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The US Economic Crisis: Causes and Solution

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The US economy is currently experiencing its worst financial crisis since the Great Depression. The financial crisis started in the home mortgage market, especially the so-called “subprime” mortgages, and is now spreading beyond subprime to prime mortgages, commercial real estate, corporate junk bonds, and other forms of debt. Total losses of US banks could reach as high as half of the total bank capital, which would lead to a sharp reduction in bank lending, which in turn could cause a severe recession in the US economy.

The paper analyzes the underlying causes of the current crisis, and also estimates of how bad the crisis is likely to be. Then, the government economic policies pursued so far (by both the Fed and Congress) to deal with the crisis are discussed. The final section makes recommendations for more radical government policies that the Left should advocate and support in response to this crisis.

1. The decline of the rate of profit

To understand the fundamental causes of the current crisis, we have to take a long-run view of the entire post World War II period. The most important cause of the subpar

economic performance in the US economy in recent decades was a very significant **decline in the rate of profit** for the economy as a whole. From 1950 to the mid-1970s, the rate of profit in the US economy declined almost 50%, from around 22% to around 12% (see Figure 1 at end of paper) This significant decline in the rate of profit appears to have been part of a general world-wide trend during this period, affecting all capitalist nations.

According to Marxian theory, this very significant decline in the rate of profit was the main cause of both of the “twin evils” of **higher unemployment** and **higher inflation**, and hence also of the lower real wages, of recent decades. As in periods of depression of the past, the decline in the rate of profit reduced business investment, which in turn has resulted in slower growth and higher rates of unemployment. An important new factor in the postwar period is that many governments in the 1970s responded to the higher unemployment by adopting expansionary fiscal and monetary policies (more government spending, lower taxes, and lower interest rates) in attempts to reduce unemployment. However, these government policies to reduce unemployment generally resulted in higher rates of inflation, as capitalist firms responded to the government stimulation of demand by raising their prices at a faster rate in order to restore the rate of profit, rather than by increasing output and employment.

In the 1980s, financial capitalists revolted against these higher rates of inflation, and generally forced governments to adopt restrictive policies, especially tight monetary policy (higher interest rates). The result was less inflation, but also higher unemployment. Therefore, government policies have affected the particular combination of unemployment and inflation at a particular time, but the fundamental cause of both of these “twin evils” has been the decline in the rate of profit.

2. Strategies to restore the rate of profit

Capitalists have responded to the decline in the rate of profit by attempting to restore the

rate of profit in a variety of ways. The last three decades in the US economy have been characterized above all else by attempts by capitalists to increase the rate of profit back up to its earlier higher levels.

I have already mentioned the strategy of **inflation**, i.e. of increasing prices at a faster rate, which reduced real wages, or at least avoided increases in real wages, so that all the benefits of increasing productivity in recent decades has gone to higher profits. More recently, more and more companies are actually **reducing money wages**, for the first time in the US economy since the Great Depression. Many Workers have been faced with the choice of either accepting lower wages or losing their jobs.

Another widespread strategy has been to **cut back on health insurance and retirement pension benefits**. Workers are having to pay higher and higher premiums for health insurance, and many workers who thought that they would have a comfortable retirement are receiving a rude awakening, and probably will have to work until an older age, leaving fewer jobs for younger workers. A recent article in the *New York Times Magazine* was entitled “The End of Pensions”.

Another very common strategy to increase the rate of profit has been to make workers work harder and faster on the job; in other words: “**speed-up**”. Such a “speed-up” in the intensity of labor increases the value produced by workers and therefore increases profit and the rate of profit. The higher unemployment of this period contributed to this “speed-up”, as workers have been forced to compete with each other for the fewer jobs available by working harder. One common business strategy has been “down-sizing”, i.e. layoff 10-20% of a firm’s employees and then require the remaining workers to do the work of the laid-off workers. This method also generally increases the intensity of labor even before the workers are laid off, as all workers work harder so that they will not be among those who are laid off.

