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The financialization approach in the financial crisis

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Abstract:

This paper maintains that the analysis of the credit system global insolvency process reached in the Q4 of 2008 and Q1 of 2009 gives important lessons for understanding the ongoing conditions in the accumulation regime. For this reason, this work exposes the main insolvency conditions which became general in those months. This insolvency moment shows us that the securitization process, as a key source of financial system liquidity and the main way to clean-up the banks balance sheets, was deeply damaged, but not death. The changes of the financial accounting rules was only option to confront this high stress moment of the crisis, in order to avoid the general collapse and to restrain the massive assets devaluation, in the Q1 2009. In the second part of the paper it is maintained that the structured finance are an important characteristic of the accumulation regime called financiarization, and although the bankruptcy of the structured finance puts in evidence its limitations. The present global financial crisis does not necessarily imply the landslide of this regime that has been very effective in the economic concentration.

Introduction

Eric Hobsbawm, the famous English historian titled few weeks ago his article in The Guardian ñSocialism has failed. Now capitalism is bankrupt. So what come next? Its answer is simple and forceful: ñThe future, like the present and the past, belongs to mixed economies in which public and private are braided together in one way or to anotherò (Hobsbawm, 2009)

The global economic and financial crisis that explodes in 2007 has triggered the alarms in the economic ideas field, encouraging the debates on the policies and strategies of development, on the course that maybe take the capitalism to the 21st century. This crisis could be a deeply break in led finance capitalism model? But, which is the real reach of this historical cut that the crisis denotes? Which is it significance, for the finance-led capitalism?

This paper maintains that the analysis of the global credit system insolvency process reached in the Q4 of 2008 and Q1 of 2009 gives important lessons for understanding the ongoing conditions in the accumulation regime. For this reason, this work exposes the main insolvency conditions which became general in those months. This insolvency moment shows us that the securitization process, as a key source of financial system liquidity and the main way to clean-up the banks balance sheets, was deeply damaged, but not death. The changes of the financial accounting rules was only option to confront this high stress moment of the crisis, in order to avoid the general collapse and to restrain the massive assets devaluation, in the Q1 2009. In the second part of the paper it is maintained that the structured finance are an important characteristic of the accumulation regime called financialization, and although the bankruptcy of the structured finance (credit derivatives plus shadow banks) puts in evidence its limitations. The present global financial crisis does not necessarily imply the landslide of this regime that has been very effective in the economic and finance concentration.

1. Insolvency of the global credit system (Q4 and Q1)

Before the outbreak of the global crisis, very few academic and expert had noticed about the grave consequences of the structured finance. Although some processes had given evidence of the fragility that produce the derivative instruments, such are the cases of: the bond crisis in the United States in 1994 (Borio and McCauley, 1995); the Asian crisis of 1997 (Kregel, 1998); the financial frauds of the Enron era (Aglietta, 2004); the exponential growth of the credit derivatives (Liu, 2004). Either more theoretical-analytical studies, like for example its consequences on payments system (Perold 1995) or the risk of securitizations over the financial stability, or the financial frauds (Correa, 1998, Toporowski, 2000, Partnoy, 2003)

The new dynamics in the financial markets that enclosed the last 30 years economic transformations were incorporated into the analysis through a thematic studies like: the external debt of the developing countries and the 80s debt crisis; the developing countries external debt securitization and the Baker and Brady Plans; also the analysis of the 90s financial globalization. Whereas the authors of the regulation theory coined the concept of finance capitalism or finance led-capitalism or financialization (Chesnais, 1996, Aglietta, 1998, Epstein, 2005, Serfati, 2009, Guttmann, 2009)

This global financial crisis was within the theoretical universe of the regulation theories (De Bernis, 1988) Within the framework of postkeynesian analysis the financial crisis were deeply analyzed in Minsky works (Minsky, 1982) Although the instability and the financial crisis were largely studied for this school of thought, the development of the structured finances did not represent singular modifications to their studies but until very recently. (Epstein, 2005, Wray, 2007) Nevertheless, Minsky (1987) warned about securitization:

> ñSecuritization implies that there is not limit to bank initiative in *creating* credits for there is not recourse to bank capital, and because the credits do not absorb high-powered money [bank reserve].ò

The monetarism flying against inflation created the market trends towards securitization:

