Sub-Prime Driven Recession: Coming Soon To a Neighbourhood Near You

The New Global Financial and Economic Crisis

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A discussion board for this pamphlet has been set up at:
http://tinyurl.com/4b6gg3

Introduction

Already millions of people are feeling the chill wind of a global financial and economic crisis that is beginning to sweep the world. In the United States (US) where the present crisis has its roots, there are scenes that are the 21st century equivalent of the great 1930's slump. Homes are being abandoned and stripped of all valuable fittings and are being occupied by the homeless. The police are being employed by the mortgage companies and banks to evict them. Empty homes are boarded up everywhere across the country. Home ownership has fallen to the lowest level since 1945 and house prices have collapsed by 11% in the last 12 months. In the US they are calling it a sub-prime crisis as if the people affected are some inferior sub-species of the human race. We could see the same pattern repeated in the UK and Scotland as the housing bubble here starts to deflate.
At the same time there are almost daily reports of panic and meltdown in the financial markets affecting every corner of global finance. The UK government had to step in with the largest nationalisation in history using $220bn* of tax payers' money to effectively prop up the global financial system. In the US the Federal Reserve, Bank (The Fed) essentially the US government, has orchestrated the rescue of one of the US's largest Wall Street investment banks in the fear that its imminent collapse would create a financial panic. Such was this bank's interconnection with the whole financial and economic system.

The language and participants of global finance are shrouded in mystery with such terms as LIBOR, hedge funds, derivatives and collateralised debt obligations

designed to confuse and keep ordinary people in the dark.
In the real economy we are starting to see major problems as people experience levels of inflation not seen for decades. The government tells us it's about 2% but it feels much higher as food, housing, petrol and utility bills rocket. At the same time these mature economies of the West face new competition from a growing large capitalist economy – China.
What lies behind this crisis and why is there talk of a 1930's style slump? That is what we set out to answer in this pamphlet.
This is not the first time that the capitalist economic system has been on the verge of a big meltdown. Capitalism has been prone to periodic economic crises ever since it first emerged. This must suggest that there is something inherently unstable about the way capitalism functions, going from boom to bust and back to boom to be followed by bust.
Indeed as capitalism expands, the gap between supply and demand becomes ever greater because, sensing the good times, capitalists rush to expand their productive output in order to make greater profits. As a result there is then a crisis of overproduction and oversupply. As soon as this point is reached, capitalists, fearing a fall in profits, scale back on production, thus sacking workers, depressing demand and deflating the economy. The crisis then becomes of a crisis of lack of demand. But as the bottom of the cycle is reached, some capitalists take advantage of the situation, buy up their competitors which in turn creates the conditions for growth again.
These economic crises are inherent and endemic to

capitalism because each boom provides the basis of the next slump and each slump provides the basis for the next boom. This becomes a perpetual cycle that will endure so long as there is capitalism.
What's more, each boom and slump tends to be bigger than the last one because each cycle brings about the ever greater concentration of capital into a smaller and smaller number of bigger and bigger capitalists. As a consequence if one of these ever bigger capitalists goes under, then it threatens to bring the whole system down with it.

The structure of the pamphlet is that in Section One, we start by trying to get behind the smoke and mirrors of modern global finance and explain in lay terms how the different markets operate and how they are linked to the real economy and real people. We find that the interconnectivity of global finance can transmit a problem such as the sub-prime crisis round the globe to its every corner so that millions of people are affected in some way by it.
This is a marked difference from the 1930s slump where a crisis in the banking system was limited to the United States. Modern finance has the ability to magnify and transmit a financial crisis in one major economy to all the world's economies.
You can read the whole of this section in one go, dip into when you want a fuller understanding of some other sections, or skip it all together and come back and read it once you have read the rest of the pamphlet.

We then take a look at the global economy since the end of the Second World War and see that it has been stagnant since the late 1960s and that the tools that have been used to avoid slumps such as those that happened in 1974/75 and 1979/1980 have come to the end of their shelf life.

Next we turn our attention to the current UK housing crisis and show it is very complex. Various problems have come together at the same time which could lead to a bigger slump than in the 1930s.

We examine the possible effects of the crisis on ordinary people around the world with a particular focus on it's affects in Scotland.

Finally, we look at a long term socialist alternative to capitalism's crises and a different economic system which could put and end to booms and slumps and provide everyone in the planet with a good standard of living – housing, food, health and culture – and a dignified and fulfilling existence. However, we also show the immediate policies socialists would put forward to defend the living standards of people in Scotland today.

* In this pamphlet we measure all financial quantities in US dollars and one billion will represent 1,000,000,000 US dollars and one trillion will represent 1,000,000,000,000 US dollars and they will be abbreviated as $1bn and $1tn respectively.

1. The Global Financial System

The global finance system has developed into a beast that can spread a crisis around the world almost instantaneously leaving no corner or person untouched. It is shrouded in mystery and is given almost god like status as it is worshiped in awe by the media. Terms such as "the Footsie reached new highs", "LIBOR has an inverted yield curve", "the Fed has cut rates", "CDOs are blowing up in all sorts of unexpected places" and "hedge funds are synthetically short", leave the ordinary person puzzled. They represent a barrier set up by financiers to create a reverence around the system and an almost obedient servitude to it. Here we will try to demystify it, showing its inner workings and how something, such as poor people in the United States unable to meet their loan repayments, can create a global meltdown of the whole financial system.

The roots of the modern financial system lie in developments in the early 1980's when investors of capital could not find avenues where they could obtain reasonable returns after a decline, from the early 1970's onwards, in the profit levels of traditional companies. Changes to the financial system were created largely by the neo-liberal governments of the US and the UK to find fresh outlets for under achieving investments. These changes were:-

- the deregulation of financial markets
- the ending of international investment restrictions abroad
- the introduction of cheap new powerful technology
- the ability to use financial models previously too cumbersome and expensive to run on less powerful expensive computers
- instantaneous communication between financial markets around the world

The new global financial system became more interconnected and based on products based on a whole

> Case Study: Leverage. Leverage is when you buy something with borrowed money because you cannot afford the full price. For example, you want to buy that new car that costs £30,000. You don't have the full £30,000 but can only put a deposit of £3,000 down on it. You borrow the rest from a finance company hoping to repay this loan from your monthly salary. If you lose your job and can no longer pay the loan the car is taken from you by the finance company.

raft of financial theories. These could not have been previously implemented without today's cheap desktop computing power. We will take a look at the different markets, the participants and how assets are transacted on these markets. We show by example how the global system is now so interconnected that this could mean that any major financial crisis could dwarf that seen in the US banks during the 1920's/30's. That set off a global slump (depression) that ended in world war, the death of hundreds of millions and the destruction of whole societies.

The key financial markets can be divided into the following distinct categories:

• money markets • bond markets • currency markets

• equity share markets • derivative markets

The participants in these markets can be broken down into the following categories:

• investors • speculators • hedgers • arbitrageurs

• executioners • risk takers • lenders and borrowers

We will first examine the key financial markets. Then we will see who the participants are and how they operate.

1. The Financial Markets

Money Markets

This is where the financial institutions and corporations raise and lend cash to run their businesses in the short-term, i.e. for periods of less than 1 year. The box below explains how it operates and relates to a central bank (essentially the government's bank).

