

Causes of the credit crunch

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The credit shock is reverberating across the industrialised world. The US housing market is suffering its biggest slump since the 1930s. Distressed sellers have seen property prices tumble by up to fifty per cent in some areas of the US. Record defaults and the prospect that more than two million families may lose their home in 2008 alone, signals capitalism's biggest test in the post-war era. In the UK, ten years of growth financed by record borrowing are starting to unravel. Property markets are imploding in Spain, Ireland and across Euroland. And the world's third largest economy, Japan, shows no sign of winning its long, tortuous eighteen-year battle with deflation.

Globalisation predicated on unfettered markets is going awry. The housing bubbles were not an accident, spawned simply by careless regulatory oversight. They were a necessary component of the incessant drive to expand free trade at all costs. Dominant corporate power became the primary driving force for economic expansion. Profits were allowed to soar. A growing share of the national income was absorbed by companies at the expense of workers. And the record borrowing provided a short term panacea, to bridge the yawning wage gap that ineluctably followed. Governments fostered housing bubbles to stay in power. Consumers were encouraged to borrow, to ensure there would be enough economic growth.

With the US housing market in freefall and the UK suffering its first bank run since 1878, the mainstream financial press has been turning in on itself, searching for scape-goats. Regulators, central banks and management at the more reckless banks have been selectively targeted and criticised for their lack of due diligence. The opprobrium heaped on chosen culprits sanctifies and provides redemption for those that failed to spot the inherent dangers in allowing economic growth to be financed by untrammelled borrowing.

But there is no mention of the underlying causes of this explosion in debt. These commentators dare not venture there, out of fear that the contradictions and flaws with the economic philosophy they have espoused will be exposed. Greed is good, but some just got a little carried away. Rap a few knuckles, offer a few sacrificial lambs and let the party recommence. Financial markets have been bailed out before, there is no reason to stop and take a hard look at how we arrived here. That would be too painful and would force recognition of the brutal truth: such an uneven society breeds asset bubbles. Rising inequality explicitly leads to extreme house price cycles. If we want to get off this destructive rollercoaster, the limits to unbridled trade need to be acknowledged. The case for a more even distribution of income has to be accepted too.

The credit boom

The collapse of the dotcom bubble in 2000-01 saw a mere tweaking of regulation, a few token limited fines, and the next wave of speculation was fermented to drive economic growth. Under government sanction, central banks stepped back from the plate and facilitated a cataclysmic accumulation of debt.

With companies given such free rein to drive wage costs down, creating property inflation became a necessary stimulus for economic growth in the Industrialised West. After the precipitous meltdown in high-tech share prices during the early part of this decade, few governments complained when strong consumer borrowing and a proliferation of debt provided the fuel for economic recovery. And few objected as an explosion in credit trading buried in a blizzard of abbreviations – MBS (mortgage-backed securities), CDOs (collateralised debt obligations), CDS (credit default swaps) or SIVs (structured investment vehicles) – allowed banks to conceal the inevitable risks from an unsuspecting and pliant public.

Indeed, rising house prices became symbolic, a modern era indicator of wealth and success. House prices were soaring, we must all be better off. Never mind that debt was rising too. Never mind that house price inflation is a zero sum game. Society as a whole does not benefit from a rise in house prices. Those already on the ladder can only gain at the expense of a growing number unable to reach the first rung.

In the short run, housing bubbles can provide a stimulus to economic growth if they hoodwink people into believing they are wealthier. And governments that have been promoting the free trade and profits first agenda are content to foster the delusion. Indeed, governments rely upon *money illusion*, hoping homeowners will take a myopic view of their record debts. Witness New Labour's boast – 'ten years of GDP growth, the longest for 300 years' (Brown, 2005). Growth was everything, it told the electorate. Runaway house prices were a function of the strong economy and a shortage of properties. A similar refrain was widely uttered in Japan during the late 1980s. Record debt levels did not matter, it was claimed, because property prices were soaring. Just focus on the asset side of the balance sheet. Eighteen years on, Japan is still suffering from that disastrous miscalculation.

Heading into a debt trap?

