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ASSESSING THE TRANSFORMATION OF GLOBAL FINANCE

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Causing the credit crunch: the rise and consequences of the New Wall Street System

1. Introduction

The long credit crunch that began in the Atlantic world in August 2007 is strange in its extraordinary scope and intensity. Mainstream discourse, referring to a 'subprime' crisis, implies that the credit crunch has been caused rather than triggered by a bubble in the real economy. This is at best naïve: after all, the bursting of an equally large bubble in the Spanish housing market led to no such blowout in the Spanish banking system (Crawford/ Tett 2008: 39). To approach an understanding of the credit crunch we must transcend the common sense idea that changes in the 'real economy' cause changes in the 'mere' financial system. We will argue on the contrary, that over two and a half decades a new financial system structure emerged within the US and that it has been this which played the decisive role in causing not only the credit crunch but the housing bubble before it.

Making the 'epistemological' break from assuming that the so-called real economy drives the supposed financial superstructure is not easy. We assume, for example, that the huge oil price bubble from autumn 2007 to June 2008 was caused by supply and demand factors in the 'real economy', instead of grasping that financial operators reeling from the start of the financial crisis blew the oil price from $70 a barrel to over $140 in less than a year before letting that bubble burst. We assume the same for commodity prices, ignoring the fact that institutional investors like pension funds and money market funds, lending to the Wall Street banks, poured hundreds of billions of dollars into commodities indices (Blas 2008: 38), much like hedge funds with their backs against the wall blowing a bubble in coffee and cocoa, etc., etc (Flood 2008: 38). And, of course, the fact that that these

financial operators could build and burst such bubbles has derived from the fact that the markets for oil and commodities are organised in London and New York and Chicago with rules made to match the interests of American and British capital. Indeed, breaking from the idea that actors in the 'real' economy rather than in the financial sector caused crisis effects also carries a political price: you can no longer blame mortgage borrowers for the credit crunch, the Chinese for the commodity price bubble and the restrictive Arab producers for the oil price bubble.

We will explore the structural transformation of Wall Street since the mid-1980s and we will argue that the resulting financial structure-cum-agents have been the driving force behind the current credit crunch, producing new actors, new practices and new dynamics. Before generating the present blowout, this New Wall Street System was spectacularly successful for the richest social group in the USA. By far the most profitable sector of the US and UK economies and by far the most important 'export' earners of those economies, they channelled astonishingly large transfers of value; thus in 2006, no less than 40% of American corporate profits accrued to the financial sector (Summers 2008: 13). The figure of 40% actually understates the share of profits accruing to the financial sector, because the latter conceals such profits by transforming them into huge employee bonuses in order to reduce headline profits data – a fact which is often overlooked.

We will firstly try to sketch the main elements of this New Wall Street Financial System and briefly show how its crisis took such spectacular forms. But we will then argue that to understand the deeper roots of this New Wall Street System we need to probe deeper into the overall socio-economic and socio-political characteristics of American capitalism as it has evolved since the 1970s.

2. The New Wall Street System

The structure and dynamics of Wall Street banking changed rather dramatically in the quarter of a century after the mid-1980s. We can bring out the main features of this changed system as follows:

1) The rise of the lender-trader model.

2) The rise of speculative arbitrage and asset-price bubble blowing.

3) The drive to maximise balance-sheet expansion and leverage.
4) The rise of the shadow-banking system and the changing role of London.
5) The rise to centrality of the money markets and their transformation into founders of speculative trading in asset bubbles.
6) The rise to centrality of credit derivatives.

These changes mutually reinforced each other, forming an integrated and complex whole which then disintegrated in 2007–2008. We will examine each of these trends in turn very briefly.

2.1 The rise of the lender-trader model

Before the mid-1980s, the Wall Street investment banks had engaged in very little securities trading on their own account (as opposed to trading on behalf of clients) and the big depository commercial banks had shunned such activity. As of 2007 the dominant investment banks were: Goldman Sachs, Morgan Stanley and Merrill Lynch, with Bear Sterns and Lehman Bros., along with Credit Swiss (a Swiss bank), somewhat smaller but roughly in the same league. However, from the mid-1980s onwards, proprietary trading in financial and other assets became an ever more central activity of the investment banks and also became increasingly central in the case of many of the commercial banks. By this last decade such proprietary trading was an absolutely central source of profits for the investment banks. Until a change in the law in 1975 banned fixed fees, the bread-and-butter of Wall Street investment bank income had been fixed (cartelised) fees for trading securities on behalf of clients. Indeed, at the start of the 1980s, this fee income had still been greater for the investment banks than profits from trading on their own account. However, from the mid-1980s, pioneered by Salomon Bros., these banks plunged seriously into proprietary trading. By the end of the 1990s, trading income was a third bigger than income from commissions for trading on behalf of others. Some of the biggest banks earned over half their profits from such trading (Gapper 2008b: 15).

As well as trading on their own account, the Wall Street banks were increasingly involved in lending funds to others for their trading activities: to hedge funds, so-called private equity groups (trading in companies), to special investment vehicles (SIVs) and conduits, created by the investment banks themselves. After the Enron scandal, SIVs and conduits were initially

not allowed to engage in active trading on their own account, but this restriction was soon lifted. Such lending to others for their trading, known in the jargon as 'prime brokerage', was also an extremely profitable activity for the Wall Street banks; for many, this was their single most profitable activity (Mackintosh 2008: 47).

