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“The social origin of the crisis”

Abstract

There are two conventional explanations on the worst financial crisis after the Great Depression of the '30s of last century . On one side, the crash of the subprime mortgages; on the other, the lack or misapplication of the financial regulations But both are hardly convincing. It is necessary to explore the social roots of the crisis, starting with the massive growth of households' indebtedness. Due to the great inequality in the wealth and income distribution, huge indebtedness has become an ordinary social condition of most families in the last decades and, at the same time, the condition for the US economy growth.

Among the origins of the great inequality there are the rough waning of the trade unions' power and the weakness of the social policies. In this framework the financial system made up a parallel, virtual world distanced from the real economy. The recall to the social structural sources of the crisis allows identifying two interlinked roots of the current crisis: on one hand, the impact of the growing inequality within the American society and, on the other, the ruinous inconsistency of the ideology of market efficiency. A non-conventional diagnostic is needed to tackle the fake post-crisis policies.

The issue we are going to discuss - the social origin of the crisis - is at odds with the conventional definition and explanation of the crisis as fundamentally a financial crisis that, between 2007 and 2008, hit the US financial market with worldwide consequences.

Putting the accent on the social roots of the crisis doesn't mean that we will undervalue its financial sources. It was not a coincidence that the climax of the crisis was determined by the collapse of the Lehman Brothers in the fall of 2008, while other big banks and insurance companies would have become bankrupt without a massive intervention of the American government.

Once said, a question arises. What went wrong? What was the cause of the worst financial crisis after the Great Depression of the '30s of last century? You know the conventional response. At the origin we find the "subprime" mortgages - that is, loans to individuals with low credit rating who are charged

higher interest rates. When households were not any longer able to manage the payment of the mortgages due to the interest rates increasing, the consequence was the collapse in the value of mortgage-backed securities. In this scenario, characterized by the huge entity of the overall mortgage debts - a total of 11 trillion dollars, of which at least one out ten was subprime - and by the crash of the houses' value, the banks that had issued trillions of mortgage-backed securities ended up on the brink of collapse with worldwide consequences on the financial markets. Thus, according to this narrative, the subprime mortgages were at the origin of the global financial collapse and the economic meltdown.

Yet, this is not fully satisfying explanation, as it sparks two interrelated questions. First, why did banks and other financial institutions finance a mammoth amount of subprime and other non-traditional mortgage loans that in the end could not be honored. And second: How was it possible that such a large number of householders embarked in mortgages they were not able to pay back? We have two specific and, at the same time, interrelated explanations. First, there was a lack of regulation in the banking system; second, households had been reckless and unaware of the concrete risk of insolvency.

The "rules" argument

Let us start with the first explanation concerning the financial system: the lack or inadequacy or misapplication of regulations. It is an explanation hardly convincing, indeed. We can begin with a telling story. The most relevant bank reform in the US in the last decades was the repeal of the Glass- Steagall Act that had been established in 1933 at the dawn of Franklin Roosevelt's presidency.

The reform was carried out in 2000 under Bill Clinton's presidency. The chairman of the Fed was the legendary Alan Greenspan who, before retiring in 2005, served under four US presidents. And the Treasury Secretary was Larry

Summers, one of the most brilliant American economists, who in the next years became president of Harvard University and, later, chief economist on the staff of Barack Obama. We owe to these first-class experts the financial overhaul that changed the rules of the Glass-Steagall Act, which had set up the separation between commercial and investment banks.

"The world changes, and we have to change with it," said Republican Senator Phil Gramm, who had written the law that will bear his name along with the two other main Republican sponsors, Jim Leach and Thomas J. Bliley. "We have a new century coming, and we have an opportunity to dominate that century the same way we dominated this century. Glass-Steagall, in the midst of the Great Depression, came at a time when the thinking was that the government was the answer. In this era of economic prosperity, we have decided that freedom is the answer."

This was the voice of the Republican majority of Congress, but the new legislation was approved by the large majority of democrats in both the Houses. And Larry Summers, Treasury Secretary, warmly commented, "Today Congress voted to update the rules that have governed financial services since the Great Depression and replace them with a system for the 21st century. This historic legislation will better enable American companies to compete in the new economy."

