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## **Bubbles, risk, crunch and war**

By Cyrus Bina and Fernando Dachevsky

*Cyrus Bina, distinguished research professor of economics at the University of Minnesota and author of The Economics of the Oil Crisis, discusses with Argentinean journalist Fernando Dachevsky the "unique and universal" economic crisis confronting the world, from its underlying causes to the "practical joke" solutions offered to the oil crisis by President George W Bush and Republican presidential candidate John McCain.*

**Fernando Dachevsky:** In your opinion, what are the actual magnitude and perspectives of the current economic crisis?

**Cyrus Bina:** The present economic crisis is both unique and universal. It is unique in that it expresses concrete contradictory dynamics of capital accumulation and its manifold contingent effects that are violently overflowing from one sector of the economy, namely the subprime mortgage industry in the United State, through the so-called structured investment vehicles and hedge funds which ultimately feed into the new infectious domain of fictitious capital, known as "securitization" - to the remaining realm of economic activity worldwide.

Here, the concrete magnitude of the crisis is not only a new chapter in the actual history of modern capitalism but also speaks loudly on the real meaning of transnationalization of capital and its global transmission in today's interconnected world.

This crisis is immanently universal in its effects and in its manifestation. It is about the polarization of wealth and, by implication, polarization of class, and the simultaneous tendency toward international and intranational dissonance and thus worldwide standardization of the working class. Let me take this occasion to reiterate that in modern capitalism, value theory is not only a theory of price formation but also simultaneously a theory of class polarization. The common feature of the system, aside from hitherto evolutionary stages, is one of renewal and destructive creation.

Although there have been a number of avoidable circumstances in this debacle - for instance, [through] careful regulation of the subprime housing market or precise legal guidelines for "securitization" of risky financial assets - the bundling of the "collateralized debt obligations" with the so-called asset-backed commercial paper, which leads to awesome turnover of capital based on ad hoc creation of fictitious credit upon fictitious credit (that is, IOU upon IOU) for the purpose of rapid profit gains and little or no cushion for security - [there] is also the question of deliberate stretch that, in turn, jeopardized the safety of the entire financial system.

The classic definition of what is known as risk (that is, calculated risk) refers to a phenomenon that should effectively lend itself to calculation based on the probability theory and thus a known probability

distribution prior to its occurrence.

However, the unconstrained piling up of risk upon risk is the stuff of uncertainty as opposed to risk which does exhibit non-linearity with chaotic patterns and which would not readily submit to probability theory, thus defying the conventional probability calculation. Therefore, for future references, both the individual agents and private and public institutions in this case need be alerted to actions (or inactions), policies (or lack thereof) that are gravely replete with unintended consequences - on top of what [Joseph] Schumpeter aptly identified as "instability of capitalism."

By focusing on a handful of the world's largest banks - from US investment banks such as Merrill Lynch, Citigroup and Morgan Stanley to others including HSBC, UBS, IKB Duetsche, Credit Agricole, Credit Suisse, Deutsche Bank, Canadian Imperial and Societe General - one can clearly see that the write-downs of risky securities (that are so far in tens of billions of dollars) will certainly continue for quite sometime. In the first quarter of 2008, the profit of big investment banks on stocks, bonds, and syndicated loans tumbled by more than 45%.

This experience has now opened a revealing window to the fully developed concept of fictitious capital, a phenomenon that in its embryonic stage was identified by Marx nearly 150 years ago. Today, the role of "fictitious capital" is either confused with the creation of surplus value or worse, deemed (axiomatically) as "phony," "unnecessary," or "superfluous" in respect to the actual process of capital accumulation even by certain sophisticated and self-proclaimed Marxist economists.

Yet, such an interpretation overlooks the reality of quasi-cannibalistic tendency of capitalist competition associated with the accumulation of capital worldwide. This criticism is also relevant to those (for instance, those within the Monopoly Capital School) who draw an exact parallel between the era of pre-globalized capital, classical trusts and administrative pricing (that is, early in the internationalization of finance capital a la Hilferding and/or a la Lenin) and that of contemporary globalization.

Moreover, the traditional left uncritically speaks of the so-called dominance of finance in accumulation, thus invoking rather anachronistically the political and economic descriptions that were once relevant to embryonic transnationalization and that are now unfit for the present epoch.