For the US, the stakes are already high. A two-and-a-half year downturn in the housing market is in danger of spiralling out of control despite the Federal Reserve's belated decision to cut interest rates in the autumn of 2007. The US authorities lost valuable time. Federal Reserve officials were sidetracked by numerous voices claiming inflation would continue to accelerate.

Inflation is not the primary issue, precisely because of the free market policies that feed and nourish property bubbles in the first place. Just as Japan overestimated inflation pressures at the top of its housing boom in the late 1980s, the US and UK are also exaggerating the risks. The same downward pressure on wages, the income inequalities and the rise in profit ratios that have driven asset prices, will ensure that any pick-up in inflation will be constrained (1).

Oil and food are a problem. Climate change and peak oil constitute fundamental costs that will have to be borne by producers and consumers alike. Nevertheless, a closer examination of the consumer prices indices suggests that by the beginning of 2008, the underlying inflation rate was running at little more than 2 per cent in the US and 1 per cent in the UK. In Euroland, it was just over 1.5 per cent (2). The bigger secular threat for all these industrialised nations imitating Japan may well prove to be one of falling asset prices leading to a debt trap – or debt deflation. And the theory of debt deflation, first put forward by US economist Irving Fisher in response to the depression of the 1930s, now provides a key template for the risks facing all industrialised economies. An aggressive free market response to a debt crisis could easily serve to make the problem worse and any collapse in asset prices more entrenched. Attempts to dispose of bad debts and repossess properties may lead to more deflation and push more lenders into trouble. The debt burden may go up in real terms, not down. And the cycle may just repeat itself until such point that a systemic financial crisis signals the need for a change of policy.

Japan's experience also highlights the dangers that many economies in the Industrialised West may yet slip into a Keynesian liquidity trap. The attempts to reflate may not succeed if investors take fright at a perceived inflation threat. The economist John Maynard Keynes was quite clear in his prognosis: interest rates had to come down quickly in a housing bust. If that did not work then there would be a clear case for government intervention to correct the market's failings.

Unbalanced globalisation

Cutting interest rates aggressively during an economic downturn triggered by a housing collapse is never a complete solution. An easier monetary policy does not cure the roots of a speculative mania. That way lies a revaluation of the political economy that begets asset inflation in the first place. Indeed, should central banks get their timing right and succeed in reflating the economy, that may simply allow governments to deflect any searching examination of the inequities that presaged overinvestment and excessive borrowing in the first place.

And one of the key inequities that must be addressed is the galloping pace of globalisation with inadequate checks and balances to corporate power. The rapid growth in world trade has been trumpeted as one of the key economic triumphs of a free market. It seems churlish to quibble when world GDP growth has been unrelentingly strong over the past four years (3).

But dig a little below the surface and the picture is not quite so benign. The systematic tearing down of trade barriers in the absence of appropriate protection and rights for ordinary workers accelerated a two-decade trend towards higher profit ratios in the West. That was unsustainable. Profit ratios can only continue to rise at the expense of a further decline in the share of national income taken by labour income, or wages. And such a divergence will increase the tendency and political pressure for consumer borrowing and house price inflation to fill the gap, between over-investment and inadequate demand.

And this dichotomy will ultimately trigger a financial crisis that will lead to a sudden reversal in profit margins. Ironically, and perhaps unwittingly, the point was made eloquently by the current Federal Reserve chairman, Ben Bernanke, in January 2004. He endorsed a key tenet from overinvestment theories, the 'tendency of the rate of profit to fall', which explains much of the lurch from boom to bust in today's deregulated markets (Bernanke, 2004). By deduction, profit ratios can only increase *ad infinitum* by heightening the long-term threat of debt deflation.

We should draw a distinction between rising profit *ratios* and high profit *levels*. The latter may occur in a more sustainable direction if free trade is matched by appropriate labour rights, so that consumption can rise without governments having to foster asset inflation as a substitute for economic growth. Hence, it is in the long-term interests of free trade advocates to allow a greater share of the spoils to accrue to workers. It is also in their interest to permit a more even distribution of wages given the clear differences in marginal propensity to consume between income groups.