This turn to the lender-trader model did not mean that the investment banks ceased their other traditional activities in investment banking, broking, fund management etc. But these activities acquired a new significance in that they provided the banks with vast amounts of real-time market information of great value for their trading activity. Philip Augar gives a vivid account of how central such informational centralisation from all the main markets was in giving the investment banks a decisive competitive 'edge' over their smaller or non-investment banking rivals (Augar 2006).

The turn to trading activity on the part of the Wall Street banks was evidently connected to the new volatility in foreign exchange markets after the dismantling of Bretton Woods, and to the opportunities created by domestic financial liberalisation, the scrapping of capital controls and the opening of other national financial systems to American financial operators. These changes offered great new opportunities for a massive expansion of Wall Street trading activity.

2.2 Speculative arbitrage and asset-price bubble blowing

By trading activity we do not mean long term investment, Warren Buffett style, in this or that security: we mean buying and selling financial and real assets to exploit – not least by *generating* – price differences and price shifts. This can better be called speculative arbitrage, a kind of activity which became a central focus of the Wall Street banks, not only the investment banks, but the commercial banks too (Saber 1999).

So too did the related effort to generate asset price bubbles. Time and time again, Wall Street could enter a particular market, generate a price bubble within it, make big speculative profits, and then withdraw, bursting the bubble. Such activity was extremely easy in so-called emerging market economies with small stock or bond markets. The Wall Street banks gained a wealth of experience in blowing such bubbles, say in the Polish or Czech or Russian stock markets in the 1990s and then bursting them to great profit. The dot.com bubble in the US then showed how the same blowing-bursting

operation could be carried through in the US without any significant loss whatever to the Wall Street banks (as opposed to some European operators, notably insurance companies, eager to profit from the bubble only to be hit by the burst.)

Both the Washington regulators and Wall Street evidently believed that they could together manage bubble bursts Greenspan 2008: 11). This meant there was no need to prevent such bubbles from occurring; on the contrary, it is patently obvious to any dispassionate observer that both regulators and operators actively generated such bubbles. And they no doubt believed that one of the ways of managing bursts was precisely to blow another dynamic bubble in another sector: after the dot.com bubble, the housing bubble, after the latter an energy price bubble or an emerging market bubble etc., etc. This may seem to involve a formidably centralised financial power at the centre of such markets. Yet just such huge centralisation did indeed exist: the New Wall Street System was dominated by five investment banks holding over $4 trillion of assets and able to call upon or move literally trillions of dollars from such institutions, moving behind them in the form of the commercial banks, the money market funds, the pension funds etc. This new system was a million miles away from a decentralised market with thousands of players, all slavish price takers, of the kind beloved in neoclassical free market fairy-tales.

Thus, the operational belief systems of what might be called the Greenspan-Rubin-Paulson milieu seem to have been post-Minskian. They understood Minsky's theory of bubbles and blowouts and believed that they could collectively use it strategically for blowing bubbles, bursting them, managing the fall-out and/by blowing some more.

2.3 Maximising balance sheet expansion and leverage

Arbitrage and bubble blowing requires more of financial operators than merely centralising maximum amounts of information about conditions across all markets; it also demands the capacity to mobilise huge funds to throw into any particular arbitrage play in order to shift market dynamics in the speculator's favour.

A striking feature of the new Wall Street business model was its relentless drive to expand balance sheets, maximising the asset and liabilities sides. Tobias Adrian and Hyun Song Shin bring out well this side of Wall Street

activity (Adrian/Hyun: 2008). The term 'leverage' refers to the relationship between a bank's 'equity' or 'capital' and its assets – the sum that it has lent out. It is usually expressed as a ratio, so that if we say that Lehman Bros' leverage at the time of its collapse was 25, this means that for every dollar of capital the bank has 25 dollars of assets. But this figure of 25 also means that for every dollar of capital, Lehman's had 24 dollars worth of borrowings – i.e. liabilities.

Tobias Adrian and Hyun Song Shin show that the investment banks used their leverage ratio as the target to be achieved at all times rather than as an outer limit of risk to be reduced, ,where possible by holding surplus capital. They also show how this approach was powerfully pro-cyclical in an asset market boom (or bubble), driving the banks to expand their borrowing as asset prices rose. We will illustrate the mechanism with the example given by Adrian and Song Shin as follows.

We will assume the bank manages its balance sheet actively to maintain a constant leverage ratio of ten. Suppose the initial balance sheet is as follows. The bank holds 100 worth of securities, and has funded this holding with debt worth 90.

Assets	**Liabilities**
Securities 100	Equity 10
	Debt 90

Assume that the price of debt is approximately constant for small changes in total assets. Suppose the price of securities increases by 1% to 101.

Assets	**Liabilities**
Securities 101	Equity 11
	Debt 90

So leverage is now down to 111/11 = 9.18. If the bank targets leverage of 10, then it must take on additional debt of D to purchase D worth of securities on the asset side so that assets/equity = 101 + D/11 = 10.

The solution is D = 9. The bank takes on additional debt worth 9, and with this money purchases security worth 9. Thus, an increase in the price of the security of 1 leads to an increased holding worth 9. The demand curve is upward-sloping. After the purchase, leverage is now back up to 10.

Assets	**Liabilities**
Securities 110	Equity 11
	Debt 99

The mechanism works in reverse, too. Suppose there is shock to the securities price so that the value of security holdings falls to 109. On the liabilities side, it is equity that bears the burden of adjustment, since the value of debt stays approximately constant.

