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On the Historical Significance and the Social Costs of the Sub-prime Financial Crisis: Drawing on the Japanese experience

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Introduction

The financial turmoil that started in the USA in August 2007 has become a global financial crisis, battering the real economy of developed countries, and fast becoming a world economic crisis. The term 'sub-prime financial crisis' is used in this paper to capture this entire process. Its historical significance is examined below in three separate but related ways. Section 1 considers the specific features of the sub-prime crisis particularly in comparison with the Japanese bubble of the 1980s and the ensuing crisis of the 1990s. Section 2 pursues the comparison further by discussing briefly the great depression that followed after 1929, and suggests reasons why the current crisis might not be equally severe. Finally, section 3 probes into the social costs of the crisis.

1 The Specific Features of the Sub-prime Financial Crisis and a Comparison with the Japanese Bubble

The historical significance and specific features of any economic crisis are always determined by the character of the preceding economic boom. Thus, the sub-prime financial crisis originated in the US housing bubble and the associated boom. To understand why this financial crisis has become so destructive for the US and the world economy, it is first necessary to examine the magnitude and character of the preceding US housing boom.

The US housing boom started in 1996, along with the New Economy boom, and lasted for about ten years. After the burst of the New Economy (or Information Technology) bubble in 2001, the housing boom became the main source of US economic recovery and growth, particularly from 2002 onwards. It is estimated that about 40% of the US economic growth in this period depended on the housing sector. [1]

The housing boom would have been impossible without the expansion of housing finance. In the USA housing loans are divided mostly into prime and sub-prime, the latter being typically loans to people of lower income and with low creditworthiness. More concretely, sub-prime loans are made to people with a record of delayed repayment on past loans, or an estimated FICO credit score of under 660 (this is a credit scoring system initiated by Fair Issac Co. with a maximum score of 900), or even debt repayments comprising more than 50% of their income.

In the past people classed as sub-prime were typically excluded from housing loans. But after 2001 there was rapid growth of loans in the USA, and especially sub-prime loans. The result of growth in lending was to push house prices steadily up, until by 2006 their level was double that of 1996. Total outstanding

[1] Kaneko and DeWit (2008), p.9.

US housing loans reached $13tr (almost equal to GDP) at the end of 2006. Within that volume of debt, the proportion of sub-prime loans increased rapidly, especially after 2001. By 2006 subprime loans represented 20% of the flow of new housing loans. At the end of that year, the stock of subprime loans amounted to $1.7tr, or 13% of the entire stock of housing loans. [2]

Some simple calculations can further convey the relative magnitude of the sub-prime loan expansion. The typical size of sub-prime loans is around $200000, and they have been obtained in the USA by roughly 8.5mn households (or more than 25mn people). [3] Further, assuming that the average size of a housing loan is about $400000 dollars, the total volume of housing credit in the USA at the end of 2006 ($13tr) was taken up by roughly 32.5mn households, or about one third of the US population. In contrast, total outstanding housing loans in Japan in 1993 (soon after the burst of the bubble) were estimated at ¥141tr (about 29% of GDP). Given that the average housing loan stood at ¥27.4mn in 1992, the total housing debt in Japan referred to roughly 5.1mn households, or 12.3% of the population. [4] It is clear that US housing loans in general, and sub-prime loans in particular, far exceeded Japanese housing loans in the course of the bubble of the late 1980s.

Nonetheless, the Japanese bubble was big enough to cause major capital losses, rising to more than ¥1400tr during the 1990s (including falls in prices of shares and real estate). But it is important to bear in mind that the housing market was only a part of the bubble. There was also a speculative boom in the stock market as well as in real estate. In contrast, the US economic boom that preceded the current crisis occurred in two relatively distinct waves. The first was the swell and burst of the Information Technology (IT) bubble, mainly in New York stock exchange in the late 1990. The second was the housing boom and its burst, which followed in the 2000s.

[2] Mizuho Research Institute (2007), p.69, p.77.

[3] Japan Cabinet Office, Policy Planning Room (2007).