> Securitization reflects a change in the weight of market and bank funding capabilities: market funding capabilities have increased relative to the funding abilities of banks and depository financial intermediaries. It is in part a lagged response to monetarism. The fighting of inflation by constraining monetary growth opened opportunities for nonbanking financing techniques. The monetarist way of fighting inflation, which preceded the 1979 ñpractical monetarismò of [thenï Federal Reserve Chairman Paul] Volcker, puts banks at a competitive disadvantage in terms of the short-term growth of their ability to fund assets. Furthermore, by opening interest rate wedges, monetary constraint provides profit opportunities for innovative financing techniquesé
> Bank participation in securitization is part of the drive, forced by costs, to supplement fund income with fee income. The development of the money market funds, the continued growth of mutual and pension funds, and the emergence of the vast institutional holdings by offshore entities provide a market for the instruments created by securitization. (Minsky, 1987)

Securitization came from the US market and hand by hand with the globalization, looking to add new profitable assets around the world for the appetite of the looking-for-a-rent institutional investors managers

> There is a symbiotic relation between the globalization of the worldôs financial structure and the securitization of financial instruments. Globalization requires the conformity of institutions across national lines and in particular the ability of creditors to capture assets that underlie the securities. (Minsky, 1987)

The securitization is for Minsky one step to possible changes in money, which could be private money

> Securitization throws light on the nature of money: *money is a financial instrument (a debt) that develops out of the financing of activity and positions in assets and becomes generally accepted in an economic community as a means of payment for goods and services and as an instrument by which debts are discharged*. It is conceivable that in the not too distant future we could be using $100 interest-bearing short-term securities as currency. Private money is a distinct possible future outcome of current developments. (Minsky, 1987)

Towards 2007 the subprime crisis soon reached other assets with high quality mortgage underlying and to other securities linked to autoloans or credit cards; including credit derivatives as CMBS, CDO and CDS. The deregulated securitization was created an opaque, fragile and disproportionate financial order, operating a volume of instruments never seen before, away from the central banks and the government regulators control, and with amounts over the volume of the commerce and the world-wide production.

The financial crisis arrived at the end of 2008 to one of its most difficult stages (and not necessarily the last one). Even though, it should not forget that from 3Q 2007 were appearing severe credit constraint episodes and bankruptcies. From those months of 2007, the toxic assets in the portfolios of the special purpose vehicles of Citigroup and others large banks began to lose money. Thus, although the bankruptcies of Lehman and the insuring AIG in September of 2008 trigger the worse episode of credit constraint, until now, it cannot be said that the all the financial crisis comes from the ñmistakeò of the American government to let break Lehman.

In fact they were a little more than 6 months in which the news of bankruptcies and rescues were interweaved with others. IndyMac Bank, saving and mortgage bank, with 32 billion dollars in assets claimed the law of bankruptcy in August of 2008, the deposits were guaranteed by the FDIC; Merrill Lynch, U.S. investment bank with assets of 1,01 trillion dollars, went to bankruptcy in September of 2008 and bought by Bank of America with support of the government; Lehman Brothers, U.S. investment bank with assets of 789 billion dollars broke in September of 2008; Washington Mutual, U.S. bank with assets of 307 billion dollars, broke and was bought by JP Morgan in September of 2008; American International Group, the large U.S. insurance Group with assets of 1,01 trillion dollars, was rescued and partially nationalized in September of 2008; Freddie Mac and Fannie Mae, U.S. mortgage banks with assets of 1,6 trillion dollars, broke and were nationalized in July 2008; Citigroup the largest US bank with assets of 2,2 trillion dollars in March of 2008, after successive capitalizations by sovereign funds in 2007 and the US government, finally is nationalized partially in February of 2009.

In Great Britain and Europe, the bankruptcies also were triggered quickly. HBOS, Halifax Bank of Scotland, with assets of 681 billion pounds went to bankruptcy and is bought by Lloyds with the help of public funds, in October of 2008; the UK bank Royal Bank of Scotland with assets of 1.9 trillion pounds was partially nationalized in October of 2008; Lloyds with assets of 1,1 trillion pounds was partially nationalized in March of 2009; the German bank Hypo Real Estate Bank with assets of more than 400 billion euros was nationalized in April 2009; the Swiss bank UBS with assets of 2.2 trillion of swiss francs the government take 9.3% of stake; Financial Fortis group with bank and insurance services, has been the greater organization rescued in Europe until now, with assets of 2,15 trillion euros, was partially nationalized by the governments of Belgium, Holland and Luxembourg in September of 2008.

