RESEARCH ON MONEY AND FINANCE

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Research on Money and Finance Discussion Papers

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Carlos Morera Camacho, School of Economics (Facultad de Economía), National Autonomous University of Mexico (Universidad Nacional Autónoma de México—UNAM). José Antonio Rojas Nieto, Institute of Economic Research (Instituto de Investigaciones Económicas). This essay is part of a bigger study currently under way on the “The World Financial and Oil Markets, 1997-2007”. It has benefited from critical observations by Costas Lapavitsas, particularly with regard to credit. The development of the database and the figures received support from Lidia Salinas Islas, Isaac Torres and Iván Mendieta.

Research on Money and Finance is a network of political economists that have a track record in researching money and finance. It aims to generate analytical work on the development of the monetary and the financial system in recent years. A further aim is to produce synthetic work on the transformation of the capitalist economy, the rise of financialisation and the resulting intensification of crises. RMF carries research on both developed and developing countries and welcomes contributions that draw on all currents of political economy.

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1. The transformation of the world economy

The world economy has experienced thirty years of dramatic changes, deriving from the profound economic turmoil that followed the oil crises of 1973-74 and 1980-1981, the collapse of ‘actually existing socialism’, and the transformation of China. Global and generalised restructuring took place as a result of these developments. Gradually new characteristics emerged in a world economy including, first, predominance of financial capital subject to dollar hegemony; second, strong dynamism and new characteristics of the world financial sector; and third, intensified articulation between national financial markets and monetary systems. To a large extent these characteristics flowed from the deregulation and liberalisation measures implemented initially by the United States and the United Kingdom between 1979 and 1982. But the majority of industrialised and developing countries have followed suit.

What has emerged is the consolidation of an international financial space through which practically all national financial processes are obliged to pass in an articulated manner. This imperative also applies to national productive and commercial activities. Without a doubt, major technological changes have sustained these transformations. Modern microelectronics and the internet have enormous capacity to maximise volume and minimise costs of transmitting information. Technical changes have made structural transformations possible and gave them momentum.

The transformation of world capitalism has further been sustained by numerous and substantial changes in the processes of work, which have typically meant generalised attacks on workers’ conditions. Without a doubt some of the most important changes experienced by capital in the last three decades correspond to both waged and unwaged labour (Munck, 2002 and Anderson, 2006). These have included, first, substantial changes in production technologies, particularly control and automation of processes; second, the extension of so-called temporary layoffs;
and third, proliferation of flexible forms of hiring. Workers’ conditions have been adversely affected through prices rising faster than wages, falls in money wages, worsening conditions of social security, layoffs, old age provision and retirement, and finally, business insolvencies and bankruptcies (Moseley, 2007:2-3; Gill 2002:643-644).

Nevertheless—as demonstrated by the extremely critical conditions of 2008-9—global capital has not succeeded in re-establishing the rhythms of growth and profitability that characterised the early post-World War II era. On the contrary, the effects of continuous restructuring during the last thirty years have been asymmetrical on production and circulation. This asymmetry has intensified since 1998—in favour of circulation. The current crisis comes at end of a boom in the US economy that lasted for nearly ten years, and which—as is now apparent—was prolonged far beyond what was justified by its true foundations. The (relatively artificial) boom actually rested on an unprecedented expansion of credit to government, to businesses and to US households. To establish this point, consider the following aspects of the US economy.

2. The restoration of profitability and the performance of the US economy

Marxist theory identifies profit as the engine of capitalism, and asserts that the rate of profit tends to fall as a result of intensified capital accumulation relative to the generation and appropriation of surplus value. However, the process is complex since, on the one hand, there is a tendency for the rate of profit to fall but, on the other, there are substantial increases in the mass of profit. These two different movements make disputes among all the factions of capital more controversial and violent (Marx, 1976).

The performance of the US economy can be analysed in line with the evolution of the rate of profit. The crisis and stagnation phase of the US economy in the 1970s were based on a fall in the rate of profit by approximately 50% from 1950 to 1970.
(Moseley 2007). There was further fall of 30% in the following decade (see Figure No.2 below).