Also, speaking of capitalist competition here, it has nothing to do with the fiction of pure competition that has been portrayed in neoclassical textbooks and that has falsely taken as a point of departure by the majority of heterodox economists throughout profession. In my view, competition is a battle of capital against capital as eloquently argued by Schumpeter and, long before him, by Karl Marx. The present battle in the realm of finance capital is about the stretching of value, which has already been created in the realm of production and which is now about to be devalued and destroyed via the fast-paced synthetic process of creative destruction (a la Schumpeter) and destructive creation (a la Bina).

Finally, some of these critics have neither the necessary methodological capacity nor adequate technical training, nor the instinctive imagination to look at the economic crises in a holistic manner, thus commencing with capital as an undivided whole (that is as a social relation) before attempting to examine its unavoidable division into commodity, money, and productive forms.

For instance, in my opinion, "financialization" - currently a vogue term used by left-leaning heterodox economists - while hoping to describe the crisis at the same time tends to obscure the roots of volatility intrinsic in the very accumulation of capital, accompanied by destructive creation of fast-paced, hypercompetitive technological change.

This, as I have long contended, retreats from the reality of the workings of the law of value in the age of

hypercompetitive globalization. I believe "financialization" is a side-track that obfuscates the desperate attempt at preservation of value in the sphere of circulation, which often leads to the weapon of mass competition in terms of shenanigans that we are now rather painfully witnessing in the course of the present crisis.

Today's economic crisis (and its very glimpse in terms of hyper-speculative activity) manifests itself acutely in the realm of finance in which the tendency to stretch the preservation of value is matched by its fast-paced destruction in the production process. It is in this context that contradictions between and within the spheres of production and circulation render perceptible and, however discursively, come within the global view.

**FD:** How is the crisis going to affect the United States? Which economies, do you think, are going to be the most affected in the short-run and in the medium-term?

**CB:** This crisis first appeared just like a hurricane in the US subprime housing market and then gathered strength before reverberating throughout the financial system worldwide. The proverbial US housing-market bubble has been waiting to be burst for a long time, as a number of keen observers, such as Dean Baker, had already forewarned, despite hollow optimism, if not shallow idealism, espoused by Alan Greenspan, former chairman of the Federal Reserve - who did not even listen to some of his colleagues who warned him to that effect as early as 2001.

The fallacy of supply-side economics and the myth of self-correcting markets, therefore, culminated in idealism of benign neglect and the straightjacket practice of neo-liberal ideology. The resultant speculative bubbles in the US real estate, mortgage institutions, collateralized debt market, asset-backed commercial paper market, and debt-obligation insurance market sequentially burst in the face of US authorities, before they hit the public and surpassed the boundaries of the United States - via the transnational channels.

The full consequence of this, for the US economy and world economy as a whole, has not yet been realized, as the crisis is still unfolding. This is the classic sign of unfolding of an economic crisis from potential to actual, and as such the battle ground between the maintenance of value, on the one hand, and its wholesale destruction before the next round of new accumulation.

This also speaks to the fragmented neoclassical economic orthodoxy (and its eclectic following in the heterodox tradition), whose macroeconomic theory is misconstrued through the fallacy of composition, thus falling back on the reduction of axiomatic micro counterparts (so-called micro-foundation) devoid of institutional significance. Today, therefore, we must recognize two different kinds of crises: (1) the periodic crisis of capitalism and (2) the intellectual crisis of bourgeois economics.

According to the International Monetary Fund (IMF), the US economy is predicted to grow not more than 0.5% and 1.6%, respectively, in 2008 and 2009. The IMF, however, misses the point that this is not an ordinary recession, given the staggering default in the US housing market, the augmented domino of derivatives in the financial system, the anticipation of further banking collapse, and inadequate policy action on the part of the Bush administration.

The projected growth for Chinese and Indian economies is respectively at 9.3% and 7.9% in 2008, which would be below 11.4% and 9.2%, respectively, in 2007. This, of course, is apart from the creeping asset bubbles that are momentarily gaining strength in the Chinese financial market. The forecast for European growth, in 2008 and 2009, is somewhere around 1.4%, compared with 2.6% in 2007. Africa and Latin

America are expected to maintain robust rates, yet disguised unemployment and creeping inflation in energy and food sectors are the likely occurrences that lead to abject poverty and intense class polarization. In the meantime, the global economic growth is likely to weaken somewhere between 3.5% and 3.7%, from 5% and 4.9, respectively, in 2006 and 2007.

The European Union is now trying to deal with the after effect of the US financial debacle. European banks attempted to write down more than US\$200 billion of debt obligation, following the US mortgage defaults, thus revealing the tiny tip of the liquidity crisis in view of tight credit market. To date, the write-downs for a few major banks in Germany and Switzerland are some \$23 billion, and they certainly will increase by the time the dust settles.