[4] Itoh (2006), chap.6

Pursuing the comparison with Japan further, there was a further common factor to both Japanese and bubbles, which eventually led to their burst. Namely, there was abundant availability of money funds that could be easily mobilised for speculative trading. In the course of the long downturn that began in the late 1970s big businesses have become increasingly reliant on self-finance. Consequently, banks and other financial institutions in advanced countries have found themselves in possession of funds that could be used flexibly in fields other than industrial activity. For banks and other financial institutions this has meant advancing funds for consumer credit, housing loans, and speculative trading in real estate and various securities. Against this background, monetary policy that lowered interest rates also tended to ignite speculative trading in real estate and securities, as happened in Japan following the Plaza accord of 1985 and in the USA after 2001.

A further common factor to both bubbles was the use of IT for speculative financial trading, including housing loans. The development of IT has facilitated rapid estimation of the schedule of return payments with variable interest rates, as well as swift financial transactions and flexible expansion of banking credit. In US finance, in particular, IT was applied to deriving credit scores for individuals as well as to designing and maintaining hybrid housing loans that had 'teaser' rates of interest during the initial years thus attracting workers with lower income. Information technology also made possible structured securitisation of housing loans and the subsequent spread of securities across the world.

There were, however, two political (and institutional) factors that facilitated the swelling of the US housing boom. First, the neo-liberal policies that lifted regulations on financial transactions also made possible the introduction of housing loans with flexible 'teaser' rates of interest. Second, the Community Reinvestment Act (1977) (encouraging banks to recycle a certain part of household savings in local community areas) and the Alternative Mortgage Transaction Parity Act (1982) (preventing discrimination against lower income persons' living areas in housing finance) facilitated the advance of sub-prime loans. Such loans appeared as an innovative policy to promote urban renewal through the mobilisation of private financial funds. Thus, financial businesses took advantage of the democratisation of financial services, which was thought to be an achievement of the civil rights movement since the 1960s. This unfortunate and paradoxical development led to aggressive expansion of housing loans to people on lower incomes, eventually resulting in disaster.

To place this development in a broader context note that, in the long historical process of capitalist development, the financial system has functioned mainly as a set of social mechanisms that mobilise idle money to serve purposes of accumulation by capitalist enterprises. However, in the twentieth century, saving by working people, including pension funds and insurance payments, has been increasingly incorporated into the social mechanisms of the financial system. Similar considerations apply to consumer credit.

Credit for consumption has been traditionally provided by pawn shops and loan sharks (a carry-over from the pre-capitalist era) as well as by consumer credit companies. These mechanisms of consumer credit have been relatively small and marginal to the modern banking and financial systems. However, as large enterprises became increasingly reliant on self-finance, formal financial institutions have had fewer opportunities to lend to non-financial enterprises. Thus, major banks and other financial institutions began to expand consumer credit and especially housing loans to working people, gradually advancing toward lower income layers. In this sense, the commodity of labour-power has become increasingly financialised.[5] This tendency was clearly present in the course of the Japanese bubble, but has been enormously exacerbated during the recent US housing boom. Banks and related real estate agencies have aggressively tempted workers to borrow by dangling the prospect of capital gains in the course of the US housing boom.

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[5] This notion is essentially similar to Lapavitsas (2009), for whom financial expropriation of wage workers is central to the financialisation of contemporary capitalism.

Note, though, that the Japanese bubble was financed mostly by funds drawn domestically from high household savings that stood around 15% of GNP. The US housing boom, in contrast, had no comparable domestic source of funds as the savings of US households were extremely low. Thus, it was financed through global fund-raising via securitisation of mortgages. Consequently, financial practices in the US housing market were quite different from the earlier practices of Japanese banks, and even of the US Saving and Loan Associations (S&L) in the 1980s.

During the 1980s the lending model for US financial enterprises that undertook mortgage business (typically S&L) was 'originate-to-hold'. But during the recent boom the main originators of mortgages were mortgage companies that did not accept deposits and proceeded to sell their loan. The buyers were typically Special Purpose Vehicles (SPV) owned by big commercial and investment banks. After acquiring these mortgages SPVs combined large numbers of them into mortgage backed securities (MBS) that were then sold to other financial institutions. Banks also originated mortgages that were then taken off the balance sheet through sale to SPVs established for the purpose. This is the substance of the 'originate-to-distribute' model.

