

Talking Points: Economic Meltdown

By Chuck Collins | October 27, 2008

Working Group on Extreme Inequality

Put over-reliance on the free market together with “hands-off” government and you get an economic meltdown, with the spectacle of the government bailing out and buying giant financial firms: the very antithesis of the “free market” that the Wall Street cheerleaders were extolling. The Bush administration turned our economy into a casino and gave rich investors almost all the chips. The following document is a series of talking points, in an easy-to-read question-and-answer format, on the key questions being discussed today about the global economic meltdown.

The Basics of the Meltdown

In early September 2008, U.S. financial leaders were saying “everything is fine.” Weeks later, we were being told that Congress needed to pass a \$700 billion bailout of Wall Street. What happened?

It is important to realize that the fiscal crisis was not some sort of unavoidable natural disaster but a human-created failure of public policy. The financial crisis and economic meltdown were caused by the convergence of:

- The implosion of an \$8 trillion housing bubble that policymakers allowed to build up over the last decade, ignoring warnings that it was unprecedented and unsustainable;
- The failure of the Bush administration to provide effective oversight to investment banks, particularly in the area of mortgage-backed securities;
- A subprime mortgage scandal fueled by unethical and illegal practices among mortgage originators like Countrywide Financial;
- A speculation binge by very wealthy investors seeking extraordinary returns, while wages for most people grew stagnant, leading to unprecedented borrowing and debt; and
- The growth of a vast unregulated “shadow” private investment system of hedge funds, derivatives, and credit-default swaps. The institutions served very high net worth investors and argued that they should not be subject to government regulation and oversight.

What is a housing bubble?

A bubble occurs when the price of a class of assets, such as stocks or real estate, rises to an unjustifiably high level. As the price of an asset rises, people observe that it is possible to buy the asset and then sell it later for a higher price. This attracts still more buyers, who bid up the price even further in a self-perpetuating cycle. This occurred in the late 1990s in the tech stocks market, and beginning in about 1997 it started to happen in the real estate market as well.

Over the last decade, there was a steady inflation in housing and real estate prices as well as other assets. While there has been some increased demand for housing, the inflation is largely based on speculation that housing prices will continue to rise.

As they balloon to extremely unreal levels, a bubble develops. People feel wealthier than they actually are and borrow against this inflated value. In addition, homebuilders hoping to capitalize on the boom throw everything they have into building lots of new houses.

Why is bubble economics bad?

Because bubbles eventually pop. The economic growth of the last two decades has largely been driven by consumer spending funded by increased borrowing and longer work hours, not on real wage growth. For the majority of the population, real wages (factoring out inflation) are stagnant or falling. Consumption by middle-class and working households has been propelled by the ability to borrow with credit cards and home equity loans. However, with the collapse of the housing market, people are no longer able to borrow against their home to fund their consumer spending. As consumer spending falls busi-

nesses will have to close or scale back, throwing more people out of work and making the whole problem even worse.

Who's in charge of overseeing the markets and why didn't this happen?

One example is the Securities and Exchange Commission's reliance on voluntary and peer oversight programs. More aggressive oversight would have led to earlier devaluations of assets and more prudent lending.

Most banks, like Bank of America, Citibank, JPMorgan Chase, and the many smaller local banks around the country are subject to federal and state oversight and are in relatively good shape. Deposits are insured by the federal government and they are more tightly regulated. For example, they have reserve requirements that force them to set aside cash and liquid assets to cover potential losses.

The current financial crisis was touched off by heavy losses in the so-called "shadow banking" sector: businesses that lend and invest like regular banks do but which are not subject to the same rules and regulations as banks. Examples include:

- **Mortgage brokers**, like Countrywide Financial. Unlike your local bank, these brokers sold mortgages on to other investors rather than holding them.
- **Investment banks** that bundled mortgages into giant securities and traded them. When the housing bubble began to pop, these investment banks were in trouble. Of the five largest investment banks, two failed (Bear Stearns and Lehman Brothers), one sold itself to a "regular" bank (Merrill Lynch) and the other two turned themselves into "regular banks" (Goldman Sachs and Morgan Stanley). What's the significance of changing to a regular bank? They'll have proper oversight now? Also, what's the difference between a regular bank and an investment bank?
- **Insurance companies** that issued complicated securities (called "credit default swaps") that were tied to the performance of these mortgages. The leading example is AIG, which required an \$85 billion federal bailout.

Did the Federal Reserve help or hurt the problem?

The Federal Reserve, under Chairman Ben Bernanke, is acting aggressively in the face of the financial meltdown. They have taken unprecedented steps, such as recently opening up a direct-lending window.