The global wage squeeze

Wages would have fallen a long way in the US and the UK without an explosion of borrowing. Debt was a panacea for the 'flattening of wage compensation', described by Alan Greenspan as a key economic feature of the West in recent years (Greenspan, 2007). Remarkably, even with a huge run-up in debt driving an economic boom, the US real median wage has still fallen since 2001 (4). Wages and salaries have slipped to their lowest proportion of GDP in decades. In the UK, the compression of wages has been striking too.

The precise cause of this squeeze on labour costs has been hotly debated. It can be viewed as an extension of the anti-inflation policies adopted in the late 1970s and early 1980s. Clamping down on wages was central to Reaganomics and Thatcherism. During the 1990s, the minimum wage was back in vogue. The British Prime Minister Tony Blair introduced one, and President Clinton boosted basic pay rates. But they failed to reverse the squeeze on organised labour that underpinned the low inflation strategy.

Some economists routinely claimed that 'policy credibility' played a critical role in keeping inflation expectations and thus wages in check. 'Independent' central banks were also cited as critical to achieving low inflation or 'price stability'. These arguments are misconceived. Inflation initially fell in response to two deep recessions during the early 1980s and 1990s. It remained low because of a fundamental shift in the balance of power between capital and labour, or companies and workers. Central banks acted aggressively to tame inflation in the industrialised west with high interest rates. And government policies sought to strengthen the corporate hand over employees. 2007 underlined the point. Higher oil and food prices pushed inflation up in both the US and the UK, but wages barely responded. Workers had precious little bargaining power, and real incomes were hit hard.

Alternatively, it may have been 'globalisation' that squeezed labour costs and led central banks to drive borrowing up to record levels. And within that rather loose term, there may

have been two different forces playing a part – rapid technological change, or lower trade barriers underpinning the dominance of corporations. Federal Reserve chair Ben Bernanke was quite clear. In his view, the high-tech revolution was chiefly responsible for the downward pressure on wages for some workers, not the growth in trade with low-cost countries (Bernanke, 2007a and 2007b). Mr. Bernanke's conclusion was warmly embraced by supporters of free trade. Politically, it was a far more appealing explanation than acknowledging the perils posed by a rising tide of cheap imports. And if technological change has depressed the demand for low-skilled workers, the prescription seems quite straightforward. Displaced workers need to retrain. For that reason, governments in the West have buttressed their support for free trade with a call for improved educational standards.

Focusing on technology provided a convenient distraction from a more pernicious issue. The arrival of China and so many other low-cost countries as trading partners has also been a key force behind the 'flattening of wage compensation'. China was a huge competitive shock for many manufacturing industries in the West. It provided such a deep pool of cheap labour that its emergence as a major exporter was bound to be deflationary. China's economic boom was spurred in no small measure by companies taking advantage of a large pool of cheap labour, to boost profit margins. Direct investment flows into China accelerated in the early 1990s. It was these inflows that provided the funding and catalyst for an explosion in Chinese export growth to the US, UK and other countries, where workers could not hope to compete at prevailing exchange rates.

China was hardly alone in benefiting from the opportunities to export cheap goods to the West. Mexico became a major destination for US companies seeking to cut labour costs. When the North American Free Trade Agreement (NAFTA) was signed in 1993, direct investment flows into Mexico were \$4.4 billion. The US enjoyed a small trade surplus of \$1.7 billion with its southern neighbour. Eight years later, US companies were investing heavily in Mexico. The direct investment inflows had quadrupled to \$25 billion. And the US trade deficit to Mexico had swollen to \$74.3 billion.

After the fall of the Berlin Wall, Eastern Europe became a major recipient of direct investment inflows too. It soon overtook Asia as a magnet for capital, with a number of countries receiving a huge influx of investment, notably Slovakia, the Czech Republic, Poland and Hungary.

The UK bubble

For the UK, Eastern Europe fulfilled the same role Mexico provided for US companies. Its close proximity, low labour costs and high unemployment rates provided compelling savings for companies looking to relocate.

The UK's trade deficit soared too. By the final quarter of 2007, the goods deficit had climbed to an annualised rate of £93.2 billion, equal to a record 6.6 per cent of GDP. The current account deficit had reached a new high too. There is nothing new about the long and steady decline in the UK's trade position. It has been going on for so long it rarely seems to trouble policymakers. But it should. It lies at the heart of the UK housing

bubble. Imports of cheap goods from low-cost countries have been fundamental to the downward pressure on wages for many workers.