Through these techniques the US housing loan market was structurally doubled: the first layer comprised original lenders (typically, mortgage companies) and household borrowers, while the second included financial institutions that distributed mortgage-backed securities across the world. These new practices freed the original lenders, such as the mortgage companies, from the limits imposed by deposits as a lending resource, and encouraged banks to seek non-deposit funds, thus leading them to wholesale borrowing in the money market. It also appeared to free banks from credit risk (individual default) and interest rate risk (fixed interest rates on housing loans but fluctuating rates on deposits).

This mode of operation characterised the US housing loan market since the middle of 1990s. There were no mechanisms of this type in Japan when the speculative bubble in housing emerged in the late 1980s. This explains why the collapse of the US housing market - subprime and other - became the source of a global financial crisis, whereas the burst of the huge Japanese bubble had essentially localised effects. By the same token, Japanese banks as holders of mortgages suffered mainly due to the deterioration in the quality of their loans following the burst of bubble. But after the US bubble burst, the effects spread far and wide as falls in the prices of mortgage-backed and asset-backed securities damaged the balance sheet of a broad array of financial institutions. These include, in addition to commercial banks, hedge funds, insurance funds, pension funds, security companies, and investment banks.

This difference is an important reason why US authorities initially committed public funds to purchasing or guaranteeing mortgage-backed and other securities from various financial institutions. In contrast, Japanese authorities injected public funds mainly into the equity capital of major banks. It was only after the crisis became deeper that the US government redirected its rescue operations of banks to include direct injection of public money into bank equity.

The Japanese (and German) financial system is often contrasted to the US (and UK) financial system. The former depends more on indirect finance (or 'originate-to-hold' banking credit) while the latter depends on direct finance (or 'originate-to-distribute' credit operating through the securities market). In recent years the view prevailed that US-UK are superior to Japanese-German methods. One apparent reason is that competitive securities markets are more transparent, rational and efficient in allocating money funds compared to indirect banking credit that relies on personal relationships (even resulting in crony capitalism) and private information. Such views gained credibility during the housing boom, as the US system of securitising loans successfully mobilised global funds to feed credit demand and house prices continued to rise.

Unfortunately, there was no real basis for the theory (or belief) that the risks contained in housing loans - including sub-prime loans - could be dispersed and objectively reduced through mortgage-backed securities. In reality the risks contained in mortgage-backed securities were not at all transparent, and became even more obscure due to misleading grading by credit rating agencies, such as Standard and Poor's or Moody's. Thus, in June 2007, two hedge funds attached to the giant investment bank Bear Stearns failed due to losses in subprime mortgage-backed securities. This set in train a rapid process of downgrading more than a thousand mortgage-backed securities by Standard and Poor's and Moody's. About six months after the end of the housing boom, the real risks contained by mortgage-backed securities issued in the USA and held across the world were suddenly revealed.

In 2007 there were roughly $700bn of sub-prime mortgage-backed securities, $600bn of (slightly better quality) 'Alt-A' bonds, and $390bn of Collateralised Debt Obligations (CDOs) [6] circulating in the global financial markets. In the summer of 008 Fannie Mae (Federal National Mortgage Association, FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation, FHLMC) went into serious crisis, and were virtually nationalized in September. These enterprises guarantee almost half of prime US housing loans. It then became clear that the quality of loans across the whole of the US housing market had seriously deteriorated. Thus, the securities generated by that market began to deliver destructive blows to global financial institutions in entirely unpredictable ways. The world financial markets entered a minefield, regularly reporting huge losses and running the risk of bankruptcy.

The sub-prime financial crisis has shown that the neo-liberal belief in market efficiency is without foundations, especially regarding financial markets. At the

[6] CDOs are securities that are backed by mortgage-backed securities and other consumer credit, such as automobile loans.

same time, it has forced a rethink of the supposed superiority of the US (and UK) over the Japanese (and German) financial system. Once the speculative bubble in the housing market had burst, the US financial system spread disaster across the world, causing major instability domestically and globally. In contrast, the Japanese crisis remained largely local, affecting mainly, and most severely, the banking sector. By the same token, the injection of public funds in the financial institutions of the US and Europe may have different results from Japanese policy in the 1990s and 2000s. The current financial crisis is likely to prove more difficult to confront. The Japanese economy went through a decade and more of stagnation (with almost zero growth after 1991), but the current crisis might cause severe falls and longer depression in major economies.

