Global Finance, the Current Crisis and Challenges to the Dollar

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It is not often that we find ourselves living through financial turmoil so serious that the International Monetary Fund calls it "the largest financial crisis in the United States since the Great Depression." Yet that is where we are today. Already, commercial banks have collapsed in both Britain and Germany, as has the fifth-largest investment bank on Wall Street. A series of hedge funds have gone under or are teetering on the brink of ruin. And it is a near certainty that more financial institutions will fail before the crisis burns out.

It is clear that the Left needs serious analysis of just what is happening to world capitalism at the moment. Too often, however, our assessments are stuck in the past, revolving around debates as to whether or not this crisis represents a repeat of 1929 and the Great Depression.

Such debates detract from the hard work of analysis that is needed. On the one side are those who assume that history tends to repeat itself. On the other side are those critics who so exaggerate what has changed (particularly the ability of central banks to dampen tendencies to financial collapse) that they present a picture of a capitalism whose contradictions have been so muted that the system is no longer susceptible to severe economic slumps.

The real challenge for radical analysis, however, is to grasp both the changes and the enduring economic contradictions within capitalism in order to understand how capitalist transformation displaces and reorganizes crisis tendencies without eliminating them.

In the absence of such analysis, much of the radical commentary on offer tends to focus on the blatant deceit and corruption of financial players who have contributed to the market upheaval. This has its purposes. But it runs the risk of downplaying the structural features of late capitalism that breed financial meltdowns – and in so doing of suggesting that the Left focus on issues like financial regulation rather than class struggle against capital.

Trying to make sense of this crisis is one important step toward developing both an analysis of late capitalism and some of the tasks that confront the Left. To be sure, any assessment of unfolding events will necessarily be partial and incomplete. Nonetheless, it is possible to offer some crucial guidelines for making sense of this crisis.

A Banking Crisis, Not a Liquidity Crisis

It is critical to recognize at the outset that, contrary to the claims of central banks, this is not a liquidity crisis, i.e. financial turmoil caused by insufficient supplies of money flowing through the financial system. Instead, we are dealing with an insolvency crisis caused by the fact that many financial institutions are effectively broke. The result is a trauma in the banking sector.

This trauma persists because a myriad of lending institutions hold billions of dollars in massively depreciated paper that nobody is interested in buying from them. There is a host of exotic names for this paper, but essentially it is an array of debt obligations – titles to payment of interest and principal on a vast array of loans. Until the crisis broke, investors had been treating this paper as a pile of assets that they could always sell, i.e. as real wealth. Yet, the value of a debt rests in the first instance on the capacity of the borrower to pay. If the borrower can't pay, the alternative is for the creditor to seize the asset. But if the asset itself is losing value, then it may not cover the loan – and there might not be anyone out there who wants to buy it. In short, it may not be convertible to cash.

And that is precisely what is happening on a larger and more complex scale today. Economic reality is demonstrating that much of this paper – tied in the first instance to tens of millions of U.S. mortgages – is worth billions of dollars less than what was paid for it. So much of it is being written off or written down (revalued at amounts that involve enormous losses). It is as if you once had $1,000 in the bank, against which you'd borrowed many times that amount (say, ten times that amount or $10,000) and you have now learned that you only have $500. Once your creditors discover that, they'll scramble to collect in the knowledge that there's no way you will ever pay off all that you owe. But your $500 will be gone pretty fast. And since you owe $10,000, a lot of your creditors (including people who bought fancy paper called "Collateralized Debt Obligations" which includes some of your loans) won't be able to collect. And they won't be able to sell off your debts to anyone else either.

Precisely such dynamics are at work when an institutional "run on a bank" occurs, of the sort that rocked Bear Stearns in mid-March. In the course of 48 hours, Bear's holdings of cash →

and liquid assets plummeted from $17 billion to $2 billion as investors pulled their funds from the bank.

