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World Economy

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27 February 2008

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The economic slowdown in the US is gathering momentum, accompanied by slower growth in Europe and elsewhere. At the same time, the credit crunch is intensifying and spreading to wider sections of the economy.

In January, \$5 trillion (£2.7tr) was wiped off world stock exchanges, with 50 out of 52 exchanges reporting overall losses for the month. While serious enough in itself, these losses on equity (share) markets are really a sideshow to the deep crisis in the more fundamental credit markets. So far, banks have reported write-downs and losses from the US subprime mortgage fiasco amounting to \$164 billion, but G7 leaders fear that the total could be \$400 billion – and even this could be an underestimate. At the same time, the crisis of the complex financial instruments is spreading to more and more sectors of financial markets.

The economic downturn and the deepening of the credit crunch are developing hand in hand. Based on the analysis carried in Socialism Today No.115 (February 2008), this article deals with some of the latest developments.

The sharp slowdown in the US economy (with third-quarter GDP growth of only 0.6% at an annualised rate) has already begun to have an effect on Europe, with growing fears of a slowdown in Japan.

The European Commission has reduced its GDP growth forecast for the 27 EU countries from last November's forecast, from 2.4% to 2%. The 15 countries of the eurozone are now expected by the Commission to grow at a rate of 1.8% in 2008, a reduction from the previous forecast of 2.2%. "The latest revisions to its outlook", comments the Wall Street Journal (22 February), "shows that what had been a 'worst-case' scenario might be taking hold, and its current forecast could be revised even lower". "Some of the downside risk that we were considering three months ago have materialised. The US slowdown is more evident now than in November". (Joaquim Almunia, EU economic commissioner)

For Britain, the EU Commission expects growth to slow

to 1.7% during 2007, down from its November forecast of 2.2%. (The British economy expanded 3.1% in 2007.)

In Japan, by contrast, the economy grew by 3.7% in the fourth quarter, up from only 1.3% in the third quarter. However, the main factor in this growth was exports, with weak domestic growth. Naoki Iizuka, an economist at Mizuho Securities, commented: "A slowdown in economic growth in the US is likely to start hurting the Japanese economy in the first quarter of 2008 and, coupled with a weaker dollar, it could contribute to much slower or even negative growth". (Financial Times, 14 February)

Developments within US capitalism, despite the 'decoupling' theory (that demand from emerging economies, like China and India, would support global economies during a US economic downturn), remains the key to the direction of the world economy.

US recession deepening

Recently released data shows that the US economy is sliding deeper into recession. Gross domestic product grew at an annualised rate of only 0.6% in the last quarter of 2007, compared to 4.9% in the third quarter. Overall, GDP growth for 2007 was 2.2%, the weakest growth for five years. Consumer spending, which accounts for 70% of US GDP, also slowed (down to 2% for Q4 from 2.8% in Q3). The Reuters/University of Michigan survey of consumer confidence registered an 11% fall between January and February: "Past declines of this magnitude have always been associated with subsequent recessions", said Richard Curtin, the director of the survey. An economist at Global Insight commented that the report "indicates an accelerating downturn. It doesn't look like a gradual letting the air out of the balloon right now". (Financial Times, 15 February)

US consumers have been hit by a combination of growing debt levels, squeezed incomes (both hourly and weekly earnings fell by 1% during 2007 in real, inflation-adjusted terms), and accelerating inflation. The consumer price index rose 4.1% during 2007, food and en-

ergy prices, in particular, are rising above average inflation. In January, for instance, "the import prices for food, energy and other commodities rose 13.7% compared to a year earlier, the biggest increase since records began in 1982". (Financial Times, 15 February) As the world economy slows, food, energy and commodity prices will almost certainly ease off, but there may well be a time lag. In the short term, commodity prices may continue to rise while the US economy slows down even more. Some import prices are, of course, increasing as a result of the continual decline of the dollar.

The major factor in the slowing of consumer spending, with all its knock-on effects, is the rapid deflation of the housing bubble. Between 1995 and 2006 the housing bubble (when house prices grew over 70% more than prices in general) accounted for about half of US economic growth. House building, housing services and furnishing, etc, accounted for some of the growth. But, taking advantage of cheap credit, many home owners used their mortgages to siphon equity out of their homes in order to augment their spending power. For many, this was a method of compensating for the long-term stagnation of income for the majority of wage and salary earners. At the peak of the bubble in 2005, home owners were drawing a total of \$780 billion extra spending power from their homes.