2 Once in a Hundred Years?

In May 2007, at a time when the sub-prime problem was clearly in the offing, OECD (2007) predicted a slowdown of the US economy. It thought that this would not herald a period of worldwide economic weakness but rather a 'smooth' rebalancing of the global economy, with Europe taking over the baton of growth from the United States. This was called the 'decoupling scenario'. This expectation was obviously built on the experience of previous speculative bubbles – for instance, the burst of the Japanese bubble after 1990s, the Asian crisis in 1997-8, and the burst of the US New Economy bubble in 2001. These had relatively limited and localised effects, and were even followed by bubbles elsewhere in the world.

Unfortunately, this scenario failed because of the specific features of the sub-prime financial crisis, which meant that it could not remain local. The sub-prime crisis is now turning into a vicious world economic crisis in a 're-coupling scenario'. The merry-go-round of bubble-crisis-bubble in successive parts of the world has broken down. As the destructive force of the sub-prime financial crisis became apparent, Allan Greenspan, the former Chairman of the Federal Reserve

Board, called it a 'tsunami'. The Japanese prime minister, Taro Aso, followed Greenspan's lead and stated that the world finds itself in a financial crisis that happened once in a hundred years. These statements seem to reflect the real threat posed by the current world economic crisis.

The question inevitably is: will the destructive force of this crisis prove greater than that of 1929? In brief, the crisis of 1929 occurred at the end of a US economic boom, became progressively deeper over the next three years in the USA, entailed a fall of share prices of almost 90%, caused nine thousand bank failures in three waves, led to a rise in the unemployment rate to 25%, and resulted in a decline of GDP of about 46%.[7] In its wake came a severe deflation spiral, a world agricultural crisis, the breakdown of the gold standard that had been restored in the 1920s, a contraction of international trade because of formation of trading blocs, and general devastation in economic life across the world. Are we approaching a similar, or even greater, economic breakdown through the current financial crisis? This fear began to spread among international financial and business circles as sharp falls in share prices took place in 2008.

The possibility that such devastation would occur again can be no longer ignored. In itself this is a contemporary manifestation of the inner contradictions of the capitalist economy. But the issue has to be approached cautiously. There have been several financial crises during the last two decades, most prominently the burst of the giant Japanese bubble of the 1980s, the Asian crisis of 1997-8, and the burst of the New Economy bubble. They have involved the meltdown of financial assets, the value of which relative to GDP was comparable, or even larger, to the great crisis of 1929. Yet, none - and this also holds for sub-prime financial crisis at the time of writing - brought a collapse of the economy through mutual destruction between finance and the real economy. Conditions are different from 1929, and the current financial crisis has to be seen in appropriate perspective.

[7] Takumi (1994, 1998) presents a detailed analysis of the Great Crisis following 1929.

Consider the following four factors that could lessen the impact of the current crisis relative to 1929.

First, following the initial shock of 1929, the gold standard restricted the flexibility of both fiscal and monetary policy by fixing exchange rates and forcing countries to hoard gold reserves. The formation of trading blocs subsequently accelerated the decline in world trade. In contrast, the system of floating exchange rates currently frees major countries from the need to keep reserves of international means of payment. This provides room for flexible operation of fiscal and monetary policy. Thus, it has become possible to inject enormous amounts of public funds to rescue banks and other financial institutions, following the Japanese methods of the late 1990s.

There is no doubt that injecting public funds into financial institutions mitigates the danger of acute collapse of the world economy, particularly when combined with emergency fiscal and monetary policies in the USA. At the same time, these policies tend to increase budget deficits and raise the burden of public debt for several years, thus contributing to persistent economic stagnation, as experienced in Japan. Furthermore, large US budget deficits can be financed only through a huge expansion of international debt, thus raising the spectre of a fall in the value of the dollar. This makes it necessary for the US government to seek international political cooperation to avoid a collapse of the dollar as well as creating a new international monetary order.

