Understanding global crisis

Speculation at expense of real economy

Across the globe countries have been hammered by a global economic crisis which originated in the developed world. Economist **Ben Fine** shares complex ideas in an accessible way so that trade unionists and working people can develop an understanding of the crisis and come up with ways of responding to it. This is the first of three parts.

Before looking at the global financial crisis, there are some concepts that need to be clarified that are central to understanding it. These are concepts such as globalisation, financialisation, neo-liberalism and Washington and Post-Washington consensus.

GLOBALISATION

It is interesting to reflect that the term globalisation which is now so widely used did not exist before 1990.

There are two ideal types of globalisation. One relates to financial markets and the idea that these are completely internationalised and operate globally at the touch of a button. The other relates to culture and the idea that it spreads rapidly and generates uniformity – in our world expressed mainly as Americanization.

The initial impetus behind globalisation was a neo-liberal one which many view as undermining and disciplining the role of the nation state. The idea driving globalisation was that the state has become increasingly ineffective in promoting economic growth.

Nowadays, as far as scholars are concerned, the neo-liberal project has failed. Literature and evidence suggest that the theory of globalisation is incorrect as firstly state intervention remains important, and secondly there have been no global uniform economic or cultural outcomes.

Far from economic convergence, the post-world war boom has seen a divergence of experience, particularly for Africa and much of Asia including the miraculous performance of the Eanics (South Korea, Taiwan, Hong Kong). The promises that neo-liberal globalisation would bring economic justice and uniformity have not been realised.

The convergence view believes that all economies can succeed if they adopt the right policies. But the reality is that the competitive success of one country or sector is usually at the expense of others.

The idea that division between the developed and underdeveloped world is a fixed relationship is also incorrect otherwise how do we explain the different outcomes for India, China, the Eanics and Africa?

It is true that global systems do allow for some countries to develop but this is not true for all. Which, how, and how much rests on global and country-specific factors. Not all economies can develop a successful car or steel industry like South Korea, or Nokia in the way Finland did.

FINANCIALISATION

Since 1980 there has been a huge expansion of financial services such as banks, hedge funds, investment bankers, futures markets and so on relative to the rest of the economy. Global finance relative to global gross domestic product (GDP) has grown from 1.5 to an astonishing 4.5. This points to a systemic financial dysfunction. Surely a growing and efficient economy would reduce this ratio? There is an over-expansion of finance relative to its positive function in the economy.

There has been a huge increase in investment within finance over the last 30 years which has been accompanied by relatively low levels of real growth. Financial services are supposed to reduce risk but why do we need so much risk reduction relative to real activity? And certainly in the wake of the global financial crisis, risk seems to have increased not decreased.

In South Africa financial services is the fastest growing sector of the economy. But this does not benefit the domestic economy it simply mobilises capital for its export overseas, often illegally. Finance has taken away about a quarter of the South African economy. It is interesting to note that when the financial economy collapsed in the recent crisis the real economy

Carbon trading means "I want to pollute so I must buy the right to do so."

continued quite well without it, at least temporarily. What does it add to real production?

So there has been an expansion of speculative finance at the expense of the real economy. But where do we draw the line between what is speculative and what is not? Companies raise finance for investment by issuing shares and these shares are then traded with a price which is supposed to reflect both general economic prospects and those specific to the company. But shares and most financial instruments involve risk in terms of future pricing and so there is some element of speculation.

China relies on banks more than any other country to finance investment but this bolsters the real economy, and in this sense is not speculative finance. The financial system serves as a mechanism to finance real expansion.

However, more often the trend has been for financial instruments and services to proliferate as an end in themselves. They are broken up into bundles and sold again and again with each transaction propelling a further speculative element. This was illustrated by the United States sub-prime housing crisis where mortgages were sold on with an increasing distance between the value of the real property and the value of the financial assets. So when people were unable to honour mortgage repayments this caused the collapse of financial institutions with a knock-on effect across the entire global economy.

