THE STORY OF THE AMERICAN SUB-PRIME CRISIS AND THE GLOBAL FINANCIAL TSUNAMI

By

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An Abstract:

This research paper tries to explore the relationship between the American sub-prime crisis and the global financial tsunami. Can we establish an affirmative answer or is the US realty crisis just one of the many reasons of the current global contagion? We also suggest solutions to the international financial meltdown and the present mayhem and disorder that are not exclusively America-centric in nature. Its indeed a time for all nations to 'put their house in order' and introspect and reflect upon what went wrong so that future policy actions and plans can be implemented in a timely and orderly manner in order to prove the often-quoted cliché that 'if America sneezes, the rest of the world catches a cold'. This crisis situation is an eye-opener to all nations to welcome globalization, but with adequate checks and balances. It also questions the North-bloc domination in policies and institutions of international trade, finance, and capital that needs an urgent revisit and reform to take cognizance of global power shifts from the North to the South. Thus, glocal solutions would be ideal mid-way compromise, especially for young nations like India to integrate, as well as protect porous economic borders in our flat world. On a larger canvass, the on-going G-20 is speculated to create yet another addition to the Brettonwoods twins of 1944 to deal with the current global mayhem.

Keywords:

Explore the relationship, American sub-prime crisis, global financial tsunami, affirmative answer, just one of the many reasons, suggest solutions not exclusively America-centric, 'put their house in order', introspect, eye-opener, welcome globalization, adequate checks and balances, glocal solutions, young nations like India, yet another addition to the Brettonwoods twins.

I) Introduction

This research paper tries to explore the relationship between the American sub-prime crisis and the global financial tsunami. Can we establish an affirmative answer or is the US realty crisis just one of the many reasons of the current global contagion? History is replete with numerous examples that depict the inherent crisis and fluctuations that America has been vulnerable to. It had five major financial crises of systemic importance since 1982, thereby making it one crisis every five years on an average. This situation becomes particularly dangerous when they cumulate into the mother of all crises that we have at present.

II) The American Sub-prime Crisis

We need to take cognizance of what's going on inside the system as the American case reiterates the fact that financial crises typically emerge from imbalances in the real economy. Basically the country inherited a huge disequilibrium in its economy that also extended to the world economy in the past decade due to excessive consumerism that rose from 2/3 of the GNP to almost 3/4 of the GNP. People have been spending six to seven percent more than what they produce. The difference is made up obviously by imports that result in a huge trade deficit that is financed by exporters like China thereby helping to keep US interest rates low. Obviously, this situation would result in a financial crisis caused by exogenous factors of globalization and rising trade flows. This process internally was supported by easy mortgage lending, sub-prime mortgages, and people taking equity out of the houses, expecting price increases. Obscurity is one big problem inherent in this new system and surprisingly, the primary gatekeepers are the credit rating agencies who hired the same financial engineers that were making up the instruments. Unfortunately, those instruments were supposed to be great because that's what the companies themselves thought, that's what the people who made them up also thought. Thus, the foundations of the new financial system were based on shaky grounds.

The domestic monetary policy also misled the economy as the freedom of imports kept a damper on inflation so latent inflationary pressures were overlooked, and there were no or relatively little regulatory or supervisory control over non-banks that had become a much more important element in the financial system. The Federal Reserve did something that central banks don't usually do. They have taken onto their balance sheet uncertain assets. Nowhere is this more clearly demonstrated than in the downturn in the US housing market and the resulting crisis in the market that sub-prime mortgages were made to people with poor credit histories.
The origins of the crisis date back to 2000, when the US housing boom was born. Over the period 2000-2003, U S house prices registered average annual increases of about 7 percent. The boom became a bubble and, in both 2004 and 2005, house prices rose at a double-digit pace, propelled by speculation, lax lending practices, and purchasing decisions that were too dependent on rosy assessments of future appreciation in house

prices. The housing boom was accompanied by an explosion in mortgage lending. Home sales and building activity skyrocketed, with new-home construction surging to what would prove unsustainable levels.
While the housing market was going gangbusters, the US Federal Reserve was busy hiking interest rates. The Fed had slashed interest rates from 6.5 per cent in 2000 to 1 per cent in 2003 ,to spur economic growth in the aftermath of the dotcom bust and the 9/11 terrorist attacks.
As the economy recovered, the Fed began to tighten monetary policy in mid-2004, raising interest rates gradually to 5.25 per cent by mid-2006.
As interest rates rose, some homeowners found it increasingly difficult to keep up with their mortgage payments. This was especially true of sub-prime borrowers, who tend to hold mortgages with flexible interest rates and are therefore more sensitive to Fed rate moves. Sub-prime borrowers were also the first to lose their jobs as the economy slowed in 2006. Over the past two years, the default rate on sub-prime mortgages has roughly doubled. More recently, defaults on so-called 'Alt A' mortgages - near-prime loans usually given to buy-to-let property investors -have also jumped, albeit from low levels.
What we now know is that the US housing boom was sustained in its later stages by lending to dodgy borrowers.
Sub-prime mortgage borrowing tripled during the go-go years of 2004 and 2005.
Between them, sub-prime and Alt A mortgages accounted for more than 40 per cent of all new mortgage loans extended in 2005.
The surge in delinquencies among borrowers has resulted in a wave of bankruptcies at sub-prime mortgage lenders.
But sub-prime lenders are not the only institutions to suffer direct losses from mounting defaults. Most sub-prime mortgages are repackaged and sold off to investors such as hedge funds, insurance companies, in vestment banks and pension funds, in the form of mortgage-backed bonds. Investors that snapped up these bonds are also feeling the pain.

Credit Suisse, the financial services group, estimates that more than $800 billion of sub-prime mortgage bonds and $700 billion of Alt Abonds are outstanding. Fed Chairman Ben Bernanke reckons that losses in the sub-prime lending market could top $100 billion. What is less clear is who holds these bonds and therefore who will ultimately carry the can. We do know that investors all over the world bought plenty of these bonds, which helped spread widely the risks associated with sub-prime loans.

