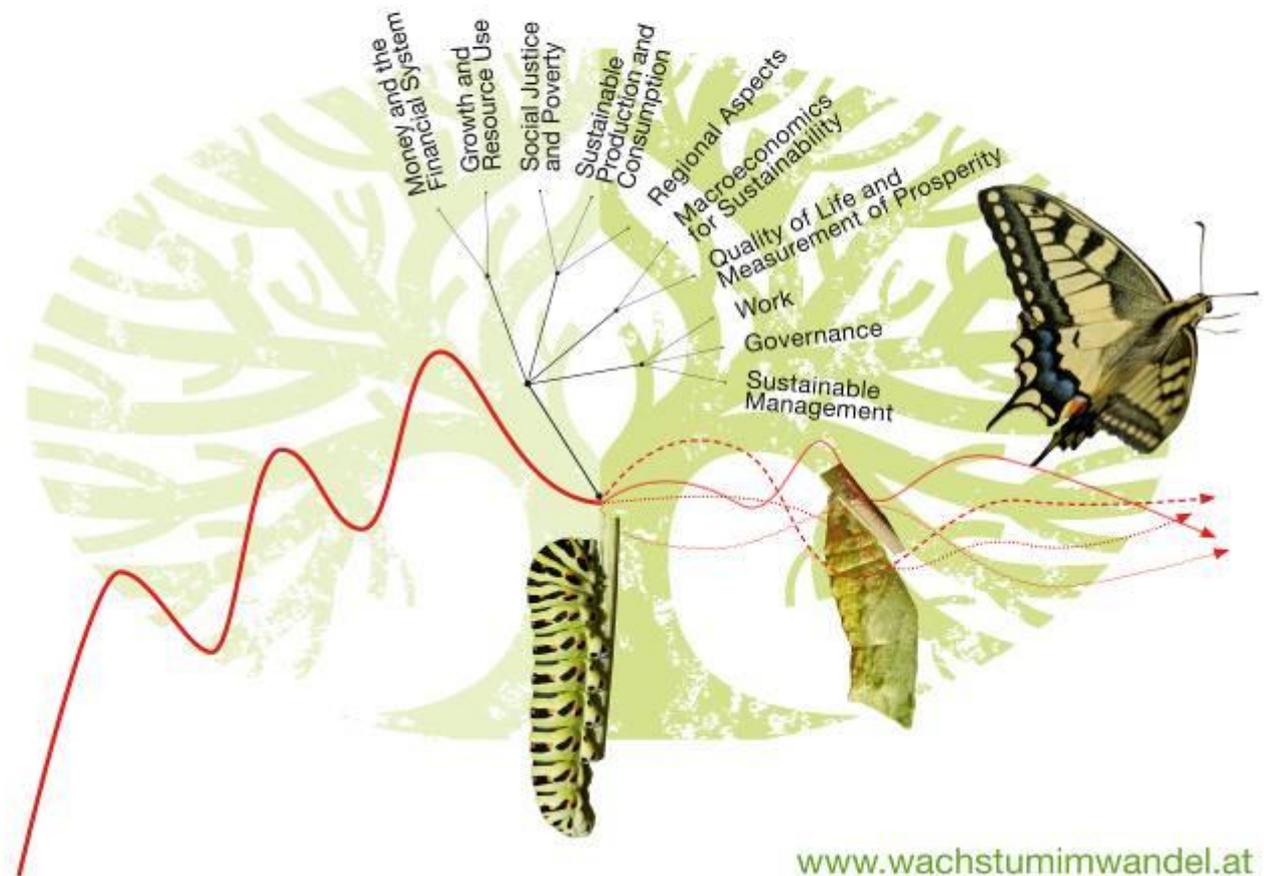


International Conference/Internationale Konferenz

## GROWTH IN TRANSITION WACHSTUM IM WANDEL

28-29 January 2010

Vienna/Wien

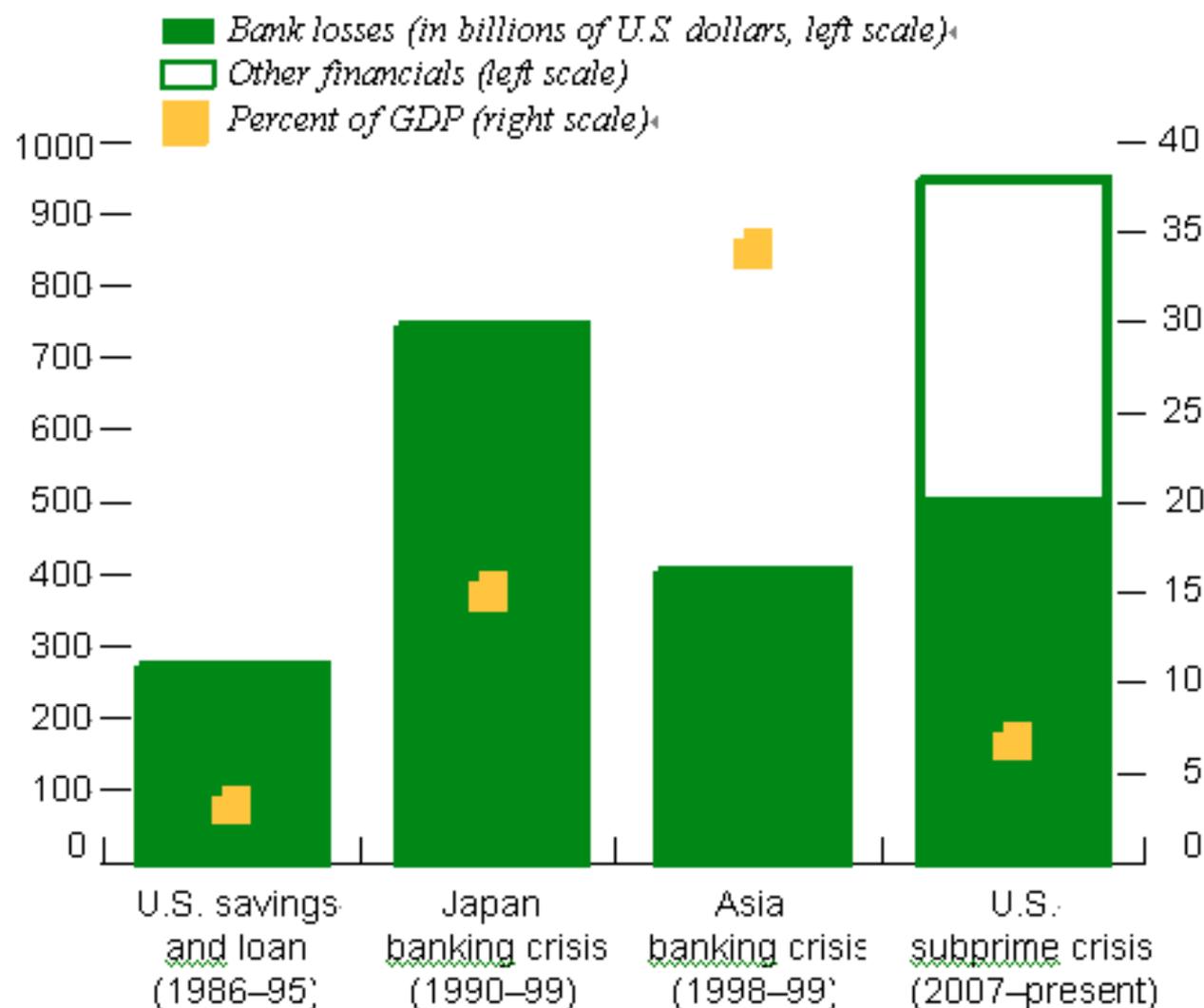




# Financialization: far more critical in this crisis than in past crises

- A comparison of the major crises since the current phase began in the 1980s shows the extent to which financial leveraging has caused the greater acuteness of the current crisis compared with the other 3 major crises since the 1980s.
- Figure 1 shows that financial leveraging added another 20% to the underlying banking crisis, thereby bringing the current financial crisis up to an equivalent of 40% of global GDP, compared to earlier crises, which rarely went beyond 20%.