This has affected not only mortgages but everything from shares to government bonds to futures markets and bundles of bundles of these.

Thus finance dominates industry and tells industry what to do. National financial institutions (NFIs), such as banks, are increasingly involved in financial dealings such as forex markets, futures markets, investments of surplus and in expanding shareholder value. US NFI's have been making 40% of their profits from financial deals so they are compelled to direct their operations towards finance rather than bolstering real production.

Investment in real activity does take place but these loans are increasingly volatile and the surplus is creamed away by finance. So financialisation has become associated with lower levels of real investment in the uncontrolled pursuit of profit.

Financialisation is a deliberate way that governments divert wealth to a class of millionaires who are not involved in productive activity. Financial returns have been astonishing in the US, while the real wages for 90% of the population have stagnated.

Financialisation is about privatisation as financial markets have expanded into all areas of economic and social life including housing, health, water and pensions.

Financialisation even extends to the environment where futures (buying and selling what is yet to be produced) create great instability. In essence a market has been created in buying and selling at what rate we destroy the environment. Carbon trading means, "I want to pollute so I must buy the right to do so." It's about trading allowing pollution to continue as before by buying carbon credits from those who still pollute, but proportionately less (and then trading in futures markets in polluting less).

THEORIES OF FINANCE

But how do we understand this theoretically? What theories of finance do we have?

The Efficient Market Hypothesis (EMH) is a neo-liberal concept that deals with spreading and reducing risk with the market guiding the investment of scarce capital.

By contrast, according to economist, Joseph Stiglitz, borrowers and lenders have different information so it is important how they relate to each other. There are two modes of relating. The Anglo American type where banks lend and if the recipient does not pay back the interest, the company is closed down. The second Japanese/German model operates through banks developing a close relationship with borrowers, including sitting on company boards. This is supposed to be the superior model.

In fact neither is superior because external relations are more important than internal ones. The role of government policy in finance is critical as are its other policies in sustaining industry and expenditure on health, education and welfare.

Both these theories accommodate the financial sector expanding into all areas of the economy with the result that there have been lower levels of investment and a reduction in real productive activity. This in turn has brought instability into financial markets.

Some people argue for a policy that creates a balance between finance and real activity but in reality such a balance is impossible because capitalism is based on the idea of borrowing to make profits.

There will always be pressures on banks to make more risky loans and to get round regulations through the creation of new investment instruments. Competition in banking is lower than in other sectors so there is the potential to make abnormally high profits which the financialisation of the economy has allowed for.

The character of our age has been a process of financialisation accompanied by an increase in inequality and low levels of growth. But China has been successful in making the banking system serve its economy.

NEO-LIBERALISM

Neo-liberalism is another term that needs to be unpicked before looking at the global financial crisis itself. What does neo-liberalism mean in the light of the financial crisis?

Nowadays it is hard to find supporters of neo-liberalism and its EMH. In this respect, neo-liberalism is like South Africa after apartheid: you can't find anybody who supported it!

Steel mills in Korea – a success story that not all countries can copy.

To examine what neo-liberalism is, it is important to make three points. These are that it is ideological, it has a scholarship and it has policy in practice. Each of these has been inconsistent in itself and in relation to the others, and has varied across time, issue and place. Neo-liberalism takes different forms and it is often contradictory.

Neo-liberalism has been characterised as pro-market and anti-state intervention. But in practice the state has intervened heavily and has promoted private capital in general and finance in particular. Interventions have also been against the interests and organisation of progressive movements especially with regard to labour market flexibility.

Neo-liberalism dates from the late 1970s as an outcome of the collapse of the post-World War two economic boom. It has gone through two phases of about equal length.

The first phase is dubbed 'shock therapy' and is summed up in the phase 'just do it!'. This extended to privatisation, commercialisation, deregulation, tight budgeting, capital and trade liberalisation and removing protections. States made heavy interventions on behalf of capital to open up markets to their fullest extent. This phase corresponds ideologically and politically to the idea of leaving everything to the market.