Figure 1 - US: Productivity and real wages in manufacturing 1980-2008, 1992=100

Calculated from Federal Reserve Bank of St Louis data

Figure 2 - US: Oil price change, rate of profit and interest rate 1965-2009
(Annual percentage levels)

Calculated from IMF and Energy Information Administration data
The recovery of the rate of profit began in 1981, based on intensified exploitation of labour. Nevertheless, the circumstances of exploitation have also changed. The changes in the labour process were expressed in what is known as deterritorialisation—the relocation of the production process to other areas of the world economy where wages are lower—which was promoted in the 1990s. However, the major strategy for restoring the rate of profit in the United States was financialisation, based on an increase in international debt and over-expansion of credit. Three moments stand out in the evolution of international debt: first, the United States becoming a net debtor, beginning in 1986; second, the arrival of crisis in Southeast Asia; and third, the impact of financial crisis of 2001 on the markets.

In the second half of the 1990s, the prices of raw materials, fuel and energy were relatively low. Interest rates were at their lowest since World War II. Substantial increases in productivity took place in the USA (see diagram 1 above). Consequently, there was an impressive recovery of the profit rate in the United States, thus expressing improvements in the overall profitability of the world economy. However, dramatic and violent increases in the prices of the raw materials, fuels and energy followed soon after. On the other hand, and in contrast to past experience, interest rates not only remained low but tended to fall.

As a result, many mainstream economists concluded that the boom at the end of the 1990s was a landmark. Apparently, the US economy had left behind the long stagnation that began in the 1970s, and opened a new period of high economic growth, increased employment, inflation reduction and moderate increases in wages. Yet, the crisis of 2001 showed that things were different, and recession established itself once again. Recovery, beginning in 2002, was slow, and growth in jobs lagged behind output. The dynamic of job losses and insufficient employment opportunities to absorb new labour supplies has been extraordinarily severe. Profound transformations have ensued across the spheres of the world economy.
(real sector), as well as in the financial and commercial system (virtual sector) and in technological development (Lapavitsas, 2008).

The international credit crisis that began in August 2007 has revealed the magnitude of the transformations that have taken place not only in banking but in all forms of capital and the state. The crisis itself was the result of an enormous expansion of mortgage loans, some of which were granted to the poorest and most oppressed sections of the working class (Lapavitsas, 2008:40). Borrowers were heavily black and Latino, giving to the crisis a racial dimension (Dymski, 2008:14-25). US and European banks were heavily affected by the collapse in the value of the mortgage-backed securities that they had created, and which turned out to be a significant portion of their assets. The resulting insolvency provoked a credit crisis, and the initial reaction of financial institutions was to hoard funds, thereby intensifying the crisis.

3. The Mexican and Asian financial crises of the 1990s, and the subsequent evolution of finance

The roots of the recent crisis and of the evolution of finance in the 2000s are to be found in the Mexican crisis of 1995 and the Southeast Asian (Thailand, Indonesia, Malaysia, and Philippines) crisis of 1997-8. Both crises evolved in similar fashion. They began with a devaluation of the local currency as a result of high trade deficits, which had reached serious levels because of the link of the currencies to the dollar in the first place. This was followed by short-term capital flight and collapse of weak financial markets.

As a result, there was strong contraction of credit and a severe drop in production, to say nothing of the brutal increase in the cost of public foreign debt. There was also a sharp rise in private sector debt (banks and enterprises), which in the case of Mexico was transferred to captive taxpayers and to fiscal revenue from oil profits. Simultaneously there was withdrawal of short-term foreign and domestic
investments and insolvency of local banking systems, which in some cases led to the collapse of both banks and national companies.

The Mexican crisis and the so-called “tequila effect” were contained. This can be attributed to several factors including, first, support from the United States, which was at the time experiencing considerable economic strength; second, the U.S. origin of the bulk of private capital flows to Mexico, which prompted immediate support by the Clinton administration (Morera, 1998 and 2002); third, the trade links of Mexico with the United States, in contrast to the intense trade interdependence among the affected Asian economies; and fourth, the deepening of the privatisation process in telecommunications and transportation, and even in areas forbidden by the country’s constitution, specifically oil and electricity.

