly large amounts of money in the domestic mortgage market. Sub-prime simply means less secure than a traditional mortgage. Constantly rising property prices encouraged banks to lend against an increasingly high proportion of a house's value. Even here in New Zealand, where the sub-prime phenomenon has so far been less serious, banks began to lend as much as one hundred percent of a property's value secured against a mortgage. After all, a $400,000 mortgage on a $400,000 property would soon be made more secure by the rise in property values. With the house soon appreciating to $420,000, the mortgaging bank's exposure to risk would fall to ninety five percent, and this trend would continue.

In the US in particular, the problem was compounded because banks outsourced their lending operations to mortgage brokers, whose primary interest was in securing the commission on the mortgage. That the actual lender was one step further removed from the borrower seemed not to be a problem as long as property prices continued to soar. To compound the problem further, banks "bundled" and on-sold the mortgages to other financial organisations such as pension funds, removing the debtor and "owner" of the debt still further from each other. Again, this was not a problem as long as house prices continued to grow and loans continued to be repaid.

What happened instead was that many borrowers, especially in the low-income "sub-prime" sector began to struggle to make payments. Rising food and oil prices, coupled with low wage rises (and even wage cuts) have meant that real incomes have been falling quite significantly for many people in the USA, especially in the lowest income brackets. At the same time, the mortgage interest rates began to climb. Many sub-prime mortgages included "honeymoon" periods with discounted interest rates and a combination of poor understanding by borrowers, changed circumstances, poor practice and sometimes out and out dishonesty by the brokers meant

authorised by Rebecca Broad, 2/15 Poronui St, Mt Eden, Auckland

many low-income homeowners found it impossible to meet their increased mortgage payments.

The lending institutions responded in many cases by issuing foreclosure notices against the mortgagor. Mortgagee sales, in addition to a more general slowing in the housing market, put pressure on the equity levels on properties which had been leveraged too high. Instead of a $400,000 dollar loan on a rapidly appreciating $420,000 property, there was a $400,000 loan on a falling $380,000 property. Mortgagee sales increased as lenders scrambled to recover whatever they could from the deal and, increasingly, homeowners began to walk away from their properties, as they too were saddled with a debt greater than the market value of the asset they had bought.

Trouble spreads

The trouble spread both within and beyond the USA. The bundling of debt into packages for on-sale to other institutions meant that sub-prime mortgages found their way into the hands of retirement funds and insurance companies and they were also picked up by financial institutions in other countries. In Britain, Northern Rock, a building society that had become a bank in 1997, sought and received government assistance in September 2007 following its exposure to US sub-prime mortgages; this support was insufficient and, in February 2008, it was taken into government ownership. European and Asian banks began to report exposure to the sub-prime sector as well.

The problems in the finance sector have escalated as the year has gone on. On September 7, the US federal government stepped in to bail out Fannie Mae and Freddy Mac, after these two mortgage guarantors revealed the extent of their financial difficulties. Fannie Mae, the Federal National Mortgage Association (FNMA), was established in 1938 as part of Franklin Delano Roosevelt's "New Deal" response to the Great Depression and was authorised to make loans and loan guarantees, thus bringing the possibility of home ownership to many working class Americans. By 2008, it held half of the country's $US12 trillion home mortgage market in either loans or guarantees. Consequently its exposure to the property market reversal was huge. Freddie Mac, the Federal Home Loan Mortgage Corporation (FHLMC), a second state-established but privately operated mortgage institution, was set up in 1970 to act as a competitor for Fannie Mae. Both are now under conservatorship, which is the US equivalent of nationalisation.

On September 15, the US government refused to bail out Lehman brothers, resulting in one of the biggest bankruptcies in US history. The collapse occurred after talks with a potential buyer, South Korean state-controlled Korea Development Bank, fell through. Yet as recently as December 2005, the International Financing Review said that Lehman Brothers had "not only maintained its overall market presence, but also led the charge into the preferred space by . . . developing new products and tailoring transactions to fit borrowers' needs. . . Lehman Brothers is the most innovative in the preferred space, just doing things you won't see elsewhere." Innovative it may have been, but resting on firm foundations it clearly was not.

Time to foreclose on capitalism?

The state comes to the rescue

A day later on September 16, the federal government bought the American Insurance Group (AIG) after a downgrade in its credit rating. AIG had been heavily involved in credit default swaps, "futures instruments" which allowed AIG to speculate on the odds of their own corporate customers defaulting on their debts! The $US85 billion bailout made it the biggest bailout of a private company in US history. It has resulted in the unusual situation of making the US government the owner of the world's largest insurance company.

Washington Mutual, the country's largest savings and loan institution, failed on September 25 after a ten-day run on deposits and it was placed into receivership. Two weeks earlier, on September 14, the iconic financial services firm Merrill Lynch was swallowed up by Bank of America as another end of an era was marked on Wall Street.