It is worth recording that a different feeling was possible. "Glass-Steagall - Senator Wellstone remarked - was intended to protect our financial system by insulating commercial banking from other forms of risk...Now Congress is about to repeal that economic stabilizer without putting any comparable safeguard in its place." And an almost prophetic opinion was expressed by Senator Dorgan who said: "I think we will look back in 10 years' time and say we should not have done this but we did because we forgot the lessons of the past, and that that which is true in the 1930's is true in 2010... We have now decided in the name of modernization to forget the lessons of the past, of safety and of soundness." (NYT, November, 5 1999). In effect, it took less than ten years to make the prediction true.

This is a clear example of a fundamental change of rules assumed with a plain awareness of scope and ends of the change. We can disapprove of the new regulation, considering that it paved the way to increased speculation, but we can't say that the next crisis was the consequence of a lack of regulations. The reform had been long discussed and promoted in the conviction that new rules would have been more advanced and better fit to regulate the new financial world.

Let us take another example. During the last decade we witnessed a huge development of innovative financial products. Banks found new business by converting consumer debt into tradable securities and "derivatives", like collateralized debt obligation (CDO) and credit default swaps (CDS). It was what economists termed the "originate and distribute" model, based on extremely high leverage that allowed investors to buy assets worth as much as thirty times the capital. Warren Buffet, the most famous American financier, was known to say that these new sophisticated products were "financial weapons of mass destruction", paraphrasing Saddam Hussein's supposed arms of mass destruction.

Confronted with this new risky framework, the financial system should have had new and tougher kinds of controls and limits. Instead, the mostly shared agreement was that banks had their own risk-measurement instruments and advanced mathematic models to control risks. In other words, the Federal Reserve, the Securities and Exchange Commission (SEC) along with the Treasury secretary, all agreed on the principle that big banks and private financial institutions might more efficiently manage and control the risks through voluntary self-regulation than through compliance with norms specifically set by law. It was just the reverse of Roosevelt's attitude, which aimed to realize "the change from voluntarism to law as the means of ordering the economy" (Arthur Schlesinger, *The Cyclical of American History*, pag.379).

Concluding this point, it is difficult to argue that the system was simply unregulated. On the contrary, all agreed the system could work more

efficiently. As Greenspan admitted some years after, there was an ideological assumption at the basis of this stance. That is, the unconditional belief in market efficiency and in its capacity of self-regulation. If markets are in themselves efficient and self-regulating, you need few rules, the minimum possible, and a mix of deregulation with re-regulation. So we have to assume that if there was a flaw, it primarily was not in the lack of regulations but in the philosophy on which they were based.

This leads to another question. How is it possible that this assumption gets so vast a consensus among bankers, economists, politicians, media and so on? We might reasonably guess that there was a basic correspondence between the neo-liberal ideology (what J.Stiglitz defines "market fundamentalism") and the preeminent interests of dominant financial groups.

The "subprime" argument

Now, we must go on to look at the second question. Where did the problem of subprime mortgages come from? Why did millions of households incur debts that placed them in a situation that they were not able to cope with? There are two circumstances that are generally pointed out. The first is historically low interest rates, which in the first half of the last decade fell to one per cent, virtually a negative rate in real terms. The second is that house prices were fast and massively growing. The critics of households' behavior (see, Th. Sowell, *The housing Boom and Bust*) argue that these two factors are the very cause of the crisis, since households were pushed to purchase homes or refinance the old mortgage without calculating their actual capacity to pay back the debt. The mortgage crisis - the argument goes - stemmed from a double mistake, respectively of Fed monetary lassitude and of families' financial rashness. So a scapegoat to blame is identified. Or maybe two, at once.

Yet let us examine more closely the mortgage argument. Consider, for comparison the Italian experience that is not unlike the general European one. If you stipulate a mortgage loan, you have to show the availability of a

sufficient income, anticipate a down payment, generally 20 or 30 per cent of the price, and pay back the debt over a number of years (generally 15 or 20, rarely more).

In the US mortgages are usually over 30 years. During this long period, when you have paid a part of the principal, you can refinance the mortgage and take out cash. In this way you can seize money to finance current expenses or also pay back old and more expensive debts. In other words, your house is not only the home where you live, but also an asset you can utilize to refinance the mortgage, a sort of automated teller machine (ATM) to which you might return in case of financial need. "Millions of homeowners jumped on this bandwagon, withdrawing nearly one trillion dollars a year in equity from their houses collectively at the peak of the boom" (M.Zandi, *Financial Shock*, p.59).