Bond Markets

Bonds are nothing but loans for a period longer than one year. They are a way of raising money by corporations and governments by lending a named amount which is normally in multiples of 100 of the currency of the loan.

The issuer or borrower will guarantee to pay the lender a fixed sum of interest expressed as percentage of the named amount. There is a risk that the lender will default on the loan. As consequence this will reward the lender with a higher rate of interest than can be obtained from a lower risk investment, say in a bank's deposit account. Corporations are particularly likely to do this. Governments rarely go bankrupt although the Russian government did default on its loan repayments in 1998. UK government bonds are called gilts (gilt edged stock) and US government bonds are called treasuries. It is a way of governments raising money to spend on large public projects or trying to reduce any deficit in their finances.

Currency Markets

This is a market for the exchange of one currency for another and this involves private transactions between very large banks. For example a sterling exchange rate of $2 means that you would exchange two US dollars for one pound sterling. The markets main centers are Tokyo, London and New York with London being the largest. The currency market is the biggest financial market by value in the world, trading on average over $3tn a day. All the market participants are active in this market, as well as corporations meeting their foreign currency requirements.

Equity Share Markets

More commonly called the stock market after joint stock companies which buy and sell shares there. Companies issue ordinary equity capital called ordinary shares to raise money for investment. These are traded on regulated markets and unregulated markets across the world. The price of these shares is driven by supply and demand, information on the economy and news affecting particular industrial sectors and companies. Indices are calculated to give investors a general feel for the direction of the overall market and its particular sectors. These are based on the market value of each company (the price of the company's shares times the number of ordinary shares issued by a company). The market values of a group of companies are added together to calculate an index. Examples are the FT-SE 100 (Footsie) which is an index of the largest 100 UK companies. The Dow Jones 30 is an index of 30 leading US companies and the Nikkei an index of 225 leading Japanese companies.

Derivative Markets

Derivatives are a paper contracts which allow you to buy or sell an asset at some point in the future. There are two basic types. The first gives you the obligation to buy or sell. These are easy to value and are based on the fact that you do not have to buy the asset until some point in the future and the money you need to do that is deposited in a bank account until such time.

The second type of derivative gives you the right and not the obligation to buy an asset in the future. These derivatives are called options, they are difficult to price and there are a variety of approaches and assumptions to do this.

All derivatives are highly leveraged with only the requirement to make a small deposit (margin) at the outset of the trade and then make or receive daily payments based on the value of the derivative to you.

Derivatives trade in two ways. The first is the listed market in the huge daily values quoted on a basic range of underlying assets – currencies, bonds, interest rates, stock market indices, commodities and even animals. These are the most simple and easy to trade and have the highest value of trades per day. Though without the proper controls they can be very dangerous. It was listed derivatives which were at the root of the recent Barings Bank collapse and the Soc Gen trading losses.

The second way they can be transacted is over-the-counter (OTC) – a private agreement between two parties. This tends to happen for the more complex, bespoke and large value derivatives such as the CDOs(collateralised debt obligations) which we will describe later on.

All the participants use the derivatives markets for a wide range of purposes. In a controlled fashion they are excellent at reducing risk and transaction costs. But the complexity

Case Study: Interest Rates

The Bank of England (BOE) cut interest rates on 10 April 2008 to 5.0%. Why can't ordinary people borrow at this rate and why have mortgage rates not moved down? The BOE controls the base rate and they moved this down by 0.25% to 5.0%. This is the rate they will lend to national banks. These banks then lend and borrow in the interbank lending market. To make any money they have to lend at a higher rate than they are able to borrow at. They also, have to consider if the bank or institution they are lending to will default on the loan. The most highly rated banks – called triple A – will be quoted a LIBOR (London Interbank Offer Rate) number which they can borrow money at. This figure only fell by 0.05% in the wake of the BOE's rate cut. This reflects the uncertainty over the financial future of all institutions – that is the likelihood that they will default on any loan which is unsecured. There are only two large triple A banks left in the market and one of them looks like it might be downgraded to double A. This means its chances of defaulting on a loan have increased. The mortgage lender that most people use will not have such a high credit rating as tripe A. They will have to pay a higher rate than LIBOR and they will to want to make a profit on the mortgage. Banks such as HBOS are paying a large premium over LIBOR. This reflects the lenders' views that HBOS's financial position will deteriorate because of its exposure to the UK mortgage market and its high dependence on the money markets to fund its loans for borrowers.

and lack of understanding of some products, such as with CDOs, can mean they are a time bomb waiting to explode.

2. The Participants

Investors

These are the largest group of participants, by value of investments. They buy and hold financial assets for 1 to 35 year periods (medium to long term). These investors are largely ordinary people who have their money invested through:- pension fund contributions, life insurance policies, endowment policies and collective investment schemes. These allow individuals to invest any excess money they have in financial assets. Examples of these would be ISAs and special funds e.g. UK equities. These investments are bought and sold and managed by large institutions e.g.:

• a pension fund company (e.g. Lothian Pension Fund)
• an insurance company (e.g. Norwich Union)
• a fund management company (e.g. Baillie Gifford).

Through ownership of these institutions, about 75% of financial assets belong to ordinary people. For example the breakdown of the average pension fund in the UK is as follows:-

• 28.7% UK equities
• 26.4% Non-UK equities
• 23.9% bonds
• 9.6% index-linked investments (inflation protected government bonds)
• 11.4% property and money market instruments (cash)

•The majority of shareholders in private corporations are similar people to those they employ and exploit. This is the irony of global finance in modern capitalism. Not only do we make the corporate profits, but we own much of them and raise the capital for them to exploit us more!

Speculators

There have been speculators since the first financial markets. They take positions (buy or sell financial assets) in anticipation that the financial assets will appreciate or depreciate because of the influence of some outside factor. A recent example was Black Wednesday when many speculators thought the UK government would be forced to withdraw from the European Exchange Rate Mechanism and cut interest rates dramatically. Some sold sterling and bought other currencies. They expected sterling to weaken against these other currencies as interest rates in the UK fell below European interest rates. This meant that investors would rather deposit money in Europe than the UK because they could obtain a higher rate of interest.

A more subtle form of speculation was the buying of property related shares – property companies, building companies and building material companies – anticipating that the likely cuts in UK interest rates would create a revival in the UK housing market. This would lead to more business for all these sectors and higher profits. These types of ‘trades’ were executed by traders in investment banks. Some later left the investment banks and set up their own leveraged companies. Together with speculative fund managers, they set up hedge funds. They combined speculation with other investment strategies which we

describe below.
Speculation can lead to financial bubbles when more investors pile into a particular product (strategy).