**Figure 1.12. Comparison of Financial Crises**



Sources: World Bank; and IMF staff estimates.

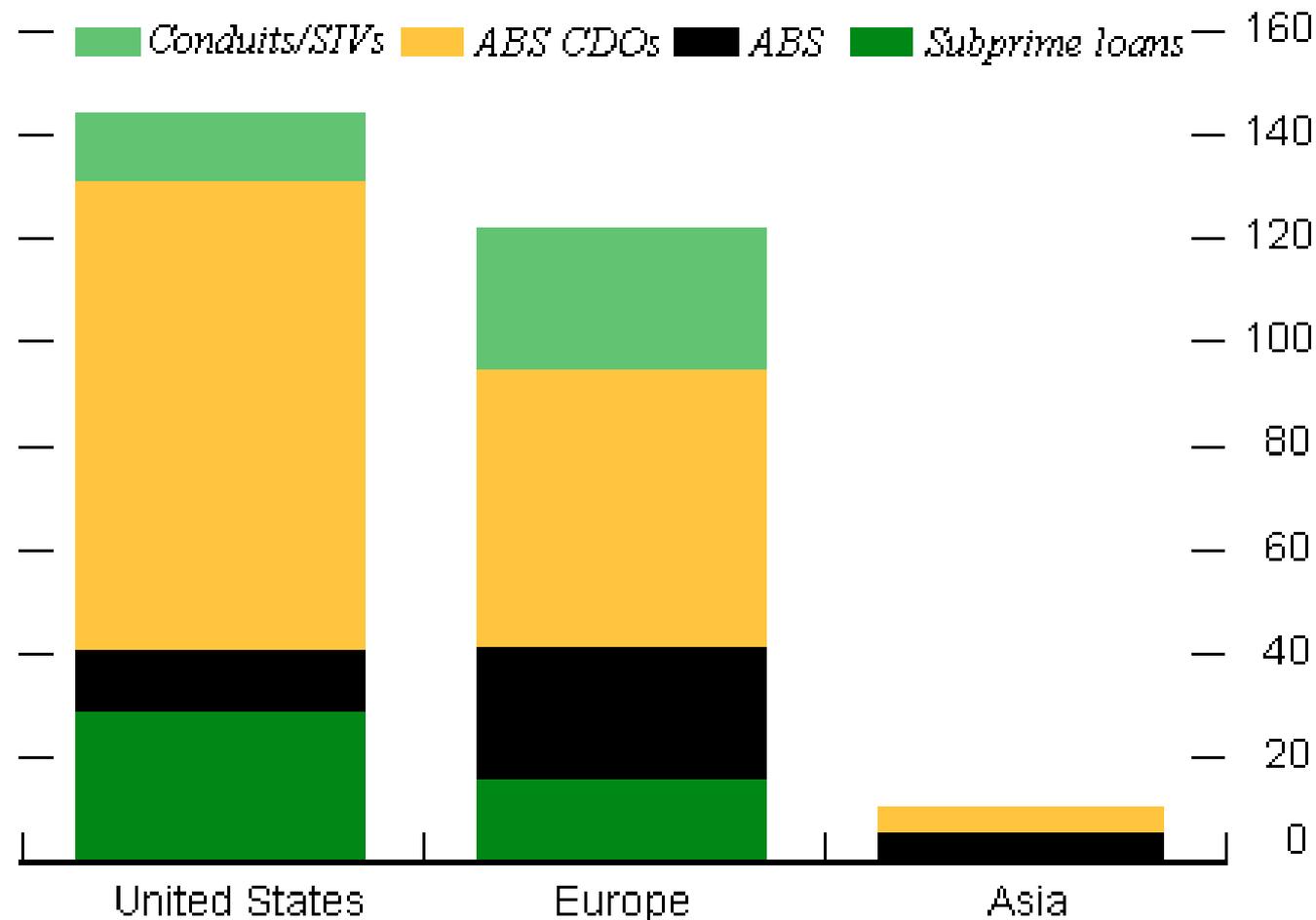
Note: U.S. subprime costs represent staff estimates of losses on banks and other financial institutions from Table 1.1. All costs are in real 2007 dollars. Asia includes Indonesia, Korea, the Philippines, and Thailand.

