The 10/10 Event: Origins of an Economic Meltdown

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Contents

The purpose of this text is to try and tell the story of our current economic situation, how we got here, and what we can expect from the near future, so as to better understand the tasks facing us.

This is neither an academic text on history, nor yet, god forbid, a treatise on macroeconomics. So in the interests of telling a listenable story we will use the old storytelling technique of jumping directly into the middle and exploring outwards in flashback and flash-forward vignettes to build the big picture. But where is the middle?

For this we pick an event. By an event we mean something that is a transforming moment of intensity that divides the flow of time into a before and an after. Despite its evident artificiality as a plot device, our event has a time and a place. The time is Friday the 10th of October (hence 10/10) 2008. The place is simultaneously the specific location of the 16th floor of the glass fronted office block at 360 Madison Avenue, New York, and all parts of the world connected to the global financial system — which is now pretty much everywhere. In that sense the 10/10 event is one of the first truly global events, as we can appreciate from the world-wide impact of its fallout.

But let's return to the specific place; the 16th floor of 360 Madison, the headquarters of an organisation called the International Swaps and Derivatives Association (ISDA). This is a private body established by the main banks and other dealers in derivatives to sort out standards for these instruments, and above all, to lobby against any regulation of this new and rapidly-growing sector of the financial industry by the various national legislatures. In this they had been, until the 10/10 event, singularly successful. As the poster child for financial self-regulation, they also had authority for arranging the resolution of Credit Default Swaps in the aftermath of so-called "credit events" that triggered their payout.

On the 10 October 2008, the particular credit event that the ISDA was trying to resolve was the collapse of Lehman Brothers on the 15th of the previous month. This was the day chosen for the auction of the shares which would determine the payout for all CDS drawn up on Lehman.

To simplify, if Lehman bonds (finance-speak for IOUs) were auctioned off for 10% of their face value, then CDS would pay out at 90% of the notional amounts covered. If they were auctioned for 80% of face value then the CDS would pay out correspondingly less. The uncertainty associated with this process was aggravated by two things.

First of all, like all derivatives, the amount of CDS sold is not limited to the actual underlying amount of Lehman bonds outstanding. Second, the CDS market is almost exclusively an "over-the-counter" market — that is to say there is no central exchange that records who sold what to who and how many of them.

The result was a complete blindness of how many CDS there were out there and who was actually holding the liability to pay out at the uncertain rate to be determined at the auction — and whether or not the sellers would be able to meet this liabilities or would themselves be pushed into collapse, possibly even creating a chain reaction of total financial collapse.

The result, in the days leading up to the 10th October, was a steady rising tide of panic which progressively froze up the crucial interbank lending or money market (of which more later) until, on the day itself, the equivalent of a total cardiac arrest in the central circulatory system of global finance occurred.

The obvious question arises, why choose this date, rather than the date of Lehman's fall, on the 15th of the preceding month? Lehman's fall, that Monday, in turn triggered the insolvency of AIG, which, had it been allowed to fall, would have rendered all the world's major banks insolvent, as AIG's miniscule, London-based subsidiary, AIG Financial Products, had sold CDS to them all, allowing them to zero-rate huge swathes of their "risk-adjusted assets" (i.e. loans) for capital adequacy purposes. Hence why the US government was forced into bailing out AIG to avoid the insolvency of the world banking system. This in turn triggered the Reserve Primary Fund, "breaking the buck", starting a run on the Shadow banking system — as we will translate into English later on.

The answer is that although the events of the 15–16th September pulled the trigger, the 10th October is the impact of the bullet itself. But in order to explain all this, we need to jump outwards from the 10/10 event, first backwards in time and across the wide ocean.

Flash. A river delta, jungle, olive-green Huey Cobra helicopters flying through the sunrise, Jim Morrison sings the End… It's the Vietnam War, in the early 1970s. This is the birthplace of the globalisation and financialisation that has defined our era.

THE CONTAINER REVOLUTION

The word 'globalisation' is bandied around a lot these days, but regardless of all the different meanings people have attributed to it, we can find a material core. This is the logistical innovation that has revolutionised international trade — containerization. The 'intermodal freight container', to give it its full title, is an ubiquitous part of our landscape today; whether on the back of trucks we drive past on the motorway, in stacks in industrial parks or as temporary structures at various sites. They are so common that we have practically filtered them out as natural features of the landscape; we hardly notice them anymore.