Hedgers
Hedgers are investors who want to protect the current value of assets from falling in the future. Take for example a UK pension fund that owns UK equities. If it is worried about the prospects for the UK economy, and hence the value of its UK equities, it can sell a derivative or something else on its portfolio and eliminate all potential losses or some of the losses. Corporations also hedge for example if they have to pay for something in a foreign currency at some date in the future. They are worried that their own currency will depreciate against the currency they have to make the payment in. So they buy an 'insurance' or hedge, through a forward foreign exchange contract to cover any shortfall in what they have to pay. Hedging has grown dramatically since the early eighties with the introduction of derivative markets. The strategy has spilled over into speculative investing where hedging can reduce the risk of a "trade" but also the potential profit.
Derivatives can be used to increase speculation too as they are highly leveraged. In some cases, they are easy and cheap to buy and sell. A recent example of speculation going awry is the Soc Gen Futures trader who lost nearly $8bn in speculative trades using derivatives based on equity share indices. There will be more on those indices later in this section. Many hedge funds use them as a leveraged speculative tool or for reducing the risk of a speculative trade.

Arbitrageurs

These are a group of investors who try to take advantage of differences in prices of similar assets or groups of assets. They will buy (go long on) the cheaper asset and sell (go short on) the more expensive one expecting over a period of time that the prices of the two assets will converge. They will make a near riskless or low risk profit depending on how alike the two assets are and other technical factors. The simplest case is an arbitrage between the shares of the companies in an index such as the FT-SE 100 and a derivative based on the FT-SE 100 index. These arbitrage trades can be quite complex and there is no guarantee that they will result in a profit. Especially if the relationship between the buy and sell sides of the arbitrage becomes more tenuous.

One such arbitrage transaction which went wrong and nearly caused a meltdown in financial markets was one involving Long Term Capital Management (LTCM). They lost $4 bn in 1998. LCTM had bought less easily tradable cheaper Russian government bonds and had sold the more expensive bonds of the developed countries expecting the prices to converge over time. But in August 1998 the Russian government defaulted on its debt payments. There was a flight from low quality cheap government bonds that LCTM had bought to the more expensive developed governments bonds which LCTM had sold. This resulted in massive losses. Because LCTM had bought and sold the bonds from investment banks, there was the possibility that their failure to make payments to these banks could lead to a domino effect through the financial markets. So the US Federal Reserve Bank stepped in with a $3.5bn rescue package.

Arbitrage trades mostly originated within investment banks. They have been taken into the hedge funds by traders who have helped set up these funds.

Executioners

These are financial intermediaries who simply carry out financial transactions on behalf of financial institutions or individuals. They take no risk and take a fee for facilitating the transaction. Mortgage brokers are the first example. They arrange a mortgage between an individual and a bank and take a fee for doing so. A second example is the case of a pension fund that wishes to buy UK equity shares and goes to an investment bank to buy them. The investment bank acts as agent in the UK equity share market and takes a commission for executing the transaction. These executioners are essentially living off the crumbs that fall off the slices of a big cake, our cake, when it is cut into lots of small pieces.

Risk Takers

These are institutions which commit their own capital in a financial transaction. Take the two examples above. In the first, a bank will raise funds and pay for the house and take this house against this loan as security. If a person defaults on the loan repayments then the bank will repossess the home and sell it to raise the money to pay off the initial sum it borrowed. There is the risk that if house prices have fallen since the date the loan was taken out then they will have shortfall on the original loan and make a loss. This will become an increasing problem in the UK as house prices fall from their all time highs.

In the second case the investment bank may go to another investment bank and buy equity shares that the second bank is offering to sell at a guaranteed price on the electronic equity share market. The second bank will have the equity shares on its books and it bears the risk that these equity shares may fall in value.

Lenders and Borrowers

Lenders fall into two basic categories. The first loans money to individuals. They are called retail lenders and there are retail arms of banks such as the Halifax Bank of Scotland and the Royal Bank of Scotland.

The second are the large banks which lend to other banks and financial institutions. These banks have large amounts of capital. They are highly rated by the credit rating agencies being given a triple A rating. This means they have a low probability of defaulting on loans or going bust. An example of such a bank is HSBC. But many of the banks have been downgraded over the last few months leading to higher rates of interest for loans.

2. The Global Capitalist Economy since World War Two

You cannot understand the current economic crises without understanding how capitalism has evolved from its last major crises – the 1920/30s depression and the 1974/75 and 1979/80 recessions.

In the 1950's and early '60's, capitalism was able to expand rapidly from this lower base level. Initially it had a more a compliant workforce. The introduction of new technology was linked to space exploration and the armament industries. There was also a growing arms economy, which excess capital could invest in, as a result of the 1950'sand '60's Cold War.

Company profits expanded and the rate of profit increased steadily over the period from 1945 to 1965. There was growing investment and accumulation of capital (profits). This all came to an end in the late 1960's as profit rates stagnated, then started to fall and the accumulated capital could not find new markets to invest in. The profits of companies are based on the extra value that labour contributes to the production process. But labour was being replaced by machines, labour saving devices and other new technology. These, in themselves, create no new value. They merely pass on the value (manual and intellectual) of the labour incorporated in their production. The amount of profits that corporations made therefore fell. This together with an over capacity of production led, in 1974/5, to the first generalized synchronized recession since the end of the Second World War. There was a massive crisis of over-production as stock piles of unsold goods and services built up in warehouses all round the capitalist world. This was compounded by a fall in the rate of profit for corporations and on top of that a hike in the oil price. After a partial and hesitant recovery the world capitalist economy entered a second recession in 1979/80.

Capitalism tried to deal with this crisis using several approaches. One was to create new avenues for excess capital. They did this in two ways. One was to privatise large chunks of state industries - that is open it up to private capital. The second was to liberalise the financial markets to encourage cross-border investment and the invention of new financial products that excess capital could speculate in.

Another solution was to create a larger level of consumer demand amongst working people so as not to repeat the previous crisis of overproduction of 1974/75 and 1978/80. They did this by expanding the credit markets for mortgages, loans and credit cards. It is this boom in credit, a credit bubble, which has come to end with the sub-prime crisis in the US and the start of the bursting of the housing bubble in the UK. This has ended one of late capitalism's tools to dampen and reduce the frequency of recessions.

New Markets?

An unexpected event happened in the 1990s which offered capitalism some reason for hope. It was the restoration of capitalism in the former Soviet Union, Eastern Europe and China. This opened up potentially new markets for capitalism to sell its goods. It was hoped that this could help solve the crisis of over production. The first two regions have proved to be less fruitful than at first expected. Although trade with the regions has doubled with the capitalist West, it was originally at very low levels. Their economies, infrastructures and capitalist systems have not developed and are still largely controlled by the local "mafia". As a consequence they have not produced a vibrant economy and financial system. Western companies are not willing to commit large investments to these new 'capitalist regimes'. However, China has followed a different path.

RECESSIONS AND DEPRESSIONS

Recession – This occurs when a period of economic growth comes to an end due to falling profit rates, leading to overproduction and stockpiling of goods. It can also be triggered by a financial crisis following a speculative bubble.

The last two major recessions in the UK occurred between 1974-5 and 1979-80. Japan has suffered a prolonged recession since 1990, which spread into much of the rest of the Far East (except China).

Depression – This is a major downturn in economic activity, leading to long-term unemployment and great hardship.

The Long Depression (1873-96) mainly affected the agricultural regions of Europe. New farmlands, particularly in the Americas and Australia, were able to produce food and raw materials more cheaply. Large scale emigration eventually helped to relieve hardship.

The Great Depression (1929-39) affected the whole world. It was triggered by the speculative bubble in US shares. Closures of factories and mines led to large-scale unemployment. Low agricultural prices forced many small farmers out of business. It took the destruction caused by the Second World War before a full recovery was made. The organizations of the working class had been greatly weakened.