Second, in the course of the great crisis of 1929 monopoly capitals in major countries rapidly reduced production and employment in order to maintain monopoly prices and profits. This behavior is characteristic of monopoly, and generally exacerbated the macroeconomic performance of major economies at that time. But under current conditions, the monopolistic malady is not nearly so evident. Even the largest enterprises are operating under global competitive pressure, and are finding it difficult to sustain monopoly prices and profits in their domestic markets. This lies at the root of the difficulties that the Big Three in the US automobile industry are currently facing. Thus the collapse of output and employment by big enterprises would probably be less severe than 1929, and mostly the result - rather than the cause - of the decline in consumer demand. Moreover, and as was mentioned above, large multinational enterprises have become increasingly self-financed. Consequently, their business activities might not suffer a heavy direct effect from the constriction of credit due to the financial crisis. On the other hand, smaller and medium enterprises that depend heavily on banking credit have suffered badly in the course of the crisis.

Third, and related to the first two, the destructive impact of the financial crisis on employment and real wages in the industrial sector remains milder than in 1929, though it is becoming increasingly severe. Worker savings, insurance, pensions, and social security, including unemployment benefits, have supported worker consumption to some extent, though with rising anxiety for the future. At the same time, the rise in unemployment, the cuts in working hours, and the reductions of wages among workers will probably allow capitalist enterprises flexibly to reduce their costs in the face of crisis.

Fourth, in the age of globalisation, the economic vitality of developing countries, for instance, China and other Asian economies, has been greatly enhanced. Their success has depended on continuous mobilisation of cheap labour, supported by direct investment by multinational enterprises from abroad. Transfer of economic surplus from developing countries through trade, investment, and finance serves directly or indirectly as a cushion to mitigate the economic crisis in the major developed countries. Imports of cheap consumer goods, for example, help to lessen the difficulties brought by economic crisis for working people, though they also press wages in a downward direction.[8] Finally, the

[8] The theory of unequal exchange by the dependency school, including Emmanuel (1972), is worth re-reading from this point of view.

accumulation of oil revenues during the period of high oil prices, subsequently recycled through the international financial markets, has also worked to mitigate the financial crisis, though it also promoted the speculative bubble in the previous period.

These factors taken together have, for the time being, mitigated the sub-prime financial crisis and made it less severe that the 1929 crisis. However, this effect cannot be regarded as absolute and everlasting. It is not clear to what extent these factors can resist the intrinsic self-destructive tendency of contemporary finance. Much will depend on the interaction between the real economy and finance, and the mutual damage inflicted. The danger would be that the severe pressure on enterprises and the state would then be transferred to working people. At the very least, the gap between rich and poor would probably increase across the world, as would the numbers of the working poor.

3 The Social Costs

Neo-liberalism has been the dominant policy framework in advanced capitalist countries since the 1980s. It draws on neoclassical microeconomics and believes in the efficiency of competitive and unregulated markets. Consequently, it has promoted privatisation of public enterprises as well as deregulation in various areas, including the financial sector. In particular, global emphasis has been placed on the presumed efficiency of US-type finance, based on securities markets. Therefore, it should be noted emphatically that the current sub-prime financial crisis has occurred not due to an external shock, such as an earthquake or war, but largely due to the internal motion of the US financial system itself.

The consequent economic losses are clear evidence that neo-liberal beliefs in market efficiency as well as in the apparent advantages of US-type finance are false. The economic losses have several aspects and may be defined as the social costs of the sub-prime financial crisis. The notion of social cost generally comprises a variety of phenomena, such as externalities imposed on a third party or society as a whole, macroeconomic losses from failure to attain optimal allocation as well as costs due to public policy. Although the total social costs of the current financial crisis are far from definite, the following four aspects can already be identified, particularly when the earlier experience of the Japanese bubble is borne in mind.

First, there are economic losses on the part of mortgage debtors. More than 2mn foreclosures has taken place in the USA already by 2007. For these debtors thrown out of their houses, past payments on loans as well as expenditure on house durables have been totally wasted. These losses have hit mostly low income borrowers in the subprime category. But even prime mortgage borrowers have suffered in terms of declines in both asset prices and incomes. As housing prices fall, the market value of a house could become less than the mortgage debt and yet, repayment is demanded even for the capital losses.

Following the burst of the bubble in Japan, house prices in the 1990s fell by more than a half in some metropolitan areas. From the point of view of the debtors, continuous repayment of the corresponding housing loans had no equivalent – it was in vain. In the USA the pace of house price decline is already faster than that of the 1929 crisis, and the fall could finally exceed the drop of 26% reached at that period. [9] Given that the total volume of US housing loans is roughly equal to GDP, the payments made in vain by debtors over a period of years could reach one third of current GDP. This would make an enormous social loss, without even considering the costs of foreclosures.