III) **Spread of the Contagion**

The 2008 World Economic Forum in Davos, Switzerland, brought many business leaders and policy makers under the theme of "The Power of Collaborative Innovation" in January 2008. The United States' sub-prime mortgage crisis and fear of possible impact on global credit markets had left participants with pervasive uncertainty in their minds. In recent days, sub-prime debt has shown up on the balance sheets of a bank in Germany and several hedge funds in Australia, in all cases with painful consequences. The US sub-prime crisis has gone global.
Problems in sub-prime lending are also beginning to spread to other types of loans. The

crisis has prompted a worldwide reappraisal of the price of risk and a flight from risky assets. Global stock markets have plunged, as the corporate buy-out boom has come to a screeching halt.
As credit conditions have worsened, fears of a credit crunch have grown. Foreign exchange markets have not escaped the turmoil, with the dollar and some emerging market currencies down sharply in recent weeks. Rising Asia has also not escaped this global meltdown and is being affected slowly, but surely. We are already seeing more government intervention into the financial sector, even in this country, the home of the 'free market'. That is likely to be followed by more expansionary fiscal policies, as governments seek to stimulate their economies and run deficits to pay for the bailout of the banks. This will cause major problems for the members of the European monetary union who are supposed to keep their structural deficits within 3 percent of GDP and will likely strain this rule if not the basic operating practices of the Union itself. The stage has been set for a looming conflict between the European central bank, which is committed to controlling inflation, and the member governments of EMU. The U.S. will find it much easier to run larger deficits, provided they are accompanied by enough buoyancy in the economy to persuade foreign lenders to continue to hold dollars. If they do not, of course, cutbacks in government spending will be required to defend the exchange rate and will lead to an even deeper recession in this country. It used to be said that, if a bank lends you enough money, you own that bank. We can only hope that this applies internationally to those governments now holding trillions of dollars in their foreign exchange reserves. In Europe, the political effects are likely to be more diffuse. If the ensuing recession is not too deep, the current crisis may provide Gordon Brown with just enough credit for the Labor party to survive the next British election and Angela Merkel with the wherewithal to remain German Chancellor. But history suggests that electorates tend to punish governments that preside over deep recessions and to look, in some cases, to the political extremes for new faces and voices. Therefore, there is reason to worry about the rise of far right parties in Europe, in particular, where they have already made inroads by running against the market-oriented policies of the European Union.

"The world economy has entered new and precarious territory", opens the latest World Economic Outlook published by the International Monetary Fund (IMF) in April 2008. It describes the current financial crisis that erupted in August 2007 as "the largest financial shock since the Great Depression, inflicting heavy damage on markets and institutions at the core of the financial system." (IMF, 2008). Other commentators have described the current crisis as a "systemic financial meltdown", a "financial tsunami", a "tipping point" in the world economy or even "the Very Great Depression" in the making (Hielma, 2008).

When even the most optimistic defenders of the ruling system speak of a "systemic crisis", then something of historical significance must be happening in our midst. Our task is to grasp the significance of the current crisis in the world capitalist system for the laboring classes, and draw lessons for our struggle against imperialism. The world economy faces a combination of financial crisis and economic slowdown, both originating in the heartland of US capitalism, with the two trends reinforcing each other. The fantasy of ‘decoupling’, according to which Europe, Asia and other economies could

grow independently of the US, has already been dispelled by the beginnings of a slowdown in Europe and Asia. Instead, there is, in reality, a 'recoupling', as the US slowdown impacts on the rest of the world. Inevitably, if the US goes down it will drag the rest of the world with it, to a greater or lesser extent. The forces that have produced the US downturn have taken a year or so to develop, and the effects of a US recession will take time to work through the world economy. The collapse of the sub-prime housing loan market in the US is a major crisis in its own right. Major banks like Citicorp, the world's biggest bank, have announced record losses – Citicorp was forced to write off $18 billion in dodgy housing loans. Altogether, American and European banks have written off over $120 billion, and there is undoubtedly much more to come. More recently, the previously unknown 'monolines', the bond insurers, which have come to play a key role in the bond and securities markets, have been forced to announce huge losses, with the US authorities now trying to mount a $15 billion rescue of a number of these bodies. In the week beginning 21 January, stock exchange speculators around the world at last began to catch up with reality, waking up to the growing evidence of a US and world recession. Shares plunged between 6-10% on major exchanges, and are now between 15-20% down on last October's peak prices. A 20% fall is officially a 'bear' market. The huge losses (€4.9bn, $7.2bn) incurred by the French bank, Société Générale, as a result of a rogue trader, is another symptom of the crisis. The forced sell-off of shares by the bank to cover its losses may have contributed to the sharp fall on major stock exchanges. But it is absurd to try to blame the crash on the hapless Jérôme Kerviel. In reality, SocGen's losses were just one symptom of a general crisis, at most exacerbating the problem. It is predictable that Kerviel's fraud will only be the first of many that will be uncovered in coming months, just as the Enron crisis in 2001 was followed by a series of scandals involving big corporations like WorldCom and a whole string of top investment banks. Alarmed by worldwide stock exchange falls, Ben Bernanke, chair of the US Federal Reserve, dramatically cut interest rates by 0.75% to 3.5%, the biggest single rate cut since 1983. This move stabilized stock markets, with many regaining their previous levels. However, lower interest rates, while they may ease the immediate liquidity crisis, will not overcome the paralysis of the financial system – and stock exchanges will continue to be highly volatile. These events were reflected at Davos, the annual forum for capitalist leaders, where the optimism of last year – stimulated by record profits and bonuses for the bankers – was replaced by doom and gloom. Most Davos delegates considered Bernanke's rate cuts 'too little, too late'. "There are hardly any dissenters from the view that the US is in recession – the debate is only over how deeply and for how long". (Lex, Financial Times, 22 January 2008) Beyond wealthy financial circles, however, Bernanke's move has reinforced the view that the Fed is always ready to step in to help wealthy investors, but not so helpful when it comes to helping working people. Already, the financial crisis and the prospect of a serious downturn have shaken confidence in the 'magic of the marketplace'. Global economic crisis will have a profound effect on the consciousness of the working class and laboring poor around the world. In the US, a pro-free market commentator, David Brooks, warned of "a backlash against Wall Street and finance sweep[ing] across a recession haunted country" (International Herald Tribune, 26 January 2008).