China: the New Competition

China has proved to be a double edged sword. While it has opened up new markets and is a source of cheap labour it also becoming the West's main competitor. It has much lower wage costs and a much lower level of automation in its production processes, which means it can achieve much higher profit levels than Western corporations. It is also a source of competition for natural resources and food as it develops a growing workforce spending more money and rapidly expanding industries able to suck up global commodities. This has led to food and commodity price inflation. This has come at a time when the West wants to cut interest rates to try and stimulate its own economies.

However, the US has cut its interest rates dramatically. It prefers higher inflation to a deep recession. The UK and Europe have cut rates very slowly or not at all. They are more concerned about inflation. More of this will be imported if their currencies weaken.

As we will show later the effect of cutting interest rates is limited because of the 'Credit Crunch' and the US may in the end have inflation and a recession a phenomenon known as stagflation.

At the same time in the West the rate of profit has stagnated and shows no sign of improving. Capitalism has really come to an impasse with low profit rates, a credit crunch, a global as yet not fully understood financial crisis, growing inflation, food shortages for the poor, commodity shortages and competition from China.

The Effect of the Crisis on the Emerging Economies

How will the emerging economy of China, along with India and Brazil, be affected? Their economies are largely based on export sales to the richer countries of the West. The effect of the global economic and financial crisis will be to slow down these emerging economies considerably. The reduction in demand for goods from these emerging economies from the US, Europe (including the UK) and Japan (which has already slipped in to a recession), together often called the Triad block, will put the brakes on their economic growth. The global corporations of the Triad bloc will also reduce their production in these emerging economies. This will also cause a reduction in the amount of goods produced there as demand for their goods decreases.

Inflation

A second major problem for these emerging economies is the growth of domestic inflation fuelled by an increase in the wealthy minority amongst their populations. Although this minority is small in proportion to these countries' total population it is, given the huge populations of these countries, significant compared to the Triad's population. This growing now wealthier population is putting pressure on the goods they are demanding – property, food, consumer goods. This is resulting in inflationary pressures both in their domestic economies and in the international economy as a whole. This demand is the largest contributor the rise in global food prices representing about 70% of the price increases we have seen in the last year. The other contributor is the conversion of wheat products into bio fuels. Ironically, the Chinese and Indian governments have raised interest rates to try and dampen this demand and hence reduce their domestic inflation. This is a bit like what Tweedledee and Tweedledum (Brown and Darling) did just before the sub-prime crisis broke in August of 2007. The effect will be to further slow the emerging economies more just as they were starting to slow as a result of the growing recession in the Triad economies.

A third major factor in slowing these emerging economies is that the property and stock market bubble in these economies has started to deflate – the Chinese stock market has declined 45% since August 2007. Therefore, the wealthy minority will start to feel less well off as the value of their assets in property and shares falls. This will lead to a reduction in their consumption.

A fourth factor is the weakening currencies of the Triad block – particularly the $ - will reduce the income in their domestic currencies from the sale of goods from the emerging economies to the Triad block.

Finally, the banks and financial institutions of these emerging countries have exposure to the sub-prime market via instruments such as the CDOs.

A combination of all these factors could well push these emerging markets into recession.

The Effect of the Crisis on Third World Debt

The mountain of Third World debt on the poorest countries and people on the world was created in the 1970s. The $182bn that was owed in 2006 by the public authorities of these poor countries to the international banks of the Triad countries is a multiple of the original debt. This is largely as a result of a big increase in interest rates by the Federal Reserve in 1982. This multiplied the size of the original debts because of the consequent increase in the debt repayments.

The Triad's international banks have already written off $300bn as a result of the sub-prime crisis. Many experts, including the International Monetary Fund (IMF), believe this figure will grow closer to $1 tn. In addition the UK government has spent $220bn nationalising Northern Rock basically to save the global financial system. Why then can these banks and their governments not write off a smaller debt which was imposed upon the poor of world via despotic dictatorships and has multiplied because of the fiscal policy of the US central bank?

Effect on Climate Change and Natural Resources

Capitalism will now resist any effective measures to reduce the effects of climate change. Such measures cut into the profitability of corporations and, as they face declining profits because of recession, they will oppose any further green measures which further eat into these already falling profit levels.

At this same stage of a global recession /downturn you would normally expect that commodity prices would decline as the commodity markets anticipate a slowing demand as global industry slows down. This is not the case as commodity prices, particularly oil, continue to rise. This is a result of several factors: the growth of the Chinese economy and its demand for commodities. The fall in the US dollar, which most commodities are priced in, means producers need more dollars to match the local currency value of the commodity. Added to these factors, there is the fear that key commodities are close to reaching their peak production again particularly oil. Since the turn of the new millennium commodities have become a major investment asset attracting both long term investors but also speculators. These higher commodity prices have started to feed through into producer prices (the price of factories producing goods) – the UK has reported the biggest increase in these in seventeen years.

Extreme weather which is one of the byproducts of climate change is reducing and wiping out harvests in the poor south. This is leading to food shortages, more starvation and rising food prices for the poorest people on our planet.

However, price rises in foodstuffs and fuel are having a far more devastating effect in the Third World countries. There is no actual shortage of food in the world, but the poor millions in the shanty towns and countryside can not afford to buy basic necessities. This is why we are seeing pictures of people in Haiti eating mud pies to fill their stomachs. Capitalist barbarism has already arrived in much of the Third World.

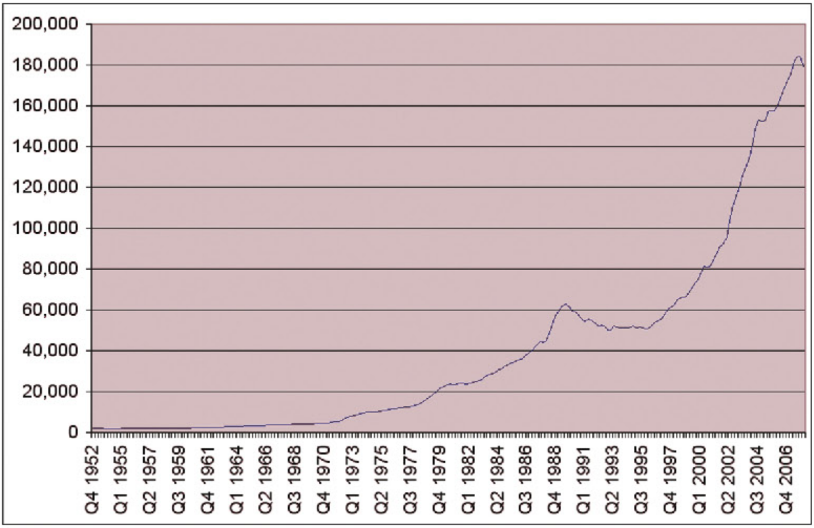
3. UK Housing Market: A Bubble about to Burst

A Brief History of Economic Bubbles

The latest news of the first monthly decline in the average selling price of a UK house indicates that the bursting of one of the great economic bubbles of modern times is well underway. We will show that the UK housing bubble is much larger than in the US because the low interest rate policies of the early part of the new century have been compounded in the UK by two other factors. The graph shows that the average UK house price has increased 4.5 times since the start of 1987 this is compared to about a peak of 3.5 times in the US. We are therefore likely to see a much larger fall in house prices in the UK than in the US where house prices have already fallen 11% from their peak. In the UK we expect to see a fall in house prices of between 20% and 40% from the peak, meaning that the average peak house price of £184,000 would fall to approximately between £147,000 and £110,000. This will have serious consequences for the economy and individuals. We will discuss this later in this section. We will also, show that, despite what Brown is saying, the main reason for the housing bubble in the UK was the Bank of England's policy of dramatically cutting interest rates to avert a recession and to revive the stock market at turn of the last century.