So the root problem is not a lack of liquidity in the system. It's that there are all kinds of institutions out there that nobody wants to lend to and whose ostensible "assets" nobody wants to buy. Worse, none of the players in the system are entirely certain as to who is holding increasingly worthless paper, or how much of it they have. As a result, the flow of funds between banks, and between banks and other lenders (like mortgage companies), keeps seizing up.

This is the reason that injecting cash into the system doesn't restore confidence. In fact, despite deep cuts to interest rates by central banks, particularly the U.S. Federal Reserve (designed to encourage borrowing) and massive injections of money into the banking system, American banks have continued to tighten lending to consumers, corporations and other banks (*Financial Times*, May 6, 2008).

When investors lost confidence in Bear Stearns, they did so for a fundamental economic reason, not a simply psychological one: Bear's actual assets, particularly those tied to real estate loans, had been losing massive amounts of value for months. In fact, in June of last year, two of the bank's hedge funds, which were deeply invested in sub-prime mortgages, effectively collapsed.

From Housing Bubble to . . .

And it is there, in the housing sector, that we find a key link between the financial crisis and material assets in the wider economy. For, central to this crisis is the collapse of a manic bubble in U.S. house prices.

For a hundred years after 1895, as Dean Baker has noted, U.S. house prices increased at the rate of inflation. Then, from 1995 to 2007, they rose 70% more than the cost of everything else. That created an extra $8 trillion in paper wealth for U.S. homeowners. And, with that ostensible wealth in their sights, American consumers ran to the stores, often after taking out loans against the increased value of their homes.

Bubbles eventually burst, of course. In this case, the pop came last summer, with a rise in the number of mortgage holders starting to default. And it just kept getting worse. U.S. housing prices dropped about 13% last year and have continued tumbling this year. As the houses they've taken mortgages on fall in value, the cost of buying them has risen for millions of Americans. Huge numbers are just putting the keys in the mail and sending them back to the mortgage lender. Others, unable to make payments, are suffering foreclosure. In March of this year, foreclosures jumped 57% in the U.S., while house repossessions by banks more than doubled compared to a year earlier. Many analysts now expect U.S. house prices to decline by another 10 to 20% over the next year.

Meanwhile, investors who "bought" those mortgages – through a variety of schemes known as mortgage-backed securities – are discovering that the value of what they own is plummeting. The borrowers can't pay and the underlying assets are in freefall. No one is interested in buying these toxic debts from them.

This is why the asset-backed commercial paper (ACPB) market has been frozen in Canada for the last six months. And now the same thing has happened to the $300 billion auction rate note market in the USA. Holders of these "assets" can no longer find buyers.

Yet housing is just part of the problem. Equally dubious junk is now being found in commercial paper tied to credit card loans, commercial real estate, auction rate notes, leveraged buyout loans and much more.

This is why estimates of the total damage of the crisis to the financial system keep rising. Initial predictions had the figure between $50 and $100 billion. Then, as bank after bank wrote off billions more, estimates in the range of $400 billion and even $600 billion emerged. In April, the International Monetary Fund calculated that the meltdown would result in losses of nearly $1 trillion. One analyst writing in the *Wall Street Journal* suggests the global damage will hit $1.4 trillion.