What these companies had been doing is trading in increasingly speculative futures markets, where much of the profit was generated by betting on what the economy would look like in the future and how secure the corporate world's debt management would be. What these "financial instruments" were doing was contributing to an increasingly fictitious bubble economy, more and more removed from the real economy. It was only a matter of time before it, like every other bubble, was burst when reality reasserted itself.

As this is being written, the European authorities are struggling to reach agreement on how to deal with the fallout in their economies. A French proposal for a €300 billion fund has been rejected by other European governments but Europe is determined to present a united front and avoid the division that plagued the US attempt to pass the bailout there.

Opposition

In the USA, opposition to the bailout has come from the left and the right. The left have focused primarily on the need to ensure that big corporate bosses do not simply use the bailout money to pay themselves huge bonuses. Certainly that sort of "snout in the trough" self-justification and greed would not be without precedent. However, principled opposition from the left should be based on explaining what the bailout is actually about and how it does not benefit workers

in the long run. As some on the US left have pointed out, health care and education are never "affordable" but at the stroke of a pen, a trillion dollars can be doled out to the super-rich of Wall Street.

On the right, opposition has emerged around the notion that the bailout represents some sort of triumph for socialism. This is nonsensical; the bail-out simply reflects the fact that capitalism can't – and never has been able to - survive without state intervention. The state intervenes to stabilise capitalism when market mechanisms fail – as they frequently do.

From boom. . .

The woes in the financial and banking sectors raise the question of why the artificial economy has become such a major feature of modern capitalist society. As far back as WW1, the Russian revolutionary leader Lenin pointed to the way in which "coupon-clipping" was becoming increasingly prevalent, as opposed to investment in plant, machinery and workers in order to expand production.

After the Great Depression of the 1930s and World War 2, however, productive investment – ie investment in the things that actually create new commodities and expanded value – increased dramatically. This was the period of the long postwar boom, from the late 1940s to the early 1970s. During this period there was a massive increase in productivity and output and sizeable increases in real wages in the industrialised capitalist world. Capitalism was now, we were told, crisis-free and Marxism was disproven.

In fact, the boom laid the basis for its own demise and a new crisis. The reason for this is that, whatever the character of individual bosses, capitalism is a system based on maximising private profit. Under capitalism, goods and services are mainly produced in the form of commodities – a commodity being anything that is produced to be sold on the market for a profit.

Workers are the section of society who have been deprived of any way of surviving other than selling their ability to work (their labour-power) to an employer. The value of a workers' power, like the value of any other commodity in capitalism, is determined by the socially necessary labour-power which goes into its creation.

If the value necessary to produce a worker in a fit state to turn up to his or her job each day is $500 a week, then that is the value of their labour-power. However, working together collectively with other workers and machinery and technology, a worker can produce $500 of goods for their

Not so much a rock, as hitting a rock

employer in, say, 25 hours. But, unlike the boss, the worker can't take the rest of the week off to play golf or go to the beach. He or she has to stay at work for 40 hours (or, these days, longer). This is surplus-labour time and the goods or services produced in this time are surplus-value, which is converted into profit for the employers. Part of this surplus-value can then be invested in hiring more workers and upgrading machinery and technology.

In the economic recovery after the Great Depression and WW2, profit rates were originally high. Large-scale investment went into expanding the workforce in the developed capitalist countries – through incorporating more and more women and immigrant workers, for instance – and in research and development, leading to technological improvements which made workers more productive. The additional surplus-value produced through these improvements is called relative surplus-value and relative surplus-value was the main form of expansion which took place for several decades following WW2. So far, so good. Or so you would think.

However, this very period of growth created a problem for capitalism. What went wrong?

. . . to bust

The process of increasing productivity through the purchase and utilisation of more sophisticated machines and technology means that the variable capital, expended on human labour-power (the source of surplus-value), falls in relation to constant capital (that spent on the buildings, equipment and raw materials). Each commodity now contains less labour-power and therefore less value. Even if total profit has increased through the number of commodities produced going up substantially, the rate of profit falls because it is measured over the total capital outlay in which the constant capital, which produces no new value, has increased in proportion to the variable capital which produces surplus-value.

Falling profit rates in the productive sphere - which is the sphere which allows everything else in the world to go round - mean that capitalists have to invest greater and greater amounts just to maintain the same amount of profit. For instance, $100 million invested in production at a ten percent rate of profit yields a $10 million profit. But as the rate of profit falls to, say, five percent, then $200 million would have to be thrown into the next round of the production process.