"that he could not calculate the madness of people" – Isaac Newton when asked to comment on the South Sea Shipping Bubble

Economic bubbles are not new of course and below we describe some of the most notable ones .



Average UK House Prices (£) Q1 1952 to Q1 2 2008

Bubbles are characterised by a frenzied greed where all rational decision making and valuation is thrown out of the window. Investors bury their heads in the sand refusing to acknowledge the real value of the assets they are buying and the fact that buyers will eventually run out. External factors beyond their control will also affect the value of the asset itself or the economic position of the investors.

Today's situation in the US and UK housing markets most resembles what happened in the famous Wall Street Crash of 1929. This started around a recovery in the US economy in the early 1920s as individuals started to buy shares in US companies. They borrowed heavily from banks to do this and they were highly leveraged – the shares in companies

SOME FINANCIAL BUBBLES

1. The Tulip Bubble (1636-7) in the Netherlands saw the Dutch population taking part in a speculative frenzy based on borrowed money. This resulted, when it burst, in many individual bankruptcies and the Dutch economy slipping into what we would now call an economic depression.

2. The South Sea Bubble (1720) in the UK saw wild speculation in a company to which the government had given exclusive trading rights in the Pacific. When it was found that there were few market prospects the bubble burst.

3. The Railway Mania (1847) in the UK led many people to invest in railway projects which had little basis in reality. The 1847 Crash also coincided with the Great Famine in Ireland. Poverty stricken peasants died in their hundreds of thousands because they could not afford the plentiful wheat crop but had to live on blight-destroyed potatoes.

4. The Wall Street Crash (1929) in the USA was preceded by a frenzy of share buying in industries which believed the 1920's American consumer boom would never end.

5. The Dot,com crash (2000) saw the biggest ever drop in share prices ($2tn) when it became clear that the many dot.com companies which had been set up were grossly overvalued.

were paid for by borrowed money from the bank. The banks took the bought shares as security against these loans. A speculative frenzy drove the price of US shares to way above what their real economic prospects indicated. A correction on Wall Street started panic selling as investors tried to sell their shares to repay their loans. This drove the stock market down by 89% over a period of 3 years and it took until 1954 for the market to recover to its pre-crash level. Banks across the US went bust as they could not recover the loans and the price of the shares they held as security had fallen in value radically. This slowed the whole economy to a halt as both individuals and banks went bankrupt and the economy slipped into the Great Depression of 1929-39 which spread throughout the world.
The 1929 Crash was a reaction to the performance of the US economy. It transferred itself into the stock market, then into the banks, from there to individuals and finally back into the economy.

The Great UK Housing Bubble
The great 1980s UK housing bubble, which is now deflating rapidly, started with problems in the economy in 1970/80s and was inflated by:

• government policy around selling council houses
• a disastrous entry into the European Exchange Rate Mechanism
• central bankers cutting interest rates to avoid a deep recession at the turn of the millennium

The last major economic recessions in 1974/75 and

What is a Mortgage?

Mortgage lending is a form of leveraged borrowing. Home buyers borrow from a bank or building society multiples of their income to buy an asset, their house, paying some initial (or in some cases no) deposit. The bank or building society takes the house as security against the home buyer not being able to meet their loan. As long as house prices stay the same or increase and the homeowner remains able to meet their mortgage (loan) repayments which relate to the inflated price the house was bought. The problems now are that house prices are starting to fall and some homeowners are beginning to have problems meeting these repayments.

In the past, mortgage borrowers had to put down a substantial deposit. This ensured that the building society or bank making the loan retained substantial funds to pay off any unforeseen demands. Building societies and banks were not highly leveraged, i.e. there were limits on the amount of money they could provide. Recently, mortgage borrowers have not had to make any prior deposit. This means that building societies and banks are more highly leveraged and can loan much greater sums of money. It also means they are in a much worse position if borrowers are unable to pay up. This is the kind of situation that caused the Wall Street Crash in 1929.

1979/80 saw a massive overproduction of goods and services with factories and warehouses stockpiled with unsold goods. Capitalist governments sought to stop a repeat of such a crisis of overproduction. One way was to find alternative avenues for investments; the other was to increase consumer demand for goods. The US and the UK in particular did this by privatising state industries. Excess capital flowed in and created a climate and appetite for credit amongst their working and middle classes.

One way this was carried out in the UK was to sell off council housing. This allowed spare capital to be invested in a growing private housing market and created a shortage of social housing meaning that ordinary people were forced to look at buying private housing rather than renting a council home.

The second way was to create a feeling of wealth through home ownership. This encouraged people to borrow money through credit – loans and credit cards. Thus, at the beginning of the 1980s, these factors started the great UK housing bubble.

Another factor, was also absent in the US, was the UK's entry in the European Exchange Rate Mechanism (ERM). Before the creation of the Euro, the ERM ensured that the different members' currencies exchanged against each other within defined limits. However, because of the weakness of the UK economy and hence sterling, the UK was forced to keep interest rates high to attract investors into sterling assets to keep it within the restricted bands of the ERM. This was not sustainable and on Black Wednesday in September of 1992, the Tory Chancellor put interest rates up from 12% to 15% and then announced Britain was withdrawing from the ERM and slashed them to 12% again. This allowed the UK to cut interest rates dramatically and bring the country out of recession but at the same time create a boom in the housing industry and a growth in credit.

The final stimulus to the UK housing market came at the turn of the millennium when the US had slipped into recession and the Dot.com shares bubble burst. The US central bank, the Federal Reserve, cut interest rates aggressively and Chancellor Brown followed suit. This fuelled a massive boom in credit and house prices. All types of liberal lending practices developed - buy to let, no deposit mortgages, loans of a multiple greater than three times one's income, re-mortgages, loans secured on equity in homes, and low fixed rate mortgages. These are the UK sub-prime loans. This is why the UK housing bubble has just come to an end.

The Fed and Bank of England Inflates the Housing Bubble

The US central bank, the Federal Reserve, cut interest rates aggressively, during 2000/2001 to dampen the domestic recession and lift the stock markets after the dot.com shares bubble burst. They cut interest rates to as low as 1.0% - in the UK they were cut to a low of 3.5%. This created the conditions for a credit boom and in particular a house lending boom which because of the low level of interest rates was aimed at low income families or even families on social security. They could be charged a much higher rate than the market interest rate to compensate for the increased risk of these borrowers defaulting on their loans.

