

# America's financial meltdown: lessons and prospects

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The international debt crisis symbolised by the collapse of Lehman Brothers and the forced sale of Merrill Lynch exposes the failure of the world's financial architecture. Ann Pettifor, whose openDemocracy article predicted the crisis in 2003, explains and looks ahead

The collapse of Lehman Brothers and the forced sale of Merrill Lynch which took shape over the weekend of 13-14 September 2008 have confirmed the scale and gravity of the global financial crisis. The difficulties at the insurance company AIG are a glimpse that there is more to come. But the extent of the wreckage makes it ever more important to analyse correctly what has gone wrong. For just as a faulty medical diagnosis can harm the patient, so a flawed economic diagnosis can lead to wrong conclusions and bad solutions.

In this respect, orthodox economists continue to be part of the problem that Lehman Brothers and Merrill Lynch (and, before them, Northern Rock, Bear Stearns, and Fannie Mae and Freddie Mac) represent. For so long they turned a blind eye to the finance sector, to privatised credit-creation and its role in fuelling asset-bubbles. In so doing they revealed their inability to predict, understand or offer solutions to a consuming crisis.

This article looks at how such failures took hold in the context of the deregulated global financial system of the 2000s, and why the predicted collapse of this system begins in the United States.

## The deregulated economy

The former chairman of the Federal Reserve in the United States, Alan Greenspan, has himself said that what is happening to Lehman Brothers and Merrill Lynch is a "once-in-a-century" event. Yet the way many orthodox economists characterise Greenspan's own role in the global "debtonation" of the post-9 August 2007 era reveals how far they remain trapped in the rituals of evasion (see "Debtonation: how globalisation dies", 15 August 2007).

The key argument these economists make here is that the current crisis has been caused by the low interest-rate monetary policy Greenspan presided over after 2001. This case permits a twofold diversion - for it pins the blame for the crisis on interest rates (not deregulation of credit-creation) and on central bankers (not the private-finance sector). The policy implications of this focus neatly avoid proposals for what is clearly and urgently required: re-regulation of the finance sector.

But the argument that makes interest-rates a fundamental cause of the crisis is wrong even in its own terms - not least as it can lead to a recommendation that higher interest-rates are a way out of the mess. The crisis facing banks and individuals - indeed whole economies - buried under mountains of debt and threatened by an intractable deflation makes this a truly deranged proposal.

The phenomenon of "deleveraging" as a way of managing these mountains of debt helps explain why. Deleveraging means paying off (or more accurately writing off) the crazy amounts borrowed on the back of tiny amounts of real money - say the \$1 million borrowed (or leveraged) on the back of \$1,000 of sound collateral; deleveraging that debt would entail paying off / writing off \$999,000. The inevitable result in many cases is bankruptcy, part of a wider deflationary momentum in the economy.

Debtors of all kinds - official, corporate, individual - are already struggling to repay at the current high real rates of interest. That is the core element of the debt crisis (or "credit-crunch"). To prescribe higher interest-rates would turn crisis for many individuals, companies and banks into catastrophe.

Also in openDemocracy on the global financial crisis of 2007-08:  
 Saskia Sassen, "Globalisation, the state and the democratic deficit" (18 July 2007)  
 Christopher Harvie, "Gordon Brown vs Scotland: the balance-sheet" (17 September 2007)

Tony Curzon Price, "Gordon Brown: between rock and hard place" (18 September 2007)

Robert Wade, "The financial crisis: burst bubble, frayed model" (1 October 2007)

Avinash D Persaud, "The dollar standard: (only the) beginning of the end" (5 December 2007)

Fred Halliday, "Sovereign Wealth Funds: power vs principle" (5 March 2008)

Tony Curzon Price, "Lehman: technocrats' endgame" (15 September 2008) Here, the context of Alan Greenspan's post-2001 role is relevant in understanding the global economy then and now. For his policy of lowering interest-rates was a reaction to the bursting of the dot.com-bubble - which, like the property-bubble which burst in 2007, was fuelled and inflated by easy, unregulated and privatised credit-creation. Moreover, these low interest-rates in the early years of the 21st century were more a function of the new global capital markets than of the powers of central bankers to set low rates.