A more recent strategy has been to use **bankruptcy** as a way to cut wages and benefits drastically. Companies declare “Chapter 11” bankruptcy, which allows them to continue

to operate, and to renegotiate their debts, and most importantly to declare their union contracts null and void. This strategy was pioneered by the steel industry in the 1990s, and has spread to the airlines industry in recent years. Half of the airline companies in the US are currently in Chapter 11 bankruptcy, and they are making very steep cuts in wages and benefits (25% or more).

The most recent example of this drastic strategy is Delphi Auto Parts, the largest auto parts manufacturer in the US, which was owned by General Motors until 1999. Delphi declared Chapter 11 bankruptcy in October 2006, and announced that it is cutting wages by approximately **two-thirds** (from an roughly \$30 per hour to roughly \$10 per hour), and is reducing benefits correspondingly. The Delphi chief executive (who used to work in the steel industry) has publicly urged the automobile companies to follow the same strategy. This strategy could spread to the unionized companies in the rest of the manufacturing sector of the economy in the years ahead

Another increasingly important strategy by capitalists to reduce wage costs has been to move their production operations to low-wage areas around the world. This has been the main driving force behind the so-called “**globalization**” of recent decades: **a world-wide search for lower wages in order to increase the rate of profit**. This is the essence of globalization. This strategy also puts more downward pressure on wages in the US, because of the much greater threat of “out-sourcing” jobs to other countries. NAFTA and CAFTA are of course very important parts of this overall globalization strategy to reduce wages and increase the rate of profit.

Therefore, we can see that the strategies of capitalist enterprises to increase their rate of profit in recent decades have in general caused **great suffering for many workers** - higher unemployment and higher inflation, lower living standards, and increased insecurity and stress and exhaustion on the job. Marx’s “general law of capitalist accumulation” - that the accumulation of wealth by capitalists is accompanied by the accumulation of misery for workers - has been all too true in recent decades in the US economy (and of course in most of the rest of the world). Most American workers today

work harder and longer for less pay and lower benefits than they did several decades ago. It appears to be the end of an era in which blue-collar workers in the US could be part of the middle class.

It appears that this all-out campaign by capitalists to increase the rate of profit in all these ways has been fairly successful in achieving this objective. It has taken a long time, but the rate of profit is now approaching the previous peaks achieved in the 1960s, as we can see from Figure 1. The last several years especially, since the recession of 2001, has seen a very strong recovery of profits, as real wages have not increased at all, and productivity has increased rapidly (4-5% a year). And these estimates do not include the profits of US companies from their production abroad, but include only profits from domestic US production. They also do not include the multi-million dollar salaries of top corporate executives. On the other hand, these estimates do include a large and increasing percentage of profits of the financial sector (approximately one-third of total profit in recent years has been financial profit), much of which will probably turn out to be fictitious (i.e. anticipated future earnings that are “booked” in the current year, but will probably never actually materialize because of the crisis). All in all, I conclude that there has been a very substantial and probably almost complete recovery of the rate of profit in the US.

As we have seen above, this recovery of the rate of profit of US companies has been accomplished at the expense of US workers. It has also been accomplished without a major depression in the US economy. I think this would have surprised Marx, who argued that just cutting wages by itself would in general not enough by itself to fully restore the rate of profit, and that what would usually be required in addition was a deep depression characterized by widespread bankruptcies that would result in a significant devaluation of capital. That has not yet happened in the US economy, and yet the rate of profit appears to be more or less fully restored. But I don’t think Marx envisioned reducing wages by as much as 90% made possible by “globalization” and the doubling of the industrial reserve army.

3. Search for new borrowers— low-income workers!

Surprisingly and disappointingly, the recovery of the rate of profit has **not resulted in a substantial increase of business investment**, and thus has not led to an increase of employment that would normally be expected. Figure 2 (see end of paper) shows that non-residential investment as a percentage of GDP has remained at low levels in spite of the recovery of the rate of profit. Instead, owners and executives have chosen to spend their higher profits in other ways besides investing in expanding their businesses:

(1) they have paid out higher dividends to stockowners (i.e. to themselves); (2) they have “bought back” shares of their own company, which has increased the prices of their stock and increased their executive compensation; and (3) they have loaned the money out (e.g. for mortgages), thereby contributing to the financial speculative bubble in recent years. Therefore, workers have not even benefited through the “trickle down” effect of more investment leading to more jobs. Instead, capitalists have spent their increased profits on luxury consumption (e.g. airplanes, expensive automobiles, multiple vacation homes, etc.)