In the case of Southeast Asia, the private and fragmentary character of the economies tremendously hindered negotiations on how to deal with the crisis. In addition, the mechanisms of contagion in the Asian region were heavily located in the productive and commercial spheres, given that the development strategy of these economies since the 1960s was to orient themselves toward foreign markets. For Thailand, Indonesia, Malaysia, and the Philippines, as well as China in 1997, approximately 50% of their trade was regional, and a similar proportion of this regional trade was with Japan. South Korea was also strongly affected and entered a recession (Chesnais, 1999: 9-10). In addition, Russia’s external bankruptcy occurred in mid-1998, and subsequently Brazil (UNCTAD, 1999: 59,71-72).

Following the Asian crisis, the international banking system became more closely articulated with both the private and public sectors of these countries. The new relationships included easy terms of refinancing agreed with the national banking systems in these countries. Debts did not disappear but rather increased as the crisis was expressed as a drop in production, trade, and employment. Asia accounts for a third of world trade and during the 1990s it represented the only region that experienced sustained industrial growth, together with the United
States. It is precisely in this region where most U.S. industrial exports are sold. In 1998, contraction in production and trade affected the U.S. economy and spilled over to countries that export raw materials, including oil.

However, in 1999 oil prices began to rise, partly due to the tremendous dynamism of China and India, and partly due to the low margin of production capacity in relation to the levels of world demand for crude. Consequently, capital flows deriving from oil profits as well as from savings in emerging economies began to flow toward developed countries and particularly the United States. This allowed the US economic cycle to go beyond what the internal savings rate would have permitted. And it also provided finance for the enormous U.S. deficit. (BIS 2003, 2005 and UNCTAD 2005).

Against this background, global financial liberalisation and the ongoing technological revolution fostered an unprecedented financial boom after 1998. At the same time, it became impossible for monetary authorities to carry out monitoring and evaluation of financial conditions. (NYT, 2002). This boom reflects the powerful development of banking and non-banking financial institutions across the world. The close articulation of these institutions with the world financial center (the United States) is the reason why the “momentary” crash of key debtors in the late 1990s actually translated into further increases in international banking assets. There was further global financial expansion after 1998, and conditions were created for an even greater crisis.

Underlying the phenomenal expansion of finance during the last ten years has been the relentless liberalisation of interest rates, financial activities and international capital flows. But note that the share of commercial banks (and savings institutions) in the total volume of loans has been declining. During this period, as was mentioned above, technological innovation became more intense in the areas of telecommunications and information, as well as in the new systems, processes and instruments used by financial institutions. The financial sector in
the USA made the most intensive use of technological information, as measured by relative spending on computer equipment and software.

Consequently, the activities of major US (and British) banks during the last two decades have shifted away from meeting traditional demand for loans on the part of industrial and commercial corporations. Banks have developed profitable lines of lending to individuals as well as drawing income from a wide variety of fees charged (see figure No. 4).

These developments have had a strong impact on credit distribution and the socialisation of credit risk, thereby introducing new elements of fragility in financial markets, which emerged sharply in 2008 (Lapavitsas, 2008: 42).
4. The role of stock markets

Stock markets played a decisive role in the crises of 1997-8 as well as in the subsequent recovery of finance, and it is important to examine them more closely. The stock market is at the heart of fictitious capital, which takes the form of financial assets, both stocks and bonds.¹ In this market the speed of transmission is almost instantaneous, making it even more difficult to foresee crises. As a rule, falls occur after phases of calm and recovery, and they can be local or regional, as in Asia in 1997-8, or worldwide, as in the USA after 2008. The collapse of Wall Street in 1997 was avoided by massive share buybacks by large conglomerates.

But the crisis of 1997-8 also revealed the consequences, limits, and contradictions of financial liberalisation, dominated by large investment funds (pension funds and mutual funds), major transnational corporations, international banks and state debt. A key pillar of this international economy of capital-money valorization is the secondary capital market, which generates increasing volatility and instability (Bannock y Manser, 2003:333). The origin and formation of fictitious capital is to be found in this market, through the issuing of securities, the formation of large companies via equity, and the immense accumulation of financial assets.

