Global Markets in Turmoil: Financial Warfare against Labor and Industry

By Prof Michael Hudson
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On Friday, October 24, the pound sterling dropped to just $1.53 (down from $1.73 earlier in the week, an enormous plunge by foreign-exchange standards), and the euro sunk to just $1.26, while Japan's yen soared by 10%. These shifts threatened to disrupt export markets and hence industrial sales patterns. Global stock markets plunged from 5 to 9% abroad, and there was talk of closing the New York market if stocks fell more than 1,000 points. Pre-opening trading saw the Dow Jones Industrial Average down the maximum limit of 550 points (largely on foreign selling) before bounding back to lose "only" 312 points as the dollar soared against European currencies.

Friday's currency turmoil and stock market plunge was a case of the chickens coming home to roost from the class-war policies being waged by European and Asian industry and banking squeezing their domestic consumer markets – that is, labor's living standards – in favor of export production to the United States. The internal contradiction in this industrial and financial class warfare is now clear: *To the extent that it succeeds in depressing labor's income, it stifles the domestic consumer-goods market*. This disrupts Say's Law – the principle that "production creates its own demand," based on the assumption that employees will (or must) be paid enough to buy what they produce.

This has not been true for many years in Europe and Asia. But production has been able to continue without faltering because of an international *deus ex machina*: U.S. consumer demand.

This is not to say that no class warfare is being fought in the United States. Indeed, living standards for most wage earners today are down from the "golden age" of the late 1970s. But the U.S. economy had its own financial *deus ex machina* to soften the blow: Alan Greenspan's asset-price inflation that flooded the banks with credit, which was lent out to homebuyers and stock market raiders. Rising home prices were applauded as "wealth creation" as if they were a pure asset, much like dividends suddenly being awarded to one's savings account. Homebuyers were encouraged to "cash out" on the rising "equity" margin, the (temporarily) rising market price of their homes over and above their (permanent) mortgage debt. So while most mortgage money was used to bid up the price of home ownership, about a quarter of new lending was reported to be spent on consumption goods. Credit card debt also soared. In the face of a paycheck squeeze, U.S. consumers were maintaining their living standards by running further and further into debt.

This could not go on for very long. It never has. Debt-financed bubbles can't last for more than a few years, even when fueled a self-feeding inflation of asset prices in which households and corporate industry borrow more and more against the rising price of their collateral. But the game was up once the housing bubble burst.

It was up not only for the U.S. economy, but also for foreign economies that had geared their industrial production to serve the U.S. market rather than their own home markets. A global industrial slowdown is now threatened, and must continue until foreign domestic markets are nurtured – just the opposite trend from the recent generation of neoliberal anti-labor policies.

To understand the dynamics at work, one needs to look at the balance of payments – not so much the balance of trade itself, but the currency speculation, international lending and arbitrage that has dominated exchange rates over the past two decades. Exchange rates no longer reflect relative wage levels, "purchasing power parity" or living costs as in times past. Today, they reflect the flow of international borrowing where interest rates are low and lending at a markup where credit is tight – and then hedging this arbitrage, and jumping on the bandwagon to speculate on which way currencies will go.

In this way the balance of payments and currency values have been "post-industrialized" just as domestic economies themselves have been. Instead of promoting industrial growth based on a thriving home market, governments throughout the world have pursued a "post-industrial" financial strategy of "wealth creation."

Japan's yen crisis – payback for the "carry trade"

Nowhere has this been more the case in Japan, whose economy has remained in the doldrums ever since its bubble burst in 1990. For seventeen years straight, quarter after quarter, Japanese land prices fell, and so did stock market prices – and hence, the collateral pledged as backing for loans. This quickly left Japan's banks with negative equity. The Bank of Japan's response was to devise a way for them to rebuild their balance sheets – to "earn their way" out of the bad loans they had made.

The policy was not to revive the faltering domestic market in Japan or its industrial corporations. From 1945 through 1985, Japanese had a model industrial banking system. But in 1985, U.S. diplomats asked Japan to please commit economic suicide. Angered by the striking success of Japanese industry, U.S. officials asked their compliant Japanese counterparts to raise the yen's exchange rate so as to make its industrial exporters less competitive, and in due course to flood its own economy with credit so as to lower interest rates, thereby enabling the Federal Reserve to flood the U.S. market with enough cheap credit to give a patina of prosperity to the Reagan Administration. This policy – announced in the Plaza Accord of 1985 – led economist David Hale to joke that the Bank of Japan was acting as the Thirteenth Federal Reserve District and the Japanese government as the Republican Re-election Committee.