# High value of financial assets at the time the crisis explodes in 2007

- High value of financial assets in major economies was very high: (data from (McKinley Report 2008)).
- In the US: financial assets were 450% to GDP .
- In the European Union it stood at 356% to GDP, with the UK at 440%, well above the EU average.
- In Japan it stood at well over 400%
- More generally, the number of countries where financial assets exceed the value of their gross national product more than doubled from thirty-three in 1990 to seventy-two in 2006.
- The global value of financial assets (which means: debt) in the whole world by September 2008 was three and half times larger (160 trillion dollars) than the value of global GDP.

## Figure 1.13. Expected Bank Losses as of March 2008

(In billions of U.S. dollars)



Sources: Goldman Sachs; UBS; and IMF staff estimates.

Note: ABS = asset-backed security; CDO = collateralized debt obligation; SIV = structured investment vehicle.

# The subprime mortgage crisis is not the cause of the financial crisis

- Much has been made, especially in the US media, of the subprime mortgage crisis as a source of the larger crisis.
- These modest-income families unable to pay their mortgage were often represented as irresponsible for having taken on these mortgages.
- But the facts show another pattern. The overall value of the subprime mortgage losses was too small to bring this powerful financial system down. The interlinking of financial markets means that even a small market's crisis, such as the subprime market, can produce ripples through the financial system

# The growing search for asset-backed securities

- An important factor for the growth of the subprime mortgage market was the demand for asset-backed securities by investors, in a market where the outstanding value of derivatives was US\$ 600 trillion, more than ten times the value of global GDP.
- To address this demand, even sub-prime mortgage debt could be used as an asset.
- But the low-quality of this debt meant slicing it into multiple tiny slices and mixing these up with high debt. The result was an enormously complex instrument that was also enormously opaque: nobody could trace what all was there.
- When the millions of foreclosures came in 2007, investors had a crisis of confidence : it was impossible to tell what was the toxic component in their investments.

# An abuse of the concept of the subprime mortgage

- Sub-prime mortgages can be valuable instruments to enable modest-income households to buy a house. But what happened in the US over the last few years was an abuse of the concept.
- The small savings or future earnings of modest-income households were used to develop a financial instrument that could make profits for investors even if those households in the end could not pay the mortgages and thereby lost both their home and whatever savings and future earnings they had put into it – a catastrophic and life-changing event for many of these households.
- This is clear in the microcosm that is New York City

## Rate of Subprime Lending by Race in New York City, 2002 to 2006

	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>White</b>	4.60%	6.20%	7.20%	11.20%	9.10%
<b>Black</b>	13.40%	20.50%	35.20%	47.10%	40.70%
<b>Hispanic</b>	11.90%	18.10%	27.60%	39.30%	28.60%
<b>Asian</b>	4.20%	6.20%	9.40%	18.30%	13.60%