Second, there are vast capital losses due to price falls of a broad range of securities – mortgage-backed securities, asset-backed securities, shares, and so on - across the world. Following the burst of the Japanese bubble, total capital losses from share prices were estimated at about ¥500tr, roughly equal to Japan's GDP

[9] Kaneko and DeWit (2008), p.22.

at the middle of the 1990s, and this is without including similar capital losses in real estate. [10] It remains to be seen whether the total capital losses in securities in the USA and elsewhere will currently reach similar proportions relative to GDP. But there is no doubt that their absolute size will be several times bigger than the Japanese losses of the 1990s.

What can be said about the implications of capital losses in securities, shares and real estate, particularly from the standpoint of the labour theory of value? To a certain extent, such losses might be offset by gains made during the preceding boom, but there is no guarantee that they would exactly balance out. On the other hand, the price falls that occur during the burst of a bubble operate as a pure loss for individual workers, enterprises, and society as a whole. It is true that a part of these capital losses remains latent as long as assets are not actually sold, and this is an aspect of the fictitious estimation of asset values. Moreover, when capital losses are actually realised through the sale of securities, the possibility exists that others might gain through such transactions. Even so, the net result is most probably negative, making this a non-zero-sum game. Understanding the social dimension of the (negative) value of such capital losses remains a thorny theoretical problem.

For the Marxist theory of value, the living labour that is embodied in the social total products per annum forms the substance of value that is newly created. This is distributed between the capitalist class (including landowners and rentiers) and wage workers. It is possible that some part of the value produced is lost due to the difficulty of realizing it in the markets (being unable to sell or selling commodities below normal prices). However, capital losses for society would not necessarily be related to, or correspond to an unrealised part of the value produced by annual living labour. Rather, the volume of capital losses is likely to be much larger.

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[10] Itoh (2006), chap.6.

It is probable that such capital losses signify, first, the destruction of part of the stock of claims on accumulated past labour and, second, the redistribution of the flow of income arising out of annual living labour. This is theoretically different from, but reminiscent of the 'moral' depreciation of machinery, that is, the social destruction of accumulated labour-time in machinery when more efficient technology in one industry becomes the social standard. In an economic crisis it is possible that such a destructive blow can take the form of capital losses in securities, shares, and real estate prices (as a devaluation of fictitious capital, to use Marx's term). This would impose (directly or indirectly) changes in the distribution of the annual flow of income as well as probably reducing the aggregate flow.

Irrespective of its impact on the size and distribution of income, a drop in securities prices certainly imposes losses on banks and other financial institutions. Under Basle II regulations on capital adequacy (introduced in 2004 by the Bank of International Settlements, BIS), the Current (or Fair) Value Accounting System has become the global standard for banks. This fits with the practices of securitised financial markets since it incorporates current estimates of the value of bank shares. It is also another example of imposing US-type financial practices across the world in an attempt to provide a more transparent environment within which to undertake risk management. The impact of these regulations has been damaging to banks because rising (but latent) capital losses have made it difficult to maintain capital adequacy ratios. The regulations have worsened the impact of the subprime financial crisis.

Japanese banks suffered greatly in the 1990s from the earlier Basle I regulations on capital adequacy, imposed by BIS in 1987. These regulations required that banks should maintain a capital adequacy ratio of at least 8%. They prolonged the crisis in Japan by worsening banks' ability to advance credit to small and medium enterprises. In short, BIS regulations, both I and II, have been ineffective in preventing the burst of bubbles and rather worsened the ensuing banking crises.

At the same time, it has to be noted that banks and other financial institutions, including institutional investors, currently manage not only the money funds of capitalist enterprises and the wealthy, but also savings and pension and insurance contributions by the mass of working people. Since large proportions of these funds are invested in shares and other securities, it is probable that capital losses and associate failures by financial institutions would also greatly affect working people. The potential costs are an important reason why the injection of public funds to rescue the financial system has not elicited stronger opposition by working people.