Assets	**Liabilities**
Securities 109	Equity 10
	Debt 99

Leverage is now too high (109/10 = 10.9). The bank can adjust down its leverage by selling securities worth 9, and paying down 9 worth of debt. Thus, a fall in the price of securities leads to sales of securities. The supply curve is downward-sloping. The new balance sheet then looks as follows.

Assets	**Liabilities**
Securities 100	Equity 10
	Debt 90

The balance sheet is now back to where it started before the price changes. Leverage is back down to the target level of 10.

The main way in which the investment banks responded to asset price rises was through repo funding. 'Repo' stands for 'repurchase agreement'. Typically, the investment bank wishes to buy a security but needs to borrow funds to buy it. On the settlement day the bank receives its security but

has to pay for it. So it uses the security it is buying as collateral for the loan needed to buy it. And, at the same time, it promises the lender that it will repurchase the security at a given future date. In that way it will repay the loan and receive the security. Typically however, the funds for repurchasing the security from the lender are acquired by selling the security to someone else. Thus, on the settlement day, the original lender to the investment bank is paid off and hands over the security and immediately the security is passed on to the new buyer in exchange for cash.

This kind of repo funding operation presupposes an asset price boom, and it accounts for 43% of leverage growth amongst Wall Street banks, according to researchers at the New York Fed. Repos were also the largest form of debt on investment banks' balance sheets in 2007–2008 (Adrian/Hyun 2008).

The question arises as to why the Wall Street banks (followed by others) pushed their borrowing to the leverage limit in such a systematic way. One explanation is that they were doing this in line with the wishes of their shareholders (once they had turned themselves into limited liability companies). 'Shareholder value' capitalism allegedly requires the ratio of assets to capital to be maximised. Surplus capital reduces the return on shareholder equity and acts as a drag on earnings per share. Moreover, the rewards of senior bank executives were often linked to changing earnings per share (Kay 2008: 15). But there is also another possible explanation for borrowing to the leverage limit: the struggle for market share and for maximum pricing power in trading activities. If you are a speculative arbitrageur of an asset bubble blower, financial operational scale is everything in moving markets by shifting prices in the direction you want to go in. In assessing which of these pressures – shareholder power or pricing power – drove the process, we should note how ready the Treasury, Fed and Wall Street executives have been to crush shareholder interests during the credit crunch, yet how resolutely they have sought to protect the levels of leverage of the bulge-bracket banks.

2.4 The rise of the shadow banking system and the role of London

Both the drive for scale and the drive to *expand* the amount of leverage available to them leads on to another basic feature of the New Wall Street System: the drive to create and expand a shadow banking system.

The most obvious features of the shadow banking system were the new, entirely unregulated banks, the most important of which were the hedge funds: these have had no specific functional role – they have simply been trader-banks free of any regulatory control or transparency in their speculative arbitrage. Private equity groups have also been in essence, shadow trading banks, specialising in the buying and selling of companies. Special Investment Vehicles (SIVs) and Conduits are similarly part of this system. Created by the Wall Street banks themselves as satellites to be treated as entirely independent for accounting purposes, they were supposed, following the Enron scandal, to be purely passive institutions, but this restriction was later lifted. In the words of Spain's director of regulation at its central bank, these SIVs and conduits "were like banks but without capital or supervision". Yet, in the words of the Financial Times: "In the past two decades, most regulators have encouraged banks to shift assets off their balance-sheets into SIVs and conduits […]" (Crawford/Tett 2008: 39).

This shadow banking system was not in competition with the regulated system: it was an outgrowth of it. The commercial and investment banks within the regulated system acted as the prime brokers of the shadow banking operators, thereby gaining very large profits from their operations. And because of the way in which this prime brokerage was organised, this increasingly central feature of official bank activity was, in reality, a way of massively expanding their balance sheets and leverage. To tap the Wall Street banks for funding, the hedge funds had to hand over collateral. However, through a practice known as rehypothecation, a proportion of these collateral assets could then be used by the prime broker as *its own* collateral for raising its *own funds*. The result was the self-financing of massively expanding and hugely profitable prime brokerage activities by the Wall Street banks without any extra commitment of their own capital whatever (Mackintosh 2008: 47) – an ingenious way of greatly enlarging their leverage ratios.

There has been a great deal of academic debate about whether deregulation or reregulation in the financial sector has been occurring since the 1980s. This seems to miss the point that there has been a combination of a regulated and an unregulated/shadow system working together, dynamically.

Shadow banking does not, however, refer only to institutional agents like hedge funds; it also refers to practices and products, and these also allowed the investment banks to expand their leverage. Since the late 1990s an increasingly important part of this side of shadow banking was the over-the-counter (OTC) credit derivatives market, notably collateralised debt obligations (CDOs) and credit default swaps (CDSs). The most obvious attractions of both of these lay in the regulatory arbitrage they offered, enabling banks to expand leverage (Bannier/Hänsel 2008). Traditionally banks had to insure their credit operations and such insurance entailed supplying collateral. The beauty of CDSs lay in the fact that, as shadow OTC products, they required no collateral and thus facilitated more leverage. CDS expansion began on a major scale after derivatives specialists from JP Morgan Chase persuaded the American International Group (AIG), the world's largest international insurance group, to start writing them on CDOs (collateralised debt obligations) in 1998 (Morgenson 2008: 1, 11).