**FD:** In your opinion, how effective will the ongoing economic stimulus, such as decrease in the interest rate, be in preventing the economy from slipping into recession?

**CB:** There is no question that the US economy is now in recession. The added danger, however, is the banking crisis in the midst of collapse. On the top of all this, there is a considerable decline in the value of the US dollar relative to other global currencies. This decline is persistent and its magnitude is consistently reflective of a significant increase in the price of gold, metals, crude oil, and basic food staples - to name a few.

The US economy is sneezing in cold sweat but at this time - notwithstanding the financial contagion - the world economy is not even uttering: "bless you." Here is the belated distinction between the transnationalization and the so-called Americanization in respect to today's global economy - and, by implication, the defunct American hegemony.

This crisis is symptomatic of the need for a clear distinction between the ideology of neo-liberalism (and thus neo-liberal policies espoused by the US government and its so-called Western allies) and the epochal meaning of globalization as an all-encompassing structure beyond the conventional notion of imperialism and/or nationalism. With this preamble, we now focus on some concrete issues.

The US government proposal for refinancing US mortgages falls somewhere between \$300 billion and \$400 billion. The Federal Reserve has already extended \$30 billion to bail out Bear Stearns (the fifth-biggest investment bank), which had about \$33 debt for every \$1 of assets it held. Wachovia, the fourth-largest US investment bank, is also on the edge of unexpected loss. Write-downs at Merrill Lynch amounted to \$9.7 billion in conjunction with 4,000 layoffs just in the first quarter of 2008.

The multiplicative effects of the subprime debacle appear to be wreaking havoc with the financial system on a continuous basis. Lehman Brothers too had to shave more than \$2.8 billion from its books. The bubble also reached into the oil futures as well - by dropping the US dollar and grabbing crude oil virtually with fiat (by only 6% down) and no intention of keeping it as transaction demand.

The Federal Reserve extended emergency loans to major Wall Street investment banks. The Fed also offered \$200 billion in Treasury securities to a select number of investment banks known as "primary dealers" that are regularly party to its open-market operation. What are the collaterals in certain of these cases? They are hard-to-sell, privately issued, risky mortgage-backed securities that for all intents and purposes are not worth the paper they were written on. US subprime mortgages are about 21% of the total.

Defaults in this segment of the market have led to a potential default of the mortgage-holding institutions

and, in due course, to the underwriting of the asset-backed commercial papers that had insured the amalgam of these collateral risks in the first place.

All this has come full circle, first leading to a substantial decline in home prices across the board, which translated into instant devaluation and thus evaporation of equity all over the place, and then was passed on and spread to the layered network of financial institutions that reluctantly had to write-down hundreds of billions of dollars on their books.

The US financial system faces potential losses of well over \$1,000 billion as a result of the credit crisis. Hence, credit crunch is the form in which this particular financial crisis manifests itself here in the US and throughout the globe.

Finally, the market for real-estate is now beginning to exhibit its universal effects on vanishing equity around the globe, from Ireland to India.

To treat the symptom of the crisis, namely the subsequent "credit crunch". The Federal Reserve, under Ben Bernanke, cut the federal fund rate seven consecutive times, from 5.25% to 2.0% by April 30, 2008 - a substantial reduction of 62%. One might be reminded that further reduction in the discount rate toward the vicinity of 1% (similar to the one, in 2004, under Greenspan) should scare any economist who has written a PhD dissertation worth the paper written on.

The unintended consequence can be the lack of interest-elasticity of investment and the ineffectual monetary policy - which, in addition to the ongoing credit crisis and banking debacle, are potentially the stuff of the Great Depression.

In the face of this, the Bush administration extended a \$168 billion stimulus tax-rebate in order to beef-up consumer spending. This package, which is too little and too late, does not even extend the duration of unemployment insurance, from, at present, six months to, say, a year, in order to cushion the massive layoffs that are now beginning to take effect across the American economic landscape. Besides, the bulk of money in this package is directed toward business, in the hope that someday it will trickle down in the economy.

On the financial side, the new Treasury Department plan, the hallmark of which is the merger of Securities and Exchange Commission and Commodity Futures Trading Commission, is designed to primarily overhaul the competitiveness of the financial system by focusing on Wall Street institutional investors rather than on the well-being of the system as a whole, including the Main Street investors.

Moreover, this plan is neither a measured prescription for safeguarding the dominos associated with limitless fabrication and multiplication of risks nor a deliberate remedy for regulating the epidemic distribution of derivatives and their contagion across the global financial system nor even an immediate response to the current crisis in which a huge number of ordinary people will certainly go under.