However the container is a relatively new introduction, only beginning its first tentative foray into international shipping in 1966. The driving visionary behind the container was a man called Malcolm McLean. Originally a truck operator from North Carolina, he had invested heavily in a new container system that could massively reduce the loading times for moving freight between truck, rail and ship. In 1968 his nascent project was on the verge of financial collapse when the Vietnam War rescued him.

As the official US line was that American involvement in Vietnam was drawing down and to be ended in 1968, the reversal of this policy meant that the resultant rush to get war materiel into Vietnam created chaos. The various different US armed forces collectively chartered more or less every freight ship they could find, loaded them with a massive array of freight and sent them across the Pacific to Vietnam. Whereupon they arrived and promptly sat offshore in a huge shoal of freighters that the virtually non-existent port facilities of Cam Ranh Bay, Da Nang were ill-equipped to handle.

Freight was forced to wait over three months before unloading was possible. In face of the resultant chaos, the US Army took a radical step and outsourced logistics and the construction of port facilities to private firms. McLean's container system secured him the contract to construct a new container port at Cam Ranh and ship Army supplies from the USA to Vietnam.

Not only did this secure the financial supply to secure and expand containerisation, but McLean decided that rather than shipping empty containers back to the US, they could make money on the return leg by taking a short detour via Japan and filling up with cheap transistor radios and other consumer items for the US market. Thus began the trans-Pacific manufactures conveyor belt which continues to this day and has been instrumental in raising China from an impoverished feudal peasant country to today's industrial workshop of the world.

McLean's Sealand container shipping company was eventually acquired by Danish shipping company Maersk and lives on in the giant Maersk container shipping that dominates freight shipping at the heart of globalised supply lines today.

CRY HAVOC AND LET SLIP THE DOLLARS OF WAR!

Under the Bretton Woods system of world money governance established after world war two, the US dollar was to be convertible to gold (against the advice of John Maynard Keynes, one of the principle architects of the system) and the rest of the capitalist "free" world's currencies were to be pegged against the dollar.

This made the dollar the preferred reserve currency for the rest of the world. It also presented the USSR with a problem in the aftermath of their invasion of Hungary in 1956 — how to prevent their cache of US dollars from being seized by US authorities? The answer was to keep them in banks outside of the US, an unusual operation at a time when banks could legally only hold deposits in the currency of the country that licensed and regulated them.

Pretty soon the banks acting as Soviet agents, holding their dollar reserves, started to contact banks in the City of London making discreet enquiries — does anybody fancy borrowing some dollars at competitive rates, no questions asked? Is the pope Catholic? Thus, the Eurodollar market was born. The Euro- prefix referring not to the location of the market (although it remains mostly centred in London, to this day, albeit the main players are American or other non-UK banks) but the Telex code of the original Soviet agent bank.

Born out of the contradictions of international trade in the Cold War, this market in "stateless" US dollars really began to explode in the late 60s and early 70s under the inflationary pressures of US spending on the Vietnam War.

As the US used the Bretton Woods system of capital controls (limits on the flow of money between countries, of which more later) and bank regulation to limit the interest rates US banks could pay on domestic deposits, these same banks moved to the freedom of the unregulated Eurodollar market in London, where they could set interest charges more in line with inflation.

OIL SHOCK

Eventually the pressures of the growing pool of US dollars outside of US Treasury and Federal Reserve control led to their suspension of dollar convertibility to gold in 1971. In 1973, after the US admission of defeat in Vietnam and the oil crisis occasioned by the Yom Kippur War, the last pretences of a fixed currency regime were abandoned and the US dollar was "floated" — the Bretton Woods system of world money management had collapsed under the pressure of the Cold War that had originally inspired its creation.

STAGFLATION

The collapse of the Bretton Woods system of fixed exchange rates and the subsequent oil shock led to chaos in the international system and a severe recession in the US and other Western countries in the mid-70s, with rising unemployment accompanied by rising inflation, a condition known as stagflation, that was in total contradiction to the assumptions of the then dominant paradigm of economic orthodoxy.

But before we deal with the collapse of Bretton Woods and the explosion of the Foreign Exchange market, we need to notice another significant financialisation vector produced by the Vietnam War's dollar bubble.

MONEY FUNDS AND REPOS

In 1971, the Reserve Primary Fund was launched. A new kind of mutual fund, it was the first of what became known as the money market funds. The idea of the fund was to provide wealthy US investors with a way of escaping the state regulations that then limied the maximum interest banks could pay on deposits.

The fund invested in treasury bills and other "risk-free" highly liquid "nearly money" instruments. The "Net Asset Value" (NAV) of the fund's shares were to be adjusted to stay at $1 and all earning from using these liquid assets in the emerging repurchase agreement, or "repo" market were paid out as interest on investor deposits.