An American characteristic of the last decades is the massive growth of private indebtedness. If you make a comparison with Italy (and generally with Europe), you find out that here families have a good deal of savings. Instead, in the US the average family saving was near to zero in the last decade. Overall households indebtedness was close to the US GDP (about 14 trillion dollars). And - according to a Fed study - the mortgage loans (about 11 trillion dollars) amounted to 82 per cent of the total debt of homeowners (Th. Sowell, *The housing boom and burst*, p.5). These figures show the overwhelming relevance of families' indebtedness and the crucial role of mortgage loans.

By and large American families have to deal with three kinds of liabilities. Credit cards (an average of 12 for each family), health care expenses, when insurance is inexistent or not sufficient to provide some specific assistance; as well as debts stemming from the fees paid to send children to college; debts that must be added to the basic mortgage. There is no doubt that in presence of very low interest rates, households were pushed either to purchase a house or to re-mortgage the old one, also in anticipation of what looked to be an endless growth of houses' value.

Yet, to buy a new home or to refinance the old mortgage, you need the

lender's agreement. As we have seen, innovative financial instruments allow banks to originate a mortgage loan without bearing a substantial risk. The banks pooled, packaged and sliced loans into tranches representing different levels of risk. Innovative finance allowed the issuance of mortgage backed securities, which banks transformed in an extensive typology of CDO followed by CDS, in this way distributing the risk into an array of derivatives that through a long journey across the world were bound to lose any reference to the basic loan.

It is worth recalling that these sophisticated, often incomprehensible, financial instruments were granted a triple A rating (in principle the highest guarantee for the securities market) by the rating agencies, which were chosen (and paid) by the issuers on the basis of their compliance in undervaluing the risk. In this way the risks connected to the mortgage loans were prodigiously shifted onto other entities (for example, a pension fund) and spread over global financial markets.

Let us now come back to households. Real estate agents were interested in obtaining a mortgage contract since they could get generous fees from the originators. So they were eager to explain to the candidate borrower how the deal was intrinsically secure and convenient. It was not just that the mortgage interest rate was very low. The borrower could even pay a reduced interest rate over the first two years and then re-negotiate the mortgage. Moreover, during the first years, you can pay only interests without reimbursement of the principal. Finally, if you are not able to pay or re-negotiate the mortgage, you can always resell the house, pocketing the difference in value due to the rising price. In any event, it is a good deal – as the broker will convincingly explain. In short, a fine deal for all, for borrowers as well as for banks that, without bearing substantial risks, gain the ability to multiply and distribute derivatives and other innovative financial instruments.

It 's worth noting that in the middle of the housing boom around two million new homes a year were built, but in the years 2003-04, the refinancing of mortgages involved the extraordinary figure of thirty million households for a

total of five trillion dollars (Zandi, *ibid.* pag.249, 6). Such a stunning mass of refinancing allows homeowners to use the resulting cash availability to pay off other debts with the advantage of being able to deduct from the taxes the interest on mortgage loan, unlike any other debt. In turn, refinancing is facilitated the avidity with which the banks seek to promote the mortgage loans, with virtually no conditions, to expand the financial base of the new sophisticated securities to be spread worldwide.

We know the outcome of this trick. When, between 2004 and 2006, interest rates went up to protect the falling dollar, the effect was a sharp jump in borrowing costs, leading to the explosion of defaults among holders of subprime mortgages. In presence of the defaulting, banks claimed back the houses and families ended up losing their homes. Others who had bought houses to speculate on the increase of value sold them. The average value of the houses crashed. In the end, banks couldn't get the credits and couldn't sell the houses, given the market meltdown. As a consequence, banks and insurance companies were not able to deal with the huge mass of financial instruments that had been issued and spread at global level.

The great inequality

So far we have indulged in a pure description of the events. But we have still not dealt with a fundamental and startling question: How was it possible that the richest country in the world was plagued by a so high households' indebtedness. Here we meet a key characteristic of the American economy in the last decades, that is to be the most unequal society among the western countries. An inequality that reached, in the first decade of the new century, the same level of the '20s of the past century, just before the '29 crisis.