Mortgage brokers sought out these loans and then laid

them off onto investment and commercial banks who repacked them as complex securities called collateralised debt obligations (CDOs). These were then sold on to hedge funds, pension funds, insurance companies and banks all over the world reaching every corner of the global financial system. The model that is used to value these products was flawed and based on a very low default rate by the sub-prime borrowers in the US and a very low estimation of the close relationship between these borrowers.
When the Federal Reserve started to put up interest rates to cool the credit boom and curb creeping inflation, the default rate amongst the sub-prime borrowers picked up dramatically. The closeness of the relationship between these borrowers turned out to be much greater than at first estimated. This caused the value of these CDOs to fall rapidly leading to losses throughout the global financial system. Losses so far are estimated at $300bn to $500bn with the International Monetary Fund believing that the final losses could be nearer $1 tn.

The Chickens Come Home To Roost
In August 2007, these losses caused the money market to dry up as nobody would make loans to each other as lenders did not know what risk the borrowers were carrying. This is an unsecured lending market (i.e. not guaranteed by the government). The interest rates quoted are based on the borrowers and lenders having the highest credit rating called triple A. There are now only two major banks which still are rated at triple A and one of those is on a negative watch – that is it could be downgraded. This means those lending money put a premium on the rates they will lend at to other financial institutions depending on their view of

how risky was the borrowers business. No matter how low central banks cut interest rates – where they would lend to the triple AAA rated banks – it made no difference to the rate where these banks would lend on in an unsecured manner to other financial institutions. This is the so called 'Credit Crunch' and it is filtering through to every level of society right across the world.

The 'Credit Crunch' is causing the deflation in the UK mortgage market. As all the exotic cheap deals end, lenders put up the rate that people borrow at to buy a house. They will only lend to the most secure borrowers because they can now only access a much smaller pool of money.

Therefore, the demand for property will fall sharply with fewer buyers seeking to purchase houses. It's a simple economic law of over supply and under demand which leads to a decrease in the price of an asset. This decline will go on for some time as it will take one to three further years to unravel the global sub-prime lending products and losses.

Recession on its Way

The consequences for the UK economy are severe. There will be a big drop off in consumer demand as credit dries up rapidly – we are already seeing this from consumer confidence surveys. The UK economy is almost certain to go into a recession some time at the end of 2008 or the beginning of 2009. Spain and Ireland are the other economies, apart from the US and UK, which are already experiencing house price declines. They both have large speculative housing markets. There are also property hot spots in the emerging economies of China, India, Brasil and Hong Kong which will follow the same fate as the US and UK housing markets. It is too difficult to estimate if we are going to enter a full blown global slump of 1930s or 1974/75 proportions but the odds of it happening are shortening all the time.

Case Study: HBOS (Halifax Bank of Scotland)
HBOS has over 20 million customers and 63,000 employees. It has the largest share of the UK mortgage market at about 20%. However, after Northern Rock, it was the biggest user of the money markets to fund its mortgage book - about 30% of its mortgages are funded this way, 50% more than its rivals. It therefore has to pay more for its funds and this is reflected in HBOS putting up its mortgages for its less credit worthy customers. Faced with a shrinking and more competitive mortgage market and higher borrowing costs than its rivals explains why its share price has fallen by 54% since the credit crunch broke in August 2007. We can expect attempted:redundancies and "productivity increases" and cuts in real wages for its workforce in the months ahead.

Conclusion: Capitalism as a casino economy

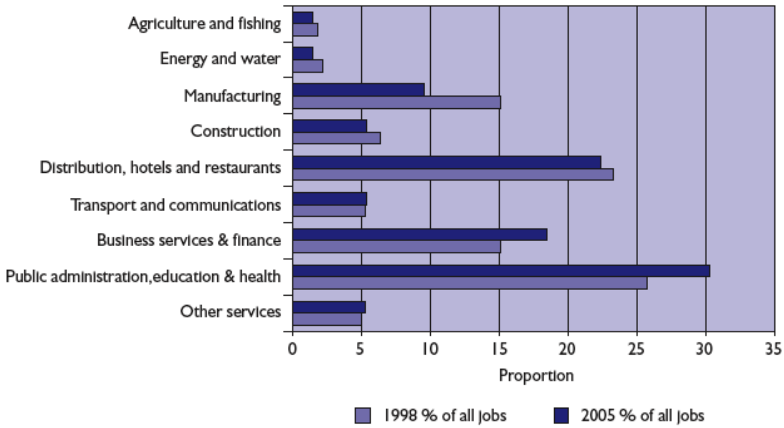
One of the key points to emerge from this discussion is that there is an inherent madness in the way the capitalist economy works. Both financiers and producers speculate widely and endlessly in their drive to increase profits. This is where the phrase ‘If you don’t speculate, you can’t accumulate’ comes from. There is no sense in which the capitalist economy is planned. Nor is there any real coordination between the different competing units of capital. Capitalists play in a casino and the problem is the chips they play with are our lives.

4. How The Crisis Will Affect Scotland

We can see several developments in the Scottish economy as result of the global and economic financial crisis. We have already noted that the tightening of credit will mean that lenders will be more aggressive in chasing up bad personal and mortgage debts. In 2008 and 2009 there will be more personal bankruptcies and repossessions than in 2007.

The mortgage market will shrink and become more competitive with no growth in new customers. This will hit the two large Scottish banks Halifax Bank of Scotland (HBOS) and Royal Bank of Scotland (RBS). HBOS will be hit the hardest. It has the largest share of the UK mortgage market and is the most exposed to money market loans. But the RBS has greater exposure to sub-prime products and has further exposure through selling other derivatives to hedge funds, fund managers and investment banks. Its recent intention to raise $26bn in a rights issue is to cover loses on sub-prime products and protect it against any future loses in its' other derivative products. We expect to see attempted redundancies at both banks.

As the chart below shows Scotland is now very dependent on the business and financial sector with 18% of Scotland's workforce, or 450,000 people employed in this sector. The tightening of credit and falling asset prices will see a fall off in business right across the sector with thousands of jobs at risk from redundancy. Falling profits in this sector will see business and financial companies try and keep wages rises down and attempt to increase productivity.



The next biggest private sector is tourism (hotels and restaurants) and this will suffer a double whammy. First, Scots, as they tighten their belts, will cut back on luxuries such as going out for meals and short breaks, Secondly, the international recession will mean less foreign visitors and therefore less spent in hotels and restaurants. Manufacturing is smaller than it was ten years ago but still employs nearly 225,000 and this will be hit by the global downturn in demand.

Scotland's biggest employer is the public sector. It will be hit by a big reduction in tax revenues especially from 2009/2010. We can expect to see threatened cuts and redundancies in this sector as the government tries to make good its shortfall in revenues.

These will be added to the cutbacks in front line services, already being imposed across Scotland, as a result of the SNP Scottish Executive's freeze on council tax revenues, and the real cut in New Labour's Westminster block grant.

5. A Socialist Alternative to Neo-liberalism

As we have shown in this pamphlet the real economy is now intrinsically linked to the global financial system. The historic role of the financial markets has been to raise capital for corporations and public funds for governments.

But financial markets have always attracted speculators, who have created financial bubbles where the assets in the markets are priced way above where they should be realistically valued at. These bubbles invariably burst and as well as causing bankruptcy and the ruin of the individual speculators have a damaging consequence for the wider economy and as a consequence the innocent majority of the population.