The source of the extra interest, over regulatory limits, was both involvement in the Eurodollar section of the interbank lending market, and the repo market — itself a way for banks to evade the interest limits.

In a repurchase agreement the two parties agree to exchange a "nearly money" instrument such as a treasury bill for a wad of cash, making an agreement for the seller of the bills to repurchase them at a later date, whether next day or next week, at a higher price. As this was technically not a loan, being more in the way of a pawn shop operation, it allowed traders to make higher margins than the legal loan rate.

TRILEMMA

In order to understand what was being broken with the incremental fracturing of the Bretton Woods system, and the significance of the final step, we need to take a very short detour into abstract economic theory, namely the so-called macroeconomic trilemma.

This states that you can have, at most, two out of three of the following: 1) stable international exchange rates, 2) free flow of international capital, 3) control of monetary (interest rates) and fiscal (tax and spend) levers of national economic policy, to allow economic policy goals like full employment.

Now the trilemma is not to be taken as gospel truth, still less a law of physics. It is the product of an abstract economic model whose assumptions are open to question, to say the least. But it is a useful way of looking at the difference between the Bretton Woods system, the Gold Standard that preceded it and the Neoliberal model that has succeeded it.

COLONIALISM AND ITS DISCONTENTS

In brief, the Gold Standard had fixed exchange rates and free flow of capital which created problems with avoiding the internal depression/recession effects of trade imbalances. The solution was found in the colonial New Imperialism of the late 19th century, the capture of external territories to be suborned into a captive “outside” that recessions can be outsourced to in the interests of keeping the “inside” workers on-board.

But that colonial inside/outside structure was progressively broken down from the turn of the century until the outbreak of the First World War by a pincer movement of resistance from both the “inside” and “outside”. Inside the industrialised coloniser nations the resurgent working class resistance known as the Syndicalist Revolt saw revitalised industrial unions force up days lost to strike up to 10 times the pre-1910 levels, along with real wage gains for the first time in a generation. Simultaneously resistance reared up in a multitude of anti-colonial rebellions from the Boers of South Africa, to the Boxers in China, the Black Hand in the Balkans, the Irish Volunteers and many others trapped on the “outside” of the colonial relationship.

The unbalanced settlement after WW1 and the attempt to restore the Gold Standard lead to the Great Depression of the 1930s, WW2 and the establishment of the Bretton Woods system in its wake, both to avoid the mistakes of the Versailles Treaty and the ward off the alarming expansion of Soviet territory and the further threat posed by the Maoist victory in China.

BRETTON WOODS

Bretton Woods is most closely associated with its chief architect, John Maynard Keynes. However, as a result of a negotiation from a position of extreme weakness on the part of the dying British Empire that Keynes sought to rescue, and the interests of the ascendant USA, it was necessarily a compromise between Keynes’ designs and American interests.

As a result, Keynes’ initial plan to base global money management on a new global monetary unit — the bancor — based not on gold alone but a basket of raw material commodities and an international trade balance clearing system designed to prevent large international trade imbalances, was abandoned in favour of a semi-gold based system of fixed exchange rates based around the dollar.

Having returned to pillar 1) of the trilemma, then the only way to allow national governments the freedom to invest in rebuilding the Western economies shattered by the war, and move to full employment, was to bar 2), the free movement of international capital. This was done through a series of controls — known as capital controls — which prevented the large scale movement of money between national areas, except by explicit government agreement.

In practice, in the initial post war period, the imperatives of the Cold War held sway; it was not so much the Marshall Plan, but the threat of the Soviets T-34s rolling westwards to the Atlantic, that prompted massive American investment into the ruined economies of Western Europe and the bomb-cratered Japan. Henry Morgenthau, Keynes’ American opposite number, said that the security and the economic aspects of the new Bretton Woods order, worked together like the blades of a scissor.

Nevertheless, as Giovanni Arrighi has pointed out, this was the first time that the control over the creation of world money had been taken into the hands of state power in the pursuit of state objectives. This was in stark contrast to the the Gold Standard era where commercial interests were at liberty to create world money in the pursuit of their own profits alone.

CAPITAL CONTROLS

It was this aspect of the Bretton Woods system, that was the last to fall. In the wake of the collapse of the fixed exchange rate regime and stagflation, one of Margaret Thatcher's first acts as a newly elected Prime Minister in 1979, was to drop currency controls, by refusing to renew the emergency acts to control money flows that had been in place since the war.