The Fed has a dual mandate to balance the need for full employment with ensuring an orderly money supply and low inflation. William McChesney Martin, chairman of the Federal Reserve for 18 years between Presidents Truman and Nixon, said, "the role of the Federal Reserve was to take away the punch bowl just as the party gets rolling." By this he meant the Fed should tighten the money supply when growth is kicking in.

But starting in the mid-1990s the Fed, under Chairman Alan Greenspan, ignored the asset bubbles that were growing up in the technology and housing sectors. Even as the economy was cooking, the Fed was pumping low-interest money into the economy, contributing to the glut of easy credit. Alan Greenspan didn't take away the punch bowl—he was spiking it with more rum.

(See: "Taking a Hard New Look at the Greenspan Legacy" by Peter S. Goodman, The New York Times, October 9, 2008; <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?hp>)

People are talking about Main Street versus Wall Street. What do they mean?

Main Street is a way of describing the REAL economy—where people grow food, own small businesses, manufacture goods, provide services, and build homes. Wall Street is the place where people trade pieces of paper—stocks, bonds, options, futures, and mortgage-backed securities—that are tied to the underlying value of the real-world things on Main Street.

When it is working properly and regulated appropriately, Wall Street can be an important source of financing for businesses that need more money than a local or regional bank could ever provide. State and local governments also turn to Wall Street to raise money to build roads, water systems, schools, and other infrastructure. Wall Street is also a place to invest a portion of retirement savings, from 401(k)-style plans to unionized workers' pension funds.

However, appropriate regulations are like speed limits—they help keep people safe, but there are always some people who want to go faster, or in the case of Wall Street, to make more money. So they look for ways to avoid those regulations, to get around those speed limits. They repeal some regulations and develop new types of investments to get around others. At first it seems to work great: Wall Street makes more money. But just like on a highway where everyone can suddenly drive as fast as they want, the speeders start endangering the safety of even the safe drivers. And sometimes, the speeders get into an accident that causes a giant pileup involving everyone, whether they were speeding or not.

Do I need to understand all these complex financial instruments to understand the economic crisis?

It is useful to understand a few basic things. Very few people understand how they work, including some people in the industry. Prominent financier George Soros avoided derivatives “because we don’t really understand how they work.” Five years ago, Warren Buffett called them “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.” For many on Wall Street, all they cared about was that they produced fabulous investment returns and that was all they needed to know.

With the explosive growth of the so-called “derivatives market” since the turn of the century, Wall Street became a casino for super-rich investors. These guys invented all kinds of new ways to gamble—hedge funds, derivatives, credit default swaps, and collateralized debt obligations that only cater to very high net worth individuals. Money going into the derivatives market didn’t flow to businesses providing goods or services; rather, these investments were actually bets on what would happen to the prices of other assets such as stocks, bonds, real estate, or commodities.

Investors who put money into derivatives told themselves that these bets actually reduced their overall risk, but obviously they were wrong about that.

What is a hedge fund?

A hedge fund is an aggressively managed portfolio of risky and oftentimes speculative bets on a wide variety of market activities. They were attractive for their lack of

regulation and high returns, often over 20%. Think of investment bankers and fund managers sitting at computers all day betting on whether the price of things—the euro, stocks, bonds, whatever—would go up or down. Originally (?), hedge funds were only open to people who could invest at least \$1 million or more—people who supposedly were sophisticated enough to judge the riskiness of the investments for themselves. But they evolved...

What is a derivative?

A derivative is a complex contract used to hedge (i.e. bet) against risks. Credit default swaps are a form of derivatives that allow investors to place bets on the possibility that a company will be unable to pay its debts.

Do hedge funds and derivatives contribute to a productive economy?

These types of Wall Street investments are focused on making or protecting trading profits rather than creating or producing any good or service. Derivatives brokers would argue that they make the economy more efficient in their search for value. They would also tell you they are the captains of the universe.

Walden Bello notes that these financial instruments are “tantamount to squeezing value out of already created value. It may create profit, but it doesn’t create new value. Only industry, agriculture, trade, and services create new value. Because profit is not based on value that is created, investment operations become very volatile and the prices of stocks, bonds, and other forms of investment can depart very radically from their real value.”

(See Walden Bello, “Wall Street Meltdown Primer,” Foreign Policy In Focus, September 26; <http://www.fpif.org/fpiftxt/5560>).

Wasn’t the problem caused by government regulations that forced banks to make loans to poor people?

