CDPR CENTRE FOR DEVELOPMENT POLICY AND RESEARCH
School of Oriental and African Studies

Development Viewpoint
Number 28, April 2009

The Roots of the Global Financial Crisis

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Loose Macroeconomic Policies

The current global financial crisis originated in the US partly because of loose monetary policy at the beginning of the decade. In the aftermath of the stock market bubble of 1999-2000, the Federal Reserve moved aggressively to cut interest rates. During 2002-2004, the Federal Funds Rate dropped to 1%-2%, helping to inflate the housing bubble of 2001-6. When the Federal Funds rate rose to about 5% in 2006-2007, the housing bubble burst.

Loose monetary policy in the early 2000s compounded both domestic macroeconomic imbalances in the USA and global imbalances. The housing bubble led to many working class households shouldering large housing liabilities. At the same time, a calamitous drop in personal savings took place.

While personal savings as a percentage of disposable income was 9-10% during the 1970s and 1980s, it fell to around 2% in the early 2000s. By 2006-7, personal savings had collapsed to 0.4% (see Table 1). A savings ratio close to zero is historically unprecedented for a mature capitalist economy.

Table 1: Personal Savings as a Percentage of Disposable Income, USA, 2000-2007

2000	2001	2002	2003	2004	2005	2006	2007
2.3	1.8	2.4	2.1	2.1	0.5	0.4	0.4

Source: Mortgage Bankers Association; Mortgage Origination Estimates, updated March 24, 2008

In 2007, the difference between aggregate domestic savings and investment in the US approached 5% of GDP. This gap corresponded to a ballooning US trade deficit, which exceeded US$ 700 billion during 2005-2007. The USA economy was on the edge of major financial instability even before its housing market imploded.

Meanwhile, the USA government ran large fiscal deficits in the early 2000s. These were heavily dependent on the purchase of US government securities by countries with substantial current account surpluses. In order to protect themselves against sudden capital outflows—which were common during the financial crises of the late 1990s—many developing countries had begun to build large precautionary stocks of international reserves.

This trend was most pronounced in developing Asia, whose aggregate current-account surplus had risen to almost 7% of GDP in 2007. China alone held international reserves worth more than US$ one trillion at the end of 2007. The great bulk of such reserves were held in US government securities. Despite low rates of return, developing countries continued to funnel their excess savings into the US economy, where they were important to sustaining the US bubble even after the Fed began to raise interest rates.

Transformation of Finance

In addition to macroeconomic imbalances, the global crisis arose because of profound transformations in the financial system.

A major trend, clearly seen in the USA, is the extraction of financial profit by commercial banks directly out of personal incomes.

Growing individual dependence on private finance is apparent in housing, including subprime mortgages, but it can also be seen in education, health, pensions and insurance. This new practice of 'financial expropriation', i.e., the systematic extraction of financial profits out of wages and salaries, is one of the root causes of the current crisis (see Lapavitsas 2009).

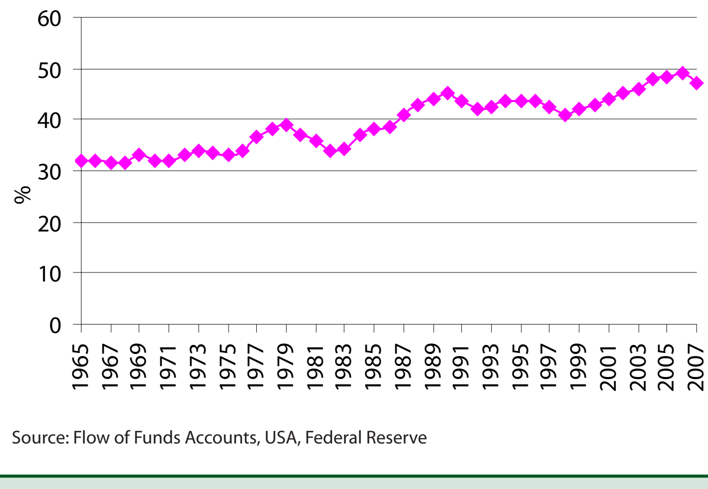
Why were commercial banks motivated to generate financial profits from such new sources? The groundwork was laid by financial deregulation, which began in the late 1960s. Once deregulation took hold, commercial banks lost the captive liabilities (primarily deposits) that had previously sustained their activities.

Equally important is that large corporations have become less reliant on bank financing. They have financed their fixed investment either through retained earnings or direct borrowing in open markets. Hence, commercial banks have had to search for new profit-making opportunities. A decisive response was to turn to consumer and real-estate loans. In the US, the share of such loans in total bank lending rose from around 30% in the 1960s to almost 50% in the mid-2000s (see Figure 1).