While there are other aspects to the Neoliberal revolution initiated by Thatcher and Reagan, such as supply side economics, monetarism and other ideological fig-leaves for ripping up full employment goals, smashing unions and attacking welfare and social services, the far less visible lifting of capital controls was the most structurally significant measure.

NEO-COLONIALISM AND ITS DISCONTENTS

But, stepping back from the level of macroeconomic abstraction, we can see in the turmoil of the 70s and stagflation, an echo of the double-pincer movement of resistance that had brought about the collapse of the Gold Standard prior to WW1.

Bretton Woods and the passage from European colonialism to US neo-colonial dominance had seen the progressive breakup of the colonial bond between the old European imperialist powers and their Third World territories. However, this process was not initiated from the centre, but by resistance from the peoples of the colonial territories and, more threateningly to US interests, these forces of anti-colonial resistance were usually unwilling to simply transfer their one-sided trading arrangements over to the new American boss, stepping in as a replacement to the old colonial exploiter. It was these kinds of tensions that had initially got the US embroiled in Vietnam.

Internally, there had been rising union militancy from the late 60s onward, which exploded into open industrial warfare with the inflation shock of the oil crisis. So once again you had this double front of internal and external resistance that buried the Bretton Woods order in a similar way to how the Gold System had earlier been brought down.

THATCHER, THATCHER, WALL SNATCHER

However, neoliberalism's lifting of capital controls did not simply mean a return to the days of the Gold Standard's free flow of capital. The lifting of capital controls, much as it brought about the ruination of third world economies and first world union power, effected something historically more irreversible, it removed, for the first time, the wall that had separated the world into "inside" and "outside" along the border lines of nation states.

At first this was not immediately apparent, as the neoliberal onslaught was part of a counter-offensive by Western capital that meant that outside of the US and Western European core, the "free world" became a virtual prison camp, with military dictatorships established in much of Latin America, Africa and Asia. From Chile to Indonesia, democratically elected governments were overthrown by "anti-Communist" military dictatorships.

The neo-colonial era gave way to the post-colonial era of the "Washington Consensus". Whereas relative underdevelopment and dependency had been maintained after the formal independence of neo-colonialism by the barrier of capital controls, now the role of reproducing subjugation passed to the "aid" policies of the old institutions of Bretton Woods, the World Bank and IMF, now using new ideologically-driven agendas of forcing government cuts on Third World regimes in return for "development" loans to line the pockets of corrupt military regimes selling their peoples into a new regime of international slavery.

DERIVATIVES

The end of international currency stability lead to another aspect of financialisation — the rise of financial derivatives as means of providing drag anchors to floating currencies adrift in the financial ocean of the new globalised world order.

The story of derivatives is a significant part of our current situation, but it is an involved one and has already been addressed elsewhere (see Financial Weapons of Mass Destruction in Red & Black Revolution 14, available at anarkismo.net/article/9850) so we will not go into it in detail here.

FROM INTERBANK TO MONEY MARKET

But it's the rise of the global money market, which is the result of these trends of globalisation, financialisation and neoliberalism that is at the heart of the story of what occurred in the 10/10 event.

We have already mentioned the rise of the Eurodollar market and the repo market and the money funds that came out of the attempts by the US to defend dollar gold convertibility. To this we need to add, in the aftermath of the 1973 oil hike by OPEC, the addition of a huge flood of so-called "Petrodollars" from the earnings of OPEC countries. Together this pool of stateless liquidity transformed the interbank lending market into something more — the money market.

These two terms are still often used interchangeably and indeed, the major players in this market are still the banks. However, to confuse the two terms is to obscure a vital historical development that has transformed our current global situation.

The money market is the interbank lending market, plus this pool of international liquid wealth that rich investors and major companies have direct access to via the institutions of the shadow banking system, but is neither regulated or controlled directly by states or indirectly, by the regulated banks they have some measure of control over.

The term "Shadow Banking system" is a neologism of 2007, coined in order to explain the new financial landscape underlying the then unfolding crisis. It has its beginnings in the money market funds we saw originating in 1971, but also includes hedge funds and other non-bank financial institutions, the special purpose vehicles set up to implement new securitised debt assets created with derivatives and a whole zoo of other players.

The best way to understand the operation of the shadow banking system, and the significance it has for our current, post 10/10 situation, is to introduce a really horrible word: disintermediation.

DISINTER-WHAT?

In any economy there are at any one time people who are producing and people who are not (due to childhood, retirement, temporary illness, training, pregnancy, etc.), and produce must flow from one to the other. In a capitalist commodity society, this means also that money must flow from surplus agents to deficit agents.