Such rationale was invented by the people who created this mess and needed scapegoats. It wasn’t light regulatory laws like the Community Reinvestment Act that forced Countrywide Financial to make predatory loans. Recently released data from the Federal Reserve show that only one of the top 25 subprime lenders in 2006 was directly subject to the CRA.

The key problem was a lack of government oversight. Cheered on by Alan Greenspan, Robert Rubin, and others who were fundamentally opposed to government regulation and who believed that the market could regulate itself, the Clinton and Bush administrations and past Congresses removed all kinds of sensible controls over financial institutions. They decided that since those Wall Street guys were such geniuses, we should just let them do whatever they'd like—no questions asked.

*(See: David Goldstein and Kevin G. Hall, "Private sector loans, not Fannie or Freddie, triggered crisis," McClatchy Newspapers, October 11, 2008
<http://www.mcclatchydc.com/251/story/53802.html>).*

Some people say Fannie Mae and Freddie Mac caused the problem.

This version of the story is currently flashing around the talk-radio airwaves, but the numbers just don't add up: The height of subprime lending was from 2004 to 2006. According to Federal Reserve data the private sector, not government regulation or Fannie Mae or Freddie Mac, was the main driver of this lending. Private firms made nearly 83% of the subprime loans to low- and moderate-income borrowers at the peak of the subprime boom in 2006.

*(See: David Goldstein and Kevin G. Hall,
<http://www.mcclatchydc.com/251/story/53802.html>, for more)*

Wasn't a push to increase homeownership what led to the collapse of the banks?

It wasn't homeownership but overly leveraged debt-borrowing by banks that led to the collapse. The majority of so-called "subprime loans" went to refinancing existing homeowners, not to first-time homebuyers.

Even before this economic meltdown, weren't a lot of people already feeling the recession?

Yes, many low-income people have been underwater in the stagnant real economy. Many tenants have lost their homes when buildings have gone into foreclosure. Even before the collapse of the banking sector, the housing-bubble bust led to the evaporation of over \$4 trillion in housing wealth between 2006 and March 2008. Lower income people and people of color have been the big losers—and there has been no bold program of relief for them.

INEQUALITY AND SPECULATION

How did those guys get so much money to bet with in the first place?

Since the mid-1970s there has been a dizzying concentration of wealth. The richest 1% of households has seen their share of the national wealth pie grow from one-fifth to over one-third of all private wealth.

This new wealthy elite used their wealth and power to press for government rule changes to protect their wealth and lower taxation. The largest tax cuts have gone to households with incomes over \$500,000. Meanwhile, those on the bottom have been clobbered by union-busting, outsourcing, and unfair competition against exploited workers in developing nations such as China.

These extreme inequalities cause two major problems. First, working people don't have enough money to buy stuff and stimulate the economy. For the last 30 years, most consumption by working people has been based on loans, credit cards and home equity mortgages—not bigger paychecks.

Second, the rich take a chunk of their money and go in search of super-high investment returns. They speculate in high-risk and high-return investments.

*(For statistics about inequality, visit: The Working Group on Extreme Inequality and look for a downloadable chart pack;
http://extremeinequality.org/?page_id=8)*

Why would the rich risk their money?

They don't risk all their money. The superrich usually have a lot of their money in stable and insured investments, so they will stay rich no matter what. They use their extra money to gamble with.

As the rich have gotten richer, more and more money has flowed into the casino economy. This inflates the price of assets. First, the rich speculated in high-tech stocks. At one point, they were investing in any company with an "E" at the beginning or a "dot com" at the end.

When the tech bubble burst in 1999, the rich moved their speculative investments into real estate, inflating the cost of housing.

To get a super-high return on real estate investments you have to go deep into high risk. That was why there was so much money being pushed out in to the so called

“subprime” mortgage lending market. Those shady mortgage companies didn’t care—they just wrote the mortgages for people who could not afford them and then immediately sold them to someone else. The mortgage companies’ funds were never at risk: they just pocketed the broker’s fees and moved on to the next customer.

How high a return did these investors want?

These high net worth investors wanted really high returns—15%, 20% or even more. After the real-estate bubble burst, the wealthy invested their money in commodities like food and oil.

Is that why gas and food prices are so high?

It’s a major reason. Have you noticed the price of oil has dropped dramatically since the financial meltdown? It went from \$116 a barrel just before Labor Day to around \$60 in late October. That’s because speculators realized the demand for oil drops in a contracted economy, and so they stopped betting on a price increase.

So too big a gap between the rich and the poor leads to economic bubbles and instability?

Yep. The last time wealth ownership was as unequal as it is today was 1928. The Great Depression was preceded by a similar speculation frenzy, which is why the decade is known as “the Roaring Twenties.”