An important further consequence of the higher profits and the continued weakness of business investment was that **financial capitalists had lots of money to lend**, but non-financial corporations did not have much need to borrow. Therefore, financial capitalists went searching for new borrowers. Meanwhile, workers were strapped with stagnant wages and were all too eager to borrow money to buy a house or a new car, and sometimes even basic necessities. So financial corporations increasingly focused on **workers** as their borrower-customers, especially for home mortgages over the last decade or so. The percentage of bank lending to households increased from 30% in 1970 to 50% in 2006. The total value of home mortgages **tripled** between 1998 and 2006. And the ratio of household debt to disposable income increased from 60% in 1970 to 100% in 2000 to 140% in 2007 (see Figure 3 at the end of the paper). This was an extraordinary increase of household debt, unprecedented in US history.

However, financial capitalists soon ran out of “credit-worthy” workers who qualified for “prime” mortgages. But they still had lots of money to lend out, so they decided to expand into “subprime” mortgages for less credit-worthy workers who had less income. These “subprime” mortgages required little or no down payments and little or no documentation of the borrower’s income (for this reason, these mortgages were sometimes called “liar loans”). Subprime mortgages as a percentage of total mortgages increased from 7% in 2000 to 20% in 2006.

The most extreme of these new types of mortgages were called NINJA loans, where NINJA stood for “No Income, No Job, no Assets”, and yet borrowers still “qualified” for mortgages (several companies actually advertised with green turtles).

You might think that this new strategy of financial capitalists – to lend to low-income workers – would be very risky and not very profitable. There would seem to be a high probability that these low-income workers would sooner or later default on their loans and the financial capitalists would lose money. However, further details of this strategy was supposed to take care of this problem.

To begin with, borrowers were given low mortgage rates for the first 2-3 years that they could probably afford (these initial low rates were called “teaser rates”). And the strategy was that, by the time the teaser rates expired and the rates were to be adjusted upward, the value of their homes would have increased enough so that a new mortgage could be taken out and the old mortgage paid off. However, this strategy worked only as long as housing prices were increasing. When housing prices stopped increasing in 2006, this strategy no longer worked. Old mortgages could no longer be refinanced, so the borrowers were stuck with higher reset mortgage rates that they could not afford, and the default rates started to increase. More on this below.

4. Structure of home mortgage market

The structure of the US home mortgage market in recent decades also contributed to the expansion of mortgages to low-income workers. Commercial banks used to make mortgages and own them for their entire 30-year term, and thus had a strong financial incentive to try to make sure that the borrowers were credit-worthy and likely to be able to keep up with their mortgage payments. But beginning in the 1980s, commercial banks no longer held onto these mortgages “in their own portfolio”, but instead sold the mortgages to investment banks, who in turn pooled together hundreds and even thousands of mortgages as “**mortgaged-based securities**”. The investment banks then sold these mortgage-based securities to hedge funds, pension funds, foreign investors, etc.

One important result of the securitization of mortgages was that the “originators” of mortgages – commercial banks and mortgage companies – no longer had a financial incentive to make sure that the homebuyers were creditworthy and were likely to be able to keep up with their monthly mortgage payments. Indeed, these originators have **perverse financial incentives** to lower credit standards and to ignore possible problems with creditworthiness, both because they will soon sell the mortgage to other investors, and also because they earn their income from “origination fees”, not from the eventual monthly mortgage payments. So the more mortgages originated, the more fees, and the more income for the originators, no matter what the creditworthiness of the borrowers might be (or not be). Investment banks have a similar perverse incentive in their role as brokers or middlemen in the securitization process. Investment banks primarily buy mortgages from the originators and sell them to the final investors, and make most of their money from “processing fees” (or “broker fees”). So again, the more mortgage-based securities sold, the more fees and income for investment banks, no matter whether or not the borrowers would be able to make their payments down the road.