The arrangement of collecting money from one (in return for interest payments) and dispensing it to the other (on various repayment terms), is carried out by financial intermediaries like banks. Banks are in the intermediation business where they make money from borrowing short term (e.g. from customers deposits) and lending long-term (e.g. mortgages).

The credit these banking intermediaries give to individual customers or companies is called retail debt. However they are also constantly lending to each other to cover short-term needs, and this interbank lending market is also known as the wholesale debt market.

However, as we have seen, from the 1970s onwards both money funds, hedge funds and large corporations realised that they could cut out the middleman — the intermediary bank — and access the wholesale market directly, saving costs.

For big corporations they did this by issuing IOUs, called bonds if for over a year or corporate paper or bills if for less than a year, straight into that wholesale market. Similarly for big savers, whether super-rich individuals, or institutional savers like pension funds and the sovereign wealth funds of oil exporting countries, they could access better interest rates than a retail bank deposit through money market funds, as already mentioned.

This is disintermediation and it is how the shadow banking system has transformed the interbank lending market into today's money market upon which the banks themselves have come to depend. Here we have a significant reversal — once upon a time the banks were the central mediators, the central circulatory system of the global monetary flow. But now, what was simply the net effect of their own activity has taken on an autonomous existence of its own and, to an increasing extent, controls the banks rather than being controlled by them.

This dependency can be measured by, if not reduced to, something called the funding gap — that is the gap between the customer deposits of the banks, their self-funding, and the money they need to back the loan book that they have.

The BBC's Robert Peston remarked that as recently as 2000, the funding gap for UK banks was nil, by the time the wholesale money market froze up in the late Summer of 2007, the UK bank funding gap was £740 billion or 40% of their loan book — i.e. this was money that they needed to source from the non-bank sector of the money market to roll over their short time liabilities on a regular basis.

CAN'T STOP ME MAO

But before tumbling from the start of the crisis in 2007 to the 10/10 event itself, we need to flash back to the 1970s one last time, to secure the final jigsaw piece to complete our story background.

In 1976 the billion plus inhabitants of Vietnam's giant northern neighbour breathed a collective sigh of relief on the news that the "great helmsman" Mao had breathed his last. Following a brief but vicious power struggle, the "capitalist roader" Deng Xiaoping gained ascendancy and, as the UK and USA took their neoliberal turn under Thatcher and Reagan, decided that now would be a good time for China to abandon its isolationist policy and open borders to the trans-Pacific trade opened by McLean's container-ships.

"Socialism does not mean shared poverty" Deng proclaimed, opening China to global capitalist trade. Although the amount of foreign direct investment capital allowed to flow into China was minimal, neoliberalism's lifting of capital controls allowed the flow of Western capital into both Japan and the surrounding "Asian Tiger" countries of South Korea, Taiwan, Hong Kong and Singapore, benefiting China's development.

Thanks to the logistical revolution effected by containerisation, the electronic and machine parts made in tiger economies could be shipped to the location of the cheapest available labour for assembly, prior to shipping to the US at no extra cost — the location of the cheapest labour was in the Special Economic Zones China opened up in Shenzen next door to Hong Kong.

STROBING THROUGH THE YEARS

Now that the foundation pieces of our jigsaw are in place, we can fast forward through the 1980s, through a series of vignettes.

Flash. A man in a white shirt with a bag in his left hand stands in front of a column of four tanks. Tiananmen Square, 1989, June 4th (or the 35th May as Chinese internet users have to call it, to avoid CP net cops), the Chinese Communist Party crushes dissent with the utmost brutality.

Flash. Night-time, the mob pour towards the nervous border guards behind the barrier, the guard in the pill box cannot raise anyone on the phone, under the press of people the guard raises the barrier, the crowd pours through into the other half of their city. Berlin, 1989, November the 9th. The Russian Communist Party does not follow the lead of their Chinese counterparts. The clumsy attempts at top-down market reform by Gorbachev are less successful than Deng's bottom-up gradualistic measures, and the USSR disintegrates in confusion and an opportunistic scramble for state property. The end result, a new oligarchy in private possession of Soviet means of production and natural resources and a state crippled by debt.

Flash. A white European man with crossed arms stands in dominance over a bowed, cringing Asian despot as the latter signs away the economic independence of the fourth largest nation in the world. It's the 1988/89 crisis known in the West as the "Asian financial crisis" and in Asia, bitterly, as the "IMF Crisis".