What are the reasons for this huge inequality? Economic growth in a country depends on the growth of population and of technological progress. Particularly through technological progress you get an increase of labor productivity. It means that you get a growing output using a reduced amount of capital and

human resources. If a country achieves a high level of productivity, as happened in the US over the last two decades, you could presume that the whole population will be well off. And it would be normal to assume a certain degree of equity in the redistribution of the labor productivity gains, that is a fair distribution between profits and workers' earnings. This in general was the situation since the end of the Second World War through the seventies, given a sort of implicit settlement between firms and trade unions (the so-called "Detroit Pact"), which was based on the commitment to a parallel increase of profits and wages. The break must be placed in the '80s at the time of the neo-conservative revolution of Ronald Reagan.

Starting with that decade, the situation reversed. The gains in labor productivity were no longer equitably shared. Wages long remained stagnant. The productivity gains went to the top of the ladder of incomes. The polarization became extreme.

How did this happen? Here we must stress some key features of social policies in the US, related to working conditions, on the one hand, and to the welfare state, on the other. We will briefly recall the main aspects of this multifaceted process.

First, is the diminished bargaining power of the trade unions. By the seventies trade unions had a membership amounting more or less to 30 per cent of the dependent workers. Currently, unionized workers are around 12 per cent of the labor force. Yet the most relevant component of the decline is the resulting membership composition. In the public sector unions continue to represent about 35 per cent of workers. But in the private sector, the unions' membership had dropped to 7 per cent. That is to say that 93 per cent of workers have neither union protection, nor collective bargaining.

So it is not a coincidence that in the last two decades, according to Lawrence Mishel of the Economic Policy Institute, "while productivity grew 80% between 1979 and 2009, the hourly wage of the median worker grew by only 10.1%".

In this gap we might recognize the powerful engine of the growing unfair distribution of revenues with the substantial stagnation of wages over the last decades, even though these were characterized by long phases of exceptionally strong economic growth.

The rough waning of the trade unions' power is a crucial element of growing inequality, but hardly the only one. We must consider the policy side of this process. Wages depend not only from the collective bargaining, but lacking that, they also depend upon the level and the dynamic of the legal minimum wage. The federal minimum wage was established by Congress in 1938. And it would have been updated according to changes in the standard of living and inflation. But over the last decades it was not the case.

Over the 1950s and 1960s the minimum wage varied in a narrow range around 50 per cent of the average wage. But in 2006, with the minimum wage set at \$5.15 per hour, it was reduced to only 31 per cent of the average wage, being in real terms the lowest in 50 years. Whether the federal minimum wage would have been indexed to the consumer price index, its value would have amounted to 8.40 dollars, according to EPI (October 2006). In 2011 federal minimum stands at 7.25 dollars per hour, but also at this level, the national minimum places a family of two below the official poverty threshold.

The growing inequality is well shown by some simple figures, whether we consider that "the richest 1% of Americans received 56% of all the income growth between 1989 and 2007... compared with 16% going to the bottom 90% of households (L.Mishel and H. Shierholz, *The sad but true story of wages in America*, EPI 2011).

In this framework there is no sense in blaming either technologic progress or globalization, so often indicated as the main causes of the ominous inequality in income distribution, for this harmful social gap. To explain the deepening and widening of inequality (with the creation of the new category of the "working poor"), it is worth noticing, aside from the uneven dynamic of wages,

some specific aspects of the social protection network, in Europe known as Welfare State.

To begin with, in the US there is no universal system of health care. The government is responsible for the assistance to the poor through Medicaid and to people aged 65 and over through Medicare. All other citizens depend upon private insurance, generally provided by the firms where an individual works. But not all companies provide health insurance. And not all workers are able to get an insurance policy that, for a family of four, costs on average 12,000 dollars annually. In 2010, about 45 million people lacked health insurance. So, if confronted with an important illness, families face growing debts. The paradox is that in the US the health care's overall cost is more than 16 per cent of the GDP (even after the Barack Obama's reform) against a half of this figure in most European countries where health insurance is universal and free.

Last but not least, unemployment insurance has been historically considered by conservatives a way to make workers lazy, since they can avoid the need to adjust to market realities. Insurance is blamed by conservative ideology as a violation of a free labor market that is a condition for a sound and dynamic economy. So, when a worker is sacked, it is not certain that he will get the unemployment benefits, given that there are a lot of eligibility conditions to comply with.