CDOs were also a clever solution to leverage problems. By acquiring large quantities of securitised loans and thus greatly expanding their balance sheets, banks should have expanded their equity base. But CDOs bundled together dozens or hundreds of such loans of very varied quality and then gave the bundle Triple A status, thus minimising equity commitment and expanding the bank's leverage. The CDOs were typically written by the rating agencies for a fee and then rated by the same agency at Triple A for a second fee!

However, leverage restrictions were also removed through public policy. Hank Paulson achieved a notable success in this area in 2004 when, as head of Goldman Sachs, he led Wall Street in obtaining a major amendment from the Securities and Exchange Commission (SEC). It agreed to relax the so-called 'net capital rule' restricting leverage for large investment banks, and effectively allowed firms to decide their own leverage on the basis of their risk models. The result was that the leverage ratios of the big banks rose rapidly. This is a rather classic manoeuvre, which was dressed up as a turn by the SEC towards *more* regulation of the investment banks. From a formal, legal point of view this was correct: the SEC acquired regulatory jurisdiction over them. Nevertheless, it simultaneously removed basic capital base restrictions. Furthermore, from 2004 onwards the SEC had seven staff to supervise the five big investment banks, which, by 2007, had combined assets of over

$4 trillion – hopelessly inadequate resources (Labaton 2008: 15-16). And, very importantly, it enabled them to transfer their capital base to new activities such as collateralised debt obligations, which subsequently became such a huge element in the trading activities of the investment banks.

All these shifts are grouped under the heading of 'financial innovation' – changes in institutional arrangements, products, regulatory structures enabling Wall Street Banks to expand their activities and profits. There are dozens of shifts of this sort that could be documented. Yet the most fundamental such shift was the construction of a very large, new shadow banking system, alongside the regulated 'official' system.

Once the Wall Street investment banks had wiped out their London counterparts by the early 1990s, thereby dominating the City of London's asset markets, the City of London's 'Wimbledonised' role in the Wall Street system became significant. Gordon Brown institutionalised the new system in 1997 by creating the unified Financial Services Authority, claiming to operate according to 'principles' rather than binding rules. One such central principle was that the Wall Street banks could regulate themselves. London thus became in the financial field for New York something similar to what Guantanamo Bay would become for Washington in the torture field: – the place where you could do what you couldn't do back home – a place of regulatory arbitrage. And the term 'Wall Street' should be understood as including London as a satellite location for these American operators. At the same time, there are some very large British commercial banks, but these should be distinguished from the City of London, because while some of these have participated heavily in the Wall Street system, others, such as the Hong Kong and Shanghai Banking Corporation (HSBC) – by some measure the largest bank in the world and the Standard Chartered Bank, both deriving from the British Empire, have been heavily focused on banking activities in East Asia.

Together, London and New York dominate the issuing of new shares and bonds; they are the centre of the foreign exchange markets and, most significantly, they dominate the sales of over-the-counter derivatives, which make up the overwhelming bulk of derivatives sales. For derivatives based on interest rates and currencies the UK has a global share of 42.5% in 2007 with the US handling 24%. The US handled 40% of credit derivatives trading in 2006 while London handled 37% (down from 51% in 2002).

2.5 The rise to centrality of the money markets and their transformation into funders of speculative trading in asset bubbles

The enormous expansion of the activities of the Wall Street banks and shadow banks required ever-larger amounts of funding. Historically, such funding has been classically supplied by the recycling of retail savings sitting in deposit accounts in depository banks and, even more importantly, by the commercial banks creating large supplies of credit money. However, in post-1980s America such retail savings were minuscule – a point to which we will return – and credit money from the commercial banks, though important, was soon hopelessly inadequate. In these circumstances the trader banks turned to the wholesale money markets. At the heart of such markets were the inter-bank markets, with interest rates at, or just a few basis points above, the Fed's policy rates. Historically, these markets were used to ensure that the banks were able to clear smoothly on a daily basis, rather than as a source of new, large scale, far less speculative funding. Then there was also the commercial paper market, typically used by the big corporations for short-term funding, again principally to smooth their funding operations.

However, in the new Wall Street these money markets were transformed. They remained centres of short-term funding, but they were increasingly funding speculative trading activity. On the supply side, the funds available for lending to Wall Street were expanding rapidly, especially through the expansion of pension funds during the 1980s and 1990s. In rather typical American style, a small change in the tax code through amendment 401K in 1980 opened the door to this development. This amendment gave a tax break to employees and employers if they put money into pension plans. This legal change was then used to enable regular salaries to avoid tax in this way and the result was a massive flow of employee income into pension plans. This flow totalled nearly $400 billion by the end of the 1980s and climbed to almost $2 trillion by the end of the 1990s (Lowenstein 2004: 24-25).

2.6 The rise to centrality of credit derivatives

At the same time as becoming the key sources of the liabilities of the Wall Street banks through short-term lending to them, the mutual funds, pension funds etc also became increasingly important targets for Wall Street banks' efforts to sell asset-backed securities (ABSs) and in particular collat-

eralised debt obligations (CDOs). These securitised loans, mainly from the housing market but also from credit card debt and car loans, offered investors a higher rate of return than they could get in the money markets; at the same time they were triple A rated by the rating agencies and thus given the status of having maximum security.