IV) **Consequences of the Sub-prime crisis**

After slowing down last year, US capitalism is now sliding into recession. The only questions are how deep will it be and how long will it last? Given the combination of a housing slump, a severe credit squeeze and a crisis in the financial system, the downturn will clearly be more serious than the relatively shallow recessions of 1990-91 and 2001. The credit crunch, which has only just begun, will increasingly retard economic growth, while minimal or negative growth will exacerbate the financial crisis. This vicious circle makes it most likely there will be negative growth for two or more quarters (the official definition of a recession), followed by a slow and painful recovery.

The puncturing of the housing bubble is a key factor in the US economic slowdown. House prices were pushed up by the flood of cheap housing loans, allowing many home owners to convert part of their equity into additional spending power. This boosted consumer spending (even more than the 'wealth effect' from the 1990s share bubble) which accounts for 70% of the US economy. At the peak of the bubble, home owners were drawing $700 billion a year from their homes. This has now fallen to under $200 billion.

To extend the scope of their highly profitable home loans business, many of the banks and other dodgy mortgage lenders developed the 'sub-prime' mortgage sector, lending to people who could not really afford to purchase their homes. Borrowers were seduced with low 'teaser' rates which subsequently shot up, interest-only repayment schemes (which only work out when house prices continue to rise), no down payments, etc. Now there are revelations of deception and outright fraud by property agents, mortgage brokers, etc, who made huge fees out of the sub-prime operation. The banks which ultimately financed the operation convinced themselves that they had abolished the inherent risks involved by securitizing the loans, bundling them into complex packages that were sold on to investors.

The excesses of the sub-prime mortgage market have now rebounded on the financial sector, triggering a generalized liquidity and credit crisis. Moreover, as the recession deepens, the loans crisis is spreading to many 'prime' borrowers who are being hit by unemployment and squeezed incomes. In fact, the piling up of housing debt is proving to be a disaster for many working-class and middle-class families. There is now a glut of unsold houses, and the rising number of foreclosures will worsen the problem. House prices are down 6% from the peak (10% in real, inflation-adjusted terms). But the house price 'correction' is far from complete: prices are likely to fall by 20% or 30%, which would wipe out between $4-6 trillion of housing equity. The sub-prime sector alone will result in about two million foreclosures (repossessions), while a 30% fall in house prices would plunge over ten million households into negative equity (owing more than the value of their houses).

As mortgage borrowing has slowed, credit card and other forms of consumer debt have risen. The household debt ratio is now 136%. At the same time, people have been hit by higher petrol and heating fuel prices. Sales over the Christmas holiday were down, and unemployment rose sharply in December. It was the biggest rise in the unemployment rate since the 9/11 attacks in 2001. In December there was an increase of only 18,000

jobs with the private sector actually losing 13,000 jobs. Despite the increase in manufacturing exports, the manufacturing sector lost 31,000 jobs in December (bringing the total lost for 2007 to 183,000). After growing about 2% in 2006, both hourly and weekly earnings fell in 2007. The poor job figures, issued at the beginning of January, were one of the signals which prepared the way for the stock exchange plunge on 21 January.

The growth of corporate profits, which soared to record levels in recent years, has also begun to slow down. For the S&P 500 companies, profits per share declined by 2.8% in the third quarter of 2007 compared with the previous year. "An earnings recession is now under way. Pressures on profit margins will contribute to weaker capital spending and perhaps depress hiring" (Morgan Stanley GEF, 3 December 2007).

Clearly, the liquidity squeeze (shortage of ready cash) that began last summer had turned into a full-blown credit squeeze (shortage of capital) which is now affecting wider sections of the economy. A protracted credit squeeze is likely to produce a severe downturn, but if this turns into a systemic breakdown of the financial system, US capitalism could be plunged into an even deeper downturn. US capitalism is gripped by a severe credit crisis, which is spreading to Britain and other European economies. This financial crisis was triggered by the US sub-prime meltdown, which brought massive losses to major banks like Citicorp and investment banks like Merrill Lynch. Over 200 US housing lenders have gone bankrupt, and more will follow. The sub-prime losses in the US, Britain, Germany and France already surpass $120 billion, and could rise to $250 billion or $500 billion. As the credit crunch spreads to other sectors, the total losses could be colossal. The US recession will bring a global economic downturn. The crisis in the US financial system will in itself have a major impact. But from the point of view of production and trade, the US still has an immense influence. It accounts for 25% of world GDP and its consumer market is six times as big as those of India and China combined. Over the last few years, the idea of 'decoupling' has been popular among both speculators and government policymakers. Europe and Asia, it was claimed, were increasing their own internal trade, becoming less reliant on the US market. This illusion arose on the basis of the slowdown of the US economy during 2007, while China, India and other economies were still accelerating. It was inevitable, however, that when the US went into recession, it would have a major impact on the Asian economies, as well as Europe and other regions. This has already been borne out by current trends.

Ironically, the decoupling argument was promoted by financial wizards at the investment bank, Goldman Sachs. Recently, however, a Goldman Sachs economist, Peter Berezin, announced an about-face: "What began as a US-specific shock is morphing into a global shock". (Bloomberg, 7 December 2007) Of the 38 countries they monitor, Goldman expects growth to weaken in 26. Stephen Roach of Morgan Stanley, always sceptical about decoupling, commented: "The American consumer is the big gorilla on the demand side of the global economy. As the slowdown goes from housing to consumption, we will find the world is not as decoupled as it thinks".

