The Economic Crisis - What are the Main Causes?

The world economic system is being buffeted by a series of crises, and this in turn has led to economic hardships for millions throughout the world. In many countries, the people are suffering in silence, but there are increasing signs of protest. There were mass protests in Britain because of tuition fee hikes, protests in France protesting the raising of the pensionable age, in Spain and Ireland because of wide budgetary cuts that have slashed spending on social services such as health care and welfare, and most recently, popular revolts that have brought down dictatorships in Tunisa and Egypt.

It is highly probable that the unfolding economic crisis is going continue sending ripples across the world, and these are to going to affect us negatively in Malaysia. There is therefore an urgent need for us to understand what is happening and why, so that we can prepare ourselves for the economic trials ahead. Unfortunately the conventional media's coverage is superficial and misleading.

In my view (and it is the view of many left thinkers, and I am not making any claims for originality!), the collapse of the planned economies of the Soviet Union and the Eastern Block, is an event that has greatly accelerated the tendency of ***outflowing of industrial capital to countries with lower costs of production*** - ie lower wages and lower tax rates. Firms that successfully relocated to these low costs locations, where the costs of labour could be as low as 1/20 that in the US and Europe, were able to reap huge profits as they were able to win over the markets of firms that did not make such a shift. As a result these successful firms had a healthy surplus that they wished to invest.

However, many of the firms that did not transfer their factories to the cheaper peripheries, were forced to down-size and lay-off workers as they were losing market share to the firms that relocated. This and the earlier decision of the "successful" firms which transferred production to lower wages locations, resulted in the ***hollowing-out of the consumer market in the US and Europe***. The "successful" firms were then holding excess funds that they wished to invest, but were faced with ***sluggish growth demand for consumer goods***. So they had to look for other opportunities to invest and realise profits, and one of the important outlets was in the financial sector - the share market, commodity trading (where contracts are made to buy or sell commodities in the future), currency trading where parties buy money in the expectation that the value of that currency will appreciate, or enter into a contract to sell a particular currency at a specified time in the future with the expectation that that currency would actually be lower than the contracted price at that specified time.

The ***existence of surplus funds seeking investment opportunities led financial institutions to create strange new financial specie such as "derivatives".*** Housing loans were packaged together and then sold as "derivatives"to investors, who thus gained a right to the income from these loans. So too were insurance policies - these too were grouped together to yield "derivatives" that could be sold to investors. It didn't end there, as there then developed a market for derivatives much like the stock market where derivatives themselves could be bought and sold. Given the fact that only about 10% of the total price of the derivative needs to be paid on purchase, (the remainder to be paid up after 30 days) the phenomenon of "leveraging" became common practice - instead of buying X shares with the fund at one's disposal, one buys 10X shares in the expectation that one will be able to sell all these shares at a higher price before the 30 day period. Financial activities fuelled by surplus funds with no outlets in manufacturing real goods, began to resemble a casino - and one where great profits could be made in a short span of time. The lure of quick profits (when times were good) led to the creation of "speculative bubbles".

But things began to unravel in 2007. There was a moderate shortage of petroleum in the world market. Manipulation of the market by the big players sent the ***oil price soaring*** to more than US 120 per barrel when the real price - if determined by the laws of supply and demand - should have only been in the region of US 60. This huge hike in petroleum prices impacted on food prices - both because the cost of food production went up (diesel for machines used to plant and harvest foods, and for the transport of food products) and because certain food crops were channelled to the production of bio-diesel.

The poorer people in the US were badly hit by the escalating price of fuel (a crucial expenditure in the winter months) and food. As a consequence they began ***defaulting on their housing loans*** in fairly large numbers. The banks had approved these subprime loans on the expectation that the housing bubble would keep expanding. If it did, houses of defaulting house-buyers could be sold off and the bank's loan outlay recovered. However, mid 2008 saw a situation where the large number of defaulters flooded the housing market at a time when the peoples' disposable income had been severely stressed by the oil price crisis. There was suddenly a glut of "subprime" properties and their prices tumbled taking down the prices of the derivative with them. The existence of widespread "leveraging" greatly augmented the financial fall-out and huge financial institutions were on the verge of collapse!

The collapse of these big institutions would have brought down the economies of the US and Europe - the still functioning firms would have been crippled by the freezing of the accounts that they had had in these banks. The resulting unemployment would have deepened the downward spiralling of the economy - the safety nets would have been sorely tested given the size of the problem. Given all of this, the Western governments did what appeared to be the only way out! They ***intervened strongly to save the financial system*** - they pumped in credit into the banks, took over some of the toxic loans, and underwrit the financial obligations of these institutions to stave off complete collapse of the system. And the intervention worked - systemic collapse was everted!

But there was a price to pay! Many Western governments ran up huge deficits in order to save the banking system. They now had to turn to the financial markets (where the surplus funds of the "successful" corporations" are parked) in order to meet their various obligations. But the financial markets are not running on the basis of charity. They assess each country's capacity to pay back the hundreds of million being asked for. If that country's finances aren't too great they may request higher repayment rates as its a more "risky" loan. If that particular country is a "poor risk" then the banks may refuse to lend as happened in Iceland and Greece. The government of such a country then might go bankrupt - again something that the other countries will not allow as that will cause too much turmoil. So the European Union stepped in with a loan - but this exacerbates the budgetary deficit in the EU countries!

There is therefore an ***urgent need for the European countries to trim their budgets*** and cut budgetary deficits so as to improve their standings in the ratings of the financial markets. This is the push behind the slashing of the social safety net that is taking place in several countries in Europe. However this slashing of social spending ***further contricts aggregate demand*** which is, as I have explained earlier on, the major cause of the current economic crisis. Falling aggregate demand in the EU zone is also the reason why unemployment has reached such high proportions in countries such as Tunisia and Egypt.

Only a regeneration of aggregate demand on a world-wide scale can fuel sustained growth of the global economy 'which may not the smartest thing to do fron the environmental point of view!). However such a regeneration cannot take place because it would require a more equitable distribution of the wealth - with a larger share going to the hands of the ordinary consumers. Though this is in the long term interest of the major capitalists corporations, it is ***extremely unlikely that the biggest 500 corporations are going to agree to measures that will redistribute the world's wealth more equitably***. And as they are multinational now, the hands of government are tied. Attempt to redistribute income more equitably in a particular country will probably lead to capital flight from that country and unemployment.

The US' attempt to stimulate the economy by putting more money in circulation (quantitive easing) is again fuelling speculative bubbles all over the world, as the underlying root cause has yet to be addressed - there just isn't enough demand in the real economy to attract investment in industrial capacity. The world capitalist economy is between a "rock and a hard place". Given the intractable nature of the problem we ***shouldn't be surprised if the world economy goes into another recession this coming year***, and we need to prepare ourselves so that the most vulnerable are taken care of. And the first step in that preparation is to decide whether you agree with the analysis presented above. We need a clear analysis of the problem to be able to steer the ship!

Jeyakumar Devaraj