That picture of Michel Camdessus of the IMF lording it over Suharto, for 30 years the undisputed military dictator of Indonesia and "friend of the West" is the iconic image of the apogee of the "Washington Consensus" rule of the non-Western world through the vehicle of the Bretton Woods institutions. It is also the "never again" image for Asian economic leaders.

The knock-on effect of that crisis leads Russia to default on the debt saddled on it by the drink-sodden Boris Yeltsin. This in turn causes the collapse of New York hedge fund Long Term Capital Management. As the LTCM hedging strategy had been designed by the guys who got the fake Nobel Prize for coming up with the main maths used to price derivatives (the Black-Scholes equations), pretty much every main financial player in Wall Street had been cribbing their moves. Hence LTCM gets the bailout denied to Asian victims of the crisis, much to the increased fury of their capitalist and governing classes. The latter peg their currency against the dollar at an aggressively low rate and build up large foreign currency reserves in a bid to be never taken by the same financial smash and grab tactics again.

This in turn aggravates further the massive trans-Pacific trade imbalance that has built up between coastal Asia and the USA. As most of the regions manufactures pass through China for the manufacturing stage, as previously discussed, this appears as a bilateral imbalance between the US and China, but is, in the full picture, a regional affair.

In order to run a current account surplus with America (i.e. running a surplus of exports over imports), China and other regional economies have to simultaneously export capital to the US, as well, in order for Americans to buy the next round of Chinese imports. Remember that this is only possible since the Neoliberal dropping of capital controls and is aided by China being able to access the money market directly, thanks to disintermediation.

Because of problems finding productive investment in the US (the competition of cheap Chinese imports being one), this influx of investment dollars results in a massive credit bubble in the US. However, rather than resulting in generalised inflation, the only prices that rise are of fixed assets that cannot be container-shipped from the East, or outsourced to call-centres or computer halls in Bangalore. In other words, real estate.

Through the trade surplus, the US is importing disinflation in manufactures and services, meaning the only price inflation is seen in property prices and the stock market. A form of partial inflation that was up until now, commonly mistaken for economic growth. Especially in countries like Ireland, the UK and USA, where workers have moved from rental housing to mortgages.

The illusion of owning a property whose value is increasing creates what's called the wealth effect — the illusion of increasing wealth — so long as the bubble continues to inflate. In fact, even the most simple reality check should reveal that having the price of a basic necessity like housing increasing faster than average wages, is in reality making the mass of average workers poorer, not richer.

Flash. A sunny morning. The second airliner flies into the undamaged tower producing a fireball straight out of a Hollywood disaster movie. New York, 2001, 9/11. Coming in the wake of the beginnings of a shaky recovery from the internet tech-bubble burst of 2000, the US Fed decides to drop dollar interest rates.

Flash. Night-time. Over a still-lit cityscape with cars driving in the street, explosions and fireballs the like of which Hollywood has never dreamed, light up the sky live on CNN. "Shock and Awe", Baghdad, 2003, March 19th. To pay for the invasion the Fed meeting following the invasion of Iraq drops dollar interest rates to an unprecedented 1%. They are to stay there for two years as the initial sprint victory is transformed into a drawn out insurgency with ever spiralling costs.

Just like Vietnam, America's new foreign military adventure is swelling the global supply of the world's reserve currency. But this time, thanks to the trans-Pacific conveyor belt, inflation is not felt in the price of imported consumer goods, but the property market inflates like bubble gum.

SECURITISATION

Here the shadow banking moves out of the shadows and takes main stage. As previously mentioned, the Chinese dollar reserves are poured back into the US money market, but in one aspect, the name of the money market is misleading.

Just as there's no exchange for foreign exchange, so what's traded in the money market is not actually money, but highly liquid debt instruments, like treasury bills and blue chip commercial paper, that can be used as collateral as if they were money. Like going to a casino, you can't normally play with cash itself, you need to exchange your cash for chips to take to the table.

Similarly, to enter the money market you need a supply of money market instruments, similarly in the longer term bond market.

Also the regulated banks, still major players, are looking for a way to free existing loans from their loan books (against which they must hold reserve capital, limiting how much they can loan) so they can make new deals.

The answer, thanks to the magic of derivatives, specifically credit derivatives, is securitisation. Through securitisation existing debts can be spun off from bank and mortgage lenders books and transformed into tradable debt instruments — more chips for the casino table.

It was the demand for these instruments by financial traders that led the explosion of the mortgaged backed securities and the now infamous CDOs, not actual demands for mortgages from house hunters. So long, of course, as Treasury interest rates remained at 1% and housing prices continued to rise.