This source of growth has now exhausted itself. House sales fell by around 25% last year. In his 'Beat the Press' web commentary, Dean Baker commented: "The annual rate of decline in median house prices for the last quarter of 2007 compared with the third quarter was 21.8%. The price of the average home fell at a 17% annual rate... If this rate of decline persists, it would have an enormous impact on the economy. The 21.8% rate of decline shown for the median house price would imply a loss of more than \$4 trillion in housing wealth over the course of the year. This is more than 50 times the size of the tax break for families being considered as part of a stimulus package by Congress". (Beat the Press, 25 January)

"US foreclosure filings, a prelude to vacancies, surged 75% last year to 2.2 million, according to RealtyTrac. In December alone, there were 215,749 foreclosure filings, almost double from December 2006". (Wall Street Journal, 17 February) The numbers of people forced out of their homes by debt will undoubtedly surge during the course of 2008, with whole areas of some states like Ohio and Michigan being turned into suburban wastelands.

The housing credit crisis is by no means confined to the subprime mortgage sector. "People with good credit histories are falling behind on house payments, also loans and credit cards at an accelerating pace", reports the International Herald Tribune (13 Febru-

ary). The chief economist at Moody's Economy.com commented: "This collapse in housing value is sucking in all borrowers". Another Wall Street financier commented: "Subprime was a symptom of the problem. The problem was, we had a debt or credit bubble". The default rate for subprime mortgages has now reached about 24%. However, the delinquency and foreclosure rate for all mortgages, now at 7.3%, is higher than at any other time since 1979 when data was first collected.

As home owners' ability to borrow against their homes is drastically reduced, they are more and more turning to other forms of debt, particularly credit card debt. In November 2007, credit card debt rose at an 11.3% annual rate, much higher than the 2% to 4% annual rate between 2003 and 2005.

The various measures being implemented by the federal government and some states will have only a limited effect on the mortgage crisis. Schemes like 'Project Lifeline' target homeowners who are beginning to fall behind on their payments, offering them a breathing space to try to refinance their loans. The schemes, however, will not help three quarters of borrowers who are in trouble, especially those who are serious defaulters.

Affecting the wider economy

So far, unemployment (according to official figures) has not risen, but the small (17,000) reduction in US jobs in January (according to preliminary figures) suggests that unemployment is rising. Manufacturing employment is being the hardest hit. GM, about to be overtaken by Toyota as the world's biggest car manufacturer, recently announced losses for the last quarter of 2007. GM is now offering redundancy packages to its remaining 74,000 unionised workers (following 30,000 redundancies in 2006). Ford and Chrysler are also trying to severely cut back on their workforces.

The Center for Economic and Policy Research (CEPR) estimates that "the next recession could increase unemployment by 3.2 to 5.8 million people, and poverty by 4.7 to 10.4 million, with at least 4.2 million also losing health insurance. The range depends on whether it is a mild-moderate recession like the last two (2001 and 1990-91) or more severe as in 1980-82". (Mark Weisbrot, Proposed Stimulus Package is Not Enough, www.cepr.net) Given the combination of the banking crisis and economic downturn, however, the coming recession could be even more severe than 1980-82.

Until now, the credit crunch has primarily affected the banking sector and housing, but it is now beginning to spread to the wider economy. The complex securities (such as asset-backed debt obligations and credit default swaps) are not merely connected to subprime

housing loans but also involve loans raised by corporations in the manufacturing and service sectors.

"High-grade debt anxiety", warned the Wall Street Journal – Europe (22 February). "The global financial crisis... is rapidly spreading into a much larger area: the market for securities tied to the credit of the world's corporations. US and European indexes that track the likelihood of corporate defaults are flashing red as traders and investors fret about the outlook for the global economy and the possibility of blow-ups among some \$6 trillion in complex securities tied to the value of corporate bonds".

Some commentators are dismissing fear of the spread of corporate defaults as a panic reaction. "Corporate defaults, however", reports the Wall Street Journal, "have seen an uptick, and ratings firms are predicting a significant rise this year".

There is inevitably an interaction between the crisis in the banking sector and the real economy. There are already plenty of signs that the credit crunch is aggravating the downturn in the economy, and intensification of the finance sector crisis will undoubtedly accelerate the slide towards recession.

Credit crunch intensifying

The credit crunch is intensifying and extending to wider sections of the economy in the US, Europe and elsewhere. "Troubles in the subprime mortgage arena are seeping into other markets, like credit cards, auto loans and college debt issued to people with risky profiles". (Gretchen Morganson, International Herald Tribune, 18 February) Currently, losses and write-downs by banks total around \$164 billion (\$84bn in the US and around \$40bn in Europe). But there is clearly worse to come. After the meeting of G7 finance ministers, Peer Steinbrück, the German finance minister, said he feared that write-offs of losses on securities linked to US subprime mortgage could reach \$400 billion. Fearful bankers and speculators are asking: "Where are the rest of the horrors" – the toxic loans that are contaminating the whole world credit system.