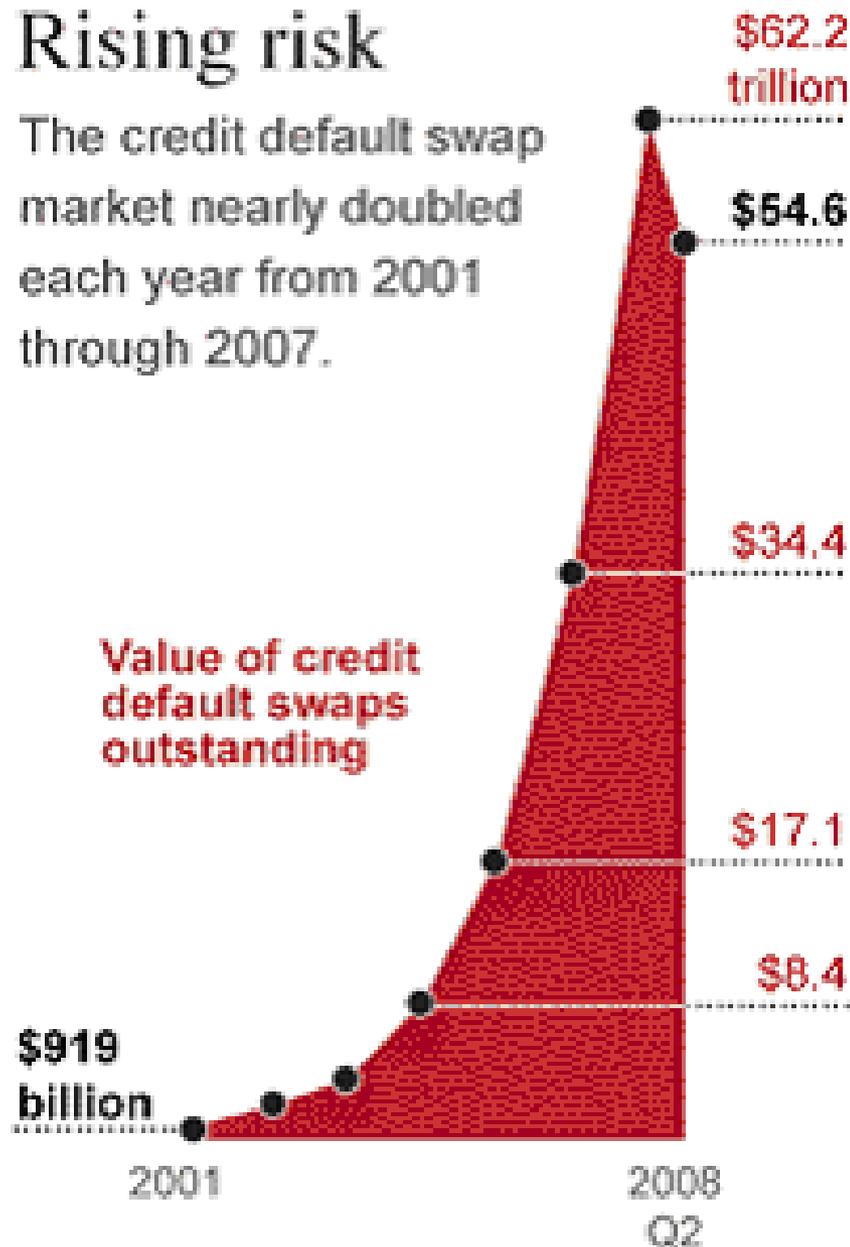
Source: Furman Center for Real Estate & Urban Policy, 2007

# The key to the tipping-point that led into massive financial crisis

- The critical component that brought the financial system to a momentary standstill was yet another complex instrument largely used to engage in old-fashioned speculation, only more extreme and on really weak ground.
- It was the US\$ 62 trillion dollar credit-default swap crisis that exploded on the scene in September 2008, a full year after the sub-prime mortgage of August 2007.
- This was more than the US\$ 54 trillion in global GDP. The graph below shows the extremely sharp growth over an extremely short period of time, from 2001 to 2007.

# Rising risk

The credit default swap market nearly doubled each year from 2001 through 2007.