During the 1990s the US economy exhibited considerable dynamism and was able to promote innovative companies, particularly in the “new” fields that encompass information technologies and biotechnologies. This was also expressed in the stock market sector, taking the NASDAQ index from 400 points at the beginning of the decade, to a peak of 5000 points. The speculative bubble was particularly acute in 1999-2000. When it burst, the NASDAQ was brought down to slightly more than 1,000 points. To date the index has not recovered the levels reached in 2000. (see Figure No. 5)

¹ Karl Marx, Capital, Vol. III, Section V: 511-531.
Speculation, as a phenomenon characteristic of contemporary capitalism, tends to be interpreted as an aspect of the “casino economy.” But the crises discussed above are not only the result of the inherent instability of financial markets. Rather, they can be attributed to slow growth and endemic overproduction throughout the 1990s, which spilled over into the crisis of the U.S. economy in 2001 (See figure No. 6).
Moreover, fictitious capital is a property title and, in the course of the development of capitalism, property rights are continually reallocated. Mergers and acquisitions were pronounced in the 1980s, up to the crash of 1987. They recovered in the 1990s and evolved to their historic peak in 2000. Following the collapse of Wall Street and NASDAQ in 2000, mergers and acquisitions again recovered their dynamism, particularly after 2004. It appears that the process of capital concentration (mergers and acquisitions) is cyclical, and historically occurs in periods of calm, following crisis and the recovery of the economy. As concentration takes place, it brings changes in the control of capital and rearranges financial powers, thus affecting world economic conditions on all levels.
5. Foreign direct investment, mergers and acquisitions, and the rising power of transnational companies

The new financial structure that has emerged encompasses complex processes formed by actors and instruments of a very diverse nature, both in terms of their origin and their operations. They include large companies and investment banks specialising in the issuing and placement of securities; mutual funds (small and medium investors); hedge funds (companies specialising in speculative short-term operations); pension funds (workers’ retirement savings); insurance companies and treasuries of the transnational companies. The new structures developed in a contradictory manner. On the one hand, they cheapened credit but, on the other, they created new elements of instability, such as greater dispersion, volatility, and capital speculation. In the emerging Latin American markets, for instance, they initially cheapened credit, but later made it more expensive. But there is no doubt that the so-called globalisation of financial markets has led to an extraordinary transnationalisation of the holdings of debt securities.

The result of this process was that foreign investment emerged as the predominant form of capital transactions on an international scale. The relationship between foreign direct investment and portfolio investment has varied in the past 25 years. In 1981, fully 19% of the annual flows of private investment were portfolio investment. However, the 1990s were characterised by growth of capital flows toward developing economies mostly through institutional investors engaging in speculative investment and intensifying the volatility of these economies. Simultaneously, foreign direct investment by transnational companies grew. In the second half of the decade foreign direct investment became the predominant form of capital transactions, undertaken by transnational companies and international financial groups in the form of mergers, strategic alliances and privatisations.

From 1993 to 1998 developing economies received 35.3% of total foreign direct investment, the highest percentage in the past two decades (UNCTAD, 2002, p. 7).
This figure is even more significant if we consider that the total flow of foreign direct investment throughout 1990-1995 remained at an annual average level of slightly more than $225bn. However, in 1996 the figure rose to $386bn, and in 1997 to $478bn (Sturgeon, 2002; UNCTAD, 2002, p. 303). During 1995-1998, developed countries channelled an annual average of 50% of these flows toward mergers and acquisitions, while the corresponding figure for the developing countries was 31%. During this period, the figure became double what it had been during the first half of the decade (UNCTAD, 2002, pp. 33, 306 and 337).