The banks writedowns amount from mid 2007 until 2010, in a favorable scene, 2.5 trillion dollars according to recently IMF report, Global Financial Stability Report (April, 2009). The investment funds assets fell 12% during 3Q 2008 to less than 22 trillion dollars (according to the estimations of Investment Company Institute).

The Central Banks and the governments have been clearance billion dollars since 2007, especially in the United States, but also in Europe and the United Kingdom. The FED and the U.S. Treasury has destined until March of 2009, 2.2 trillion dollars in different programs from rescue and capitalization, although these programs are engaged 9.9 trillion dollars in different financial support programs. The Bank of England has spent 850 billion dollars and the European central bank (ECB) an 850 billion dollars, to which it must add the amounts, although smaller, coming from the treasuries of each one of the European countries towards their own banks. In addition, the central banks were opened swaps among themselves, and the IMF opened new loans program for the developing countries governments, whose treasuries and central banks also participate in the global bailouts. Nevertheless, the greatest relief was the change in accounting standards implemented at the end of Q1 2009 that had slowed the losses and the deterioration of asset prices

The globalization of the structured finance explains the magnitude and deepness of the financial crisis, which really was born in the US mortgage stock market. The structured finance talks about the combined action of the instrumental and operative innovation that changed the basic operation of the financial markets. Thus, structured finances makes reference to all that process of credit securitization and the reborn of derivatives instruments at the 80s and the credit derivatives at the 90s, which became with the reborn or creation *ex profeso* of financial organizations like the special purpose vehicles, or monoline insurances, or preexisting like hegde funds, the mutual funds, the investment funds, the large funds of funds, investment banks, and other institutions that the literature gathers as shadow banks. Others of the fundamental actors in the explosion of structured finance were and continue being the rating agencies, ranking in opaque instruments, without market or with a very restricted market.

The structured finance pushed the financial deregulation and liberalization, creating markets all around the world with the force of the credit expansion, generating very lucrative businesses. This globalised financial market, in spite of the large number of participants in the different segments of the market, is supported by a small number of large financial conglomerates, which went into successive writedowns, and capital losses. The crisis came because the fall in the prices of the assets underlying by real estate, and later many others, but also because the reduction in the market liquidity which is depends of the securitization expansion.

In this point, it no longer mattered how fast the central banks reacted in lowering the interest rates, but directly how much would accept to buy (or how much it was financial and political feasible to do it) securities that even came losing price and market. Nevertheless as it were noticed for more than 15 years by diverse scholars, due to the assets volume thus created by the structured finance, the opacity intrinsic and characteristic of its operations, the action of the central banks against a systemic crisis is extremely limited.

From the first crises generated by the operation with derivatives at the beginning of the 90s, like Procter and Gamble, or the Orange County, the financial authorities has facing the problems giving funds and trying to obtain that the large financial conglomerates of the derivatives OTC market put in operation measured of self-control and self-supervision. In spite of the magnitude of the crisis, in the debates about the market restructuring and regulation, the same ideas prevail: to obtain funds and to persuade to self-regulation.

The financial crisis contained all the operation of the structured finances for a while, it was not like in other crisis episodes, like in a corporative sector crisis, or a country or group of countries, or a type of instrument or a small (relatively) group banks. It was globalised quickly and it found the central banks worried to maintain restrictive monetary policies; the governments worried to maintain the affection of its voters; the markets with a financial resources in operation very over any macroeconomic parameter; the firms in the road of the financialization (its profits depending of their treasuries); and the employees families with stagnant or declining income and in many countries overindebtment.

As argued in the next section, the current crisis is knocking down significant segments of the structured finance operation, and it is not yet very clear the way that can take the reform of the financial systems. The huge and growing area of businesses for capitalism which were unlocked by the structured finance continues to stand in several of its segments, at least until now. Because several of their segments continue transferring resources, even less, which are helping to alleviate, albeit partially, the insolvency situation that became general in Q4 2008 and Q1 2009. Among others, those are: the margins on interest rates; the government budgets; the workers saving funds; the rising labor productivity; the reduction in workers incomes; the increasing exploitation of natural and energy resources; the renewed speculation in the traditional business of arbitrage in commodities and currencies.

