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Causes of the economic crisis

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Karl Marx (1884):
"It is precisely because the money form of value is its independent and palpable form of appearance that the circulation form M … M' ["money–more money"] which starts and finishes with actual money, expresses money-making, the driving motive of capitalist production, most palpably. The production process appears simply as an unavoidable middle term, a necessary evil for the purpose of money-making. This explains why all nations characterized by the capitalist mode of production are periodically seized by fits of giddiness in which they try to accomplish the money-making without the mediation of the production process" (Marx 1884/1978: 137).

Because profit seeking is the driving force in the capitalist mode of production, many capitalists will consider the (surplus value) productive sector of the economy as a troublesome or unnecessary roundabout. Money capital which seeks profits within the finance sector, makes a shortcut in its hunting for profit.

Summary of my argument: The economic crisis is not due to any "external shock", but the outcome of an *endogenous* process of accumulation of finance capital based on particular conditions in the real economy (i.e. the basis for financial profit seeking), and proceeding by new means of financial profit seeking ("financial innovations")

1. The basis of financial profit seeking

1.1. The rising dominance of shareholder value

An important aspect of the turn to neoliberalism around 1980 was the increasing emphasis on shareholder value. This turn reflects a change of power relations within the corporate system.
In the United States, dividends as a proportion of total profits in non-financial companies excluding farming doubled from 24.7% in 1980 to 50.1% in 1990, exploded after the year 2000, and reached a stunning 87% of total profits in 2003.
Redistribution of profits in favour of shareholders → inflation in share markets→ rising capital gains for shareholders.

The New York Stock Exchange Index (NYSE Index): a historical peak of 4700 points in August 2000. From 2003 onwards an exceptionally strong increase to new historical peak of about 10,600 points in July 2007.

1.2. Subprime lending, house price inflation and mortgage refinancing

Role of subprime lending exaggerated.

March 2007: value of subprime mortgages in the US estimated at 1,300 billion dollar, corresponded to only 12% of total mortgage debt.

Large-scale refinancing of real estate, – primarily homes – made possible by a low interest rate and the price inflation of houses, apparently a far more important cause.

In 2005, 40% of existing mortgages were refinanced.

Table 1: US household debt by end of year, 2000 and 2007

	2000	2007	Percent growth, 2000–2007
Total debt, billion US dollar	6987	13803	97%
Mortgage debt, billion US dollar	4798	10540	120%
Other household debt, billion US dollar	2189	3263	49%
Mortgage debt as share of total debt	69%	76%	
Total debt as share of disposable income	94%	133%	

Sources: Federal Reserve, *Flow of Funds Accounts of the United States*, 2nd Quarter 2010, table D.3, www.federalreserve.gov/releases/Z1/; and Shaikh (2010: 53).

Mortgage refinancing → home owners obtained "free cash" for consumption. → private consumption in US rose by 20,1% from 2000 to 2006, although real wages increased very little:

In 2006: real wage in the US business sector excluding agriculture was only 0.6% higher than in 1973, while labour productivity was 81.4% higher than in 1973.

1997–2006: Consumers drew more than 9000 billion US dollar in cash out of their home equity, an amount equal to more than 90% of disposable personal income in 2006.

1.3. The turn to mandatory fully funded pensions

The essential aspect of the pension reforms in Western countries since around 1990 is the shift from mainly “pay-as-you-go” schemes where current payments of pensions were financed though current taxes, to fully funded pensions.
→ an enormous rise in the assets and turnover of different types of institutionalised pension funds, as well as pension savings managed by insurance companies.
End of 2007: pension funds globally managed a capital of 22,000 billion US$, and insurance companies 18,000 billion dollars, totalling 3 times the US GDP.