Latin America was the most important recipient of foreign direct investment aimed at mergers and acquisitions throughout the entire decade. Its annual average during the entire period was approximately 57.5%. A total of more than $196bn was earmarked for mergers and acquisitions, and most of these resources ($125bn) were invested during 1996-8 in Brazil, Argentina, and Mexico. During this period, South Asia (India) and East Asia (China, Hong Kong, Taiwan), as well as Southeast Asia (Indonesia, Republic of Korea, Philippines, Singapore, Thailand, and Malaysia) also witnessed significant mergers and acquisitions ($44bn). The largest volume of such resources was directed toward China, Hong Kong, and South Korea. Nevertheless, the greatest volume of mergers and acquisitions was registered in 1999-2001, when investment almost doubled ($82bn).  

The coming together of productive, financial, technological and organisational factors altered the profile of transnational corporations and gave them the greatest power they have ever had in the world economy. Their percentage share of the world GDP rose from 17% in the mid-1960s, to 24% in 1982, and to more than 30% in 1995. In that year there were 39,000 transnational companies (including more than 4,000 in developing countries) that already dictated the course of the world economy, with 270,000 subsidiaries abroad (of which 119,000 operated in developing countries). At present there are 60,000 transnational companies with

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2 Figures were calculated based on statistical information from UNCTAD, 2002.
800,000 subsidiaries. But the degree of concentration and centralisation of capital is even greater if we consider that the 100 largest transnational companies (not including banks and financial companies) controlled a third of foreign direct investment. During 1988-1995, 72% of these flows went to mergers and acquisitions of all types which, together with strategic alliances, were the international transactions that grew the most rapidly.

6. Extreme weakness of US industry in the late 2000s

During the past two decades the behaviour of U.S. industry (representing almost a third of the world total) has been very uneven. From 1991 to mid-2000, industrial production rose continuously at an annual average real rate of approximately 4.6%. Nonetheless, beginning in 1998, industrial production grew at increasingly lower rates, and during the first few months of 2001 at negative rates. Only in mid-2002 (almost 18 months later) did rates of change become positive again. And it was not until the beginning of 2004 that the level of industrial production reached again the levels of the half of 2000. In all, US industrial growth stagnated for three and a half years. The retreat and stagnation of industry during a period of almost forty months was reflected in two indicators: first, in the stagnation of industrial capacity for almost thirty months (see Figure No. 6); and second, in the severe fall of capacity utilisation (Morera y Rojas 2008: 112-113)

In December 2008 the level of industrial production in the USA was equivalent to that in the summer of 2004. Compared to December 2007, the drop was nearly 8%. This was the biggest fall in US industrial production since the spring of 1975. US industry currently stands at the level of five years ago and presents the dynamism of thirty five years ago—a difficult predicament. Meanwhile, capacity utilisation dropped to 73.6%. At its highest, between 1968 and 1973, years of unrestrained growth, capacity utilisation in the USA stood at nearly 90%. In the 1980s the average level of utilization was above 80%, and at times it was almost 5% higher.
In the autumn of 1982 US industry experienced one of the worst falls in its history but still managed to recover. Nevertheless, capacity utilisation dropped to a mere 72% at the end of that decade, while in the 1990s—in the winters of 1995 and 1997—it achieved maximum levels of 85% during certain months. From 1998 to the present, US industry was never able to return to those utilisation levels, even with the dramatic expansion of credit in the 2000s, which stretched production beyond its real potential.

During the boom of the 2000s the maximum level of capacity utilisation level was registered at the end of 2006 and the beginning of 2007. From that time to 2009 there was not merely a deceleration but a clear decline. The level in December 2008, as was already mentioned, stood at 73.6%, which is worse than the drop at the end of 2001, but similar to the level registered in September 1982. That was the lowest level in recent US economic history, and furthermore, the most drastic decline since 1975. In short, the fall has been tremendous (Morera and Rojas, 2008: 112-113) (see Diagram 6).

