Crisis and Neoliberal Capitalism

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Part I: The Financial Crisis and the Real Economy

It is impossible to predict the course of the financial crisis. The effects of the crisis on the real economy could be very large, especially if it engulfs more and more of the financial sector. But even if the financial crisis is contained, the bursting of the housing bubble—which began in 2007 and is bound to continue for some time—will have a powerful downward impact on the economy.

A speculative "bubble" arose in the housing sector of the U.S. economy starting around 2002. By the summer of 2007, housing prices had risen by 70% since 1995 corrected for inflation. Yet since 2002 the real value of home rents had been flat. By 2006 the ratio of the Housing Price Index to the Homeowners Equivalent Rent had risen sharply to an all-time high of 168.3, compared to 110.0 in 1995. This is clear evidence of a huge asset bubble in the U.S. housing market. This bubble created an estimated $8 trillion in inflated new wealth, which was about 38% of the peak total housing wealth of $21 trillion. When this bubble started to collapse in 2007, it set the stage for both a financial crisis and a recession in the "real" economy.

There are two ways in which the collapsing housing bubble affects the real economy. First, there is a downward wealth effect on housing investment and consumer spending. The collapse of the bubble in the housing sector has led to a sharp drop in residential investment. Since the second quarter of 2007, it has been falling at 21.6% annual rate. Second, falling home values are causing a reduction in consumer spending. Since 2002 households had been borrowing against their homes to get funds for consumer spending. One study estimated that during 2004-06 Americans took $840 billion per year from their home equity through borrowing and capital gains from the sale of housing. This was almost 10% of disposable personal income in the United States.

Suddenly, in 2007, people could no longer supplement their income with funds borrowed against their home, which has now led to a large drop in consumer spending, at a 3.1% per year rate in the third quarter of 2008. This happened before the financial crisis had begun to affect consumer spending. If all of the estimated $8 trillion of inflated home value disappears, the estimated effect on aggregate consumption would be a reduction of about $320 billion to $480 billion per year, or about 5% of total consumption. Dean Baker, co-director of the Center for Economic and Policy Research and a respected analyst of the financial crisis, estimated the total effect of the collapsing housing bubble to be a decline of between 3.1% and 7.0% of GDP.

The collapse of the bubble also affects investment in new plant and equipment by business. After several quarters of little growth, business investment fell at a 1% annual rate in the first quarter of 2008. The bubble-propelled and debt-financed expansions of 1991-2000 and 2001-2007 produced a growing amount of productive capacity, relative to ordinary income. As the current crash develops, industry will find it has substantial excess productive capacity. As a result, the incentive for business investment may be depressed for some time. In the last recession in the United States, in 2001, business fixed investment fell for two consecutive years, at an accelerating rate, for this reason.

A severe recession was averted in 2001-2002 by the start of the housing bubble. It does not seem possible for a new bubble to arise and avert a serious recession this time. Also, the financial crisis is likely to make the coming recession more severe. One way this happens is that banks' reluctance to lend to business due to the financial crisis will worsen the recession. Secondly, the stock market collapse precipitated by the financial crisis will have effects similar to the effects of the housing price collapse—it will tend to reduce consumer and investment demand. The only bright spot for the U.S. economy has been exports, but they are not likely to continue to do well in the face of a spreading global recession.

Part II: The Restructuring is Just Beginning

Every form of capitalism has contradictions that eventually bring about a structural crisis of that form of capitalism. In the 1970s the system of state-regulated capitalism, having produced rapid growth and high profits for a few decades, stopped working effectively and went into structural crisis. The predominant form of capitalism changed to the "neoliberal" form, which means a type of capitalism in which the state plays a limited role in the economy, particularly withdrawing from activities that benefit ordinary people. It now appears that neoliberal capitalism can no longer overcome two key problems and is entering a structural crisis of its own. First, the high and rising inequality it generates means that the majority has insufficient income to buy the growing output of the economy without relying on an unsustainable buildup of household debt. Second, the deregulated financial system of neoliberal capitalism is inherently unstable, as we have so clearly seen in recent months.

From 1945 to 1973, a regulated form of capitalism predominated in the world, including in the United States. Regulated capitalism here included extensive government regulation of business and finance, regulation of the macroeconomy (aimed partly at achieving a relatively low unemployment rate), social programs that amounted to a modest welfare state, relatively cooperative relations between big business and trade unions, restrained competition between big corporations, and trade and capital flows regulated by governments and international institutions.

The shift to neoliberal capitalism in the United States involved the deregulation of business and finance, the reduction of active government macroeconomic policy (and a shift of aim to assuring low inflation, not low unemployment), sharply reduced social programs, a big business and government attack against labor unions, unrestrained ("cutthroat") competition among large corporations, and relatively free movement of goods, services, and capital across national boundaries. This neoliberal transformation of capitalism was relatively thorough in the United States, the United Kingdom, and in international financial institutions such as the International Monetary Fund and World Bank.

As neoliberal capitalism enters a period of crisis, we can see the rapid loss of legitimacy of the previously reigning dominant "free market" ideology. This is similar to the sudden demise of the previously dominant Keynesian ideology of regulated capitalism in the 1970s.

Capitalism is going to be restructured, in the United States and globally, during the coming years. The outcome of this restructuring process, however, is not pre-determined.

So far the bankers have led the initial stage of restructuring. Treasury Secretary Henry Paulson, the former CEO of Wall Street giant Goldman Sachs, has been succeeding so far in getting the government to rescue the banks in ways that mainly benefit the bankers. This process has encouraged rapidly growing concentration of the financial sector, as the largest banks merge with one another and get big cash infusions and new federal backing.

However, the restructuring is just beginning. We can fight for changes that would benefit the majority rather than the bankers. First, the underlying reason for the financial crisis is all those people unable to make the payments on their mortgages. The government should pass an emergency measure to ease mortgage terms to reflect the declining values of homes and the declining economy. This would impose a onetime loss on the financial institutions that invested in the risky new mortgage-based securities, but it would also make it easier to know the value of the mortgage-backed securities, eliminating a source of great uncertainty in the financial system.

Second, millions of people have learned the important lesson that banks and other financial institutions are not ordinary private companies. If General MIls loses money, or even goes bankrupt, it harms its shareholders and workers— but its competitors gain. But if a few major banks lose money and are in danger of going under, this threatens the entire financial system, and with it the economy as a whole.

The obvious conclusion is that the financial sector cannot be operated on a profit-and-loss basis. Instead, it should become part of the public sector, operated to serve the public interest. If banks, which are granted the power to create our money supply, and whose credit is essential to the welfare of the entire public, were made public institutions, then public policy aims could guide their actions. They could be directed to stay away from speculative activities and instead make loans for socially valuable purposes. This would include steering credit into renewable energy technologies, fuel-efficient vehicles, low cost housing, and other good purposes. An advantage of public ownership of the banks over another cycle of government regulation of private banks is that reregulated private banks would simply press for the elimination of the regulations—as they did successfully starting in the early 1980s.

The developing financial and economic crises have exposed the high-flying financial operators for what they always were—thieves who got rich without doing anything productive. This has also exposed their fallacious free-market ideology. This is a promising time to build popular movements that can fight for progressive changes in our economy.

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