The second phase of neo-liberalism was marked by two broad elements.

The first element in the 1990s was to moderate and respond to the excesses of the first phase which had dramatically increased inequality and poverty in the world and had seriously degraded the environment and contributed to climate change. The second element's aim was to sustain neo-liberalism and to promote the expansion of private capital.

The second phase of neo-liberalism has now revealed its dependence on financialisation, with the overwhelming commitment by governments to devote resources to bailing out the banking system.

WASHINGTON AND POST-WASHINGTON CONSENSUS

The two phases of neo-liberalism described above corresponded with the Washington and post-Washington consensus.

But there was a pre-Washington Consensus associated with Robert McNamara's presidency at the World Bank from the mid 1950s to the end of the 1970s. The idea was to modernise and develop industry and help establish services in order to fight the Cold War. This meant establishing a genuine, workable set of policies to counter the growing power of the Soviet Union.

Allied to this was a policy of decolonisation which involved pursuing the same modernising, industrialising route in former colonies. The International Monetary Fund (IMF) was responsible for stimulating short-term development through loan finance whilst the World Bank financed long-term development. The result was the severe indebtedness of underdeveloped countries.

The Washington Consensus (WC) emerged in the 1980s with a new World Bank ethos with rhetorical emphasis on leaving everything to the market with minimal state intervention. This period was characterised by pushing for free trade, fiscal austerity, structural adjustment, liberalisation of finance and exchange controls and privatisation.

The WC corresponded to the first phase of neo-liberalism where under the cloak of non-intervention, international financial institutions and governments pursued highly interventionist policies to allow for the free flow of capital and finance. This was deeply damaging especially to the continents of Africa and South America whose development was set back by a couple of decades.

In the 1990s the WC came under assault because of the catastrophic effect of these policies in increasing poverty and non-delivery, especially in Africa. By the end of the 1990s, the World Band was forced to rethink its rhetoric and scholarship and even began to admit the failure of its policies.

Simultaneously, although not acknowledging it, the Bank was responding to the huge achievements of the Asian 'Tigers' which were supported by interventionist developmental states.

The Post Washington Consensus (PWC) which corresponded with the second phase of neo-liberalism, offered a rhetoric favouring increased state intervention in the economy and the adoption of poverty friendly policies. The PWC argued that an unregulated market was imperfect and that some state intervention was necessary. However, the market should not be tampered with too much. Controlled globalisation would bring benefits to all.

In practice, the PWC policies have even hardened on those associated with the WC, even more so in wake of the crisis as efforts are made to support the private sector in worsening economic circumstances. In addition, both the WC and PWC had no understanding of development (other than as relying on or correcting the market, respectively) and they effectively set aside the experiences of the Asian Tigers and the idea of a developmental state. Instead, the World Bank responded by projecting itself as a 'knowledge bank' through which it aimed to crowd out alternative ways of thinking and to dominate global training and policy perspectives.

The World Bank began to incorporate formerly critical NGOs and progressive donors such as the Scandinavians. Now instead of overtly supporting privatisation, for example, the PWC supported public/private partnerships, using the state overtly to support the private sector. In this way it involved the private sector in government areas of delivery such as telecoms, energy, transport, health and water – in essence, at least partially privatising through the back door.

This was not a fundamental rethink but a reframing of former policies in different circumstances after easier and more profitable privatisations had already been achieved. In the case of growth of future health provision in Africa, for example, the World Bank is looking for the private sector to play the dominant role. LB

Ben Fine is Professor of Economics at the School of Oriental and African Studies at the University of London.

This is the first of a three part series which examines the global economic crisis. In the following SALB volumes, Fine will explore the developmental state, macro- and micro-economic policies and industrial and social policy. These articles are based on lectures given to a Global Labour University workshop in Johannesburg in October 2009.