7. Savings and investment on a world scale

The import of foreign direct investment, however, becomes clear only in the context of global savings and investment. Relative to world GDP, international savings and investment have progressively declined over the past thirty years. The share of industrialised countries in both savings and investment has remained dominant, but their share relative to world value added has declined steadily, falling from 26% in the 1970s to 20% in the new millennium. (Morera y Rojas, 2008: 101-102) At the same time, the emerging economies and oil-producing countries have boosted their share from negative or very small numbers to nearly 7% (see figure no.3).
Historically, money capital has flown toward developing countries as a result of savings in industrialised countries. This trend was reinforced by the activities of pension funds in industrialised countries coupled with international monetary flows. But this international circulation of money capital has been recently transformed by the rapid industrialisation of some developing countries as well as the growth of oil revenue in petroleum-producing countries. Indeed, emerging economies and oil-producing countries have played a strong role in generating world savings during three periods in recent years. First, at the time of the second oil shock, 1978-1982; second, at the time of the industrial boom in Southeast Asia, 1994-8; and third, after the recovery of oil prices in 2000-2007, and the industrial boom in China and India.

Nonetheless, savings and investment relative to world output remained on a downward trend since the beginning of the 1970s. They reached their lowest historical growth rates in 2002, and since then they have gradually recovered (see Diagram No. 3). At the same time, in emerging markets and oil-producing
countries a tendency toward increasing savings and investment began two decades ago, except for the years of the Asian crisis. After 2000 the participation of emerging economies and oil-producing countries in world savings took an ever greater importance, in view of booming oil prices and industrial development of China and India (Morera and Rojas 2008: 125, IMF-GFSR 2007, and UNCTAD, 2006).

Total savings and investment have doubled in the past twenty years. Specifically, during the past five years, savings rose by 50% and the savings rate reached 22.9% of world output. In broader historical perspective, world savings in 1965 amounted to nearly $4.43tr (in constant 2007 U.S. dollars, as for the rest of the figures in this section). They then fell but rose again during the oil boom of the 1970s, reaching almost $7.35tr in 1979, a rate of 24.7%. With the drop in oil prices and the debt crisis in 1982, world savings experienced a strong decline, falling to $5.36tr in 1983, a rate of 21.4%. In the course of the 1980s and 1990s savings began slowly to rise again, reaching $8.95tr in 1997, corresponding to 23.1% of world GDP. This fell subsequently and savings reached their lowest historical level in 2002, at $7.68tr and 20.5% of world output (Morera and Rojas 2008: 101-102).

Since 2002 savings have slowly recovered, reaching 22.9% of world GDP in 2007, standing at approximately $11.09tr. The recovery of savings in the 2000s was due to the emerging economies and oil producing countries, something unprecedented in the history of capitalism. It was also a result of the activities of pension funds in the USA, Great Britain and Japan (IFSL, 2007). Pension funds have played an important role in savings and investment partly due to regulatory changes that allowed entry of foreign capital in areas and countries previously closed. This led to proliferation of high-risk securities and financial assets (Morera and Rojas 2008: 107).

The circulation of money capital toward emerging markets is an expression of the international dynamics of savings, but also reflects the conditions of valorisation in
emerging markets, namely dynamic industrialisation and oil production. How did the world economy arrive at this position? It is possible that this outcome has a connection with the phenomenon of overproduction. However, for most economists, the catalyst of this development is the qualitative transformation of Asia, where savings have increased but investment has fallen abruptly since the end of the 1990s. This, in turn, has served to finance the enormous deficit in the US current account. Other economists also stress monetary and fiscal policies deployed by Asian countries. However, this does not explain why investment flows have been directed to the United States even though other emerging markets offer higher interest rates.

The important point is that the world financial system is structured under the hegemonic power of the dollar. This was established in the 1980s, when the United States reached agreements with representatives of other capitalist states, including the Plaza Accord and the Louvre Accord. It was strengthened in the 1990s when complex economic and political mechanisms were applied for the purpose of facilitating the handling of world money capital. This includes regulations and prudential interventions in the practices of the international banking system and financial markets. The Bank of International Settlements has played a vital role in this regard, centralising information and making international banks comply with accepted practices in financial markets. The role of the International Monetary Fund has been even more important, since it has influenced and designed the capital accumulation of entire countries through regulating access to liquid funds.