1.4. The growth of sovereign-wealth funds

Table 2: Sovereign-wealth funds of at least 50 billion US dollar at the end of 2007

Country and name of fund	**Size of fund, billion US dollar**	**Year of Iniciation**
United Arab Emirates: Abu Dhabi Investment Authority	875	1976
Norway: The State’s Pension Fund Abroad	380	1996
Singapore: GIC	330	1981
Saudi Arabia: several funds	300	n.a.
Kuweit: Reserve fund for future generations	250	1973
China: China Investment Corporation	200	2007
Singapore: Temasek Holdings	159	1974
Libya: Oil Reserve Fund	50	2005
Qatar: Qatar Investment Authority	50	2005

Source: *The Economist*, 19.01.2008: 63.

At the end of 2007: the total sovereign-wealth funds globally amounted to 2,876 billion US dollar, most of which invested in shares and bonds. Of the total amount, 2,103 billion US dollar, or 73%, were petroleum related funds.

1.5. The rising deficits and foreign debt of the United States

For the 25 years 1982–2006: accumulated public sector deficit in the US amounted to 5624 billion US dollar.

Public deficits are covered mainly by issuing government securities (Treasury Bills and Bonds) which are mainly sold abroad. Dollars accumulated as trade surpluses by foreign countries are re-circulated back to the US mainly through purchases of US government securities which are sold to finance the budget deficit. **The US government's issuances of Treasury bonds serve a double purpose: They cover the government deficit as well as the current account (and trade) deficit.**

Table 3: The financial balance of the US with the rest of the world. Billion US dollars

	1994	2000	2004	2006	2008	2009
(1) Total financial assets of the rest of the world	2904.9	6584.9	10523.4	13979.6	15008.3	15816.5
(2) Total liabilities of the rest of the world	1702.3	3490.2	5590.2	7234.2	8379.3	8689.2
(3) Net foreign debt of the US	1202.6	3094.7	4933.2	6745.4	6629.0	7127.3
(4) GDP of the US	7085.2	9951.5	11867.8	13398.9	14441.4	14258.7
(1) as percentage of (4)	41.0	66.2	88.7	104.3	103.9	110.9
(3) as percentage of (4)	17.0	31.1	41.6	50.3	45.9	50.0
Addendum:						
Net foreign acquisitions of US government securities and govt.-backed securities	259.8	150.6	912.9	748.7	963.0	817.8
Net foreign financial investment	134.7	455.5	544.4	807.4	583.9	215.9

The figures for 2009 are preliminary.

Sources: www.federalreserve.gov/releases/z1/ tables L.107 and F.107 (financial data); and www.gpoaccess.gov/usbudget/ (GDP).

In 2006, the net foreign debt of the US was more than twice as big as the total debt of all developing countries.

US deficits → pumping up the finance sector with liquidity → an important part of the basis of financial profit seeking.

These mechanisms have also increasingly made the US the effective demand locomotive in the world economy in the last 30 years.

2. New means of financial profit seeking

2.1. Credit derivatives

Credit derivatives have two things in common: (1) they serve to spread risk from the original creditor to other actors in the finance system, and (2) they are in general traded "over the counter" (OTC), directly between financial actors and not via an official securities exchange.

Total global notional amount of OTC derivatives outstanding rose from less than 100,000 billion US dollar by the end of 1998, to 683,800 billion (almost 50 times the US GDP) in June 2008.
Worldwide estimated notional amount outstanding of credit default swaps (CDSs) rose from almost zero in the year 2000 to 58,200 billion US dollars by the end of 2007.

CDOs play basically the same role as CDSs. A CDO represents a "package" of bonds, loans or "asset based securities" (ABSs) with different ratings.
CDOs are sold worldwide. The global issuance of CDOs rose from 68 billion US dollar in 2000, to a peak of 521 billion in 2006.
When collateralised loans are converted to CDOs, the original creditor bank does not any longer need to have coverage for these loans in equity and deposits on the liability side of its balance sheet. The bank earns a fee on selling the loan, and the loan disappears from its balance sheet. Therefore, there is no limit to how much credit the bank can create. The "instrument" which eliminates the risk of the original creditor bank, and makes that bank continue creating credit, results in an enormously increased risk for the finance system as whole.