The disappearance of manufacturing jobs has been unrelenting since the early 1980s. Over a million jobs vanished in the recession of the early 1980s, and a further million were shed following the Lawson boom. There is a crucial distinction, however. These losses occurred as a result of recession. The jobs lost since New Labour came to power have been the result of free trade and cost-cutting. There has been no recession to explain the contraction of manufacturing employment over the past decade, although one is now looming.

Despite these losses, total employment has gone up, hitting new highs at the end of 2007. For New Labour, this is proof that unmitigated free trade works. There is nothing politicians or policymakers can do to stem the job losses to cheap countries, they claim. But so long as service employment continues to absorb the slack, there is no reason to fret. An economy can thrive without manufacturing, the argument goes.

Theoretically that is true. But the flaw in this argument can be seen in the sheer scale of the rise in consumer debt needed to counter the deflationary impact of shipping so many goods east. The downward pressure on prices of consumer goods that results from globalisation allowed central banks to keep interest rates low, driving debt levels up. The housing bubble in turn provided alternative jobs in the service sector. Britain has created large numbers of service sector jobs. But they have been contingent on the credit bubble that the authorities had to create, to fill the void generated by the loss of manufacturing jobs.

For a while, 'globalisation' worked for the UK, as it benefited not just from the surge in house prices at home, but also the credit bubbles that have emerged across the world too. There have been many, and the financial sector in the UK has boomed on the back of a global credit bubble. Now of course, it is starting to unravel. As an economic strategy, it was never sustainable. If the housing bubbles deflate aggressively across the West triggering problems in emerging market economies, it will have inflicted immense damage to the longer-term growth prospects of the UK economy.

The backlash against free trade

A backlash against free trade is now gathering momentum in the US, and protectionism has become a key battleground for the 2008 presidential election. 'China's steel comes here, our jobs go there' was Hilary Clinton's blunt assertion to a gathering in Ohio ahead of the primary. 'We play by the rules, they manipulate their currency. And we get tainted fish, lead-laced toys and poisoned pet food in return', lambasted the presidential hopeful (5). Nobel Laureate Paul Samuelson caused a stir too by suggesting that the arrival of India and China onto the world stage might inflict more harm than good on US workers (Samuelson, 2004). Credited with developing the comparative theory of trade in 1964, Mr Samuelson has provided much intellectual justification for the explosive growth of international trade.

Few economists would dispute the original premise of the theory of free trade. It makes sense for a country with a comparative advantage to trade with another where it

suffers a relative disadvantage. If Norway enjoys a comparative advantage in logging timber for example, it makes sense for it to buy wine from France. But free trade today is no longer driven by comparative advantage, rather the ability to maximise profits by cutting costs. And the cost advantage enjoyed by so many developing economies is so great, that it has been impossible for many manufacturing industries in the industrialised west to compete.

Many aspects of globalisation should be embraced, not rejected. Technology has brought countries and their citizens closer together. There is no turning the clock back. The internet is here to stay. The ability to outsource has manifestly been transformed by the dotcom revolution. To pretend otherwise would be foolish and deny the potential benefits – both economic and political – that may come from an integrated world economy.

Equally, ardent supporters of free trade have to concede ground, otherwise the protectionists who want to retreat into isolationism will win the argument. We will return to the 'beggar thy neighbour' policies of the 1930s. The benefits of free trade have to be kept in perspective, set against the costs of allowing huge asset bubbles to emerge, not just in the West, but also in emerging market economies. The two are indelibly linked.

The need for fundamental reform

Talk of heightened regulation to rein in banks is understandably rife. In the UK, the Financial Services Authority (FSA) has admitted to 'blunders' in its supervision of Northern Rock. And there is no question that the regulators failed in their job. The party got out of hand, and on both sides of the Atlantic there were too few dissenting voices during the heady boom.