**FD:** How is the crisis going to result in the magnitude of petroleum prices? Will the prices keep growing?

**CB:** The transmission of the subprime crisis in the housing market has resulted in default in the mortgage market and then through the collateralized asset market wreaked havoc with the underwriters of such amalgamated risky debt obligations in one sweep. The forced write-downs of these assets in the investment banking sector, on the one hand, and the slowdown in the pace of economic activity, on the other hand, stirred the US economy toward recession. At the same time, the continuous decline of the US

dollar since 2002 against the euro and other significant international currencies revealed the structural shift and moribund status of the United States relative to what it used to be under the Pax Americana.

In the last meeting of the World Economic Forum at Davos, Switzerland, even sympathetic liberals and social democrats realized, rather belatedly, that the American economy is no longer functioning as the engine of the world economy. Their lexicon was "decoupling", signalling rather aptly what I have already foreseen, despite the pageantry of Reaganomics and the pomposity of "the only superpower," well over two decades ago.

Meanwhile, Bernanke, as chairman of the Federal Reserve, responded to the crisis (what is manifested as credit crunch) by cutting the short-term (discount) interest rate, thus discouraging the inflow of portfolio investments, curtailing the demand for the dollar, and consequently furthering the decline in the value of US currency.

Fearful investors seeking shelter pushed the price of gold above \$1,000 an ounce, registering yet another decline in the value of the US dollar. An increase in the price of metals more or less followed the same mechanism, thus created tendency for bubbles in the market for these commodities. The price of agricultural products (food) has also increased, in part due to the heightened global demand and, in part because of competition between food and fuel - thanks to the ethanol hype - that is now being recklessly promoted by the populist governments and self-promoting interest groups in both the United States and Latin America. The food crisis has already manifested itself in a number of food riots around the globe, from Bangladesh to Haiti.

Finally, the global oil value - the long-run center of gravity around which the market fluctuations tend to gravitate - has been set based upon the highest cost oil region, the USA. However, the \$130-plus oil and what is driving the price globally have something to do with a combination of factors: (1) continued demand from the United States (4.5% of the world population consumes 25% of world's oil consumption), plus increasing global demand, including China (with double-digit growth rate), and, somewhat similarly, India along with the rest of the growing developing countries; (2) a tendency toward speculation and propensity for asset-holding activities; (3) a sizeable decline in the value of denominating currency, the US dollar; (4) political events of relevant significance.

Concerning the last point, the very drumbeat of war by the Bush-Cheney administration against Iran, despite George Bush's incredible denials to the contrary, is not only influencing oil prices but also causing the volatility.

It appears that the US fiasco in Iraq is about to be obscured by yet another potential fiasco, this time much more devastating, in Iran. The replacement of Admiral William Fallon, commander of the US Central Command in the Persian Gulf, with a careerist and seemingly neo-con-friendly military officer, army General David Petraeus, is indeed not the kind of information that could simply escape the minds of those who have set their eyes on the prize in Wall Street.

At the same time, the precipitous decline in the value of US dollar gives rise to two separate effects in the price oil: (a) the direct effect via the nominal value of oil in dollar and (b) the indirect effect via flight from dollar to oil due to speculative asset-holding or exchange value. The impending global recession, of course, will have *ceteris paribus* [all else being equal] a moderating effect on demand, thus a possibility of moderation in price in real terms. However, the flight from the dollar does not readily lend itself to a predictable outcome, due to its uncertain speculative nature.

**FD:** Since oil is an essential input to the production of a great number of products, what could happen if the price of oil keeps growing as the US economy slows? How much of the actual problems in the US industry are consequences of the high petroleum prices?

**CB:** Crude oil, its most significant joint-product, natural gas, and its manifold derivatives, such as gasoline, jet fuel, home-heating oil, and so forth are not only constituent components of the energy sector as a whole but also inputs to essentially a whole host of production processes that are defining the bulk of production worldwide.

Yet it would be a grave mistake to focus exclusively on the use-value of crude oil. For, while the physical (input-output aspect) and thus material requisite of oil is necessary, it is by no means sufficient to speak of oil as a commodity without focusing on its exchange-value, that is its value formation and thus price determination in conjunction with the social dimension of value.

In other words, the same processes that obtain their negative impact from increasing price, soon or late, tend to adapt to the situation by reinventing the production process and cutting demand, much like the adaptability of the biological species in nature. However, we must be careful not to label them as natural but social, at the very heart of which lies the historically specific socioeconomic system.