We saw that it was such a speculative bubble which was one of the main causes of the 1929-39 depression.

Neo-liberalism, which was the main capitalist solution to its slumps of 1974/75 and 1979/80, has since the early 1980's opened up and deregulated financial markets. This was to ease the raising of and movement of capital around the world and to create an alternative home for underperforming investment capital. This was to avoid a repeat of the crisis of the over-production of goods and services seen in the depressions of 1974/75 and 1979/80.

This has created a wave of speculators – by US investment banks and latterly the new hedge funds – who have exploited these deregulated and globally connected markets.

New Labour

New Labour has been amongst the biggest supporters of this neo-liberal project. Gordon Brown has made two major contributions to this. The first was to remove control over interest rates from an elected government. This was the major instrument for regulating the economy. Now, control is in the hands of an unelected committee of the representatives of global finance. This committee decided to cut interest rates aggressively at the turn of the millennium and then to put them up in the spring/summer of 2007. This has exasperated the problems in the UK credit and housing markets.

The second was to create an ineffective body to regulate the financial markets in the UK, the Financial Services Authority (FSA). The FSA has proved to be a toothless organisation lacking in the expertise, skills, experience and powers to police the financial markets. One has only to witness their low level of prosecutions of financial crimes in the City. The most damning indictment of their ineptitude was their failure to spot the crisis in Northern Rock which most of the financial markets had detected at the start of 2007. They have admitted their failure in this case and Brown has announced there will be an investigation into it. It is an investigation to be carried out by the FSA themselves!

New Labour's privatisations and the use of Private Financial Initiatives (PFIs) are other examples of their love affair with neo- Liberalism. PFIs basically allow private companies to build projects and then lease them back to the government for a period of years. We pay exorbitant rates of interest and at the end of the lease it is the private companies that own the schools and hospitals to do as they want with them.

The SNP

The new SNP administration in Scotland is repeating the same mistakes. Their main objective is growth for the Scottish economy; for growth read more and easy profits for private global and local companies. It's an unattainable target given the current and likely future state of the global economy and the crisis in the financial markets. We can see this by the SNP's attempts to curry favour with individual business people such as Brian Souter and Donald Trump.

Their replacement for PFI's is essentially the same beast in the form of a Scottish Futures Trust. They have frozen council tax but this is leading to cuts in services and jobs across the country and they have no plans for a radical progressive local income tax that would carry out some wealth redistribution from the rich to the less well off.

Their plans for independence are within the European Community, with Scotland remaining part of the Sterling Zone. This would mean that control of interest rates would remain with the Bank of England. Even if Scotland were to later join the Eurocurrency Zone, this would mean handing decisions over to a European Central Bank which is also more concerned with fighting inflation than relieving the effects of a recession. Either option would also mean a limit to the size of the budget deficit a Scottish government could run to fund public spending projects such as schools, hospitals and housing. This would mean a dependence on PFI type schemes for any public services.

The Alternative – An Economy under Common Ownership and Democratic Control

There is an alternative to the speculation of the money markets and the booms and slumps of a capitalist economy. It is an economy owned by the people, run by the people, for the benefit of the people.

Instead of hundreds of types of different goods being produced without any idea if anybody wants them or if they will serve any useful purpose, the consumers and producers and the locally communities will democratically decide what is needed by society. We live in a world of limited and declining resources and it is only rational to plan what should be produced and what needs should be met by these goods.

It would mean that the major components of the economy would be taken into common ownership. Industries and services would be run by the people who work in them with democratically elected management boards. It would require a new style of revolutionary democracy based on mass participation, with people discussing and voting on proposals. All shades of opinion would be able to be represented and allowed to put their plans and proposals to a network of local, regional and national assemblies.
Planning and its implementation would take place at the

level of society most appropriate to the plans themselves. This type of participative, decision making, pluralist socialist democracy is a million miles away from the Soviet bureaucratic command style economic planning that took place in the former so called “socialist” countries.

A vibrant planned economy decided on by a mass participatory socialist democracy is the only rational alternative to capitalism’s four horseman of death - slumps, war, climate disaster and poverty - for the billions in the poor South.
It is an alternative that the Scottish Socialist Party is campaigning and fighting for.

6. Immediate Socialist Solutions to the Crisis

Socialists also have answers to the immediate crisis. We would:-

• provide sustainable and affordable social housing for rent. The £110 billion that the UK government spent on saving Northern Rock would alone pay for 2 million of such houses!
• take under common ownership all banks involved in house lending and turn their mortgages into cheap social loans
• take under common ownership the house building companies and task them with building social housing
• set in law the right to open the accounts of any financial firm or pension fund to inspect its investments and strategies
• set up an empowered independent body of people with market experience to regulate the financial markets. They would be elected and accountable to an assembly of individual investors and enforce stiff penalties and sanctions
• pass legislation to stop repossessions happening and turn the property involved in the loan into socially rented housing.
• raise the threshold for personal bankruptcies from £1,500 to £10,000
• freeze all food prices and bring the production, distribution and sale of food under social ownership - food meets a basic human need
• demand the Triad banks and their government write off the developing world's debt

• end the massive expenditure on arms and nuclear weapons and use this to pay for social amenities and services
• raise taxation on the rich and on companies to provide the funds for expanding social provision of housing and social services.
• Cut the excise duty on petrol prices and increase the tax on the oil companies profits.
• Introduce a free public transport system to reduce our dependency on the car and reduce pollution and oil consumption.
• Bring the Oil industry under common ownership.
• Introduce a food for oil and technology and skill programme with countries in the poor south.
• Bring the power and gas companies under common ownership and reduce prices – heating and cooking are a basic human need

The UK's deflating housing bubble is just but one manifestation of an interconnected global financial and economical crisis.
Socialists will have plenty of opportunities in the coming months and years to show there is a rational and humane alternative to the disease that is capitalism as the global crisis challenges its very foundations and its accepted ways of running our lives.

7. Postscript – September 2008

The effective nationalisation by the US government of Freddie Mac and Fannie Mae highlights the very origin of the current global financial and economic crisis. These two agencies control almost half of the US mortgage market. They were originally set up by the US government to stimulate the housing market and hence the market for credit. They were the pioneers of repackaging house loans into mortgage backed securities (MBS). These MBS were forerunners of the CDOs which are at the centre of the so called sub-prime credit crunch. Both entities faced the prospect of not being able to renew over £200 billion of borrowings on the money markets in September 2008. Because house prices are still falling in the US their mortgage book looks very unattractive to both investors and lenders of cash to them.

It this drying up of credit to consumers and the fall in their house prices that is reducing demand for goods and the driving force in slowing world economies. House prices and have fallen by over 20% from their peak in the US and by nearly 13% in the UK. As we have shown, that along with Spain, these are the housing markets with the largest house price bubbles. These declines will continue as the supply of money available to lend to potential house owners shrinks and banks remain reluctant to lend when the asset (the house) they are using as security is declining in price. Demand for mortgages is falling to as recession bites and people are losing their jobs or not feeling their job is secure. Brown's removal of stamp duty on house purchases will do nothing to change the supply of funds for house purchases or the falling demand for houses.