Third, public money used to rescue banks and other financial institutions is a type of social cost. In the USA, for example, the Bush administration eventually succeeded in passing the Financial Stability Law at the beginning of October 2008, allowing it inject up to $700bn into the financial system. This is about equal to the total volume of Japanese public funds (¥70tr) injected into the banks in the 1990s. This took place mainly in the form of equity to allow banks to meet the regulations of Basle I. In some cases the funds functioned as a kind of subsidy aimed at restructuring failed banks by effectively nationalising them, only to re-privatise them subsequently. This was the case, for instance, for the Long-Term Credit Bank of Japan, which became Shinsei Bank, and for Nippon Credit Bank, which turned into Aozora Bank. In other cases, however, the bulk of the injected public funds were returned to the state as the economy recovered after 2002, and following rationalisation and mergers among banks. Nevertheless, roughly ¥10tr remains uncollected, and that is a pure social cost. As public funds in the USA are largely used to buy problematic securities from banks, it is possible that a proportionately larger social cost would result as these securities become progressively worthless.

Funds committed under the Financial Stability Law, however, do not cover the whole of the public funds expended by the US government and the Federal Reserve Board in the course of the current crisis. According to one report, the

USA has pledged up to $7.7tr to ease frozen credit markets. [11] This includes $3.2tr already tapped by financial institutions as well as $2.4tr committed by the Fed to intervening in the commercial paper market. The total of committed funds runs to about half the size of the US GDP, and is nine times what the USA has spent so far on wars in Iraq and Afghanistan. It is probable that a significant part of those funds would also be lost through default or deterioration in the prices of securities, thus being shifted onto the shoulders of tax payers.

More broadly, the UK and several other EU countries have been committing public funds to rescuing financial institutions. This passes under the name of international cooperation with the aim of preventing a worsening of the current financial impasse. Through injection of public funds, several banks and other financial institutions have effectively been nationalised, or are close to submitting their management to public control. This development is completely contrary to the theoretical precepts of neo-liberalism, and actually runs closer to socialist arguments about managing the capitalist economy than even to traditional Keynesianism.

Fourth, there are also social costs caused by the destructive effects of the sub-prime financial crisis on the real economy. These are hard to estimate but are plainly vast. They include, for instance, a fall in profits and revenue of capitalist enterprises, a fall in production, and a rise in idle capacity and idle resources more generally. It is predicted, for instance, that growth rates in the major economies will fall in 2009, and become mostly negative. For the OECD as a whole, such falls would range from 1.4% in 2008 to –0.3%; for the USA, from 1.4% to –0.9%; for Japan from 0.5% to –0.1%; and for the Euro area, from 1.1% to –0.5%. [12] A significant part of the costs imposed by these developments - both for the individuals involved and for society as a whole - includes the ensuing rise in

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[11] Pittman and Ivery (2008).

[12] OECD (2008), No.84.

unemployment. It is likely that this will become greater as the real economy is progressively hit harder. The Director General of the International Labour Organisation, for instance, announced in October 2008 that unemployment across the world was likely to increase from 197 million in 2007 to 210 million in 2009. He also stressed that this was a tentative estimate that may well turn out to be too low. [13]

In conclusion, the sub-prime financial crisis has clearly signified the historical limits of neo-liberalism and showed the need to bring three decades of neo-liberalism to an end. At the same time, the crisis has also revealed the fundamental instability and contradictoriness of the capitalist economy, and cannot be attributed to mere mismanagement, or wrong economic policies. Neither the Japanese type of indirect finance, nor the US type of direct finance was able to prevent the disastrous swell and burst of huge bubbles. Under the dominance of neo-liberalism, the capitalist economy has been largely freed from social control and regulations, especially in the field of finance. Financialisation of labour-power advanced headlong.

The current crisis has shown that neo-liberal theories and policies are deeply problematic. However, it is not yet clear what theoretical approaches can offer well-founded alternatives. Keynesianism should not be the only other approach contesting the field. Radical political economy, based on Marxist theory of money, credit and finance, finds in the current crisis an opportunity to test and develop its ideas and proposals. [14] It could also propose alternatives to neo-liberalism that serve the interests of working people more successfully than alternative ideas emanating from the mainstream.

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[13] ILO, Press release, 20 Oct. 2008, (Reference: ILO/08/45), http://www.ilo.org/global/About_the_ILO/Media_and_public_information/Press_releases/lang--en/WCMS_099529/index.htm

[14] Some of these ideas were put forth in Itoh and Lapavitsas (1999).

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