The reader might ask: didn't **someone** care about and pay attention to the creditworthiness of the borrowers? Surely the final investors or owners of the mortgage-based securities should have cared. However, these mortgage-based securities are extremely complicated and consist of hundreds or thousands of mortgages. It is a very

time-consuming and tedious task to carefully examine the creditworthiness of such large numbers of borrowers. Therefore, the final investors depended to a large extent on the **bond rating agencies** (Moody's, Standard and Poor's, Fitch's) to evaluate the risks in the mortgage-based securities and to assign "ratings" to them, similar to their rating of corporate bonds. The highest rating for the lowest risk securities is AAA, and the ratings go down there as the risk of the securities goes up.

However, there was also a perverse incentive at work with the rating agencies as well. Rating agencies are private, profit-making businesses, who compete with one another for the rating business of the investment banks. Rating mortgage-based securities became a very lucrative business in recent decades, along with the growing securitization of mortgages. Therefore, there was (and continues to be) a very strong incentive for the rating agencies to give the highest AAA rating to even risky mortgage-based securities, so they will continue to get the business of these investment banks in the future. Plus the personnel of the rating agencies were often wined and dined and golfed by the investment banks, as further inducement for a AAA rating. It has recently come out that, in some cases, investment banks requested that specific employees of the rating agencies be removed from the rating of their mortgage-based securities, because of the "excessive diligence" of these employees, and these requests were generally granted.

In sum, the securitization of mortgages was a process that was filled with perverse incentives to ignore the credit risks of the borrowers, and to make as much money as possible on volume and processing fees.

5. The current crisis

The housing bubble started to burst in 2006, and the decline accelerated in 2007 and in 2008. Housing prices stopped increasing in 2006 and started to decrease in 2007, and have fallen about 15% from the peak so far. This meant that homeowners could no longer refinance when the mortgage rates were reset, which caused delinquencies and

defaults of mortgages to increase sharply, especially among subprime borrowers. From the 1st quarter of 2006 to the 2nd quarter of 2008, the total number of mortgages in foreclosure almost tripled, from 1% to 2.75%, and the number of mortgages in foreclosure or at least 30 days delinquent more than doubled from 4.5% to 9.2%. These foreclosure and delinquency rates are the highest since the Great Depression; the previous peak for the delinquency rate was 6.8% in 1984 and 2002. And the worst is yet to come. The “American dream” of owning your own home is turning into an American nightmare for millions of families.

Estimates of the total number of foreclosures that will result from this crisis in the years to come range from 3 million (Goldman Sachs, IMF) to 8 million (Nuriel Roubini, a New York University economics professor, whose forecasts carry some weight because he was one of the first to predict several years ago the bursting of the housing bubble and the current recession).

So far (as of August 2008), there have been about 1 million mortgage foreclosures. Another 1 million mortgages were 90 days delinquent (foreclosure notices usually go out after 90 days), and another 2 million were 30 days delinquent. Therefore, a total of 4 million mortgages were either in foreclosure or close to it at this time. These data make the low estimate of 3 million foreclosures look too low. The reality will probably end up somewhere in between the low and high estimates, with perhaps 5 million foreclosures (which would be roughly 10% of all home mortgages in the US).

Defaults and foreclosures on mortgages mean losses for the lenders. Estimates of losses on mortgages for the financial sector as a whole range from \$500 billion to \$1 trillion, depending mainly on the number of foreclosures. In addition to losses on mortgages, there will also be losses on other types of loans, due to the weakness of the economy in the months ahead: consumer loans (credit cards, etc.), commercial real estate, corporate junk bonds, and other types of loans (e.g. credit default swaps). Estimates of losses on these other types of loans range from \$400 billion to \$700 billion. Therefore, estimates of the total losses for the financial sector as a whole as a result of the crisis range from

around \$1 trillion (Goldman Sachs, IMF) to \$1.7 trillion (Roubini). (Actually Roubini's \$1.7 trillion estimate is his "optimistic" scenario, assuming 8 million foreclosures as discussed above. He also has a "pessimistic" estimate of \$2.7 trillion (!) of total losses, which assume a 25% reduction of housing prices, rather than a 20% reduction, which in turn would result (according to Roubini) in 21 million mortgages with negative equity and 10.5 million foreclosures.) Bridgewater Associates, the second largest hedge fund in the US, has recently estimated a total loss of \$1.6 trillion. Everyone's estimates keep getting bigger by the month.