Japan flooded its economy with credit, lowering interest rates and fueling the world's largest real estate bubble of the 1980s. The stock market also soared to reflect the rise in Japanese industrial sales and earnings. But after the bubble burst on December 31, 1989, the mortgage debts and stock that that Japanese banks held in their capital reserves fell short of the valuation needed to back their deposit liabilities. To help bail out the banks, Japan's government urged them to engage in what has become known as the "carry trade": lending freely created yen credits to foreign financial institutions at remarkably low rates, for these borrowers to convert into other currencies to buy bonds or other assets yielding a higher rate. If the domestic Japanese market lacked credit-worthy borrowers, let them lend to foreigners. As a new source of revenue for the banks in place of loans to domestic real estate and industry, low interest rates enabled them to flood the global economy with credit. This served global finance by providing speculators and “financial intermediaries” with an opportunity to get a free arbitrage ride, in contrast to Japanese industrial exports that threatened to displace U.S. and European auto, consumer electronics and other industrial production.

Borrowing rates remained high within Japan itself. As veteran Japan watcher Richard Werner (author of *Princes of the Yen*) recently described the situation to me, “while Japanese small firms were killed by the continued refusal of banks to expand credit (and many a small firm president was killed by having to sell a kidney to the loan sharks he was forced to resort to), foreign speculators received ample yen funds for a pittance.” The silver lining to this credit creation was that Japanese exporters were aided as the conversion of yen into foreign currencies drove down the exchange rate. (Yen credit was “supplied” to global currency markets, and was spent to buy and hence bid up the price of euros, dollars, sterling and other currencies.)

So the yen remained depressed, helping Japanese sales of consumer goods, while foreign borrowers were enabled to ride their own wave of asset-price inflation. Speculators could borrow at only a few percentage points interest in Japan, and convert their debt into foreign currency and lend to equally desperate countries such as Iceland at up to 15 percent.

Hundreds of billions of dollars, euros and sterling worth of yen were borrowed and duly converted into foreign currencies to lend out at a markup. Arbitrageurs made billions by acting as financial intermediaries making income on the margin between low yen-borrowing costs and high foreign-currency interest rates. As Ambrose Evans-Pritchard wrote over a year ago in the *Financial Times*, “the Bank of Japan held interest rates at zero for six years until July 2006 to stave off deflation. Even now, rates are still just 0.5pc. It also injected some $12bn liquidity every month by printing money to buy bonds. The net effect has been a massive leakage of money into the global economy. Faced with a pitiful yield at home, Japan’s funds and thrifty grannies shoveled savings abroad. Banks, hedge funds, and the proverbial Mrs Watanabe, were all able to borrow for near nothing in Tokyo to snap up assets across the globe. BNP Paribas estimates this “carry trade” to be $1,200bn.”

All this was conditional on the ability of lenders to get a continued free ride. Now that the free lunch is over, Japan’s postindustrial mode of rescuing its banking sector is coming home to roost. It is doing so in a way that highlights the inherent conflict between finance capitalism and industrial capitalism. Whereas industrial expansion is supposed to keep going – and can continue to do so as long as markets keep pace with production – debt bubbles end, usually abruptly as we are seeing today. Now that Iceland has gone bust, Hungary looks like it is following suit.

As global currency markets no longer provide the easy pickings of the last decade, the yen carry trade is being wound down. This involves converting Icelandic currency, euros, sterling and other non-Japanese currencies back into yen to settle the debts owed to Japanese banks. This repayment – and hence re-conversion into yen – is pushing the yen’s price up. This threatens to make Japanese exports higher-priced in terms of dollars, euros and sterling. Last week, Sony forecast that its earnings will fall as a result, and other Japanese companies face a similar squeeze in sales, not only from rising yen/dollar prices but from the global slowdown resulting from two decades of pro-financial anti-labor economic policies.

Evans-Pritchard rightly accused the world’s central banks of having created this mess. “It was they – in effect governments – who intervened in countless complex ways to push down the price of global credit to levels that warped behavior, as the Bank for International Settlements (BIS) has repeatedly noted. By setting the price of money too low, they encouraged debt and punished savings. The markets have merely responded with their usual exuberance to this distorted signal. Private equity was tempted to launch a takeover blitz at a debt-to-cashflow ratio of 5.4 because debt was made so cheap. The US savings rate turned negative because interest rates were held below inflation.” He should better have said, asset-price inflation. Gains for wealth-holders at the top of the economic pyramid polarized economies. What was rising for the bottom 90 percent was debt, not asset-price gains from easy money.