# *WHAT NOW?*

- We all need debt, whether we are a firm, a household, or a country.
- But do we need this level of debt? And even more importantly, do we need such complex instruments to finance what are mostly rather basic needs for firms and households. No.
- A lot of these needs can be met with traditional banking loans.
- We need finance because it “makes” capital, and large-scale projects need vast amounts of capital: at this point, only finance can reach these orders of magnitude.
- The problem is that finance entered domains –such as consumer loans and home mortgages which were securitized and sold as financial instruments-- where traditional banking would have been a safer option for consumers, and in the long run, for the stability of whole economies.
- We need to expand and strengthen regulated banking and make finance less invasive and aggressive.

# This crisis compared with other crises of our global era

- One important difference between the current crisis and the other post-1980 crises is the order of magnitude that speculative instruments have made possible and the fact that speculation increasingly thrived on finance itself.
- A second important difference is the larger economic landscape: the stronger recognition that we have an environmental crisis at our hands and that we need to act now, because international treaties are not enough.
- A third difference is the greater recognition that the extremes of wealth and poverty have become problematic: we now know there is no trickle down, and, more concretely, epidemics due to poverty and inadequate healthcare will affect also the rich.

# Is this crisis an opening for novel economic criteria

- This combination of differences compared to prior crises creates an opening for novel economic criteria.
- Yes, we need financial institutions. We have to use that new capital for needed large-scale investments or to develop manufacturing sectors in young economies.
- Instead, the last decade especially has seen financial capital used for extremely speculative investments that largely served to enrich the already rich (both firms and households).
- The combination of crises is an opportunity to re-orient financial capital to a broad range of needs.

# There is much work to be done: Using the crisis as an opportunity

- This mix of conditions should also become the opportunity to upgrade vast parts of our economies worldwide.
- The search for profits at all costs is becoming a boomerang. We have hints of this across our economies.
- For example: The search for profit in raising cattle and in raising pigs, have led to extremely abusive practices of animals that have created serious health threats to people.

# Maximizing profits at all costs: The boomerang effect

- In the UK, feeding cattle the non-sellable parts of cattle (such as spine), is one factor linked to the dreaded so-called mad-cow disease (Kreuzfeld syndrome).
- Asian flu (SAR) is linked to inadequate housing for poor people who raise birds for human consumption, and now we know that the latest “new” disease, so –called swine flu (H1N1), is linked to the extreme conditions in which pigs are raised to maximize profits.
- If we add to this the enormous levels of work place injuries across the world –from the meat-packing industry in the USA to the dismantling of huge iron clad ships by unprotected workers in India) , we begin to see the vast costs to society and to economies of narrow criteria for understanding and defining profitability.

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- The greater our capacity to produce wealth has become over the last twenty years (and finance has played a critical role here), the more radical the condition of poverty has become.
- It used to be that being poor meant a plot of land that did not produce much. Today being poor for the 2 billion or so is having nothing, only one's body –no plot of land, often not even a stable shack that might be called home.
- We have the capacity to feed everybody on the globe, but feeding is not the priority of our economic actors, so we have more hungry than ever before.

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- The abusive conditions under which diamonds are extracted, and use of those profits for armed warfare rather than development purposes.
- Fewer may have heard about coltan, a key mineral for electronic components (notably cell phones), which is mined by unprotected workers who use their naked hands to extract it and live basically in a condition of slavery, and die too young from poisoning to have been able to pass on the news of their abuse to the wider world.
- Finally there is the by now well established fact that discovering oil in a poor country becomes the formula for even more poverty and a small elite of super rich.

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- Yes, we need to change the logics through which we understand profitability and what is genuine prosperity. The triple crisis we confront should become an opportunity to redeploy our enormous capacities to make capital and to produce towards a more distributed economic system. If we think of all the work that needs to be done to clean our environment and feed and house everybody, there would be no unemployed people and no “unemployed” capital in search of increasingly speculative gain