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Free-Market Illusion and Global Financial Crisis

Dr. Kalim Siddiqui * Mainstream, Vol. XLVI, No. 49, November 25th 2008: New Delhi, India.

The financial crisis facing the Wall Street is the worst since the Great Depression and will have a major impact on the US and global economy. The ongoing global financial crisis will have ‘domino’ effect and spill over all aspects of the economy. The Western world’s messianic faith in the market forces and to deregulation, the market friendly governments have no choice but to step in. This point is well summarised by recent United Nation’s *World Economic and Social Surveys* (2008) is that “markets cannot be left alone to deliver the appropriate and desired levels of economic security”.

The top five investment banks in the US have ceased to exist in their previous forms. Bears Stearns was taken over some time ago. Fannie Mae and Freddie Mac are nationalized to prevent their collapse. Fannie and Freddie together underwrite half of the home loans in the United States, and the sum involved is of \$ 3 trillion – about double of entire annual output of British economy. This is the biggest rescue operation since the credit crunch began. Lehman Brothers, an investment banks with 158 years old history declared bankrupt; Merrill Lynch, another Wall Street icon, chose to pre-empt a similar fate by deciding to sell to the Bank of America; and Goldman Sachs and Morgan Stanley have decided to transform themselves into ordinary deposit banks. AIG, the world’s largest insurance company has survived through the injection of funds \$85 billion from the US government.

The question arises why this has happened?

Besides cyclical crisis of capitalism, there are some recent factors which have contributed towards this crisis. Under the so-called “innovative” approach financial institutions systematically underestimated risks during boom in property prices, which makes such boom more prolonged. This relates to short-sightedness of speculators and their unrestrained greed, who during the asset price boom believed that it would stay forever. This resulted into keeping the risk aspects at minimum and thus resulted into more and more risk taking financial activities. Loans were made on the basis of collateral whose value was inflated by a bubble. And collateral is now worth less than the loan. Credit was available up to full value of the property which was assessed at inflated market prices. Credits were given in anticipation of rising property prices will continue. Under looming recession and uncertainty, to pay back their mortgage many of them are forced to sell their houses, at a time when banks are reluctant to lend and buyers would like to wait in a hope that property prices will further come down. All these factors would lead towards a further decline in property prices.

The Northern Rocks’ deposits, for example, were doubled from £10 billion to £23 billion between 1997 and 2006. However, there has been 6 fold increases in its mortgage lending over the same period. This means that retail deposits

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as a proportion of Northern Rock's total liabilities and equity, fell from 63 % to 22 %. The company was unable to fund its ambitious mortgage growth from its deposits and it began borrowing increasing amounts of funds from money markets on short-term basis. This worked very well, because market conditions had been stable and raising funds in the money market was not a problem. In August 2007, when money market froze, the company got itself into a position whereby it was running out of money and its strategy of borrowing short and lending long became impossible, thus ending in catastrophic.

The current major Western government intervention in the financial markets may be aimed to avoid recession. But we must not forget that bail out to these reckless financiers, who promoted speculation and underestimated risks, would mean rewarding them on their wrong doings. The fact that bailout implicitly condones the earlier behaviour that led to the financial crises. It is irony that from being the greatest advocate of a deregulated banking system. The US Federal Reserve and Bank of England may well turn out to be the largest holding company of banks.

The very assumption that rescue plan is to help is not true in the light of past experiences. The IMF and US Treasury bail-outs 10 years ago in Indonesia, Thailand, Brazil, Russia and Argentina did not work for those countries. Although it did enable Wall Street to get back most of its money. The people of these poor countries paid for the financial markets' mistakes. Joseph Stiglitz, a prominent US economist, argues on the bailout: "Defenders of the bailout argue that the institutions are too big to be allowed to fail. If that is the case, the government had a responsibility to regulate so that they would not fail. No insurance company would provide fire insurance without demanding adequate sprinklers". (Financial Times, 25th July, 2008)

Moreover, the 1990s experience of Latin America clearly shows that financial liberalization does not necessarily contribute positively to investment and economic growth. These countries that had opened up their financial sector to attract capital inflows often experienced instability in their financial markets and speculative attack on their currency. De-regulation in the US started during Reagan administration and continued apace since then. In 1999, the US Congress scrapped regulatory restraints on financial sectors. The regulation was dismantled because it was said that finance is the engine of growth as long it is given free rein. It unleashed concentration and centralisation of power into a small group of financial companies.

The question arises who should pay the price for taking irresponsible decisions? Those who are in-charge and responsible for the running these financial institutions that collapse walk away without paying any price but in fact substantially enriching themselves. For example, Lehman Brothers, the major Wall Street bank which collapsed, but its CEO Richard Fuld Jr. who was at the helm of affairs during its period of irresponsible behaviour, received \$ 62 million pay in 2006. According to recent report in the Financial Times, the compensation for major executives of 7 largest United States banks

amounted to \$95 billion over the past 3 years even as the same banks recorded around \$500 billion in losses.

John Maynard Keynes argued that the fault of the market economy was that it does not distinguish between “enterprise” and “speculation”, so that unfettered functioning of the markets made the livelihood of the people dependent on the whims of speculators. He had wanted finance to remain national, so that the state could have autonomy to pursue policies suited to the national needs. Keynes, who wanted desperately to save capitalism, argued that it could only survive through state intervention. With the increasing dominance of finance capital this policy was reversed in early 1970s when the “free-market” fundamentalism was imposed in the name “efficiency” in most of the countries through the IMF and World Bank.

In short, this crisis is an inevitable consequence of the path of globalisation and free-market fundamentalism that is unfolding in recent decades. This process has been accompanied by growing economic inequalities both within countries and between the rich and poor countries. The *Human Development Report*, 2007-2008 confirms this with indisputable statistics. Forty per cent of world’s population living on less than \$2 a day accounts for 5 % of global income while the richest 20 % accounts for three quarters of world income. The global financial crisis must open the eyes of the developing countries many of them earlier uncritically supported financial sector liberalisation. It is time put an end to financial liberalization and to take steps to strengthen the financial sector in a manner which safeguards the country’s economy and contribute to sustained development.

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