Warren Buffet: CDOs and other credit derivatives are "financial weapons of mass destruction".

2.2. Hedge funds

Hedge funds do not only invest in objects which they expect will rise in price, so-called "long positions", but also in objects which they guess will decline in price, so-called "shorting" or "short sales".

Assets under management by hedge funds worldwide rose from an estimated 39 billion US dollar in 1990, to a historical peak of 1868 billion in 2007.
March 2010: 59% of all funds had address in Cayman Islands, obviously to avoid taxation.

Hedge funds invest in all types of liquid assets which can have relatively rapid and often large price changes, such as shares, bonds, currencies, credit derivatives, all types of raw materials from metals to petroleum and, not least, food grains. Big and quick money is the driving motive of the hedge funds.

Collapses of hedge funds has been frequent. Among the most spectacular bankruptcies before the finance crisis in 2008 were Long-Term Capital Management (1998), Bayou Hedge Fund Group (2005), and Amaranth Advisors (2006) which lost 6.5 billion dollar in the hitherto largest hedge fund collapse in history. In August 2007, the US fund United Capital Markets declared itself ”illiquid” and stopped all payments to its partners.

The illusion that hedge funds could make "absolute returns" regardless of the ups and downs of markets was shattered in 2008, when the funds' reported average return on equity was *minus* 19% according to data from Hedge Fund Research. The crisis wiped out about 25% of the hedge funds' assets and forced many of them out of business, causing severe losses for a large number of banks.

The many failures of hedge funds well before the financial crisis of 2008-09 did not discourage the banks from showering big loans upon them, in some cases up to 90% of the funds' investments.. **Through high leverage, hedge funds can cause irreparable losses for the biggest banks, and especially when hedge funds unite to practice shorting of shares, so-called crowding, they can bring any corporation and even large currencies to fall.**

2.3. Private equity funds

Two types of funds are often categorised as private equity funds, viz. *buyout funds* and *venture capital funds*. Here, I will discuss only the buyout funds, which are by far the most important in terms of capital under management.

Private equity funds speculate in objects of low liquidity, mainly through buyouts of firms registered on the stock exchange.
Standard method: to buy out companies with a high equity share which they think are undervalued on the stock exchange. The companies are immediately withdrawn from the stock exchange and their equity is charged to repay loans which were used to finance the buyout.

Globally, committed capital in the funds rose from 47 billion US dollar in 1990 to about 500 billion distributed on 2700 funds in January 2007.
In 2001, private equity funds worldwide made buyouts of less than 50 billion US dollar, corresponding to ca. 5% of all acquisition and merger transactions. In 2006, total buyouts amounted to about 640 billion US dollar, accounting for approximately 30% of total acquisition and merger transactions worldwide.
After a buyout, unprofitable parts of the company are as a rule sold immediately or closed down. The remains of the company will be restructured, slimmed and split up before they are sold again and the profits are reaped.
A regular feature: Dismissal of workers and draining of the company's equity capital.

Uwe H. Schneider, professor of economics of law at the Technical University of Darmstadt:

> "Many of these alleged investors are in reality equity robbers. (…) At least 5000 German companies employing 800,000 workers are owned by these so-called new investors. Too many among them do not have any long-term interest in research and innovation, in future products and creation of new jobs. (…) We are destroying our future."

In 2006, borrowing financed 66% of the total buyouts of about 640 billion dollar. In 2006, 77% of buyouts by European funds were financed by borrowing. Up to 80% leverage has been quite frequent.

During the crisis 2008–09 this combination vanished many private equity funds went bankrupt. Bloomberg News: "Managers saddled with $1.6 trillion in buyouts made during the three-year boom [2005–07] have marked at least 6 of the era's 10 biggest deals at or below cost."