A report confirmed the impact that slower US growth is already having on Asian exporters. "From Chinese garment companies to Japanese equipment manufacturers, Asian exporters say they see weakening demand from the United States, a development with potentially wide-ranging effects for Asian economies". (Exporters across Asia Brace for US Downturn, International Herald Tribune, 25 January, 2008) Europe will also be hit by the US slowdown (apart from the impact of the financial crisis). Moreover, the housing bubbles in Britain, Spain, Ireland and other European countries are also in the process of deflating. Given the crucial role the housing bubble has played in driving consumer spending, there will undoubtedly be a slowdown in Europe, though it may not be so severe as the US and will vary from country to country.

The Chinese economy grew by 11.4% in 2007, the highest growth rate in 13 years. The trend of declining exports, however, will mean slowing growth in the next period. The idea that China could rapidly switch to stimulating domestic demand is fanciful. Low wage levels and huge inequalities mean that domestic purchasing power is extremely low. The rapid growth of the Chinese economy over recent decades has been structurally dependent on export growth, using the foreign currency revenue from exports to finance investment and the purchase of raw materials. The switch to dependence on internal demand would mean a painful readjustment, which could only take place over a considerable period of time.

Moreover, a collapse of China's stock market as a result of the world financial crisis could have a major political impact in China. Paradoxically, the stock markets play very little part in China's real economy. However, over 100 million people have invested in shares, mostly during the last few years of booming prices. A massive sell-off would wipe out the household savings, pension provision, etc, of millions of families who were encouraged to invest in the stock exchange by the Chinese government. "Large-scale public protest is a possibility: thousands of irate investors demonstrated at the headquarters of the ministry of finance the day after the increase in trading tax by 0.2% last May, precipitating an instant sell-off". (Financial Times, 21 January, 2008).

It is also fanciful to believe, as some western commentators do, that household savings in China, and for that matter India and other Asian countries, can be used to finance a new growth cycle in the advanced capitalist countries. The lack of a social safety net, for instance, with the elimination of village communes and the 'iron rice bowl' provided by state-owned enterprises to their workers, has meant that families have tended to save more in order to provide for ill health and old age. They are not easily going to hand over their vital family savings to western capitalists; especially if they see investors burn their fingers in a crash of the Chinese stock exchanges.

World export growth will also be hit by a decline in the price of oil and other commodities, as world demand slackens. This will cause major problems for regimes that overwhelmingly depend on the revenue from commodity exports, for instance Putin in Russia, the Iranian regime, and the Chávez government in Venezuela. Moreover, their demand for imported manufactured goods will be severely reduced.

The Federal Reserve has cut US interest rates to 3.5% and other central banks (Bank of England, European Central Bank, etc) are likely to follow with rate cuts, though probably not so drastically. Lower interest rates will ease the liquidity problems of banks and businesses, but will not themselves overcome the credit crunch, or stimulate a revival of demand for goods and services.

Leaders of the Bank of England (Mervyn King) and the European Central Bank (Jean-Claude Trichet) have so far been reluctant to cut interest rates to the same extent as the Federal Reserve. They argue that there is still a serious danger of inflation, fearing the prospect of a **return to 'stagflation'** (as in the 1970s), combining slow or even negative growth with accelerating inflation. In the short run, it appears that capitalism faces a more serious threat from recession or slump than from a revival of inflation. The main ingredients of inflation in the last period have been soaring oil and gas prices, commodity prices, food prices, etc. This is a product of rapid growth in China, and India The prices of these commodities will decline as growth slows. At the same time, a slowdown of growth has a deflationary effect, with increased unemployment and lower wage levels accompanied by overcapacity and overproduction of goods.

Wage levels cannot seriously be blamed for higher inflation, as real wages have generally trailed behind rises in the cost of living. In the future, the threat of inflation could re-emerge, especially if US capitalism attempts to pay off its international debts by printing dollars, flooding the world with devalued dollars. However, in the short term it seems more likely that world capitalism faces a period of stagnation and deflationary trends similar to the position of Japan during its decade-long stagnation in the 1990s. West European powerhouses like Germany are already in a recession and Eastern counterparts are rushing to the IMF for saving their fragile economies.

Major economies, particularly those with balance of payments deficits, will attempt to revive domestic growth through the growth of exports. But they will all be competing with one another in a shrinking world market. This may lead to competitive devaluation of their currencies in an effort to boost their export sales. The incipient trade wars of the last few years, moreover, will escalate, with the adoption of more and more protectionist measures. The US, for instance, has had a certain growth of exports and may well encourage the decline of the dollar in order to promote its exports. However, a collapse of the dollar would provoke turmoil in the world currency system, aggravating the crisis in the world finance system.

Whatever the precise character of the unfolding downturn, whatever its duration, the coming period will be one of growing difficulties for world capitalism. The 'successes' of globalization will evaporate, to be replaced by sharpened antagonisms between rival capitalist powers and intensified social and political crises.

Political consequences

Last year, the sub-prime crisis and its repercussions marked a turning point, and this has now been amply confirmed. Global capitalism now faces a combined financial crisis and

economic slowdown, which will interact and deepen the crisis. This marks the end of the recent phase of globalization, which has been dominated by finance capital and a frenzied short-term drive for profit. For a few years, this promoted rapid growth in China and to a lesser extent the United States, the binary axis of the world economy. Now it has turned into its opposite, with a recession in the US that will drag China and the rest of the world down with it. The capitalists can blame nobody but themselves. The 'success' of globalization has been undermined by the system's inner contradictions.