The result of deregulation (i.e. "globalisation") in the 2000s was and is that capital can flow free and untrammelled around the world. The accompanying collapse of the Bretton Woods system (which contained mechanisms for curtailing the growth of imbalances between nations) meant also the growth of large balance-sheet contrasts (massive deficits in the United States and Britain, huge surpluses in China and Japan, for example). The countries in surplus - China most of all - exported their excess capital to the US.

This flood of capital lowered rates of interest in the US - to the chagrin of Alan Greenspan, who by this time was trying to raise rates. Greenspan could have done this by erecting barriers to the movement of capital - capital controls - thereby preventing China's surplus capital from having an impact on US interest-rates. Instead, he preferred to pretend that he was impotent in the face of a mysterious "conundrum".

An Alan Greenspan or any other central banker armed with controls over the movement of capital would be able to switch a key lever of the economy: the rate of interest. That is, not just the "policy rate" or the "official rate" (often known as the "bank rate") but all rates - safe and risky, short and long. Where central bankers abandon such controls, and delegate powers over interest-rates to private bankers, they are impotent in the face of capital movements that affect the yields on bonds, and therefore of interest-rates within their domains.

The sharecropper society

The momentous news of the collapse of Lehman Brothers and the sale of Merrill Lynch - part of the larger process unfolding since "debtation day", 9 August 2007 - brings all the failings of the seven years that preceded it into even sharper focus.

In 2003, as part of a team at the new economics foundation, I edited a book intended to "shadow" the International Monetary Fund's "world economic outlook", which we believed was based on the delusions of orthodox economics (see *The Real World Economic Outlook*, Palgrave, 2003). An article in openDemocracy at that time - five years ago almost to the day - heralded the "provocative new research ... which argues that the 'first world' is approaching a major debt crisis... The reckless financial policies of leading western powers in the last two decades make it likely that the next seismic debt crisis will be in America, not Argentina" (see "The coming first world debt crisis", 1 September 2008).

The book and article explained that the current, post-Bretton Woods international financial architecture ("globalisation") was so structured as to enable the United States to "hoover up" money from the rest of the world, and use these resources to live beyond its means. I wrote then: "It is this financial system which makes US financiers so confident that the rest of the world will continue to finance their nation's extravagant spending binge. In the words of David Goldman, head of debt research at Bank of America Securities: 'America is at little risk for the foreseeable future, simply because the world's capital has nowhere else to go' (Wall Street Journal, 13 August 2003)".

The fall of Lehman Brothers is final confirmation that the world's capital does now have somewhere else to go. This event thus marks the beginning of the collapse of today's international financial architecture, which has rested on very shaky foundations since Richard Nixon's administration unilaterally dismantled the Bretton Woods system in 1971 and began to shape the new.

The reason why the Lehman Brothers collapse is historic is that this institution expected until a very late stage to be saved by the state-run Korea Development Bank (KDP). But Seoul looked at the books and had other ideas: on 9 September 2008 - to the astonishment of Lehman's shareholders and investors - this ever-so-reliable ally of Washington refused to fund a bail-out.

The fact that such sovereign wealth funds as the KDP are no longer willing to finance reckless US institutions is of itself of the greatest significance. It implies a lack of confidence in the solvency of US financial institutions, and indeed of the United States as a whole. This will lead to a fall in the dollar, which will have profound economic implications for the global economy, and for globalisation as a whole.

The billionaire investor Warren Buffett wrote a letter to shareholders in March 2005, in which he predicted that by 2015 the net ownership of the US by outsiders would amount to \$11 trillion. "Americans ... would chafe at the idea of

perpetually paying tribute to their creditors and owners abroad. A country that is now aspiring to an 'ownership society' will not find happiness in - and I'll use hyperbole here for emphasis - a 'sharecropper's society'."

Buffett was and is right. The collapse of banks and investment funds, and of the international financial system - a consequence of the unpardonable folly of the powerful - is serious and dangerous enough. But what is even more to be feared is the emergence of a sharecropper society, angry at its downfall. Thus will America's problem become the world's.