2.4. Leverage within the finance sector

From 1990 to 2007, the debt of the US finance sector increased by an average of 11.3% per year, from 2600 billion US dollar to 16,000 billion US dollar. The debt of the finance sector increased from 26% of total debt within the private sector in 1990, to 39.6% in 2007. ***Between 1990 and 2007, the rising debt of the finance sector accounted for 44% of the total debt increase in the private sector of the US (cf. table 4).***

Table 4: Debt of finance sector firms in the USA, 1980–2007

	1980	1990	2000	2007
Debt within the finance sector, thousand billion US dollar	0.6	2.6	8.1	16.0
As percentage of the US GDP	22.2	44.8	82.7	115.9
As percentage of total debt within the private sector *	17.7	26.0	37.3	39.6

* Households are included in the private sector.
Source: Foster and Magdoff (2009: 121−122).

Example: An investment bank or a hedge fund or a private equity fund (a financial investor) borrows 900 million US dollar at 3% interest to undertake a financial investment of 1000 million US dollar. The investor's guess is that the investment will yield a total return of 50 million US dollar (5%). If the investor's guess comes true, the return on equity will be 23 million US dollar, in other words 23%. The leverage has resulted in a percentage return to equity which is far above the total return on the investment.

3. Overaccumulation of financial capital

3.1. Cannibalistic features

Mainstream argument in favour of free financial markets: Devices such as credit derivatives, hedge funds and private equity funds serve to "correct" asset prices and create equilibrium in asset markets. By contrast, these devices create an instability which can lead to severe economic crises. ***With credit derivatives,***

hedge funds and private equity funds capitalism has developed strongly cannibalistic and self-destructive features.

Table 5: Aspects of the financial sector in the USA

	The financial sector's share of total profits in the corporate sector. Percent		The financial sector's share of total value added in the corporate sector. Percent		Shares of total gross domestic product. Percent			
					Finance		Manufact. industry	
1980–82	16.0	18.3	8.0	9.3	4.8	5,6	19,4	17,7
1983–85	14.5		9.0		5.4		18,1	
1986–88	19.3		9.9		5.9		17,2	
1989–90	22.8		10.0		5.9		16,6	
1991–92	29.5	25.5	10.9	11.6	6.3	6,9	15,8	15,4
1993–94	23.6		10.9		6.3		15,7	
1995–96	24.3		11.1		6.5		15,7	
1997–98	23.7		12.1		7.3		15,4	
1999–2000	27.7		12.7		7.8		14,7	
2001–02	40.8	36.2	13.5	13.7	8.1	8,2	13,1	12,3
2003–04	37.1		13.8		8.1		12,3	
2005–06	33.3		13.9		8.3		11,8	
2007	33.1	33.1	13.7	13.7	8.1	8,1	11,7	11,7

Source: Estimated on the basis of data from Bureau of Economic Analysis: www.bea.gov/, tables 1.1.5, 1.14 and 6.16 B–D.

The most visible achievement of the new financial innovations so far is enriching financial speculators, squeezing the productive sectors of the economy through a drastic redistribution of total profits from the "real economy" to the financial sector and through redistribution of incomes from wages to profits, in short, a massive accumulation of financial capital. The finance sector has grown to a gigantic parasitic machinery, which through the luxury consumption of its actors and recurring crises squander enormous economic and human resources in its hunting for a biggest possible share of total profits (cf. table 5).

3.2. Indicators of global financial wealth

Globally, total notional amount of outstanding OTC derivatives reached historical peak of 683,800 billion US dollar (47 times the US GDP) in June 2008, declining to 614,700 billion in December 2009.

Total global net financial wealth of high net worth individuals (each HNWI possessing at least one million US$) reached 40,700 billion US$ in 2007.

Another study reports that the global amount of return seeking financial assets increased three times more than the worldwide GDP, from 12,000 billion US dollar in 1980, to 196,000 billion in 2007, which was four times larger than the total world GDP in that year.
An average return of 7% on 196,000 billion US dollar corresponds exactly to the total GDP of the US in 2007.