The problems are clearly spreading to other sectors, and even the estimate of \$400 billion losses could turn out to be on the low side. Other problem areas include:

- **Monolines:**
The monoline bond insurers currently insure around \$3.3 trillion of bonds and other securities. They play a vital role in guaranteeing the AAA credit rating of the insured securities. However, some of the monolines are now in trouble. The downgrading of the credit rating of some insurers has resulted in the downgrading

of the securities they insure, leading to a seizing up of markets (ie the municipal bond market) and forcing holders of the insured securities to write-down their value. So far, a rescue plan has come to nothing. However, failure to stabilise the monolines could have a devastating effect on financial markets. (See "Monline Crisis")

- **Hedge funds:**
Unregulated, private clubs of super-rich investors, hedge funds control an estimated \$1.4 trillion of investments, with huge involvement in the most complex securities, derivatives, etc. They previously made huge rates of return for their members, but reports this year show big losses by some hedge funds. "After years of explosive growth", comments Jenny Anderson, "this secretive, sometimes volatile corner of the financial world is entering a dangerous new era. The running turmoil in the markets is stoking fears that more of these funds will fail, some, perhaps, spectacularly". (International Herald Tribune, 13 February)
- **Credit default swaps:**
These are complex financial instruments used to insure other securities. The total outstanding value of credit default swaps has soared to an incredible \$45.5 trillion! This is a gross figure, and insurance claims against the default of insured securities will only be a fraction of this colossal sum. But how much is at stake? What are the losses likely to be? Nobody knows. Fears are now growing, therefore, of a collapse of the credit default swap market – which could be a financial catastrophe on an even bigger scale than the subprime mortgage crisis.
- **Leveraged buy-outs:**
Until the credit crunch hit last summer, predatory private equity firms were feverishly buying up companies in order to restructure them and sell them on at a profit. These operations were initially financed by bank loans, and then, after the companies were restructured, the bank loans were sold off as debt securities. Since last summer, however, there have been no buyers for these securities and the investment banks are therefore saddled with around \$150 billion of debt, which is tying up their capital. Some financiers are now arguing that the banks should write off these debts, or a big part of them, as unsellable. This would mean further big losses.
- **Muni-bond market paralysis**
This mainly concerns the US municipal bond market, but could spread to other countries. Through issuing bonds, municipal authorities

raise short-term loans to cover their expenditure through so-called 'auction rate securities'. These were previously insured by the monoline bond insurers to guarantee their top investment grade rating. With the emergence of the monoline crisis, however, many municipal bonds are, in reality, no longer guaranteed, and therefore the market has seized up. There is now a growing crisis in financing municipal government expenditure.

- US consumer debt
The default rate for non-subprime mortgages, credit card and auto loans, student loans, etc, is beginning to rise.
- Commercial property loans in the US and Britain:
Property speculation based on high levels of debt (leverage) boomed until last year. This activity also depended on the securitisation and selling-off of the bank loans initially used to finance property development. Property companies are now finding it harder and harder to refinance their loans.
- A new commodity and emerging markets boom:
Volatility on major stock exchanges has led hedge funds and other big speculators to turn towards booming commodity markets and shares in 'emerging markets' such as China, India, Russia, etc. Most of this activity is highly leveraged, with the speculators taking advantage of lower interest rates to use cheap credit to speculate in oil, gold, platinum, iron ore, aluminium, etc, the prices of which are soaring. So far, the economies of China, India and the oil producers are still growing, persuading speculators that there are still big profits to be made. In reality, this is a new bubble which will burst as the major economies go into recession and countries like China and India also begin to slow.

The current situation is not just a financial crash like the very serious stock exchange crash of 1987 or the collapse of the 'dotcom' bubble in 2000-01. There is a deep crisis of the core banking system, which is at the heart of capitalist finance, the sector that now dominates global capitalism. In recent years, the banks abdicated responsibility for control (intermediation) of the global credit system to a shadow banking system dominated by a free-for-all market in complex, highly liquid and largely unregulated securities. However, through their own 'special investment vehicles' (or off-balance sheet activities), the major banks (together with hedge funds and other investment firms) were among the major players in this shadow system. This system of global financial

relations, fuelled by unprecedented levels of debt, is now in a very deep crisis – and it has only just begun to unfold.

Monoline crisis

THE CRISIS of the monolines has still not been resolved. Previously obscure, it has recently become clear that these entities, which insure around \$3.3 trillion of bonds and other securities, play a key role in some crucial sectors of financial markets. Several of these entities are already effectively insolvent, and the failure of more has the potential to trigger a systemic financial crisis. "It is critical that sufficient capital is infused into the bond insurance industry as soon as possible. Their failure or loss of AAA rating is a potential source of systemic risk". (Lawrence Summers, former Treasury Secretary, Financial Times, 27 January)

Writing from Davos, Gillian Tett commented: "Almost all the financiers I have met so far in Davos believe it will be difficult (nay, impossible) to restore confidence in the financial world without a 'solution' for the monoline problem". (Financial Times, 24 January)

The monoline crisis could result in losses for the banks on the scale of the subprime mortgage meltdown.