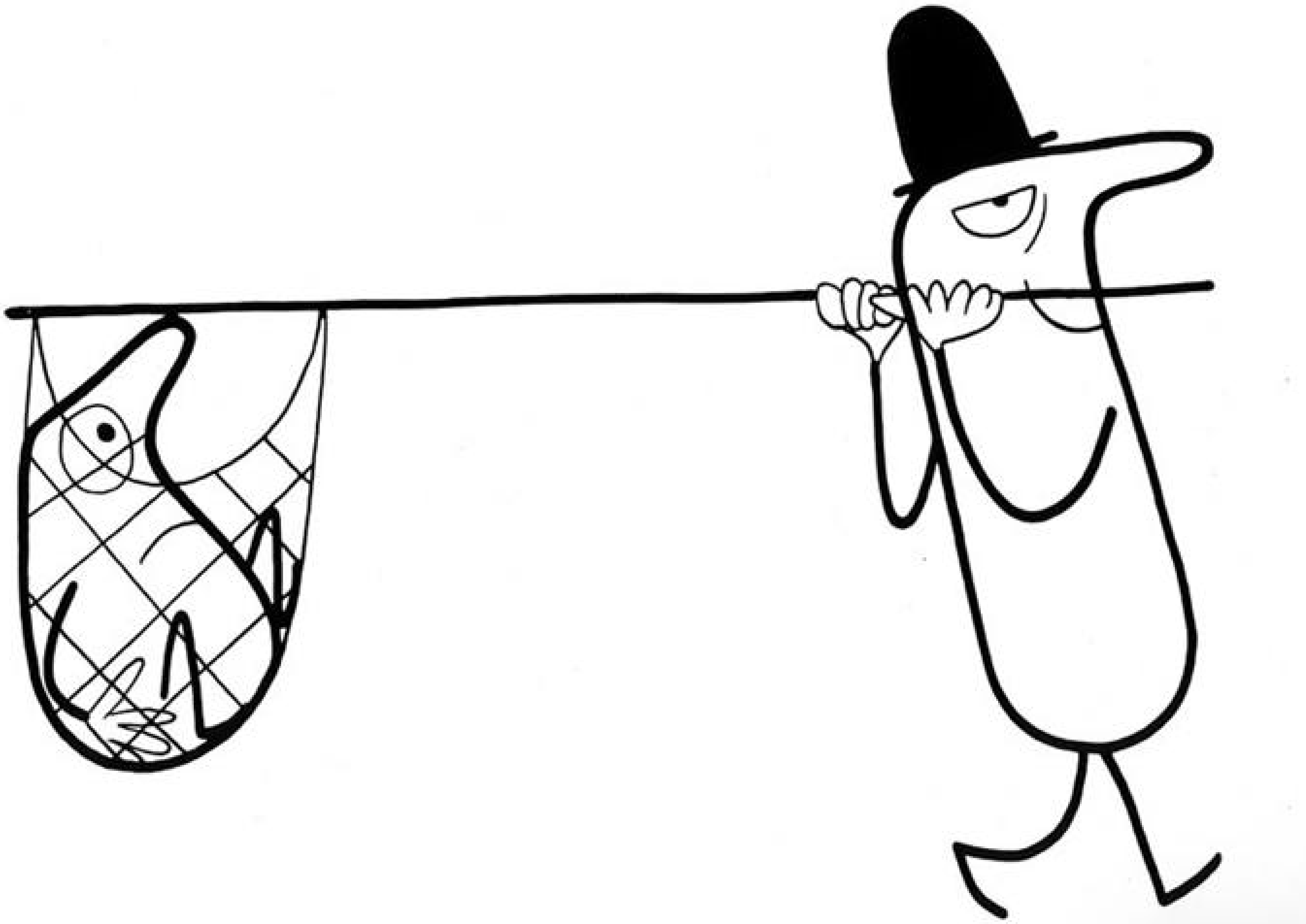
Whatever the ultimate figure – and it is likely to be at the higher end of the predictions – it represents a very large hit for the system. It also means that there are huge losses still to be recorded before the financial system recovers. Nouriel Roubini, among that very small minority of economists who saw the sub-prime meltdown coming and one of the few who have consistently warned that its consequences would be extremely serious, has argued that "the worst is still to come" for the U.S. and global economies.

Global Slowdown

Just how deep and prolonged the slowdown in the global economy will be remains to be seen. But in recent years as much as half of all U.S. economic growth has been housing-driven. Borrowing against rising home values, American consumers fed the engine of the world economy, particularly in their enormous purchases of manufactured goods from around the world. During this round of credit-driven growth, U.S. household debt more than doubled, increasing from $6.4 trillion in 1999 13.8 trillion in 2006.