It is further estimated that about half of the total losses of the financial sector will be suffered by banks. The rest of the losses will be borne by non-bank financial institutions (hedge funds, pension funds, etc.). Therefore, dividing the total losses for the financial sector as a whole in the previous paragraph by 2, estimates of the losses for the banking sector range from \$450 billion to \$850 billion. Since the total bank capital in the US is approximately \$1.5 trillion, losses of this magnitude would wipe out from one-third to one-half of the total capital in US banks! This would obviously be a severe blow, not just to the banks, but also to the US economy as a whole.

The blow to the rest of the economy would happen because the rest of the economy is dependent on banks for loans – businesses for investment loans, and households for mortgages and consumer loans. Bank losses result in a reduction in bank capital, which in turn requires a reduction in bank lending, in order to maintain acceptable loan to capital ratios. Such a reduction of bank lending is commonly called a "credit crunch". Assuming a loan to capital ratio of 10:1 (this conservative assumption was made in a recent study by Goldman Sachs), every \$100 billion loss and reduction of bank capital would normally result in a \$1000 billion (i.e. \$1 trillion) reduction in bank lending, and corresponding reductions in business investment and consumer spending. According to this rule of thumb, even the low estimate of banks losses of \$450 billion would result in a reduction of bank lending of \$4.5 trillion! This would be a severe blow to the economy and would cause a severe recession.

Banks losses may be offset to some extent by “recapitalization”, i.e. by new capital being invested in banks from other sources. If bank capital can be at least partially restored, then the reduction in bank lending does not have to be so significant and traumatic. So far, banks have lost about \$500 billion and have raised about \$400 billion in new capital, most of it coming from “sovereign wealth funds” financed by the governments of Asian and Middle Eastern countries. So ironically, US banks may be “saved” (in part) by increasing foreign ownership. US bankers are now figuratively on their knees before these foreign investors offering discounted prices and pleading for help. US government officials are not sure what to think about this increasing foreign ownership of major US banks. It is also an important indication of the decline of US economic hegemony as a result of this crisis. However, it is becoming more difficult for banks to raise new capital from foreign investors, because their prior investments have already suffered significant losses.

In addition to the credit crunch, consumer spending will be further depressed in the months ahead for the following reasons: decreasing household wealth; the end of mortgage equity withdrawals (which was very significant in the recent boom); \$4 a gallon gasoline, and declining jobs and incomes. All in all, it is shaping up to be a severe recession.

6. Government policies

The federal government has acted fairly vigorously in attempts to prevent a more serious crisis, and has been modestly successful in the short-run, but it remains to be seen how successful it will be in the long-run.

6.1 Federal Reserve

The Federal Reserve has adopted very expansionary policies (lower short-term interest rates and increased loans to commercial banks) in the hopes that banks would increase their lending to non-financial corporations and households. However, these traditional

policies have so far not been very effective, because banks have been unwilling to increase their lending, both because they do not trust the creditworthiness of the borrowers and also because the loss of capital that they have suffered (and will continue to suffer) requires that they reduce their lending in order to maintain acceptable loan to capital ratios.

Because of this failure of traditional policies, the Fed began to improvise with new unprecedented policies. Most importantly, it extended loans to investment banks for the first time. Investment banks are not regulated by the Fed, so it has always been thought that the Fed had no responsibility to act as “lender of last resort” to investment banks when they are in trouble. However, when the investment bank Bear Stearns was on the verge of bankruptcy in late March, the Fed decided that it had to act as lender of last resort to Bear Stearns and JPMorgan Chase, which took over Bear Stearns. Since Bear Stearns was heavily indebted to so many different financial institutions, its bankruptcy would have caused very widespread losses and could have resulted in a complete “meltdown” of the US financial system – nobody lending money to anybody for anything – and a disaster for the economy. That was the Bernanke’s nightmare, and why the Fed intervened so quickly and decisively as lender of last resort to these investment banks. The Fed justified its going beyond its traditional boundaries by saying that “the financial system of the US was at risk.” The Fed’s statement and its action are clear evidence of how fragile and unstable the US financial system is at the present time. And the worst is yet to come.