The crucial point about these so-called 'structured securities' was not that they were securitised loans. These could in principle be perfectly safe: after all, a bond is, in reality, itself nothing but a securitised loan. Such bonds have a clearly identifiable source in an economic operator whose credit-worthiness (and cash flow capacities) could be assessed. And they have clear prices in the secondary bond markets. But these products in the form of CDOs came from hundreds of thousands of unidentifiable sources whose creditworthiness and cash-flow capacity were not known; they were over-the-counter (OTC) and without any secondary market whatever to determine prices, far less an organised market to minimise counterparty risk. In short, they were at best extremely risky because more or less totally opaque to those who bought them; at worst they proved to be a scam, so that within a few months of late 2007 the supposedly super-safe super-senior debt tranches within such CDOs were being downgraded to junk status.

Thus, the money market and pension fund managers were drawn into speculative bubble activity on the part of Wall Street, both on the funding (liability) side and on the asset side, enabling ever-larger balance-sheet expansion.

3. Exploring the causes of the crisis

It might, in principle, have been the case that the cluster of mutually re-enforcing innovations which we have called the New Wall Street System were *responses* to the emergence of a housing market bubble in the US in and after 2001. If that had been the case we would have had a classic Minskian crisis linked to housing. But it was not the case. All the key innovations were set in place before the onset of the so-called housing bubble. Indeed, there is ample evidence that Wall Street quite deliberately *planned* a house price bubble. Thus, the Wall Street banks spent billions of dollars on advertising campaigns to persuade Americans to increase their mortgage-related debt;

Citigroup alone spent $1 billion on a campaign with the theme 'Live Richly' in the 1990s, designed to get home owners to take out second mortgages to spend on whatever they liked. Other Wall Street banks acted in a similar fashion, with a great deal of success: debt in second mortgages climbed over $1 trillion dollars in a decade.

But the bubble that generated the credit crunch of 2007 lay not only or even mainly in the housing market: it lay in the financial system itself. The crisis was triggered not only by the scale of the debt bubble, but by its forms. In a normal over-lending crisis of the banking system when banks have ended up with non-performing loans (as in Japan in the 1990s), both the scale and location of the crisis can be identified without great difficulty. In 2007 however, the debt bubble within the financial system was concentrated in OTC derivatives in the form of individual collateralised debt obligations (CDOs) which had no market price or pricing mechanism whatsoever and which were distributed in their tens of thousands across most of the main institutions at the summit of the financial system (and/or within their satellite institutions such as SIVs). The proof that these assets were worth anything was nothing more than the rating given to them by the rating agencies. Thus, as soon as this set of debt accumulation arrangements protected by credit ratings was shown to be junk in the two cases in August 2007, the suppliers of credit funding, such as money market funds and pension funds, grasped that they had no way of knowing how much of the rest of the CDO mountain was also junk, so they fled the system and produced the credit crunch. Because the financial system was extraordinarily centralised, abandoning it meant refusing to keep supplying credit to a handful of opaque investment banks and other institutions at the summit

These institutions at the summit initially spread the word round that the effect of their securitisation of debt had been to disburse risk widely across a multitude of institutions. But this seems to have been false: the top Wall Street institutions had themselves been holding on to the so-called super-senior debt tranches in tens of thousands of collateralised debt obligations (CDOs) (Tett 2008). They had been borrowing billions in the money markets to buy these super-senior tranches, gaining an interest rate on them some 10 basis points above their costs of money market borrowing. And to continue to turn that profit they had to keep going back to the money markets to roll over their debts. Yet now the money markets were shutting down.

When investors in the money market fled the recycling of short-term borrowing in the summer of 2007, the entire pyramid centred on the CDOs began to crumble; when the Wall Street banks tried to off-load their CDOs they found that there was no market for them. And the insurance companies which had insured the CDOs with CDSs similarly found the market in these collapsing.

Much remains obscure about the precise mechanisms through which the credit crunch acquired its scope and depth in 2007-8, mainly because the main Wall Street operators themselves sought to obfuscate both the nature of their plight and their manoeuvres by which they attempted to survive. However, by the end of October 2008 the crisis had passed through a number of phases: first, the attempt by the Fed and Treasury to defend the continuation of the Wall Street investment bank model as the top of the system by acting as its lender of last resort; second, the collapse of this effort with the collapse of Lehman Brothers and the disappearance of the investment bank model, producing a drive to consolidate a universal bank model in which the trading activities of the investment banks would occur within and protected by the depository universal bank; in this phase, the Fed essentially substituted itself for the creditor institutions of the credit system, supplying loans, 'money-market' funding and 'commercial paper' market funding for the banks. This massive central bank funding operation between April and October 2008 has involved about $5 trillion of credit from the Fed, the European Central Bank (ECB) and the Bank of England (equivalent to about 14% of global GDP). Assuming that this state funding can continue without raising serious sovereign credit-worthiness problems, the most difficult and dangerous phase of the response to the crisis – the deleveraging of the biggest banks, in the current context of negative feedback loops from deepening recessions – can get under way in a serious fashion. How and when that is achieved will give us a sense of the overall contours of the credit crunch.

3.1 An accidents theory of the crisis?

Most of the mainstream debate on the causes of the crisis takes the form of an 'accidents' theory; in other words, it explains the crisis by reference to contingent actions by say, Greenspan's Fed or the banks or the rating agencies etc. We have argued against this in Part 1 above, saying that the rather

coherent, well-integrated object which we have called the New Wall Street System should be understood as generating the crisis. But in addition to our argument in Part 1we should note another and very striking feature of the last twenty years: the extraordinary harmony between Wall Street operators and Washington regulators. Typically in American history there have been phases of great tensions not only between Wall Street and Congress but also between Wall Street and the Washington executive. This was true, for example, in much of the 1970s and early 1980s. Yet there has been extraordinary harmony in the last quarter of a century, a clear sign of a rather well-integrated project.