Between 1980 and 2000, U.S. imports increased 40%, accounting for 19% of world imports and roughly 4% of world GDP. Now, as the housing bubble bursts, as consumers hold off on big purchases and try to pay down debt, world exports to the U.S. will decline and global growth will taper off. In fact, imports into the U.S. dropped by over $6 billion in March, a clear sign that the global slowdown is spreading. Moreover, even a modest move by U.S. consumers to rebuild their savings will knock about 1.5% off U.S. economic growth per annum.

Across the U.S., construction spending, industrial production, private employment and manufacturing output are all falling. The



U.S. economy is clearly in recession. It remains to be seen just how significant the accompanying global slowdown will be.

The Dollar, World Money and the Current Crisis

Alongside the turmoil in financial markets, the current crisis also poses major challenges to the U.S. dollar as the dominant form of world money today.

World money is necessary to the measuring and allocating of value – prices, profits, wages, etc. – within and between regions and nations. In order to do this efficiently, global money must be considered to be effectively "as good as gold" – something that everyone will accept because it is a stable and universally recognized means of payment.

For most of the history of capitalism, gold has anchored the system of world money, either through an actual gold standard (in which international payments were made in gold) or a gold convertibility standard, under which the leading currency could be converted into gold by the world's central banks.

Since 1971, however, when U.S. President Nixon broke the dollar's tie to gold, the U.S. dollar has operated as *inconvertible* world money. This has produced two tendencies: first, a significant long-term decline in the value of the dollar relative to other major currencies; and, secondly, a new volatility in world currency markets, as investors try to avoid holding on to currencies whose value may plummet. But in the absence of any other viable candidates for world money status, the dollar continued its reign.

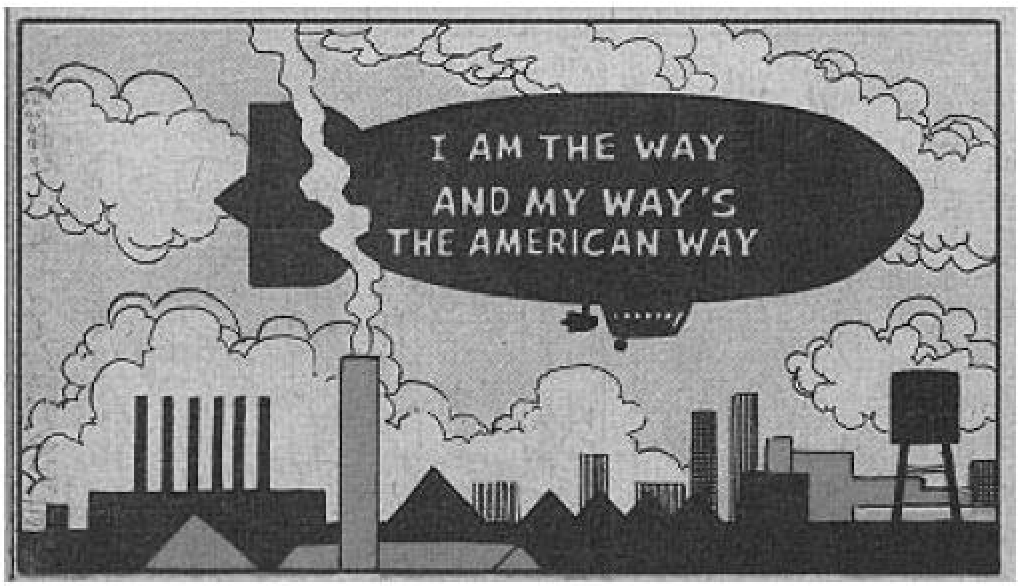
Indeed, throughout the last decade or more, the status of the dollar seemed to be rising. Despite huge deficits in the U.S. current account – the balance between what economic actors based in the U.S. owe the rest of the world and what the rest of the world owes these U.S. actors – the dollar kept riding high. This led some pundits to argue that current account deficits (i.e. debts to the rest of the world) are irrelevant where the dominant imperial power is concerned. Even as the U.S. economy started to run deficits of $500 billion per year and more with the rest of the world – deficits that are essentially paid for by printing and shipping off dollars – these commentators insisted that there would be no meaningful consequences for the economy of the United States.