The emergence of the monoline crisis was a major factor in the sharp fall on world stock exchanges after 21 January. The rating agencies downgraded the credit ratings of three major monolines, creating fears that there could be a total collapse of monoline insurance, with incalculable knock-on effects. In the last quarter of 2007, two of the biggest US monolines, MBIA and Ambac, were forced to write-off \$8.5 billion losses.

In the past, monolines mainly provided insurance to the issuers of municipal bonds, undertaking to continue interest payments for the life of the bond in the event of a default. This guaranteed the insured bonds an AAA rating that made them more attractive to investors. It was essential, moreover, for the monolines themselves to have AAA ratings, otherwise their credibility would be in question. In the past, the monolines mainly insured municipal bonds that were relatively low risk. This meant they only required a relatively thin capital cushion to insure against a low level of defaults. More recently, however, the monolines turned to insuring much more risky bonds and securities, including asset-backed securities, collateralised debt obligations, and other 'structured finance' securities of the kind that were linked to the subprime housing market.

Since the subprime crisis last summer, the risk of defaults in these much more risky sectors has increased

significantly. The rating agencies decided that the monolines' capital base of around \$22 billion had become completely inadequate given the increase of risk on the \$3.3 trillion of bonds and securities they are supposed to be guaranteeing. Therefore, the ratings agencies downgraded the credit status of the monolines.

But the downgrading of the monolines meant that the credit rating of the insured bonds and securities was also reduced.

For instance, after downgrading the monoline, Am-bac, at the end of January, the credit rating firm, Fitch, downgraded 137,500 bonds. Some of the owners of these bonds, for instance pension funds, were then forced to sell them because they are only allowed to hold AAA rated securities. Banks and other investment vehicles were forced to reduce the book value of their insured bonds and securities, thus wiping out some other capital base.

The monolines insure around \$2.4 trillion in bonds and securities, with around \$1 trillion of non-municipal bonds, in other words, more high risk securities.

The major banks own around \$615 billion of structured securities insured by the monolines. Reduction of the credit rating of these securities from AAA to AA would reduce their value by \$20-25 billion. If the status was reduced to A the losses would be between \$140-150 billion.

Some analysts calculate that every 1% fall in the value of insured securities produces \$10 billion losses. This would mean total bond portfolio losses of between \$150-200 billion, the equivalent of the current subprime losses (which may increase over the coming months).

In January, the US authorities began an attempt at a rescue package for the monolines. When news of this emerged after 21 January, there was a brief recovery of US and global stock exchanges. However, as yet, no rescue package has been agreed, and some doubt whether there are even concrete, viable plans at all.

The rescue is being headed by Eric Dinallo, the New York State insurance regulator, who has been talking to a dozen or so New York banks since 23 January. Essentially, Dinallo is proposing that the banks inject \$15 billion of capital into the monolines. This is a crazy situation. The banks are being asked to pay out huge sums in order to bail out the firms that are supposed to be insuring them against losses.

The rescue attempt faces several apparently intractable problems. Neither the monolines nor the banks appear to have much confidence in Dinallo, who is a financial sector regulator not a banker. They would far prefer the New York Federal Reserve to be head-

ing the operation, as with the rescue of Long Term Capital Management in 1998. So far, the Fed has appeared very reluctant to get involved.

Then there is the problem that various banks have very different levels of exposure to the bonds and securities insured by the monolines. For some, it could be that contributing to a rescue plan would be preferable to bearing the losses from a total collapse of the monolines. Other banks, however, are not in this position and do not see why they should cough up.

At the same time, banks are extremely short of capital as a result of the subprime mortgage crisis and the credit squeeze that has followed. Some have received capital infusions from Chinese banks and sovereign wealth funds. But they are reluctant to see a big portion of it swallowed up by a monoline rescue.

The veteran billionaire financier, Warren Buffett, recently offered a deal to three of the most shaky monoline insurers, offering to reinsure up to \$800 billion of municipal bonds insured by the monolines. The monolines have rejected this on the grounds that it would take away their most secure business, leaving them only with the most risky insurance portfolio. In the same way, the monolines are resisting proposals from the authorities to split their business into 'good-bank' and 'bad-bank' sections, separating municipal bond insurance from the more risky security sector.

Fifteen billion dollars is a huge amount of money, even in today's financial markets. However, many commentators doubt that it will be sufficient to guarantee the monolines against insolvency. But the repercussions of a monoline collapse are incalculable.

This article will appear in the March 2008 issue of Socialism Today