3.2 An ideological theory of the crisis?

An alternative explanation much favoured in social democratic circles is one that argues that both Wall Street and Washington were gripped by a false ideology which led them astray, an ideology of 'free markets' or perhaps 'neoliberalism', which was treated as a synonym for 'free markets'. An ingenious right-wing twist on this line of explanation is to say that the ideology was 'laissez-faire' – i.e. no regulation – while what is needed is 'free market' thinking, which implies some regulation. The consequence of this kind of explanation is often a rather rudderless discussion of 'how much' and 'what kind' of regulation (Baker et al. 2005).

The problem with this explanation is that while the New Wall Street System was legitimated by free market, laissez faire or neoliberal ideology, the practitioners, both in Wall Street and in Washington, do not seem to have had such an operative ideology at all. Philip Augar's serious and detailed study of the Wall Street investment banks argues that they have actually operated in large part as a conscious cartel – the opposite of free markets (Augar 2006). And it is also evident that neither they nor Greenspan believed in the serious version of free market ideology: neoclassical financial economics. Greenspan has not argued that financial markets are efficient, always clear, etc. He has fully accepted that they can tend towards bubbles and blowouts. He and his colleagues have also been well aware that there can be horrendous financial crises in which the American state may have to throw huge amounts of tax-payers' money into saving the system. Greenspan has also always grasped that all the various risk models used by the Wall Street banks were flawed, and were bound to be so, because they

presupposed a general context of financial market stability within which one bank in one market sector might face sudden threats; their solutions were thus in essence about diversification or risk across markets. They therefore assumed away the systemic threat problem that Greenspan and others were well aware of: namely, a sudden negative turn across all markets (Beattie/Politi 2008: 6; Greenspan 2008: 11). Greenspan's two main claims were rather different. First, that between blowouts, sweeping away restrictions on what private actors get up to is the best way for the financial sector to make very large amounts of money. A heavily restricted financial sector will make far less money. This claim is surely true. His second claim has been that when bubbles burst and blowouts occur, the banks, aided strongly by the actions of the state authorities, can cope with the consequences. The current crisis may have made many doubt this but it seems certain that many bankers would privately argue that the jury is still out on this one.

3.3 Options for the organisation of financial systems

The serious intellectual debate about the organisation of financial systems in capitalist economies is not, in fact, one between free markets and regulation at all. It is, rather, a debate between three options:

1) A public utility credit and banking system.
2) A capitalist credit and banking system geared to capital accumulation in the productive sector.
3) A capitalist credit and banking system subordinating all other economic activities to its own profit drives.

We can briefly look at each of these in turn.

The public utility model

All modern economic systems, capitalist or not, need credit institutions to smooth all the main kinds of exchanges, they need banks to produce credit money and they need clearance systems to smooth the payments of debts. These are vital public services, like a health service. They are also inherently unstable: the whole point of banking, after all, is that banks do not hold enough funds to cover all the claims of their depositors at any one time. Ensuring the safety of the system requires that competition between banks should be suppressed. Furthermore, policy questions as to where credit should be channelled for future development are issues of great public

economic, social and political import. Thus, public ownership of the credit and banking system is necessary, along with democratic control.

This model can, in principle, operate within capitalism. Even now the bulk of the German banking system remains in public hands through savings banks and land banks. The Chinese financial system is overwhelmingly centred on a handful of huge, publicly owned banks and the Chinese government does indeed steer the credit strategies of these banks.

A capitalist credit system geared to capital accumulation in the productive sector

A private capitalist credit system centred on banks would operate under the logic of money capital: in Marx's formula M-M' – advancing money to others to make more money. There may be competition between banks but there would also be rather strong capital requirements, supervised by the state; they may also be more or less strong steering of the credit operations of the banking system towards certain goals rather than others.

This was broadly the approach of the French and Japanese banking systems in the post-war decades and it is by no means clear that credit steering by the state authorities has been entirely abandoned in these cases. However, such steering capacity has been weakened by internal liberalisation and above all by the dismantling of capital controls and the rights of other external operators to move into (and out of) the national financial system. But there are still ways of counteracting the pure money capital drives of the financial system with longer term capital accumulation goals.

Financial system dominance and rentier capitalism

This has been the model adopted in the US (and the UK) since the 1980s: making money capital king and entirely subordinating the public functions of the credit system to the self-expansion of money capital. More than that, the entire spectrum of capitalist activity is drawn under the sway of money capital in that the latter absorbs an expanding share of the profits generated across these other sectors. This has been the model that has risen to dominance in what we have called the New Wall Street System. It has been a generator of extraordinary financial wealth within the financial system and has actually transformed the entire process of class formation in the US and the UK. And it is this model that is now in deep crisis.

The interesting question is why *this latter model* achieved intellectual ascendancy in the Anglo-Saxon world. To find an answer to this question does not, however, take us further into ideological exploration. It takes us, finally, back out of the financial sphere into the wider and deeper field of socio-economic and socio-political relations in these countries since the 1970s.

3.4 Financial system dominance as a national capitalist strategy

When we set the New Wall Street System in this broader context we can begin to see how its rise to dominance within the US could have been seen as a strategic idea for tackling the problems of the American economy from the 1980s onwards.