The outcome is that a huge number of the unemployed lacks any benefit. In any event, the benefit generally amounts to 40 per cent of previous earnings and is granted for a maximum of 26 weeks. Faced with a situation of long-term unemployment, the extension of these benefits has to be decided by law in a framework of unavoidable harsh opposition by the conservative part of the Congress. It is not a coincidence that at the end of 2010, president Obama to prolong unemployment benefits for millions of the long term unemployed was forced, against his previous commitment, to reconfirm in its entirety the Bush's tax reduction, preserving an additional bonus to the richest two per cent of Americans.

This aspect of social policy is particularly ruthless during a harsh crisis, like the current one, with 14 million unemployed and 45 million Americans currently dependent upon food stamps -renamed Snap (Supplemental nutrition assistance program) – worth 130 dollars per month in 2010, insufficient to provide an acceptable minimum of food for millions of families.

The need of a different diagnostic

To conclude, let us come back to our issue. Due to the great inequality in the wealth and income distributions, huge indebtedness is an ordinary social condition of most families. It is also worth considering that indebtedness has even become a necessary condition for US economic growth. Households' debts had grown from 66.1 per cent to 99.9 per cent of GDP over the decade to 2007. The increasingly indebted families were seen as the "consumers of last resort" to keep the economy going. At the same time total debts in the US economy had reached more than 350 per cent of GDP (Robin Blackburn, *The subprime crisis*, p.65).

There is also a difference within the quality and function of indebtedness. Banks and other financial entities in search of easy profits, stemming from the proliferation of increasingly sophisticated and flawed financial products, are indebted to one another, are also using a shadowy secondary banking system to hide much of their exposure. In this sense the financial system makes up a parallel, virtual world distanced from the real economy. In this fractured landscape households' debts, consisting in mortgages, credit cards, automobile debt and so on, end up as the propelling engine of economic growth. In other words, without families' growing indebtedness consumption demand would have dropped sharply and the economy would have been essentially stagnant.

So it is unsurprising that Alan Greenspan, after the 2001 financial bust, continued keeping low interest rates, convinced that, notwithstanding the

growing mortgage indebtedness, the housing boom was a necessary condition to support the growth of the economy while at the same time increasing the American families' wealth through booming house values.

Dealing with these structural aspects of economic growth and its ill-redistribution does not mean obscuring the impact of the largely glorified financial dislocation of the American economy, which was also a crucial component of both two boom and bust in the course of the last decade. But recalling the social structural sources of the crisis allows the identification of two interlinked roots of the current crisis: on one hand, the impact of the growing inequality within the American society and, on the other, the ruinous inconsistency of the ideology of market efficiency, married with the retrenchment of the politics and the State functions. These are two roots basically stemming from the same unique neo-liberal ideology that has dominated policy over the last decades.

This different diagnostic, aimed at going behind the financial market dysfunctions to encompass the social and ideological aspects of the crisis, is not a pure academic stance. The policies that American and European governments are adopting in the aftermath of the crisis depend in large measure on the diagnostic about the origin of the current crisis. If we consider that the problem just requires us to make some corrections in finance regulations, we must know that this is necessary, but insufficient and misleading.

Concluding his last essay, J. Stiglitz notes that "the failures in our financial system are emblematic of broader failures of our economic system, and the failures of our economic system reflect deeper problems in our society". Then he adds that "The Washington consensus policies and the underlying ideology of market fundamentalism are dead" (*Freefall*, pagg.295-296). While the former proposition is indubitably well-founded, the latter looks rather optimistic. Old neo-conservative ideology is hardly out of game. The painful

experience of President Obama and the Republicans' strong return show that the hope for new "New Deal" is far from a reality.

In any case, it is true that the correction of the deep social imbalances, stemming from the dominant economic model in the western countries during the last decades, needs a vastly renewed political platform. If we are not able to cope with this intellectual and political challenge, we risk a deep and maybe irreversible decline of old Western countries vis a vis the new so called emerging ones. It is not surprising that countries like China, India, Brazil and others increasingly appear to be destined to become the key players in the XXI century's globalization process.

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