The reality is much more complex. It is true that the world money-issuing state can get away with deficits that would not be tolerated in the case of any other nation-state. But it is not true that it can do so infinitely. Sooner or later, as more and more of the currency floods into world markets to cover these deficits, a point must be reached at which some of those holding dollars become tempted to unload them in favour of other currencies or assets. And at that point, an inevitable decline in the dollar's value would →

set in, increasing the pressure on others to dump it as a depreciating financial asset.

In fact, precisely this process has been underway for some time now. Beginning in 2001, private investors began to dump dollars. What prevented a major collapse in the value of the dollar at that point was central banks in Asia, particularly China and Japan, who stepped into the breach and invested massively in the USA.

These Asian central banks have been effectively returning to the U.S. the dollars it ships overseas to pay for its current account deficit (this is done by making foreign investments in the U.S., be it in U.S. treasury bills or the stocks of banks and corporations). Some commentators have held that this process could continue for decades, dubbing it "Bretton Woods II," after the original Bretton Woods agreement that created the post-World War II dollar-gold regime.



But there have always been three inherent flaws in this arrangement. First, this massive recycling of dollars back to the U.S. only fuels speculative bubbles, as U.S. financial institutions try to make profits by finding borrowers for this money, be it investors in dotcom stocks or low-income home buyers. Yet, when these bubbles burst, as has the most recent one in housing, it makes the U.S. national economy a less attractive place for investment (since investments have become highly risky and unprofitable). Secondly, as the Federal Reserve lowers interest rates to prevent the bursting bubble from becoming a full-fledged crisis (as it has been doing in recent months), it makes dollar-denominated assets less and less attractive, since higher interest rates are available elsewhere. Finally, as low U.S. interest rates provoke a flight from the dollar, investors holding the U.S. buck have a greater and greater incentive to get out of it.

And even foreign central banks are doing so, albeit incrementally, under the byword of "diversifying" their holdings – i.e. reducing the percentage of international reserves they keep in dollars. In recent years, China, Russia and South Korea have all reduced the proportion of international reserves they hold in dollars. Russia, for instance, has gone from 30% to 50% of its reserves in currencies other than the dollar. More recently, a number of Middle East oil-exporting states have done the same. So worried are U.S. officials by these moves that, when the United Arab Emirates was musing about dropping its currency peg to the dollar, U.S. officials visited the UAE central bank governor to lobby against the move.

Why does the U.S. government care about countries reducing their dollar holdings? Put simply, the ability to print dollars to pay debts is a huge imperial privilege. It is, in the words of the *Economist* magazine, as if you could write cheques that no one would ever cash, a privilege known as *seigniorage*. This has allowed the U.S. great flexibility in financing imperial wars and it has provided an enormous boost to the U.S. national economy, which has paid for goods with paper.

But now private investors and central banks are becoming increasingly reticent about taking ever-growing amounts of these blank cheques. Furthermore, for the fist time in several generations, they now have a meaningful alternative to the dollar with the euro. And many signs indicate that the euro is starting to play a larger world money role.

When it was first introduced in 1999, for instance, the euro comprised 18% of all global reserves. Today it represents 25% of international reserves. As a means of payment for cross-border operations, the euro now figures in 39% of all such transactions, versus 43% for the dollar. And in international bond markets, 49% of all debt was denominated in euros in 2006, compared to 37% for the dollar.

None of this is meant to suggest that the euro will simply displace the dollar. The European Union economy is not large and dynamic enough for that to happen and the dollar is still the world's dominant currency by a considerable measure. But these trends do suggest that the dollar's role is diminishing now that there is a viable alternative. With this in mind, Deutsche Bank predicts that the euro will constitute between 30 and 40% of world reserves by 2010.