Therefore - by focusing on dynamic interactions of the economy as a whole - the fact that the price of oil is increasing beyond the expectation of the public is itself an indicator of sorts for the primary influence of the turbulent economy and not the other way around. In other words, it is not only utterly false to replicate the textbook message of supply-side economics that "supply shocks" (such as the oil crises since the 1970s) are responsible for past US recessions, thus reversing the direction of causality, but it is also misleading the public as to the physical (that is external), and not social (internal), origin of economic crises.

To be sure, in a grand loop of dynamic interaction the \$130-plus oil will undoubtedly reinforce the decline of the US economy and, for that matter, shunt the world economy toward deep recession. Consequently, if we draw a parallel between the present economic crisis (respectively, in the US and the world) and the gravitational fields in astrophysics, we may be able to perceive how the quantitative result of the oil price hike, which itself is an outcome of the dynamics of the world economy, in turn obtains its effect on the gravitational field of the latter.

Hence, the prognosis of both the right (the orthodoxy), and the liberal/radical left (the self-proclaimed "heterodoxy") does not seem to hold water in this case. The significance of high oil prices is, therefore, inseparable from the dire need for reorganization, if not restructuring, of the US and world economy via the present crisis.

Finally, the proposals that would push the envelope toward US domestic oil exploration - such as the one by the Bush administration in regard to drilling in the Alaskan National Wild Refuge (ANWR) and his recent calls for more extensive drilling of US coasts - do not alleviate the pressure of supply even by a long shot but also create an impression that all these problems are due to the lack of self-sufficiency, thus relying on public fear to achieve their end.

It's also imperative to note that the recent proposal by the George W Bush administration - concerning high gasoline prices - to lift the moratorium on the exploration of oil and gas from the long disputed Outer Continental Shelf on the coast of California and Florida is not only silly but a smokescreen. This proposal has no validity and is a wishful thinking in the view of the fact that production from these fields will come

to market no later than 2030 - according to an unimpeachable comprehensive study.

Therefore, Bush's pitching, and Republican presidential candidate John McCain's catching, over this crucial matters are essentially practical jokes. Any reasonable policy should rather seriously look into the development of alternative sources of energy as well as alternative system of transportation (that is, public, clean, safe and renewable) in the United States.

Focusing on oil demand/supply alone is a mirage; global oil price formation is the most complex issue in economics. In the meantime, while fear mongering in both domestic and foreign policy is the *sine qua non* of the Bush administration, the hoax of "energy independence", particularly in today's interdependent world, is the hallmark of the US Democratic Party candidates in the present election year.

**FD:** How is the crisis going to affect the oil producing countries, such as Venezuela?

**CB:** The present crisis is multidimensional, thus its impact is wide-ranging and varying from country to country. Oil exporting countries, particularly the developing countries with a relatively sizable population (such as Iran and Venezuela), are potentially subject to high food prices, which would translate into the loss of sizable foreign exchange due to the importation of basic staples, such as corn, rice, wheat, etc. Prices of other food items that are dependent on these commodities are also expected to rise.

This situation is in part due to a new US phenomenon (production of fuel from corn, and so forth), which is ostensibly motivated by the fiction of energy self-sufficiency and the fabrication of so-called "national security", which then unwisely is replicated by countries like Brazil - despite the apparent double-injury reflected in the high price of food and inexhaustible source of pollution against the environment with its implication for global warming. Hence a potential crisis is on the horizon through the competition of food and fuel.

On the other hand, the high price of crude oil can be translated into added oil revenue for oil exporting countries, such as Iran or Venezuela. This may offset the negative effect of high food prices in these countries. Yet, due to a significant decline in the value of the US dollar - the denominating currency - the real price of oil is not as high as it appears, which in turn speaks to the real level of oil revenues of the exporting countries, such as Venezuela and Iran.

This is particularly significant for Iran and Venezuela, whose respective governments do not see eye to eye with the Bush administration (particularly in the case of the latter, which is under severe embargo), whose bulk of foreign exchange may be in euro or, if in US dollars, does not entirely lend itself to a shopping spree in the US goods market.

To all this, we may add the impact of an impending global recession and its moderating influence on the worldwide demand for oil. Thus, in the final analysis, in the absence of structural change and the persistence of the center of gravity (of production), a change in the price of oil (and, by implication, change in exporting countries' oil revenues) is subject to the complex set of contradictory factors that are spelled out above.

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*This is an edited and updated version of an interview of Cyrus Bina by Argentinean journalist Fernando*



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