2. Continuity and change in the accumulation regime

The newspaper Financial Time opened in March of 2009 a special series on the future of capitalism where it express the great fear that the crisis leads to the abandonment of the free market, leading to protectionism and to a renewed inflationary statism that only exacerbate the economic problems. However, also other voices emerge that attribute the crisis to the financial intermediaries and to the regulatory authorities and that reiterates the importance of the regulation. Free markets advocates are concerned about the new force who acquires their main critics.

Critics have questioning the free market model, the neoliberalism and even the viability of the finance accumulation regime or the neoliberal led-finance model or the model based on the consensus of the globalization. (Wade, 2008) Or as Serfati (2009) argue, this crisis stressed the internal limits of the financialization of accumulation regime. Thus, it considers that: ñWe have reached the point of systemic crisis. More precisely, capitalist evolution is confronting with its own `internal' limits - the periodic coming of crisis of overproduction and overaccumulation, with high levels of unemployment.ò

The analytical framework of finance led-capitalism recovers, thus is still of a descriptive and initial way, a distinctive feature of the capitalist accumulation today. To use the words of Serfati (2009) ñFinance capital are specific social relations which give claim's owners the right to collect revenues (interests, dividends, fees coming from Intellectual property rights,é) which in last resort, can only sees drained from value created in production and non-market wealth (land, accumulated knowledge)ò

It is for that reason that in this analytical framework, this crisis is particularly serious, because it prevents or slows down, even temporarily the mechanisms of profit formation. The financial way of formation of the profits of the corporations and financial groups are at the heart of the crisis. It happens in the US, Europe and Latin America. It is not just the problem of toxic assets free fall prices, but also the most important source of business and profits for transnational companies, investment funds, banks and, until recently, the investment banking. Moreover, dominate the operations of mergers and acquisitions. (Vidal, 2002 Vidal, 2008, and Vidal, 2009). It also means the increase of corporate financing with own funds, it could be said the placement of shares, treasury management and other means of securitization.

Corporations have changed the composition of its shareholders growing the interests of the investment companies (Plihon, 2003). As it emphasizes by Guttmann when being characterizing the capitalism lead by finances or with financial domination, ñthe fast growth of these called *institutional investors* in the last quarter of century has turned to them into the main shareholders of great companies in the entire world. They frequently use their property rights to impose the based financial logic in the quarterly income by action like the measurement that defines the yield (Guttmann, 2009:22). The addresses of the firms do not doubt in the aggressive management of cash resources, in the placement of multiple securities, making liquids other no-liquid assets, inventories, future sales, etc. In growing by means of the merges and acquisitions, streamlining the acquired assets and generating new financial resources from them.

The financialization advances in US, UK, Europe corporations, as well to Asia and Latin America, as a means of centralizing the profits. The crisis in Latin America has also created a strong contraction for large Latin American corporations that are funded abroad. The need of foreign currency grows because the domestic operations of foreign corporations, investment funds, pension funds, hedge funds. In this context it is relevant the relations of each Latin America economies with other countries and regions and the differences in the composition of the financial systems.

On this basis, it could be question: Are we in course of a change in the accumulation regime? , Are we facing the limits of the financiarization model? , or even is it the end of the globalization? They are questions that put under a crucial test the theoretical model, or the set of conceptual instruments whereupon Marxist, regulationist, and postkeyensian have been analyzing the transformations in the capitalist economies and the financial systems over the last 30 years.

One of the key transformations of this liberalized, deregulated and global capitalism has been the deepening of the finances in the profits formation, and therefore of the wide ñdependencyò of the finances, for the formation and distribution of the profits, the wealth and the political power. For this reason, this financial crisis cast into doubt not only the viability of banks and global finance, the mechanisms of huge centralization of the wealth until now, but also of the existence and reproduction of fortunes and wealth thus expressed and highly concentrated as financial assets.

On the other hand, this deregulated capitalism, also called neoliberal deeply transformed the government institutions constructed during the stage of the ñgolden ageò capitalism, this transformation not only implies changes in the assets property, high concentration, new mechanisms of profits formation, but also changes in the state institutions. Some were dismantled by the very deregulation, others were renewed, or many others replaced by formulas of ñprivatizationò from the basic services, health, education, national security and justice.

We do not have an answer to the simple question posed by Eric Hobsbawm at the beginning of this paper. But his simple answer opens up a whole of possibilities.

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