Certainly, recent trends suggest a declining global appetite for the dollar among investors. In 2007, for instance, foreign residents borrowed $596 billion in long-term stocks and bonds in the U.S., down from $722 billion the year before (*Wall Street Journal*, April 15, 2008). Yet, this relative decline in the dollar poses a real dilemma for the U.S. state. In order to prop up the dollar, and retain the seigniorage privileges that boosts its national economy and underwrites the financing of imperial militarism, it would have to raise U.S. interest rates. But interest rate hikes would deepen the recession in the U.S. (making it harder to borrow and pushing many indebted Americans into bankruptcy and default) and they might topple more indebted corporations and banks.

For the moment, the U.S. state has chosen to try to offset the recession by keeping interest rates low. But this only depresses the value of the dollar and weakens its world money status. And this gives the U.S. state less financial means to maneuver on the world stage.

And so, the U.S. state confronts a dilemma: to prevent a deep slump it must pursue policies that weaken the world standing of the dollar. In the medium to longer term, however, a diminished dollar will create tighter constraints on the financial capacities of U.S. imperial operations. This is a real and abiding contradiction and the U.S. state is not able to wish it away.

Persistent Contradictions

If the current financial crisis illustrates anything then, it is the persistence of fundamental contradictions of neoliberal capitalism. With an enormous "dollar overhang" sloughing through the world economy, asset bubbles regularly form – in Japanese real estate, in East Asian stock markets, in dot-com, or in U.S. real estate. And each time, central banks intervene to *monetize* debt obligations, i.e. to give legal tender for junk. And the end result is to flood the financial system with money that will flow into yet another speculative bubble, as seems to be happening at the moment in commodities such as oil, gold and foodstuffs. Meanwhile, global dollar surpluses will continue to exert downward pressure on the value of the greenback.

Thus far the U.S. Federal Reserve has offered up $500 billion in U.S. treasury bonds, effectively as good as cash, for junk on the books of banks and investment houses. The bank of England is proceeding along the same lines.

But as they flood the system with money, these central banks also prime the pump of their nemesis – inflation. This has prompted the International Monetary Fund to issue a stern warning about rising inflation. As soon as central banks think they have stabilized the financial system, they are likely to heed the warning by turning to anti-inflation policies that will trigger corporate bankruptcies, job losses and declining living standards.

Of course, capitalist classes the world over will try to make sure that working classes and the global poor bear the brunt of the inflationary hardship. And the weakness of the international left is not promising in this regard, despite important and inspiring movements of resistance in much of Latin America.

Too often, however, sections of the Left imagine that their role is to offer policies that will avert crises of capitalism. In so doing, they gravitate to a kind of Keynesian politics designed to boost demand and consumption.

It is not the job of the Left to save capitalism from itself, however. To be sure, we have an obligation to advocate and agitate for policies to protect the victims of the crisis, policies that cut against the very market logic of neoliberalism. A case in point would be campaigns for publicly-funded social housing programs at a time when, in the U.S., millions face foreclosure. Equally important are campaigns to raise social assistance rates in order to protect the most vulnerable.

But equally vital is a Left that names the actual contradictions of capitalism, one that addresses the disasters of the neoliberal model and publicizes the inherent conflict between capital accumulation and the satisfaction of human needs. And this requires a Left that speaks openly of *socialism* as the alternative.

We now confront a significant crisis of the neoliberal reorganization of capitalism. And every crisis represents an opportunity – for both the old order and the forces of the new. The Left is not especially well-equipped in this regard. But we must do what we can so that the Left is better prepared when the next crisis breaks, as surely it will. To this end, it is incumbent on us to seek to understand this crisis, to agitate to protect its poorest victims and to do the patient work of socialist education about real alternatives to the logic of the market. **R**

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