Financing the U.S. “trickle-down” economy from below

The soaring yen and plunging foreign currency rates are the result of unwinding the Japanese “carry trade” strategy to rescue its banks. Japanese industry will pay the bill. And despite the fall in sterling and the euro, Europe’s policy of emphasizing exports to the American market rather than to sell to its own domestic labor force looks pretty bad in view of the imminent economic slowdown in store. U.S. consumer spending and living standards will have to fall – and it seems, to fall sharply – in order to finance the “trickle down” economy at the top. Current Treasury policy is to bail out the creditors, not the debtors. The banks are being saved, but not U.S. industry, and certainly not the U.S. wage earner/consumer. Instead of pursuing a Keynesian type of deficit spending in a manner that will increase employment (government spending on goods and services, infrastructure spending and transfer payments), the Treasury and Federal Reserve are providing money to the banks to buy each other up, consolidating the U.S. financial system into a European-type system with only a few major banks. The financial system is to become monopolized and trustified, reversing two centuries of economic policy to prevent financial dominance of the economy.

None of the money being given to the banks really will trickle down, of course. Instead, the largest upward transfer of property in over seventy years will occur. The policy of giving money to the wealthiest sectors – these days the financial sector – turns the trickle-down economy into a euphemism for the concentration of wealth. The pretense is that America’s economy needs the financial and property overhead in order for the “real” economy to “take off” again. But a stronger financial sector selling yet more debt to the economy at large threatens to deter recovery, not to speak of a new takeoff.

Seeing the imminent shrinkage of the U.S. market, lenders and investors are dumping their shares, not only those of U.S. firms but also stocks in European and Asian export sectors. This is the “inner contradiction” of today’s financial rescue operation. Finance itself cannot survive in the face of a stifled domestic “real” economy.

So the world ought to be at an ideological turning point. But the last thing that Europe’s oligarchy wants to see is higher labor standards. Nor does the U.S. financial class. Europe and Asia put their faith in a U.S. consumer-goods market rather than their own. The U.S. financial sector found this appealing as long as consumption was financed by running into debt, not by workers earning more money or paying lower taxes. Industrial and political leaders throughout the world have been so anti-labor that there is little thought of raising domestic living standards via higher wage levels and a tax shift off labor and industry back onto property where progressive tax policies used to be based.

Here's why it is impossible to go back to the past, as if this were some kind of normal condition that can be recovered. When Alan Greenspan flooded the mortgage market with credit, homeowners borrowed against ("cashed out" on) the rise in housing prices as if their homes were a piggy bank. The difference, of course, is that when one draws down a bank account there is less money in it, but no debt is involved to absorb future income in repayment schedules. "Equity loans" have left a debt residue, which now has turned into negative equity with loans still needing to be repaid. This will leave less for consumption. So U.S. consumer spending will fall because of

(1) no more easy mortgage or credit-card credit,

(2) debt deflation as consumers repay past borrowing, "crowding out" other forms of spending, and

(3) downsizing and job losses lead to falling wage income.

Lower consumer spending means less sales by U.S. and foreign manufacturers – especially those in countries whose currency is rising against the dollar (*e.g.*, Japan). Lower sales mean lower earnings, which mean lower stock prices. And in the stock market itself, price/earnings ratios are falling as the credit that fueled stock-market speculation by hedge funds and other arbitrageurs is cut back. So the combination of falling price/earnings ratios and falling earnings mean less in the denominator (earnings) to be multiplied into prices (earnings capitalized at the going interest rate).

Declining stock market prices are reducing the coverage of corporate pension funds (as well as personal retirement accounts), requiring higher set-asides to fully fund these accounts. In the face of tightening bank credit, this will cut back new corporate spending on plant and equipment, further slowing the economy.

As foreign exporters are rudely awakened the dream of an American demand, when will the point come at which Europe and Asia seek to build up their own domestic consumer markets as an alternative?

The first problem is to overcome the ideological bias in which central bankers are indoctrinated, in a world where politicians have relinquished economic policy to bankers trained in Chicago School financial warfare against labor and even against industry. It probably is too much to hope that today's European central bankers and kindred economic managers will drop their neoliberal anti-labor ideology and see that without a thriving domestic market, their own industrial firms will languish. The solution must come from a revived political sector representing the interests of labor, and even of industry itself as it sees the need to revive domestic markets.

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