This means that a prolonged recession or slump (more than two successive months of negative GDP growth) is on the card for the world's major mature economies. In the second quarter of 2008 all the major mature economies slipped into negative GDP growth or flat growth apart from the US. The US has escaped a decline in GDP because it cut interest rates very aggressively, pumped money into the money markets, gave tax cuts and the declining value of the US dollar meant that its export revenues came in higher. All these factor have disappeared and the US is almost certain to have negative GDP growth in third and fourth quarters of 2008. The other major economies have reacted less swiftly to the crisis and have focused on fighting inflation by keeping interest rates high and have not cut taxes. They have paid the price with negative or flat growth and any measures they take now will have a much smaller positive effect on their economies.

The financial system is paralysed and despite central banks – the US and European in particular - pumping money into the system, lending has not increased. Instead banks have hoarded money to replenish their capital against further potential losses from complex derivatives. Several medium sized banks – Lehmans and Merrill Lynch – are in trouble because their smaller capital base and exposure to complex derivatives make them potential bankrupts. Investors are unwilling to pump fresh capital into them because of this risk. A second complex instrument hangs over the whole banking industry: credit default swaps (CDSs). These have been heavily sold by banks to insure against companies going bankrupt. The prices of these instruments has been rising hitting the balance sheets of the banks. The real crunch comes when companies start to go bankrupt and the banks have to pay out on the insurance. These products were sold in large volumes from 2001 onwards when the global economy had just comes out of recession – it is estimated that there is over $30 trillion of this insurance outstanding. As we enter a recession the rate of bankruptcies will increase and the recovery of assets from bankrupt companies will likely to be lower than estimated in pricing these CDSs. Banks will take big hit globally – up to £5 trillion worldwide. This is likely to take some banks down with a domino effect through the banking system. This is why the financial markets are so worried about Lehmans because it has exposure with CDSs and other mortgage related securities to other banks and financial institutions.

The major emerging economies – China, India and Brasil - have been hit by the global downturn in the mature economies. China's GDP and manufacturing growth rates have slowed down as the demand for their exports has slowed. While not in recession these big slow downs have resulted in pain for Chinese workers as factories have closed and workers have been laid of. Domestic demand has been dampened in these economies as their governments have chosen to raise interest rates to quell inflation. China's massive infrastructure spending programme is keeping its economy growing and also keeping up demand for natural resources globally.

Inflation – both food and natural resource – hangs over the capitalist system. Food inflation will continue as climate change affects crops and the demand from China for western style foods will only diminish slightly as the rate of Chinese economic growth only slows. Natural resource inflation is likely to slow after the speculative bubble of the last two years had burst and global demand from the mature economies slows as they slide into recession. However, we expect it to continue rising at the rate of growth that we saw from 2000 to the middle of 2006 when natural resources as whole saw their prices rise by 250%. This is largely as a result of the massive infrastructure programmes going on in China and the other emerging economies. This will give capitalism little room for manoeuvre.

Lehman Brothers effective bankruptcy in filing for chapter 11 protection marks the second leg of the greatest financial and economic crisis that capitalism has faced since the great depression of the 1930s. Lehman Brothers is the largest financial bankruptcy in US history. On the same day one of the big three investment banks, Merrill Lynch, was taken over by Bank of America. The Thundering Herd as Merrills was once known, does not have as much mortgage backed exposure as Lehmans and the Bank of America' capital base could easily absorb any further potential losses that Merrills may incur. On the same day the major bond insurer AIG failed in its bid for buyout of its trouble hit business and is now looking for a short-term loan of $40 billion from the US government!. Such were the unknown extent of Lehmans future potential losses on mortgaged backed securities and other derivative instruments that no bank or institution was willing to step in and buy it for virtually nothing. The US government has taken the gamble that the global financial system can absorb the losses that investors all around the world will be hit with as a result of Lehmans defaulting on its obligations.

The implications for the financial system and hence the global economy are far reaching. The money markets have frozen up again with short dated interest rates rising as nobody knows who has exposure to Lehmans and more importantly credit default swaps (CDS). CDS are the second leg of this great financial crisis. CDSs are insurance sold by banks to protect against companies going bankrupt. This price has risen from about 1.5% to 2% overnight wiping about $150bn off banks' balance sheets.

We will come to be as familiar with CDSs as we are with sub-prime collateralised debt obligations (CDOs). As we have pointed out some $30 trillion has been sold over the last seven years by banks to investors. There is a double whammy as bankruptcies rise the value of these contracts increases to the investors and the banks have to pay out any of the debt not recovered when a company or companies on which the CDSs have been sold goes bankrupt. The banks that have sold these products have seriously underestimated the bankruptcy rate – not foreseeing a recession at or one of this severity and overestimated the rate of recovery of a bankrupt company's assets. We could well see losses to the global banking industry of $5 trillion. As nobody knows who has sold these CDSs – they are unlisted, unregulated instruments – or on what companies, banks will be reluctant to lend to each other no matter if interest rates are cut or money is pumped into the money markets by central banks. This will dry up lending and push up the cost of credit. This will lead to further declines in house prices and the removal of credit as a tool to try and reflate the global economy.

The global recession will therefore be deeper and more prolonged with natural resource prices falling as the financial markets anticipate much reduced demand for them. Several medium and small banks are almost certain to go down as a result of CDS's losses with the possibility that one of the major banks will follow leading to a domino meltdown of the global financial system.

Capitalism's solutions to the crisis are unlikely to work. Tax rebates will be used to clear credit or be hoarded for that rainy day. Budget deficit spending will be inflationary and carried out on a modest scale. Much of the demand for materials from such projects will not benefit local economies but the natural resource companies and add further inflationary pressure. Energy savings' packages proposed by governments will be passed back to the poor with higher energy prices.

The workers and poor of the world are starting to fight back and say it is not our crisis and we won't pay for it. Workers from Boeing in the US to council workers and civil servants in the UK are striking for higher pay to maintain their living standards. The very poorest of our fellow civilians, who make up the overwhelming majority of the world's 6.6 billion population, are marching and demanding basic foods in wake of shortages.

Capitalism has runs its course and its latest crisis has shown the emptiness of neo-liberalism. It has opened up a debate about housing, the financial system and the right to affordable food and energy. Socialists have an opening to put the case for a rationale society based on meeting the needs of the entire world's population and that can use our finite resources in a sustainable way. It is one we should all go out and seize.

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Last but not least to the memory of Ernest Mandel who inspired me to try to understand modern finance and ecomonics and to try and change the system that brings such misery to the majority of the world's population.

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FOOD CRISIS: The world's poorest face starvation and hunger as the food runs out See page 4

GRANGEMOUTH STRIKE: Richie Venton looks at the recent oil workers strike and explains why it is a struggle for us all See page 12

THE GREAT BANK ROBBERY

They lose billions... but it's us that have to pay?

by Raphie de Santos

AS the poor South starves, even running out of essential food stuffs such as rice and wheat, because of demand from the increasingly enriched Chinese population, capitalism is calling on the workers of the West and East to bail them out of their latest global financial crisis.

Capitalist banks are asking their shareholders for billions of US dollars to cover the losses they have made against the sub-prime products that they have on their balance sheets.

...continued on page 2

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