Eventually capital reaches the point at which, regardless of the size of the mass of profit - which can be enormous - it is insufficient for the scale of investment needed in new and more productive machines, labour-power and raw materials to keep the production process going. Things grind to a halt. In the early 1970s, the older industrial capitalist countries reached crisis point, as their industrial plant became increasingly in need of replacement. The crisis hit Britain first, as it was the first modern industrial society and its plant was the most outdated. It hit countries like Japan and Germany later, as their industries had been rebuilt after WW2.

Attacks on workers

To restore higher profit rates, capitalists cut costs. They do this by laying off workers, driving down labour costs and increasing the rate of exploitation. For instance, they will try to drive down wages to a level below the cost of labour-power, so that there is an increase in surplus-value – the extra value produced by the worker and pocketed by the capitalists. And they will often speed up the rate of work, forcing fewer workers to churn out more commodities.

Additionally, the crisis causes many individual capitalists, and often whole sectors, to go bust because they cannot compete with other capitalists. When they go bust, all their workers end up unemployed.

It is not just workers in the private sector

who experience much harder times in a crisis. Public services are financed out of total surplus-value, thereby lessening the amount which can be converted into profit. This isn't a big issue in boom times, but when falling profit rates eventually bring about a crisis, capitalists argue for cuts to many forms of state spending – especially in areas like health and education.

They also try to convert as much of the public sector as possible into profit-making ventures, either by privatising them (as with rail, Air NZ - both of which were then so run down by private ownership the government had to buy them back - Telecom etc nationally and buses and other council services at the local level) or by imposing user-pays charges and cutting costs (health and education).

Under capitalism, workers are always forced to fight for even crumbs; we need to take possession of the whole cake

Ballooning artifical economy

Falling profit rates in the productive economy also send capital rushing into the artificial economy. Buying and selling shares, currency trading, insurance and even buying and selling debt – in fact, even betting on debt – have become increasingly pronounced, especially since the 1980s.

Traditional banks, new investment banks and credit and other finance institutions rushed headlong into these areas, leading to vastly-inflated paper values. Even companies we generally think of as producing actual goods like cars increasingly invested in the artificial economy. Indeed, the artificial and real (productive) economy – the one where actual goods and services containing new, expanded value are produced – became increasingly merged.

Thus what is involved is not merely a few especially greedy speculators and other cowboys in the artificial economy, but the *necessary and inevitable operations of the capitalist system itself*.

While the paper values in the artificial economy are unreal – ie they don't match actual values of goods and services – the debt built up in this sector of capitalism still has to be paid. If you loan funds to buy debt at vastly inflated prices and then the price of the bits of paper on which the debt details are typed collapses, you still have to pay back the loan (and the attached interest). When financial institutions can't do this, the interconnections between them can set off a chain reaction of collapses.

In the past two decades we've had the stock market crash of 1987, the 1990 junk bond market crash, along with a savings and loans crisis in the US, the 1994 US bond market crash and in 1997 a financial crisis hit the new 'Asian Tiger' economies. The following year there was a hedge fund crisis and in 2001 the dot.com bubble burst.

State intervention

In the current case the interconnections between a raft of financial institutions – linkages which are produced through the operations of the capitalist system itself – have spread the problem like a virus. In order to contain it, the capitalists have resorted to state intervention

Despite all the rhetoric about keeping the state out of business, any serious capitalist knows that the state is essential not only to maintain favourable conditions for capitalist profits but also to rescue capital from crisis. This can be done by bailing out big companies – whether by advancing them cheap loans or handouts or by temporarily nationalising them – and by further attacks on workers' wages and conditions.

The impact on workers

Each time surplus-value from the productive sphere of the economy has to be siphoned off into the artificial sphere in order to pay the accrued debts and prevent a complete collapse, the productive sphere becomes even more squeezed and stagnant.

Although workers have no say over the operations of either inter-related sphere of the modern capitalist economy - the productive or the artificial sphere - it is always workers who are expected by the capitalists to pay for the crisis.

If the bosses are able to prevent workers from struggling successfully to maintain and improve wages and conditions, then they can solve the crisis in their own interests – at least until the next one comes along, as it inevitably does under capitalism. If workers fight back successfully, the crisis will actually be intensified.

So workers face two options: surrender and accept worse living and working conditions or fight back in a way that goes beyond the existing system to something better.

Something better

That something better would be for workers to take possession of all the means of producing and circulating real wealth. That way we could establish a system of planned production to meet the needs of humanity instead of the anarchy of the market and investment that focuses solely on maximising the profits of the wealthy few. We could have a shorter work week, more leisure time and free public health, education and transport. We could solve world hunger and poverty.

That's a far more attractive world than the chaos of the market.

Unlike the parties currently sitting in the NZ parliament, the Workers Party is dedicated to the cause of workers' liberation and workers' power. Moreover, we fight for workers' rights all year round. We encourage you to come and join us in the fight.

For more information: http://workersparty.org.nz
P.O. Box 10-282, Dominion Rd, Auckland