3.3. Crisis and austerity policy

Many mainstream economists claim that the present debt crisis of states is the result of "irresponsible fiscal policy" through many years and has no connection to the financial sector crisis of 2007-08. This is not true, cf. table 6.

The big government rescue packets especially to the financial sector changed public finances from near balance to large deficits.
IMF, ECB and majority of economists claim that governments have to restore budget balances by cutting wages, reducing public employment and pensions, as well as privatizing public property. ***The magic spell of this policy is "expansionary austerity", which may best be characterised pure humbug.***

Table 6: Economic indicators before and during the crisis

Country	*Public budget deficit*[1)]			*Public gross debt*[2)]			*Rate of unemployment*[3)]		
	2006	2008	2010	2006	2008	2010	2006	2008	2010
France	2,3	3,3	7,0	70,9	77,8	94,1	8,8	7,4	9,3
Germany	1,6	+0,1	3,3	69,3	69,3	87,0	9,8	7,3	6,8
Greece	6,0	9,8	10,4	115,6	116,1	147,3	8,9	7,7	12,5
Ireland	+2,9	7,3	32,4	28,8	49,6	102,3	4,4	6,0	13,5
Italy	3,3	2,7	4,5	117,4	115,2	126,8	6,8	6,8	8,4
Netherlands	+0,5	+0,5	5,3	54,5	64,5	71,4	4,2	3,0	4,3
Portugal	4,1	3,6	9,2	77,6	80,6	103,1	7,7	7,6	10,8
Spain	+2,0	4,2	9,2	45,9	47,4	66,1	8,5	11,3	20,1
Great Br.	2,7	4,8	10,3	46,2	57,0	82,4	5,4	5,7	7,9
USA	2,2	6,3	10,6	60,8	71,0	93,6	4,6	5,8	9,6
Euro-zone	**1,4**	**2,1**	**6,0**	**74,5**	**76,5**	**92,7**	**8,3**	**7,4**	**9,9**
OECD tot.	**1,3**	**3,3**	**7,7**	**74,5**	**79,3**	**97,6**	**6,1**	**6,0**	**8,3**

[1)] Public budget deficit as percentage of GDP. + means surplus.
[2)] Public gross debt as percentage of GDP.
[3)] Annual average number of unemployed as percentage of total labour force.
Source: OECD, *Economic Outlook*, no. 89, May 2011, p. 353, 367 og 372.

Table 6: Youth unemployment in selected countries*

Year	Spain	Portugal	Ireland	Italy	France	Great Britain	Sweden	USA
2007	18,2	18,8	8,9	20,4	19,6	14,3	18,6	10,6
2010	41,7	26,6	27,9	27,8	23,3	19,5	22,8	18,4

* Annual average of number of unemployed in the age group 15 to 24 years as percentage of the total number in this age group who are not under education. The figures for Portugal and Sweden are for 1st quarter in the years 2008 and 2011.
Sources: *The Economist* – Special Report: The Future of Jobs, 10.09.2011, p. 4; and *The Economist Online*, 05.07.2011, «Youth Unemployment: The outsiders»: www.economist.com/blogs/dailychart/2011/07/

3.4. The only way out of the economic crisis: a dramatic overall depreciation of financial assets, forced or by means of inflation

Depreciation of financial assets implies losses for the creditors and benefits to the debtors.

Forced depreciation will necessitate that the states take over the "system relevant" banks to avoid what Irving Fisher called debt deflation: total collapse of the credit system, dramatic fall of effective e demand, and rapidly increasing mass unemployment. Nationalisation of banks will meet strong opposition from the political right. Therefore it is possible only in countries with strong and determinate left parties and equally strong trade unions.

Therefore **the inflation alternative**, most probably led by the USA, seems to me to be the most realistic possibility.