In the last period the capitalists have surely had everything they could wish for. There has been the largely unfettered working of the free market, with little or no regulation of the shadowy financial networks that flourished in the period of securitization, derivatives, etc. Governments of both 'left' and 'right' have promoted the interests of the banks, big corporations and the super-rich. The share of wages in the wealth produced has been reduced to record lows, while there has been an unprecedented surge in profits. Facing minimal taxation, the super-rich have enormously increased their share of the wealth. Yet their system is once again in deep crisis and the working class and poor laborers internationally will pay the price. Millions will lose their jobs, their houses, and their modest savings. A serious recession – or to put it bluntly, a slump – possibly followed by a period of stagnation, will impose terrible hardships on the working class and the poor. In the case of a serious slump, workers can initially be shocked, preoccupied by the struggle for daily existence. But there can also be defensive struggles against attempts by the capitalists to offload the crisis onto the working class, such as the strikes we have seen in the recent period in Latin America, Germany, France and elsewhere.

The world economic crisis of capitalism, however, will also provoke a political crisis. The economic downturn, financial crises, and the events through which they will unfold, will have a profound effect on the consciousness of the working class, especially its advanced layers. Already there is a questioning of the viability and legitimacy of the free-market capitalist economy. Fervent advocates of globalization and neo-liberal policies are now confronted with the paradox of the fragility of the financial system with the huge rewards it generates for insiders will destroy something even more important – the political legitimacy of the market economy itself.

The more politicized workers will also increasingly challenge trade union and labor leaders who have embraced the market economy and support neo-liberal economic policies, who now act as a barrier against working-class struggle. There will be intensified battles to reclaim trade unions as democratic organizations of mass struggle, and renewed moves to establish new mass workers' parties that can mobilize workers and give them a class voice. Increasingly, rejection of a crisis-ridden capitalism will be reinforced among the conscious layers of workers by support for an alternative to capitalism based on democratic socialist planning on an international scale, together with workers' democracy. Thus, financialization of capital and globalization will worsen the living and working conditions of labor worldwide as retrenchment, lay-offs, and unemployment would become commonplace. Surprisingly, this has already begun, more in Asia, especially China and India in comparison with the US, UK, and France. **Thus,**

the clichéd statement 'when the US sneezes the rest of the world inevitably catches a cold' is back in global jargon.

V) Is there a way out?

Can action by the Federal Reserve and US government avert a recession? Bernanke's 0.75% cut in the base rate on 22 January was designed to further ease the credit crisis and reassure Wall Street investors. The Fed may cut rates further over the next few months. But the general view of capitalist policymakers (reflected in the reaction at Davos) is that it is 'too little, too late'. When overstretched banks and financial institutions are facing a shortage of capital, a lower base rate, in itself, will not solve the problem. Moreover, since the sub-prime crisis erupted, all lenders have become much more restrictive, imposing tighter conditions and higher interest rates on both company and household borrowers. This situation could continue for a prolonged period, even if the Fed further reduces rates.

On 23 January, 2008 George Bush and Congressional leaders agreed a stimulus package in an attempt to head off a recession-a strongly opposed move that is still hanging. The package amounts to around $150 billion or 1% of US GDP. Bush dropped his earlier demand to make his previous tax cuts (for the super-rich and big corporations) permanent but the 'compromise' negotiated with House of Representatives Democrats is mainly based on tax rebates and other tax concessions that will mainly benefit the wealthy and big business. Bush conceded that every worker earning less than $75,000 would receive a $300 rebate, including many who are currently paying no tax. At the same time, the package will pay additional amounts to higher earners and business. This means that most of the money will go to people who are well off and are unlikely to spend the extra cash immediately. The package does not include measures advocated by some Democrats, for increased state spending on schools and infrastructure and emergency aid to state and local governments (whose tax revenues are being undermined by the property crash and economic slowdown). The Democratic leader, Nancy Pelosi, described it as "a remarkable package", but New York Times columnist, Paul Krugman, commented: "The worst of it is that the Democrats, who should have been in a strong position… appear to have caved in almost completely… They extracted some concessions, increasing rebates for people with low income while reducing giveaways to the affluent…" (International Herald Tribune, 26 January 2008). The revival package has been rejected by Americans themselves who feel that the tax-payers hard-earned money cannot be used to bail out the greed of a few.

This fiscal stimulus package will not avert a recession, which is already gaining momentum, though it may cushion the downturn after a time lag. Neither the Fed's interest rate cut nor Bush's fiscal package will reverse the housing slump or rapidly overcome the colossal debt burden of the financial sector. Even if interest rates are reduced to a lower level (to a near-zero level in real terms, given current inflation), they will not succeed in reviving the economy through another credit-driven housing boom. In this respect, the lesson of Japanese capitalism in the 1990s is clear. Japan's massive debt-overhang from its frenzied property boom of the late 1980s paralyzed the economy for

over a decade, and still weighs to some extent on the economy. Neither negative real interest rates nor a series of massive government spending packages succeeded in stimulating sustained growth in the Japanese economy. “In 2001”, comments Wolfgang Munchau, “the US got away with an unusually short recession helped by aggressive interest rate cuts and an expansionary fiscal policy. But in Japan in the early 1990s, and in Germany in the early part of this decade, it took ages for low interest rates to help the real economy”. (Financial Times, 20 January 2008)

Nor will increased exports provide an easy way out for US capitalism. Exports have grown faster recently, but they account for only 12% of GDP. Such is the deindustrialization which has taken place over the last three decades; the US could only significantly increase its export growth on the basis of large-scale capital investment in new plant and equipment, which is unlikely to take place under existing conditions. Moreover, a slowdown in the rest of the world will cut the markets for US exports.

Measures taken by the central banks, cutting the base interest rates and extending credit to the major banks, has eased the immediate liquidity crisis. Inter-bank lending, which completely seized up when the sub-prime crisis broke last August, has begun to function again (though at higher rates of interest than before). But this has not eased the credit crisis. The major banks are hoarding capital, fearing further losses which they cannot at this stage fully calculate. In recent years, the banks made loans to borrowers on a huge scale and then packaged them into securities which were then sold on to investors. This proved extremely profitable for the banks and other financial intermediaries. The use of derivatives, it was claimed, spread the risk of losses as a result of borrowers’ defaults, virtually abolishing risk. Ultimately, however, the shadow banking system which developed, largely free from any government or central bank regulation broke down under the impact of rising sub-prime housing defaults in the US.