So far, the Fed’s unprecedented policies have been mildly successful, but by no means a complete success. At least an all-out financial collapse has been averted (for now). And “investor confidence” seems to have been restored somewhat by the demonstrated commitment by the Fed to do everything it can to avoid a financial disaster. However, commercial banks and investment banks have still not increased their lending. And the Fed’s policies do not solve and cannot solve the fundamental problems of declining housing prices and rising foreclosure rates.

Going forward, the ability of the Fed to reduce interest rates still further will be limited because its target rate of interest is already very low (2%) and therefore cannot be reduced much more, and also because of its concerns about rising inflation and a falling dollar (which also leads to higher inflation) (lower interest rates would tend to accelerate both of those disturbing recent trends). Critics of the Fed argue that the Fed's sharp reductions in interest rates in recent months are at least partially responsible for both of these worsening problems.

6.2 Congress

Congress fairly quickly passed an "economic stimulus" bill of \$168 billion in February, that includes tax rebates for households and tax cuts for businesses. These tax cuts have had some positive effect on the economy in the last half of 2008, but their effect is likely to be small and temporary. At best, the tax rebates will provide a one-time boost to consumer spending, since these rebates can be spent only once.

In July, Congress passed a law to deal with the foreclosure crisis which allows for the replacement of existing mortgages which are in default with new mortgages that would have a value of approximately 85% of the **current** market value of the houses, and these refinanced mortgages would be guaranteed by the Federal Housing Administration (how this "current market value" is to be determined is a crucial detail which so far has not been specified). This 15% "write-down" of the principle, plus the prior 15% decline of prices means that the maximum write-down for lenders will be approximately 30% (and less to the extent that some equity has been paid on these mortgages). The bill appropriates \$300 billion for this purpose, which it estimates could help as many as 1.5 million homeowners. However, this refinancing must be initiated by the lenders, and it remains to be seen how many lenders will initiate these writedowns, unless the mortgages are very bad.

Another problem with this bill is that housing prices in some areas are likely to fall more than an additional 15%. Mortgages on these houses are likely to be the ones that the

lenders will voluntarily refinance, and any further losses would have be borne by the government (i.e. by the taxpayers). This would be a partial bailout of the lenders.

Another bailout of the lenders - and this one a complete bailout - was the takeover by the US Treasury in early September of Fannie Mae and Freddie Mac, the two giant home mortgage companies, who either own or guarantee almost half of the total mortgages in the US, and in the last year have accounted for over 80% of all new mortgages, as other sources of mortgage loans have dried up. The Treasury plan promises to repay creditors in full, with taxpayer money if necessary. William Poole (ex-President of St. Louis Fed) has estimated that the total cost to taxpayers could be in the neighborhood of \$300 billion.

The justification of this bailout of Fannie and Freddie was similar to that of Bear Stearns - that they were in danger of going bankrupt, and if that happened, then the US home mortgage industry and the home construction industry probably would have collapsed almost completely, which would have dealt a serious blow to the US economy as a whole.

And just last week (as I write on September 20), the credit crisis entered a new more dangerous phase, and there was a dramatic escalation of the government's bailout of financial capitalists. Credit markets froze up almost completely; no one would lend money to anyone, except the US Treasury. Banks would not lend to each other, investors withdrew almost \$100 billion in one day (!) from money market funds (which are supposed to be super-safe, but were now being questioned), and there was a massive "flight to safety" of Treasury bonds, which reduced the interest rate on 3-month Treasury bills to 0.2%! (shades of Japan).

Then Secretary Paulson announced that he would seek authorization from Congress to purchase \$700 billion (!) worth of mortgage based securities ("toxic waste") from US banks. \$700 billion is a lot of money; it is \$2000 for every man, woman, and child in the US, and it is over twice the Federal government budget for all nondefense spending

(\$315 in 2007). The justification for this bailout, once again, is that if these toxic securities are not taken off the books of the banks, then the banks will continue to cut back on their lending, which will continue to do damage to the rest of economy.