Unfortunately, the government is supposed to protect the “real economy” from the speculative casino economy. But our government sided with the speculators.

GLOBAL DIMENSIONS

Is the rest of the world having this problem?

It’s been said that “when the U.S. gets a cold, the Global South gets pneumonia.” The economies of countries like Mexico are heavily dependent on selling stuff to the United States.

Many poor countries around the world have already been clobbered by predatory lenders. In the 1960s and ‘70s, reckless bankers lent gobs of money to corrupt governments who then left the people with the debt. So this is like a predatory lending double-whammy for them.

Are the causes similar in other parts of the world?

Yes, the current financial crisis in the United States, which is now spreading around the world like wildfire, is rooted in a dangerous notion of market fundamentalism that began with the elections of Reagan and Thatcher almost three decades ago. They argued that markets can solve most problems and that we should get government out of the way.

Under this philosophy, world leaders pressed “free-market” policies both in the United States and, along with the World Bank, in the Global South. The three tenets were privatization, deregulation, and cuts in public subsidies and social-safety nets.

In the 1980s, the World Bank and its sister organization, the International Monetary Fund, were given enhanced authority and resources to press free-market policies on poor countries as a condition to reschedule owed debts and to obtain new loans. This process was called “structural adjustment.” For example, in the Philippines farmers were pressed to shift from rice and other subsistence crops to bananas and pineapples for export. Today, these same farmers are paying a high price as prices of rice and other food staples skyrocket.

What should be done at the global level?

Rising unemployment in the United States is already spreading around the world. A global recession would especially hit poor countries that are already suffering from the food price crisis. The U.S. government should:

- Work with leaders of other leading economies to coordinate a recovery plan to stimulate the real economy in industrialized countries and beyond. They need to support infrastructure programs and investments in alternative energy, to create green jobs and advocate tax measures and government spending programs aimed at supporting the purchasing power of middle- and lower-income populations.
- Support expanded debt cancellation. Currently, external debt payments cripple the ability of many developing countries to stimulate their economies. Any resolution of the crisis must include an expansion of the resources available to the countries eligible for multilateral debt re-

lief—without onerous economic policy conditions.

Do we have anything to learn from how other countries are responding?

There are global alternatives emerging that we in the U.S. can learn from. Today, those hurt by market fundamentalism have come together to push alternative notions of development, financial institutions, and practices in action.

What are other countries doing and not doing?

In most cases, other central banks are ensuring that taxpayers get an equity stake in the failed firms rather than just taking troubled toxic assets off their hands. U.S. Treasury Secretary Paulson appears to have changed his attitude about this. The United States is now open to purchasing shares in banks through direct recapitalization, as the UK has done. It's only right that since large parts of the financial system are being supported by taxpayers, governments should take equity stakes and act as activist investors to protect the public interest and ensure that taxpayers are eventually reimbursed.

Beyond the immediate action, the G7 governments must work to ensure that a crisis of this scale does not happen again. Every time there's a big financial crisis, they always say, we can't deal with prevention now—we're too busy putting out the fires. They promise to get to solutions later—but that day never comes. They need to work on a new regulatory architecture that covers not just banks but also the parallel financial system—hedge funds, private equity, and what is left of the investment-banking sector. Part of that has to be greater capital requirements and more transparency.

For two decades, the G7 and the international financial institutions promoted a hands-off approach to financial markets. They were cheerleaders for so-called financial “innovation” that led to extremely risky products like mortgage-backed securities that have now gone bad. As a result, what should have been a containable subprime mortgage crisis in the United States triggered a global financial crisis with enormous social and economic costs. It's fascinating that in October, the IMF noted that the two countries that are expected to be virtually insulated from the crisis are China and India—two countries that have ignored the World Bank and IMF's advice and

maintained strong controls over their financial sectors.

SOLUTIONS: WHAT CAN WE DO?

What should we in the U.S. do?

Beyond aid to the banking system, we should press for a Main Street agenda, help for the real economy. We are organizing for a “Main Street Bottom-Up Investment” plan—a sort of economic stimulus for the real economy, not the casino economy.

What would “Bottom-up Investment” look like?

This could take the form of stimulus checks to working people which would trigger consumer spending. Aid to local and state governments is critical at this time to that our communities can preserve essential services and prevent the layoffs of tens of thousands of workers.

Investments in infrastructure, like building schools, roads, and new energy systems, are always good for putting people to work. Bold public investments in upgraded buildings and energy conservation efforts will reduce our need for oil and be a win-win for everyone. Green infrastructure would create millions of jobs that couldn't be outsourced—good-paying jobs anchored in the local economy.