Lending to individuals can often be predatory, an aspect that took extreme forms in the course of the recent bubble. Mortgage lending rose dramatically in the US during 2001-2003, and then dipped, but remained at a very high level. As demand for ordinary mortgages began to slow after 2003, lenders increasingly offered subprime mortgages.

During 2004-2006, such mortgages totalled US$ 1.75 trillion, or almost one fifth of all new mortgages. They were marketed to the poorer segments of the US working class, many of the borrowers being Black or Latino households.

Figure 1: Lending to Consumers and Real Estate as a Percentage of Total Bank Lending, USA



Source: Flow of Funds Accounts, USA, Federal Reserve

Poor households were often lured into shouldering such mortgages because they were offered low initial interest rates, which could be adjusted upwards later by the lenders (the so-called Adjustable Rate Mortgages or ARMs). During 2004-2006, ARMs totalled US$ 4.3 trillion, or almost half of all new mortgages. There was little chance, at the outset, that a large proportion of these would be repaid.

The Spread of Securitisation

Another major trend in the transformation of finance was the adoption by commercial banks of the practices of investment banking. Banks began to seek profits by operating in open financial markets, or through proprietary trading. Financial engineering and the rise of derivatives trading have been associated with the turn of commercial banks toward such financial practices.

The combination of the two major trends that we have highlighted, namely, drawing profits from personal incomes and resorting to investment banking, led to the huge financial bubble of 2001-2007.

The housing collapse in the USA would not have precipitated a global crisis had commercial banks not adopted investment banking techniques. This took the form of widespread securitisation of mortgage loans. Simply defined, securitisation meant parcelling subprime mortgages into small amounts, packaging them with large composites of assets and selling the lots as new securities.

During 2004-2006, almost 80% of all subprime mortgages were securitised. As a result, subprime-mortgage-backed securities ended up in the portfolios of major financial institutions throughout the world. When US subprime mortgage holders began to default in large numbers in 2007, the rapid increase in the risks of such securities had an immediate global impact. Many financial institutions suddenly faced illiquidity since mortgage-backed securities were no longer saleable.

Why were commercial banks able to adopt functions traditionally reserved for investment banks? One factor was the successive waves of mergers and acquisitions after the early 1980s that created greater scope for securities underwriting and placement. Another was the introduction of measures, such as the 401K private pension schemes, which channelled the savings of working class households into open financial markets.

A further factor was financial engineering, which also created opportunities for banks to trade on their own account. These factors were exacerbated by the abolition in 1999 of the Glass-Steagall Act (in force since 1933), which now formally enabled commercial banks to engage in riskier investment banking practices.

The adoption of investment banking functions meant that commercial banks became heavily reliant on borrowing liquidity in open financial markets.

By 'securitising' mortgages and selling them off to other financial institutions, they seemed able to generate further liquidity to deal with liability demands while maintaining a brisk pace of new lending.

Commercial banks were thus encouraged to minimise traditional liquidity cushions on their balance sheets. Furthermore, by securitising mortgages, they appeared to shift credit risk off their balance sheets, and could minimise the amount of capital held to support their assets.

For a short period of time, securitisation seemed a marvellous device that allowed commercial banks simultaneously to generate more liquidity, remain solvent, and make large profits. However, when the housing bubble in the USA eventually burst and mortgage-backed assets became unsaleable, this strategy quickly unravelled.

Financial Crisis Ensues

Saddled with mortgage-backed assets, both investment and commercial banks were unable to borrow freely in the money market. The disappearance of liquidity began to push several banks toward insolvency since they could not refinance their obligations. Collapsing asset prices then led to large losses. With bank solvency in doubt, liquidity became even scarcer.

The destructive interplay of illiquidity and insolvency eventually led to the bankruptcy of independent investment banks, which had been operating with extremely low capital ratios. Commercial banks, meanwhile, were placed in a similar predicament, further compounded by the risk of runs on their deposits. Inevitably banks became extremely conservative about further lending, and the collapse of securitisation led to credit shortages.

Tightness of credit impacted on aggregate demand, leading to falling output, collapsing exports and rising unemployment. A full-blown financial crisis became a severe and widespread recession affecting both developed and developing countries.

At present large numbers of commercial banks in developed countries are effectively bankrupt, surviving purely because of state support of their capital and liquidity. Therefore, confronting the recession should also involve dealing with the systemic financial problems at the root of the crisis. Policies should tackle the failure of deregulated banking that combines commercial and investment functions. Policies should also deal with the macroeconomic imbalances that encouraged the speculative financial excesses of the last decade.

Reference:

C. Lapavitsas (2009). 'Financialised Capitalism: Crisis and Financial Expropriation', forthcoming in *Historical Materialism*, 17: 2. Also available in draft form on Research on Money and Finance as Discussion Paper #1, www.soas.ac.uk/rmf.