As I write, the details of this mega-bailout have not yet been worked out. The most important question to be decided is: *what prices* will the Treasury pay for these securities and how will these prices be determined? The higher the price, the more this will be a bailout of the shareholders of these banks, a bailout that taxpayers will have to pay for. Another important question is whether there will be write-downs of the money owed by homeowners on their mortgages as part of this package.

7. Left policies

Thus we can see that there is a very difficult dilemma in capitalist economies for governments and the public and also for the Left. When a financial crisis threatens, or begins, there seem to be only two options: (1) bail out the financial capitalists in some way, or (2) suffer a more severe financial crisis, which in turn will cause a more severe crisis in the economy as a whole (because of the “credit crunch” described above), which would cause widespread misery and hardships. Thus, risk-taking financial capitalists make a fortune during a boom, and then their excessive risk-taking causes a crisis which threatens the rest of us, and then we have to choose between bailing them out or having a full-blown financial and economic crisis. In effect, financial capitalists hold the government and the rest of us hostage to their demands for a bailout.

This dilemma has become even more acute in recent decades, for two main reasons:

(1) the increasing concentration of financial capital, which means that the large banks have become “too big to let fail”; and (2) the increasing complexity and interconnectedness of the financial system, so that the failure of even a modest sized bank would have widespread systematic repercussions (e.g. Bear Stearns).

In recent years, governments all over the world, when faced with this dilemma, have increasingly chosen the first option of bailing out the financial capitalists. Examples include: Mexico in 1994, the Asian crisis of 1997-98 (Thailand, Indonesia, Korea, the Philippines), Japan repeatedly over the last decade, and the US in the Saving and Loan crisis in the late 1980s, and now the current mortgage crisis. But this means that financial capitalists receive the profit in the good times, but do not suffer the losses in the bad times. Instead, the losses are “socialized”, i.e. are paid for by the government, and ultimately by the taxpayers. It is quite a good deal for financial capitalists; a kind of “socialism for the rich”.

The only way to avoid this difficult dilemma is to make the economy less dependent on financial capitalists. And the only way to accomplish this greater independence from financial capitalists is that the government itself should become the main provider of credit in the economy, especially for home mortgages (and perhaps also for consumer loans, and maybe even eventually for business loans). In other words, **finance should be nationalized**, at least housing finance to begin with.

Another reason to nationalize housing finance is that providing credit for home purchases should be a function of the government, rather than of private businesses (whose primary goal is maximum profit, not affordable housing). Decent affordable housing is a basic economic right. There should not be enormous profit made on the provision of credit for housing, as has been the case in recent years. Without this huge profit, mortgages would be cheaper and houses more affordable. There was also a lot of fraudulent activity in the housing industry in the recent boom, and this fraud would be eliminated. Therefore, the government should take over a significant share of this important economic function of providing credit for housing.

The government could raise the money that it will lend out in two ways: (1) tax the rich, and use this tax revenue to loan to homebuyers; and (2) borrow from the rich at low interest rates, like the existing Treasury bonds, and use this borrowed money to loan to homebuyers. The money borrowed by the government would be repaid from revenue

generated by its loans to households.

We have to do something like this. Otherwise, we will continue to face the same cruel dilemma of either bailing out financial capitalists or suffering a worse economic crisis over and over again in the future, and our children and their children. Within the institutional framework of financial capitalism, these are the only two options. In order to create other options (more worker-friendly options), we have to change drastically the institutional framework of financial capitalism; we have to convert capitalist finance into nationalized government finance.

What this means in the current crisis in the US is that the takeover of Fannie Mae and Freddie Mac should be made permanent, and merged into one government agency, whose purpose would be to provide affordable mortgages to credit-worthy families. That would nationalize about 80% of current mortgage lending. Only in this way can we begin to reduce our dependence on financial capitalists, at least in the home mortgage market, which is the crucial market at the present time.