From the 1970s through the early 1980s, the American state waged a vigorous battle to revive the industrial economy, partly through a mercantilist term in external trade policy but above all through a domestic confrontation with labour to reduce its share in national income. This, it was assumed, would return American industry to world dominance. This was the vision of such leaders as Paul Volcker. Yet the hoped-for broad-based industrial revival did not take place. By the mid-1980s, non-financial corporate America was falling under the sway of short-term financial engineering tactics geared towards the governing goal of enhancing immediate 'shareholder value' and has since then been linked to wave after wave of 'mergers and acquisitions' and buy-outs by financial operators encouraged by Wall Street investment banks which have profited handsomely from such operations. Though legitimated as enhancing industrial efficiency, this seems very doubtful indeed in most cases. A better case could be made for arguing that these trends have been fed by the new centrality of the financial sector within the structure of American capitalism. This is not to say that American industrial production disappeared; it remained substantial notably in the defence-budget related sector as well as in cars, aerospace, information and communication technologies and pharmaceuticals.

A full explanation of this trend is, I think, not yet available. However, it is clear that the trend produced some characteristic, structural features of American capitalism which have been present ever since. A protected military industrial sector funded out of federal and state budgets along

with some high tech sectors, especially in ICT, which were also strongly supported in the 1980s and 1990s by state subsidies, and involving real new industrial investment in the late 1990s but without a transformative role in the overall economy – the main impacts of ICT have been in the financial sector and retail. But the bulk of the American economy, on which growth has depended, has been marked by stagnant or even declining incomes amongst the mass of the population and the absence of a growth motor from new investment. In these conditions GDP growth in the US has not been driven by new investment whether in the private sector or in the form of state infrastructure investment. It has instead come to depend upon the stimulus of consumer demand. Yet such household consumption was itself inhibited by stagnant mass incomes.

This circle was squared in two main ways. Firstly and most importantly, the problem of stimulating consumer demand could be tackled through the massive, sustained supply of credit from the financial system. And secondly, cheap consumer imports could be bought on an endless basis from abroad – especially from China – because dollar dominance enabled the US to run up huge current account deficits since other countries allowed their exports to the US to be paid for in dollars.

The supply of credit from the financial system to the mass of consumers through the usual mechanisms of credit card, car debt and other loans and mortgages was, however, supplemented by the distinctive mechanism of asset price bubbles which generated so-called wealth effects among the mass of consumers. The stock market bubble of the 1990s raised the paper value of the private pensions of the mass of Americans, thus giving them the sense that they were becoming richer and could spend more. And the housing bubble had a double effect of this sort: it not only made American consumers feel that the value of their house was rising, enabling them to spend more, but was combined with a strong campaign by the banks urging them to take out second mortgages and use the new money for consumption spending.

Thus, the New Wall Street System, which we have described above, directly and centrally fuelled the consumer-led boom in the US, a boom which continued from 1995 to 2008. This boom ensured that the US continued to be a central driver of the world economy and it also formed the basis for a massive global propaganda campaign which claimed in effect

that the US boom was the result, not of debt-fed growth aided by pathological trends in the US financial system, but of the American free market institutions.

Here, then, was the basis in the broader social relations of American capitalism for the rise to dominance of the New Wall Street System: it played the central role in ensuring debt-fed growth. This Anglo-Saxon model was based upon the accumulation of consumer debt: it was growth today, paid for by hoped-for growth tomorrow, and it was not based upon the strengthening of the bases of value-generation in the economies concerned. In short, it was a bluff and one buttressed by some creative national accounting practices which exaggerated the extent of the American boom and of productivity gains in the American economy.

And we should add that the role of China and other Asian exporting economies in this growth model extended beyond their large export surpluses of consumer goods to the USA. These export surpluses were recycled back into the American financial system via the purchasing of US financial assets, thus cheapening the costs of debt – i.e. massively expanding 'liquidity' within the financial system.

The results of these trends can be summarised in the following figures. Aggregate US debt as a percentage of GDP rose from 163% in 1980 to 346% in 2007. The two sectors which account for this great rise were household debt and debt within the financial sector. Household debt rose from 50% of GDP in 1980 to 100% of GDP in 2007. But the really dramatic rise in indebtedness occurred within the financial sector itself. This rose from 21% of GDP in 1980 to 83% in 2000 and 116% in 2007 (Wolf 2008: 15).

4. Conclusions: what implications?

The ideological effects of the crisis will be significant, though of course far less significant than imagined by those who believe financial regimes are the product of intellectual paradigms rather than power relations. The cant dished out by the US Treasury and IMF to other countries in the past is over. American-style financial system models are now viewed as dangerous, and no less dangerous is the EU banking and financial system framework, which the crisis has shown to be a house of cards, even if one which at the

time of writing is still standing. The central EU idea is that banking systems are secured by good rules rather than by authoritative states with tax raising powers. This has been shown to be a dangerous joke. The whole European Economic and Monetary Union (EMU) project has encouraged banks to grow too big for their national states to save them while offering no alternative whatever at an EU or even Eurozone level. Worse, the single market and competition rules in the financial sector ludicrously insist upon no state aid for banks! More, they insist on free competition between banks at all costs. And the stability criteria also mean that a full-blown credit crisis *must be* transformed into a 1930s-style depression in order to respect the EU limits on public sector deficits. Obviously all these house-of-cards rules are for the birds, yet they are simultaneously the central planks of the EU political economy.