By 2007, as US Treasury Secretary Tim Geithner said in a 2008 speech, the combined assets (i.e. loans) of the shadow banking system actually outweighed the $10 trillion on the balance sheet of the regulated banking system.

Flash. July 2007, Société Générale quietly announces that it is closing two of its Hedge Funds as they are unable to calculate the Net Asset Value (NAV) of the underlying assets — a collection of CDOs. Other people start to ask whether any of the funds they have invested in contain CDOs and if so, how much are they worth? The questions are many but the answers are few.

By the time traders get back from their Summer holidays at the beginning of September (by no coincidence the most popular month for financial crashes or panics), the bank previously feted by the UK financial establishment for its daring and un-stuffy attitude to relying massively on the money market for funding, Northern Rock, falls to a bank run. Thus begins the drawn out credit crunch crisis that results in the fall of Lehman a year later.

TWO YEARS ON

Now is a good time to take stock of where we are in the aftermath of the immediate crisis signalled by the 10/10 event. At the time many promises were made by US, UK and European governments to plug the gaping holes in regulation that had allowed the wheels to fall off.

Two years on we can say that in fact next to nothing has really been achieved. Despite the law recently passed by the Obama administration in the US, no real limits to the use of credit derivatives, and the problems they bring of unlimited leverage and "too interconnected to fail", have really been put in place.

European efforts driven by the French and Germans, always more sceptical of the Anglo-American model of unrestrained financial innovation, are being quietly but effectively blocked by a UK still keen to protect the City of London's dominant role in derivatives and eurocurrency trading (even if most of the big traders there are American or other non-UK firms).

Above all, the continuing march of disintermediation and the shadow banking system, while certainly having suffered a temporary setback in relative asset volumes, still finds the way ahead open for further expansion tomorrow. The only new regulations still on the table is the Basel III increase in the capital reserve requirements for regulated banks, which has no effect on the shadow banking system.

Although the amount of liquidity held in the shadow banking system has fallen from $22,000 bn in 2008 to $17,000 at the most recent estimates, it still remains comparable to the liquidity held in the regulated banking sector.

In the initial panic following the money market heart attack on 10/10, US, UK and other EU governments tore up the neoliberal rulebook and rushed to provide state support for the banking and financial system. Both these costs and the loss of tax and spiralling welfare costs from galloping unemployment have left these states with large fiscal deficits (the gap between a state's yearly income and spending)

No sooner had the initial panic passed, however, and the neoliberal orthodoxy re-asserted itself by saying that budget deficits must be reduced or states will suffer A Terrible Fate Worse Than Death at the hands of the money markets. In May of this year, Greece endeared itself to neoliberal preachers of austerity by being forced into the hands of the receivers (a.k.a the IMF and European authorities) by a combination of fiscal incompetence, corruption and fraudulent bookkeeping.

Even within the twisted framework of conventional economics, the agenda of the advocates of austerity does not make sense. It's not just that the inflation that they have been threatening us with since early 2009 has failed to appear. Its that the conventional distinction between structural deficits and cyclical deficits is completely ignored.

As previously mentioned, its normal for state budgets to go into deficit during the bust phase of the boom and bust cycle (or the "business cycle" as economists coyly euphemise it). This is cyclical deficit, which is normally distinguished from structural deficit — the amount of mismatch between income and spending even in the growth phase of the cycle.

Today all of the current deficits are being treated as if they were structural imbalances, with no reference to the depth of the current crisis. The German representatives are pushing for the allowable rate of budget deficit, expressed as % of GDP, to be reduced from 3% to 0.3%, regardless of what stage of the boom and bust cycle countries are at.

Although the German ruling class' psychosis around anything that might possibly cause inflation may be an historical special case, the general picture of the neoliberal right seizing the crisis as opportunity to attack state provision of social services and the social wage is not.

And yet, the current budget deficits in countries as diverse as Ireland, the UK and US, are not only due to the cyclical effects of loss of tax income (both PAYE and VAT) from the unemployed and the increased outgoings of welfare payments, but the greatest corporate welfare payments ever made. The bail-outs of the insolvent banks that meant the taxpayer, via the state, has been landed with the bad debts of the capitalist class investors in both legal and shadow banking systems. The cuts to public services we are now faced with are to pay for turning the losses of the rich into winnings.

In response to the obvious question — why can't the rich be made to shoulder their own losses? — we are told that if we did that the banks would go broke and capital flight would bankrupt the country. Essentially, the threat is that unless the majority of working people stomach massive cuts in their income to bail out the rich, the latter will take their ball home and we won't have a banking or financial system so capitalism will collapse. That the fundamental implausibility of this threat by the capitalist class to destroy capitalism has not been challenged anywhere in the media is a testament to the latter's intellectual bankruptcy.