Suddenly, the big banks were forced to take direct responsibility for their ‘off balance-sheet operations’, conducted through various arms-length investment vehicles. Now, even though the immediate liquidity crisis has eased, the banks have become much more restrictive in their lending, imposing tighter conditions and charging higher interest rates (despite the fall in central bank rates).

When the crisis came in the form of the sub-prime crisis, there was panic throughout the banks and other financial institutions. No one knew where the risk was – in fact, risk was generalized, the whole credit system was contaminated by toxic loans, many of them as yet unidentified.

The sub-prime crisis marked the beginning of a chain reaction which is still continuing. The crisis of the monolines, the bond insurers, has now come to the fore. Altogether, the monolines are estimated to be insuring $2,400 billion-worth of bonds. However, the increased risk of defaults on the insured bonds has raised the specter that the monolines have insufficient capital to cover all likely losses. Ironically, the credit ratings of some of these monolines have now been downgraded, effectively making them insolvent. Two of the biggest, Ambac and NBIA, have combined losses of $8.5 billion – and there is

currently a desperate rescue operation, mounted by Eric Dinallo, the New York State insurance supervisor, to raise $15 billion from major banks in order to prevent a collapse of the monoline sector. This hangs in the balance. If the rescue fails and a series of monoline insurers collapses, a systemic financial crisis could be triggered.

Some of the major banks, like Citicorp and Merrill Lynch, have gone with their begging bowls to the sovereign wealth funds, the investment funds set up by oil producers, China, etc, to channel their huge foreign currency reserves into investments in the advanced capitalist countries. This may prevent the bankruptcies of the major banks, but this source of additional capital is not available to the smaller banks, which are desperately hoarding cash and imposing tighter credit conditions on businesses and household borrowers.

So far, the collapse of a major bank or finance house has been averted. But it is clear that a number of major institutions are facing not merely a credit crisis but the possibility of insolvency. However, the massive sell-off of shares by Société Générale, triggered by the discovery of a $7.2 billion (€4.9bn) fraud, apparently played a role in triggering the stock exchange falls in mid January. So far, Société Générale has been shored up, but there remains the possibility of a series of major banks or finance houses facing insolvency, which could trigger a much more serious crisis. The situation is far worse, for instance, than the collapse of the hedge fund, Long Term Capital Management, in 1998, which was rescued by a consortium of major US banks. Fortunately for US capitalism, LTCM turned out to be an isolated case.

Government and central banks are now calling for tighter regulation of a whole range of activities, especially the operations of the shadow banking system. But the damage has already been done, and it is too late to eradicate the effects of all the dubious operations of recent years, including outright fraud which will undoubtedly emerge. Central banks will undoubtedly attempt to prop up banks and ease the credit squeeze with lower interest rates. They may also try to collaborate in controlling wild gyrations in the world monetary system. But it is much harder for them to influence capital flows and currency alignments than in the past. Currently (according to the Bank for International Settlements), over $3.2 trillion is traded every day on world currency exchanges, a 70% increase from 2004.

VI) Is India protected from Bubblenomics?

Mainstream economists explain the current crisis as the bursting of the housing bubble that had inflated to unprecedented levels since 2001. The Economist described this bubble in 2005 thus: "the total value of residential property in developed economies rose by more than $30 trillion over the past five years, to over $70 trillion, an increase equivalent to 100% of those countries' combined GDPs. Not only does this dwarf any previous house-price boom, it is larger than the global stock market bubble in the late 1990s (an increase over five years of 80% of GDP) or America's stock market bubble in the late 1920s (55% of GDP). In other words, it looks like the biggest bubble in history."

There is the argument that over the past several years, the United States' trade deficit has persistently drained spending from the United States' economy. As a result, much of manufacturing failed to recover after 2001 which then prompted the Federal Reserve to push interest rates to all time lows. This staved off recession but gave rise to the housing bubble – a house price inflation, a construction boom, explosive growth of non-traditional sub-prime mortgages, a debt financed consumer spending scenario and, yet, larger trade deficits. These gave rise to trade surpluses in the rest of the world, distributing the sub-prime holdings globally. The trade surpluses persisted as the Asian countries pursued export-led growth and they blocked appreciation of their currencies against the dollar to maintain their competitiveness. A great portion of the surpluses were re-invested in dollars. Therefore, long-term interest rates did not rise even when the Federal Reserve raised short-term rates in 2004. Artificially low interest rates prompted investors to increase risky lending at diminished risk premiums. On the consequences for the global economy, there have been statements from responsible analysts and even the Federal Reserve that the United States' economy is likely to face a contraction in the second and third quarters of 2008, annualizing about one percent. Against this backdrop, it is possible to look at likely consequences for the Indian economy and impact, if any, on gross domestic product (GDP) growth. At the top are concerns of a direct impact on financial institutions in India. The RBI has clarified that the exposure of Indian banks and institutions to the crisis is 'marginal'. There is a story in Business Standard that claims that State Bank of India, ICICI Bank, Bank of Baroda and Bank of India are set to book mark to market losses on their foreign offices to credit derivatives. The Business Standard has estimated the total of these losses to be around US$3 billion for the four banks put together, and has commented that the provisioning made by these banks so far has been quite small. Given the size of the banks and their balance sheets, even if these figures were accurate, there would be little impact on the overall performance of the banks. In short, the direct fall-out effect of the collapse of the sub-prime mortgages to institutions in India is likely to be quite insignificant. Second, it is clear that there would be weak (or no) growth in the United States, and estimates (World Bank, 2007) suggest that high-income countries would grow at just 2.2 percent this year, as against 7.1 percent for developing countries (estimates put China at 10.8 percent, India at 8.4 percent and South Asia at 7.9 percent). Given low inflation expectations in the United States, the World Bank suggests that emerging countries would pull high-income countries behind them. The benign part of the projection is that low growth in the developed countries would keep commodity price increases under control, lessening risks of inflation in the developing countries, and adding to stimulus for growth. The other side of the coin is that contraction in the United States would lead to less demand for imported goods, impacting imports. There is the argument that the Indian economy is sufficiently decoupled from the rest of the world and that there is robust domestic demand and employment creation – this would cushion the economy from external shocks. But this may not be quite true. In 2002, trade was only 17 percent of GDP but it is now close to 40 percent. Thus, the trade dependency of the Indian economy has doubled in the last five years. The United States is the top trading partner for India (though China is catching up) and there would be the concern that exports to the United States may fall. The current monetary policy in India is battling with the need to control inflation, keep interest rates at level that promotes growth while simultaneously attempting to prevent undue appreciation of the rupee – a