Who is going to pay for the bailouts?

Citizens should demand that the people who created this mess pay for the cleanup operation. We're just adding the \$800 billion for the first bailout to the national debt. Instead of implementing any long-term solutions, the U.S. Congress just raised the national debt ceiling to \$11.3 trillion!

How do we make the speculators pay?

We could tax the transfer of stocks—and eliminate loopholes that corporations used to avoid taxes. We could impose a surcharge on very high incomes, like on CEOs who earn over \$2 million. Investors with tremendous wealth were the big winners in the unregulated casino economy. It is only fair that they pay a big chunk of the cleanup.

(See Chuck Collins and Dedrick Muhammad, “How to Bailout Wall Street (and Main Street) Without Soaking the

*Taxpayer,” Alternet, September 25;
<http://www.alternet.org/workplace/100223/>*

How can we make sure this never happens again?

We must shut down the casino! We need to press Congress to beef up the oversight of the banking system. These big unregulated hedge funds and other financiers need oversight. If they want our tax dollars to help them, then they should be regulated.

With all the bank mergers, it looks like we’re creating corporations that are too big to fail. Won’t this require future bailouts?

When a private company is “too big to fail,” then they become essentially quasi-public entities. In exchange for government protections, we the people should get an ownership stake in return. It is appropriate that the Treasury Department take ownership interests in banks that we are helping. Over time, this will protect the U.S. taxpayer and give us a stake in the “upside” when the banking system stabilizes.

How will our communities—the real economy—get access to credit?

Access to credit is the lifeblood of an economy. We need banks to support small businesses and consumers, not get caught up in the casino.

What about the people losing their homes?

Part of fixing the problem is stopping the foreclosures and working with people so they can stay in their homes. Stopping foreclosures not only helps those who are in danger of losing their homes but also stabilizes housing prices within communities. Any “bailout” should be aimed at real people in the real economy.

What about all those CEOs and executives that made millions before their banks collapsed.

Should they have to pay?

Yes. We should pass laws limiting how much CEOs can make at these bailed-out companies. It is not okay that someone should take home more in a day than one of their coworkers makes in a year.

Isn’t our government controlled by Wall Street, big corporations, and the wealthy? How is it possible to enact reform?

The people have got to get reengaged and are demanding these changes. Let’s organize an economy that works for everyone, not just the wealthy.

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This document is under regular revision, so please send your comments to: chuckcollins7@mac.com.

Financial Market Meltdown: An Annotated Resource List

A lot has been written and said over the last several weeks about the causes of the Wall Street meltdown and the remedies required. We've sifted through the chattering and provide several recommendations.

ANALYSIS: HOW DID IT HAPPEN?

Audio

Great Big Pools of Money

Terrific radio journalism exploring the human and systemic dimensions of the current financial crisis.

Download an mp3 file or listen online. Transcript also available. By This American Life.

http://www.thislife.org/Radio_Episode.aspx?episode=355

Video

Market Meltdown: The Bailout, Inequality and the Election

A 50-minute session moderated by Chuck Collins of the Institute for Policy Studies. Speakers Dean Baker, of the Center for Economic and Policy Research, Barbara Ehrenreich, author of *Nickel and Dimed*, and Jared Bernstein of the Economic Policy Institute discuss economic aspects of the 2008 presidential campaign. By C-SPAN.

<http://video.google.com/videoplay?docid=1799828763957317166&hl=en>

Article

Firing Back on the CRA Libel

“Conservatives are twisting the facts with a revisionist history about the Community Reinvestment Act (CRA) that encourages lending in low-income communities.” By Sara Robinson for OurFuture.org.

<http://www.ourfuture.org/print/29502>

Article

Wall Street Meltdown Primer

A global perspective on financial bubbles and the crisis of overproduction in capitalism leading to the current crisis. By Walden Bello in Foreign Policy In Focus.

<http://www.fpif.org/fpiftext/5560>

SOLUTIONS: WHAT CAN WE DO?

Brief

Sensible Plan For Recovery

A 4-page PDF overview of a comprehensive plan to stabilize Main Street as well as the banking system. By the Institute for Policy Studies.

<http://www.ips-dc.org/reports/#75>

Institute for Policy Studies

“Ideas into Action”

Founded in 1963, the Institute for Policy Studies is a progressive multi-issue think tank that links ideas to action for peace, justice and the environment.

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Working Group on Extreme Inequality

The Working Group on Extreme Inequality reaches out to different constituencies, generates educational materials, and promotes public policies to slim grand accumulations of private wealth.

extremeinequality.org