Ranged against the sleek apostles of austerity we find the so-called Keynesian opposition of trade union bureaucrats and social democrat intelligentsia. So-called because, whereas Keynes saw that the problems of his age were due to a broken international monetary system, today's sub-Keynesians have no proposals to fix this system at this level, and no real analysis of the changes of the last four decades.

If this article has any purpose it is to argue the case that globalisation is not a slogan or a conspiracy of neoliberal policy, but a material development of the productive forces. And that financialisation is more than an outbreak of regulatory laxness, but a transformation of the global relations of production that shape the capitalist world system.

But the sub-Keynesians are not the only ones who want to turn the clock back. The rise of China as the world's leading industrial power has worried even the most pro-neoliberal imperialists in the US and EU. Again, unable to really comprehend the changes that they themselves have brought about, they now focus on the new front of the "currency wars" as the great white hope to put China back in its box and shore up the teetering edifice of Western power.

The biggest error of all is the shared assumption between both the neoliberal champions of austerity and the sub-Keynesian defenders of deficit stimulus that there is a single unified "general interest" in the nation-state, much as they disagree what it is.

Although this notion of "general interest" was always a chimera in the class society of capitalism, the current direction of the divided interests of the capitalist and working classes in the West has also been affected by the changes in the world system.

Disintermediation has divided not only individuals but also corporations into two vastly unequal categories.

On the one side are the "mediated", whose only access to credit is via banks that currently have no interest in issuing new credit to "retail" customers. In this category also fall the small and medium enterprise businesses that, while not setting the world alight with the size of their profits, happen to create most jobs for the workforce.

On the other side are the disintermediated, "direct access" large capitalist corporations and super-wealthy who care not about the lack of credit coming out of banks at the moment as they are still able to access the global financial money and capital markets directly.

This poses the possibility of a kind of tourniquet effect, of a relative recovery of capitalist profitability within the "inner circle" of the disintermediated, alongside a persistent high unemployment, lack of credit for SME and general stagnation for the greatest number.

In such a world the disintermediated have no particular fear of a generalised decay in the national societies of which they are nominally apart, as it does not threaten their ability to make profits from the global capitalist machine. Debt-deflation spirals actually increase the wealth of those who are net capital holders. Those who have amassed great fortunes in the neoliberal decades, expect to continue making money during the decade of austerity their well-fed lackeys are promising us.

But if the "general interest" is a myth as far as the "austerity now" brigade are concerned, it is no less so for the working class. The vision of an alternative that the sub-Keynesians hold out, is an illusion. They have no official explanation of why their alternative, supposedly in everyone's interest, is not the governing one. In private they may admit that it's because the governing orthodoxy is in the narrow class interests of the capitalist class. In that case then, how can an alternative be posed except that to admit itself as the antagonistic interest of the working class?

Further, where can the agency and the power be found to impose one class agenda over another, if not through the class struggle? Yet the very union bureaucrats who are advancing the sub-Keynesian agenda are the same people who deliberately sabotaged any class struggle or development of real worker's challenge to the austerity agenda, for fear of losing control over their membership and thus their bargaining chips with the bosses.

It is true that the austerity agenda is an attack on the working class and must be resisted. But it must be resisted from a position that knows that no "deal" in the general interest is possible. It must be fought on the basis of developing class power, both inside and outside of the formal wage relation, given the weakening effect of long-term unemployment on industrial bargaining power. Above all it must be fought on the basis of class antagonism and autonomy and the reaching out across national borders. That is where we are today.

FURTHER READING

As this text makes no pretensions to being a referenced academic work, I've avoided the use of footnotes as they can interfere with the flow of reading. However there are a few texts (which are properly referenced) which I'll mention for those interested in further reading. For the containerisation revolution, see Marc Levinson, "The Box", 2006. Despite missing the actual 10/10 event itself, the FT's Gillian Tett's "Fool's Gold", 2009, is a well-written human story of the people who created the world of the CDO and the subsequent fall. On derivatives there's my own "Financial Weapons of Mass Destruction" for an introduction and the canonical text is Dick Bryan and Michael Rafferty's "Capitalism with Derivatives", 2006. On the role of capital controls and Thatcher's role in bringing them down, Conrad Herold's article for The Commoner no. 5, "On Financial Crisis As A Disciplinary Device Of Empire: Emergence and Crisis Of The Crisis", 2002.

Paul Bowman
The 10/10 Event: Origins of an Economic Meltdown
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