task considered to be very difficult to accomplish altogether. Already, export orders for the textile sector have fallen significantly, and large job losses are being reported. The appreciation of the rupee is largely due to accentuated capital flows, and free and flexible financial markets and, hence, the concern of the RBI Governor that this is likely to be exacerbated by the contraction in demand in the United States. The policy response in India is likely to be to ensure that that the rupee does not appreciate 'too much', a task that will entail active sterilization operations by the RBI. These operations, through issue of market stabilization bonds, entail an additional fiscal burden on the government for the interest costs of these bonds. Energy costs have risen but adjustment of consumer prices has not been possible due to political compulsions of the coalition. It is likely that fiscal stresses on the government may increase. It is this total picture of rupee appreciation, lower exports and fiscal stress that is causing worries in the Indian Finance Ministry and the Planning Commission.

VII) Quo-Vadis?

Recently released global figures reiterate the recessionary trends spreading from the fulcrum of crisis- the USA to the Euro-zone, which for the first time in thirteen months has shown GDP cuts lower than expected down by -0.2 to -0.5 with the highest fall demonstrated by the largest economy, namely Germany, with Italy following suit, and many others to join in. The exception of France showing +0.16 percent GDP growth is largely attributed to political will of implementing a rescue package on an emergency basis. The current financial turmoil is forcing central banks to step in and bailout those financial institutions that are simply "too big to fail". The Bank of England, for instance, extended a L25 billion emergency loan to the ailing Northern Rock last year. Last March 14, 2008 the US Federal Reserve guaranteed the loans of JP Morgan to rescue Bear Stearns, the fifth largest investment bank in the US with $2.5 trillion worth of trading contracts with firms from around the world. Even more momentous was the US government's decision last September 7, 2008 to take over the two biggest mortgage lending agencies in the country -- Fannie Mae and Freddie Mac – effectively placing US housing finance under direct government control and increasing the gross liabilities of the US government by $5.4 trillion, a sum equal to 40 per cent of GDP.[1] Nine days later, the US Federal Reserve agreed to provide American International Group (AIG) – among the world's largest private insurers with operations in 130 countries -- with an $85 billion loan to help it stave off bankruptcy. This rattled stock markets across the globe, plunging share prices and prodding private banks to hold on to their reserves. This has forced the world's leading central banks to band together and inject $300 billion into the global financial system to ease the credit crunch and prevent further panic – for now.

The solutions to this massive problem lie in the very causes that led to its occurrence. The dual phenomenon of "Globalization" and "Financialization" are at the heart of the problem. The unprecedented devastation of productive forces wrought by the last inter-

imperialist war cleared the stage for around two decades of relatively stable and sustained growth in the advanced capitalist countries. But by the late 1960s, Europe and Japan were fully reconstructed as industrial powers rivaling the United States and worldwide economic growth began to slow just as monopoly capitalist competition intensified. Even as big business continues to invest in new technologies in its drive to extract ever greater profit, growth rates, national productivity rates, capital stock formation and net profit rates have been on the decline since the 1970s. Average net profit rates in the G7 countries fell from 17.6% in the 1950-70 period to 13.3% in 1970-93. Only the US economy appeared vigorous in the second half of the 1990s but only on the basis of a speculative build-up in the equities markets using foreign borrowing which fueled overinvestment in information technology and buoyed consumer spending. This dotcom bubble went bust in 2001, replaced by the housing bubble which has brought upon us the present crisis. Underlying this systemic tendency towards crisis is the fundamental contradiction in capitalism itself: between social production which enables great strides in productivity on the one hand, and the private ownership of the means of production which ensures that only a few profit from production by exploiting the many. This contradiction inevitably leads to crises of overproduction – a situation in which there is a glut in commodities relative to the capacity of people to buy them.

The shift to neo-liberal economic policies in the 1980s is monopoly capital's attempt to revive falling profits due to the worsening crisis of overproduction – by forcing open markets, sourcing cheaper labor and raw materials, and securing profitable investment outlets. Through the IMF, the WB and the WTO – all of which are imperialist controlled "multilateral" institutions – liberalization of investments and trade, the privatization of public assets, deregulation of markets and cutbacks in social services and welfare spending, are imposed on client states under the hypocritical slogan of "free-market globalization". Combined with the re-integration of the former Soviet Union and China into the global capitalist system, imperialist globalization has truly succeeded in rewarding international monopoly capital. On the other hand, these reforms which aim to maximize profits and minimize wages, benefits and social spending for workers and the people have only resulted in the immiseration of the vast majority in the world. The net result is that by 2000, the richest 1% in the world own 40% of global assets, the richest 2% own 51%, while the poorest half of world population own barely 1% of global wealth.