This crisis of the US and EU models will no doubt have two intellectual effects: to raise the credibility of the Chinese model and to begin a debate that has been silenced since 1991. The Chinese model of a state-owned bank-centred financial system is the serious alternative model to those of the Atlantic world, but essential to the security of this model is the maintenance of capital controls and a non-convertible currency. All of this China has. It is also the traditional socialist model for financial system organisation, and discussion of this model, silenced since 1991, is sure now to return to public political life, albeit on the fringes to start with.

Some predict much more sweeping short-term changes, such as the replacement of the dollar as the global currency or the collapse of Western leadership institutions within the world economy. The US government's complete debauching of the dollar in the near future could, perhaps lead towards a stampede to dump it globally, along with a retreat into regional or narrow imperial trading blocks. Yet no less likely could be a temporary strengthening of the use of the dollar over the next decade: a long stagnation in the US is likely and it will likely be combined with very low interest rates and a low dollar. This could produce a new dollar carry trade replacing the yen carry trade of the last decade in which everybody borrows in dollars to take them across exchanges into higher value assets (Gowan 1999). This would produce a strong trend towards a decoupling of other exchange rates with the dollar, but it would not necessarily undermine the central element

in dollar dominance: the readiness of other states to accept payments for their goods and credits in dollars.

We are also likely to see the intensification of the two basic structural trends in long-term credit-debt relations in the world economy: that between the Atlantic world and its traditional South in Latin America, Africa and elsewhere, traditionally policed by the IMF – this has weakened over the last decade but is likely to be re-enforced in the present crisis; and that contrary long-term credit-debt relation between the East Asian New Growth Centre economies and the United States. This is also likely to deepen and tighten, particularly between China and the US. This is a power relationship in which China (and other creditors) can exercise real political leverage over the US. We have seen this leverage operating in both the timing and the form of the renationalisation of Fannie and Freddie. The Financial Times reported that US Treasury Secretary Paulson confronted the fact that "the Bank of China had cut its exposure to agency debt over the summer" and he thus "found himself with a fait accompli. The federal government had to give reassurance to foreign investors in agency debt if it wanted to avoid chaos in financial markets and a run on the dollar." It smacks of previous debt crises in Latin American countries, where the ultimate pressure for a bailout came from foreign investors (Gapper 2008a: 39), and we will see it again as the US Treasury seeks buyers of its large new tranches of debt in 2009. Moreover, the East Asian economies, above all China, will likely become ever more central to global macro-economic trends while the US's centrality will weaken during its long stagnation. Additionally, this strengthened financial clout of China and other East Asian states could impinge upon the old imperial credit-debt relationships between the Atlantic world and the South by offering alternative sources of financial support to countries in the South which were traditionally controlled by the IMF/WB. This threat is already prompting warnings in the Atlantic world for Washington to restrain the traditional brutality with which it has imposed its predatory regime on Africa, Latin America and elsewhere (Rothkopf 2008: 15).

Yet, whether this will mean that East Asia will start to build new market centres and new market institutional arrangements for the world economy with which to challenge those of the Atlantic, and especially the Anglo-American world, remains unclear because of the internal divisions within East Asia and because of the strategic priorities of China at the present time.

Thus, East Asia has an overwhelmingly a clearly obvious rational collective interest in building its own centralised commodity and oil markets and in promoting them to world leadership, ending the dominance of London and Chicago. Such new market frameworks have sprung up, and there are three of them: one in Hong Kong (China) one in Japan and one in Singapore. Finally, China is currently overwhelmingly concentrated on maintaining domestic growth and carrying through the leap from the coast to dynamic capital accumulation in the interior. It is thus showing not the slightest interest in challenging the US or the Atlantic world for leadership of the shaping of the institutions of the world economy. Thus, the US has some breathing space. Yet, such is the social and political strength of Wall Street and the weakness of the social forces for an industrial revival of the US that it would seem most likely that the US capitalist class will squander that breathing space.

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Abstracts

This article approaches an understanding of the current credit crunch by exploring the structural transformation of Wall Street since the mid-1980s to show that the resulting financial structures and financial agents have been the driving force behind the current credit crunch. After sketching the main elements of this New Wall Street financial system to show how the crisis took such spectacular forms, the article probes deeper into the socio-

economic and socio-political characteristics of American capitalism as it has evolved since the 1970s to gain a better understanding of the deeper roots of the current crisis. It concludes by showing possible implications of the crisis for the financial system as well as structural trends in long-term credit-debt relations in the world economy.

Der Artikel erklärt die derzeitige Kreditkrise mit der strukturellen Transformation des Wall Street-Systems seit Mitte der 1980er Jahre. Nach Einschätzung des Autors haben die aus den Veränderungen hervorgegangene Finanzstruktur und ihre AkteurInnen die Krise entscheidend vorangetrieben. Die Hauptelemente des neuen Wall Street-Regimes haben dazu beigetragen, dass die Krise so spektakuläre Ausmaße annehmen konnte. Der Artikel beschreibt überdies die sozioökonomischen und die soziopolitischen Charakteristika des US-amerikanischen Kapitalismus seit den 1970er Jahren und schafft auf diese Weise ein besseres Verständnis für die Wurzeln der aktuellen Krise. Schließlich werden mögliche Folgen der Krise für das globale Finanzsystem und die weltweiten Schuldner- und Gläubigerverhältnisse diskutiert.

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