More regulation is inevitable. But if we pin the blame for the housing bubbles on the regulators, central banks or even 'greedy' bankers, we will fail to redress the real causes. They were almost certainly all culpable. But they were mere actors. Regulation was lax because it suited the politicians of the day, who wanted the economic growth that came from allowing borrowing to spin out of control. Interest rates were kept too low because financial stability was never considered important. Governments needed housing bubbles, as they were wedded to a free trade model that was inviting wage destruction for the masses amidst an unsustainable drive to cut labour costs.

The political discourse over what went wrong has barely begun because few are willing to acknowledge the real cause of the housing crisis. A thriving blame industry has emerged, with much hand-wringing by the politicians. Presidential hopeful Hillary Clinton blamed the Republican-led administration. Alan Greenspan and Ben Bernanke, both with strong Republican leanings, are also cited. But it was the Democrats that signed up to many of the trade deals that stripped the US of so many manufacturing jobs, and paved the way for boom and bust. Hillary now rails against policies championed and implemented by husband and former president Bill.

And in the UK, the Conservatives attack New Labour for economic *incompetence*. The emphasis should be noted. There was nothing wrong with the free trade model *per se*, or

the underlying economic policy, they imply. It was just a lack of competence at the Financial Services Authority and within the Treasury, that saw it all unravel. In truth, the Conservatives supported the free trade policies that underpinned New Labour's economic mirage.

A regulatory backlash provides a convenient smokescreen for more fundamental reform to economic policy. A more equitable balance of power between capital and labour will have to emerge, otherwise protectionist pressures will intensify. Securing that will be no small task. I do not pretend to have all the answers to that vexing issue. My primary aim is to diagnose the problem.

There are, however, a number of important points to be noted. The concentration of corporate power through mergers, acquisitions and leveraged takeovers has to be reversed. The ability of large multinationals to control and drive labour costs down, by moving jobs around from one country to another, lies at the heart of the debt problems facing the West. Until we recognise that point, the West will not be able to shake its destructive dependence on housing bubbles. We will continue to lurch from boom to bust, with debt traps and debt deflation threatening prolonged economic stagnation.

There are two ways to even out the playing field: reduce corporate power, or increase the strength of labour. Many argue for the latter, and among emerging market economies in particular, the case for greater labour regulation is overwhelming. The commercial logic for outsourcing would be far less appealing for transnational companies if Chinese workers had the same rights as their Western counterparts. Free trade deals were signed by Western politicians on both sides of the political spectrum without anywhere near enough attention to worker rights in developing countries. But persuading the Chinese authorities to introduce full union rights for its 300 million or so workers may prove nigh on impossible.

A quicker alternative may be to reduce the ability of companies to expand profit margins by cutting labour costs. Big companies can hold on to their profits for longer. Smaller companies create more competition, allowing the 'benefits of free trade' to be disseminated more quickly to workers and real wages to rise. That would make consumers less reliant upon debt.

Whatever the remedies, the immediate task is to prevent debt deflation taking root. Central banks and governments have presided over the biggest credit bubble in modern history. We have to hope they are up to the task.

Graham Turner is the founder of GFC Economics, an independent economic consultancy which provides forecasting services for some of the world's largest banks. This article is based on *The Credit Crunch: Housing Bubbles, Globalisation and the Worldwide Economic Crisis*, published by Pluto Press.

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Notes

1. The ratio of current profits from production to GDP in the US climbed to 12.0 per cent in Q3 2006, its highest level since Q1 1966 (Bureau of Economic Analysis).
2. The ex-food/energy/shelter inflation rate was 2.0 per cent in the US by January 2008 (Bureau of Labour Statistics). The ex-food/energy/alcohol and tobacco inflation rate was 1.3 per cent in the UK by January 2008 (Office for National Statistics). The ex-food/energy/alcohol and tobacco inflation rate was 1.7 per cent in Euroland for January 2008 (Eurostat).
3. World real GDP growth has averaged 5.2 per cent y/y in the three years to 2006. That was the best performance since the 1971-73 period, when GDP rose by an average 5.6 per cent y/y (International Financial Statistics, IMF).
4. The median usual weekly earnings of full-time wage and salary workers in constant (2006) dollars fell from \$678 in 2001 to \$671 in 2006 (Bureau of Labour Statistics).
5. 'Democratic rivals clash over economy', *Financial Times*, 15.02.2008.