Hence the flipside to the crisis of overproduction is the over-accumulation of capital in the hands of the monopoly capitalist elite. With overproduction rendering further investment in new productive capacity (such as factories and employment) increasingly unprofitable, a rapidly rising share of surplus capital is seeking profits not in the real economy but in financial speculation -- a process sometimes referred to as the "financialization" of the global economy. This involves the frenetic increase in the trading of currencies, equities, bonds, debt securities, financial derivatives and other complex synthetic financial instruments, taking advantage of even the slightest differentials and momentary changes in bond prices, interest rates, and currency exchange rates in different markets around the world. Moreover, this financial debacle ultimately impacts on the real economy as even the biggest banks and financial

institutions faced with huge uncertainties are now averse to issuing new loans for housing, investment or for the purchase of cars and other durable goods. This means less investment and consumer spending which in turn means slower growth and even recession. The IMF warns that the US economy may shrink by 0.7 per cent over the 1-year period ending the fourth quarter of 2008, despite aggressive rate cuts by the Federal Reserve and a fiscal stimulus package. Recovery would be slight in 2009 with growth expected to be only 1.6 per cent. These estimates have been revised downwards several times and may still prove to be overstated as the crisis unfolds (IMF, 2008 a).

Almost 10% of the US workforce is now unemployed or underemployed, and job losses continue to mount. The private-sector has shed 411,000 jobs over the past six months. Last month alone (May), 26,000 workers lost their jobs in manufacturing, 34,000 in construction, 27,000 in retail trade, and 39,000 in professional services, most of whom were temps. Over 150,000 temps have been terminated over the past year. The nominal rise in employees' earnings are falling well behind inflation now running at 4%. This implies continued losses in the real value of wages or the purchasing power of most workers which has been stagnant or declining since the 1970s (ITUC, 2007).

Impact on working people in South-bloc countries

Banks from the underdeveloped countries in the South have less exposure to sub-prime loans and the housing market bust in the US. But the adverse consequences of the current global financial crisis on the welfare and livelihoods of exploited classes in the oppressed countries will be more severe and protracted.

First, the global credit crunch means reduced capital flows for third world countries who are chronically dependent on foreign capital inflows to pay for older debts, sustain imports from the advanced capitalist countries and paper over chronic deficits they incur as imperialist states plunder their economies.

Second, most unindustrialized countries who are dependent on exporting agricultural products, raw materials, minerals, low-value added manufactures and services (e.g. business process outsourcing) to the advanced capitalist countries will be faced with shrinking exports due to the combination of depressed consumption in the North. Unindustrialized countries that are more deeply bound to neo-colonial trade relations with imperialist centers, particularly the US, would be the most severely affected. This includes the so-called newly industrialized economies which export significant volumes to the US by way of China. That is, by exporting parts and equipment of labor-intensive manufactures that are assembled in China before being shipped and sold in the US and EU markets.

Third, aside from being dependent on low-value commodity exports, unindustrialized countries are also dependent on the export of labor, particularly to the wealthy industrialized countries. International labor migration serves as an outlet for the surplus labor that cannot be absorbed by stunted domestic industries in these countries, as well as an important source of foreign exchange remittances that help pay for imports and debt-

service. But recessions and rising unemployment in the advanced capitalist countries are invariably associated with the tightening of borders to keep out foreign workers. This means higher unemployment in labor-exporting countries, reduced earnings for foreign remittance-dependent households, and lower consumption spending in the domestic economy.

Fourth, and perhaps most importantly, as financial instruments and stock markets become less attractive to financial investors, speculative capital shifts more into commodities trading such as oil, minerals and agricultural commodities. This is contributing to the precipitous rise in food and energy prices beyond what conditions in the real economy warrant, thereby rapidly eroding the real incomes of the vast majority especially in the third world. Food accounts for 30-40% of the consumer-price index in most developing countries, compared with only 15% in the G7 economies. The Economist estimated that two-thirds of the world's population suffers double-digit rates of inflation this season (mid-2008). This is pushing millions of people deeper in poverty. In the Philippines, for instance, the Asian Development Bank estimates that "for every 10 percent increase in food prices, about 2.3 million more fell into poverty." They will be joining nearly three billion people — half the world's population -- who are living on less than two dollars a day, including 1.3 billion workers (The World Bank, 2008).

Credit ratings agencies have been criticized for their role in the sub-prime fallout. Although they undoubtedly share part of the burden, they shouldn't be the scapegoat. They are part of the dysfunction of the originate-to-distribute model and for that reason we have to deal with the difficulties that come from their activities. It is a chain and each of the links of the chain has to be analyzed, starting with the way credit was being distributed, packaged and securitized. There should be a code of conduct and global monitoring, similar to the kind for auditors, involving the main regulatory organizations. Charlie McCreevy [European Commissioner for Internal Markets] and [French finance minister] Christine Lagarde have expressed the view that there should be some kind of registration of credit ratings agencies at the EU level. Thus, there should be a registration process at the EU level and the enforcement should be done at the level of national authorities.

We need to rewrite the rules and redesign the global financial architecture as it has proved wanting. The Brettonwoods twins were created with a special purpose in mind in the post-World War II era, primarily of restoring liquidity and solving balance of payments disequilibrium, along with providing for the development needs of the Third world nations; all of which still remains to be attained. The G-8 needs to be widened to include promising economies like India and China, so also the UN Security Council that needs to take India and Japan under the banner of its permanent membership. The on-going G-20 Summit in Washington needs to take multi-pronged efforts to contain the contagion and redefine the role of global regulators to reassure the world economy, especially new and emerging economies that the balance between risks and benefits of integrating with an open world

economy is restored. A third international organization may just be declared soon at the Washington meet of the G-20 for addressing the much-awaited new revival strategy. Non-monetary measures, especially fiscal need to be used effectively to spur demand, investment, and economic activity.

Glocal solutions would need to be devised by domestic economies to cope with this global recession problem as their individual structures, institutions, and policies are uniquely different. India, for instance has started to take several measures like reassuring the realty sector at home that banks would accelerate lending, and also further reduce interest rates to spur demand for housing and investment in new projects. The return to single-digit inflation after a long period would prompt the RBI to initiate further interest, repo, and reserve-repo rate cuts to infuse liquidity. The Government also seeks to fulfill its promise of implementing the long-overdue Sixth Pay Commission that would increase people's demand, but should hopefully not fuel demand-push inflation.

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