These policies account for the decrease in world interest rates that facilitated the recovery of international financial flows and the end of the crisis. This is also the context in which the behaviour of world savings has changed. Three major trends

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emerged in the past decade, as indicated by Jaime Caruana, director of the Monetary and Capital Markets Department of the IMF: first, increases in foreign capital flows, primarily toward emerging markets, second, the globalisation of financial institutions, and third, the globalisation of financial markets (Caruana 2007). That is the background of the dramatic increase in foreign capital flows (accumulation of financial assets with international investment banks, public and private debt portfolios, stocks and debt portfolios, loan portfolios, deposits and foreign direct investment). By April 2007, these flows had risen to $9tr, almost a fifth of world output (Caruana 2007:119).

8. The accumulation of US foreign debt and its impact on developing countries

The USA remained an international creditor until 1985, a position it had maintained since World War I. However, its strength as world creditor had been deteriorating for some time. From 1986 US foreign debt increased, and its liabilities continued to rise throughout the 1990s. At the end of 1996 US net debt had reached $456bn (including market securities). A year later the debt had risen to $776.5bn, equivalent to 13% of its GDP, and before the end of 2000 it had become $1.3tr, equivalent to 18% of its GDP, as is shown in figure 7.
After 1998 the volume of capital flows to and from the USA increased significantly. In 2004 debt stood at $2.2tr, though, as a result of the dollar’s devaluation in 2004, the net value of US liabilities decreased from 20.5% to 20.1% of GDP (Morera and Rojas, 2008: 116). Nevertheless, the dollar value of assets held by foreigners rose as proportion of US GDP. At the end of 2003 foreigners held assets worth 97% of US GDP, while in 2005 the proportion had gone up to 107.4%. The net inflow of foreign investment in 2004 and 2005 was much greater than the necessary sum to finance the deficit in the US current accounts, and the excess flowed back to the world economy.

There are significant asymmetries in the composition of foreign property in the hands of US residents compared to US property in the hands of foreigners. In 2005, for instance, 27% of US total assets abroad was direct investment (facilities and equipment), in contrast to only 19% of US liabilities in the hands of foreigners. Foreign investors in the USA tended to purchase negotiable financial assets (stocks, bonds, public securities and banking liabilities) that could be liquidated more easily than direct investments (Jane D Arista, 2007:14-15). A further major
difference is that the Federal Reserve and other entities in the US government invested insignificant amounts in other countries. In contrast, foreign public sectors had invested approximately $2.3tr in the USA in 2005, around 16% of total foreign investment. By the middle of the decade foreign public institutions had become important sources of capital flows to the United States.

Large flows of private foreign investment and rapid expansion in world liquidity were the result of monetary policies in industrialised countries in response to the recession of 2001 (BIS 2004). Abundant liquidity and low interest rates propelled a global search for greater returns. With a view to protecting profitability, the Federal Reserve increased interest rates after 2004 and reduced the rate on sovereign bonds, a process that lasted until September 2007. At the same time, securities markets in emerging economies were stimulated. Moreover, the Federal Reserve encouraged commercial loans in dollars in place of loans in yen, thereby renewing speculative interest in US financial securities. All these developments took place while the international system of bank payments continued to be dominated by a few currencies, above all, the dollar, the euro, the yen and the pound.

As a consequence of these trends, foreign portfolio investment in emerging economies reached high levels in the third quarter of 2005 (BIS, 2005c). The increase in liquidity in the United States, Japan and many emerging economies intensified in 2005. The plethora of capital spilled over into other national markets, and in some cases even returned to the markets where it had originated. Still, excess liquidity was spread throughout the world economy, encouraging growth of domestic credit in the USA and elsewhere.

The link between domestic and foreign debt was fundamental, since both have an effect on US and global demand. Rapid financial liberation in the 1980s and the relaxation of prudential norms for granting loans exacerbated domestic debt accumulation. US households went increasingly into debt during 1995-2005,
associated with a decrease in the rate of saving and increases in consumption. Aware of easy credit availability, consumers considered access to credit as a substitute for savings, especially after 2002, when debt was used both to acquire appreciating residential property and to extract liquidity for consumption. Enterprise also took advantage of low rates in bonds markets to apply for loans in order to repurchase bonds or stocks in the secondary market, thus strengthening their profitability.

In short, private capital was the driving force behind international capital flows and an important source of the expansion of credit in the USA. At the same time, excessive volumes of foreign private capital appeared, exacerbating investment flows out of the USA, and increasing liquidity both in the USA and the world market. Moreover, massive amounts of foreign government investments took place in the USA. For emerging economies, these trends had considerable repercussions, driving monetary authorities in those countries to intensify the level of intervention. The aim was to stop appreciation of domestic currency and contain domestic growth of money and credit. Consequently, the accumulation of reserves played a fundamental role in the process of expansion and contraction, creating further scope for generation of international liquidity (see Diagram 7).

To put it differently, the strategies used by the large private financial institutions dominating the international payments system to increase their profits also intensified the vulnerability of emerging economies. As more developed and developing countries freed their capital accounts in the 1990s, the value of their currencies came increasingly to depend on the operations conducted by financial among various financial instruments and markets, rather than depending on trade (Cornford, 2005). Changes in the differentials among interest rates denominated in different currencies became the driving force behind capital and foreign currency...

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4 Family debt increased from 65.7% of the GDP in 1995 to 92.1% at the end of 2005. Federal government debt, on the other hand, diminished during that same period from 49.2% to 37.2% of the GDP.
flows. Thus, the problems in monetary control world-wide were exacerbated (see figure 8).

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Figure 8 - Non-Stock-Market Credit by instrument, June 98 - June 08 (Total contracts)

Calculated from BIS data

The extraordinary increase in the reserves of emerging economies during the last decade points to the pressure to use surpluses from trade to create a buffer to diminish vulnerability to external forces (Painceira, 2008; BIS, 2008: 44-52). In order to undertake this policy emerging countries were obliged to lend their savings to developed countries, instead of investing in their own economies. In effect, countries with high rates of savings were obliged to accumulate idle money to cover imports and to service foreign debt in case of future financial crises.  

5 “Although foreign-exchange reserves held on the books of central banks provide support for expansions of money and credit in the domestic economy, monetary authorities in these countries must sterilize some or all of the buildup in reserves by selling holdings of domestic assets or issuing central bank liabilities to prevent overexpansion. Both of these sterilization techniques inhibit the growth and stability of domestic capital markets by constraining the central banks’ ability to support those markets.” (D’Arista 2007: 32)
Consequently, emerging economies lost some capacity to invest productively. They were obliged to concentrate massive reserves as a mechanism of compensating for the inflow of foreign capital. The massive accumulation of reserves strengthened their reliance on the dominant currencies, and particularly on the dollar, the main international currency (Lapavitsas, 2008: 43).

9. Conclusion

Restoring the rate of profit has been the focus of efforts by both state and by capital, since the crisis of the 1970s. Profound changes have taken place in the social relations of production between capital and labour for more than three decades. The scope of capitalist operations has been considerably broadened by the collapse of the so-called socialist regimes and the profound transformation of China. But a most striking development is that, under the predominance of banking capital and the hegemony of the US dollar, the strategy of ‘financialisation’ was imposed on all forms of capital.

Vital to ‘financialisation’ were changes in the labour force as well as a transformation of the state. The nature of work has altered and many of the social advances achieved in earlier periods were reversed, particularly in education, health services, and pension systems. New financial institutions, operating under the logic of private profitability, transformed the wage income of both productive and unproductive labour into financial assets. Workers were thus subjected to even greater exploitation. In addition, the state privatised strategic enterprises under its control, and allowed central banks to play a strategic role in determining interest rates and operating monetary policy. These transformations generated favourable conditions for placing great masses of savings in the hands of capital as never before, thus making it possible to expand credit to the limit. Large parts of this wealth came from developing countries.
The world economy has become integrated in different ways, also as a result of the immense social, political and cultural transformations that have taken place. But at present the world economy is once again in crisis, perhaps one of the worst crises in the history of capitalism. This is the first fully-fledged crisis of globalisation, or “financialisation”, with the United States at the epicentre. Despite the triumph of neo-liberalism in recent years, the crisis presents an opportunity to put alternatives in place and prevent a mere reorganisation of neoliberal policies and methods.
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