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Addressing the Financial Crisis Requires **Improvements in Equity**

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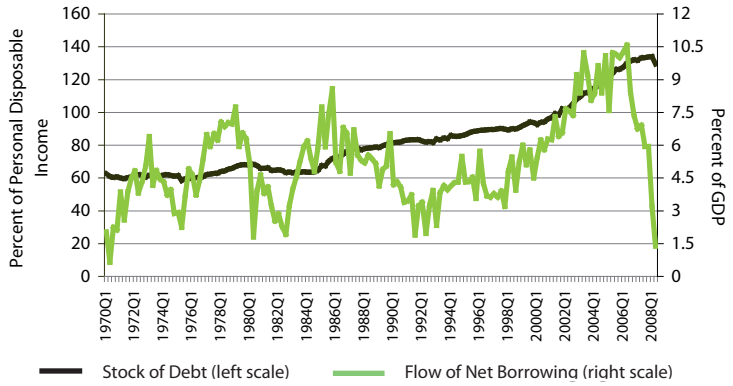
At the heart of the current financial crisis lies a massive overextension of credit to US households, whose debt reached a record 133 per cent of their disposable income in 2007 (see Figure). This condition arose not so much from 'failures' in financial markets, instruments or regulation, but as a consequence of two related underlying processes that have pushed up individual borrowing in many economies over the past 20 years.

First, lending and the selling of financial services to individuals have developed as central lines of business for leading banks. Credit to individuals reached almost 50 per cent of all balance-sheet lending of US commercial banks in 2006. Citigroup and Bank of America committed, for example, over three quarters of their loan portfolios to such lending.

Through such services, financial intermediaries have tapped directly into the income of wage earners as a source of profits (See Lapavitsas, 2009, and dos Santos, 2009). These practices proved disastrous in real estate markets in the aftermath of the dot.com crash. The high relative profitability of mortgage lending fueled an expansion of aggregate credit that led to speculative price bubbles.

US Household Debt and Borrowing, 1970Q1 - 2008Q2



Financial innovation accompanied this tend. Firms adopted new instruments that appeared to allow the safe expansion of lending to poor and minority borrowers with low and uncertain incomes. Lured by high returns, banks and investment funds exercised scant scrutiny of the new instruments that they bought through risky, highly leveraged positions. Yet their profits hinged on predatory mortgages that could be paid only if home prices continued to rise indefinitely.

Rising Debt

Second, US administrations led by both political parties supported rising individual debt and homeownership as central tools for achieving macroeconomic and social stability. After the 1990-91 recession, the US economy became increasingly dependent on consumption. From 1991 to 2005, household consumption and residential investment rose from 69.6 per cent of GDP to a record 76.4 per cent, while the declared income of the bottom 90 per cent of the population fell from 36 to 32 per cent of GDP.

This trend could be sustained only by increased borrowing by the majority of the population. Household borrowing grew from less than two per cent to over 10 per cent of GDP over the same period (see Figure). Rising home prices and ownership rates were vital in this regard since they provided a growing collateral base for borrowing. And they were aggressively encouraged with state support for mortgage lending and, particularly after 2001, very low interest rates.

This expansion soon extended to 'subprime' markets, where mortgage lending was also supported for political reasons. Promoting 'market-based' housing policies, Democratic senators urged Freddie Mac in 2006 to be more aggressive in helping poor and minority households buy into the housing boom. Similarly, Alan Greenspan claimed in his autobiography that 'government encouragement of subprime mortgage programs enabled many members of minority groups to become first-time home buyers…and this boded well for the cohesion of the nation.'

Reform Measures

Given the deep structural and policy roots of the current crisis, recovery from it will require more than simple reforms in regulations and financial instruments. Three measures, which challenge the recent policy consensus in rich and developing countries, could help usher in economic recovery.

First, real improvements in the distribution of income are needed. As happened in the 1920s, rising inequality fueled mass borrowing by low-income households in recent decades. As the Figure shows, lending to households in the US has plunged since 2006 to levels last seen in 1970, threatening to precipitate significant falls in consumption and aggregate demand. Unless real incomes improve for the majority of households, this process will become painfully protracted and prolong economic recession. Increases in unemployment benefits, real wage gains and progressive tax cuts are vital to the restoration of economic stability.

Second, the public provision of housing, pensions, education and health care needs to replace private provision through capital markets. Privatisation of these services has passed onto individuals not only their costs, but also the financial risks associated with illness, labour-market uncertainty, and instability of investment. In order to manage these risks and access basic services, wage earners have had to make sizeable payments to financial firms. As millions now lose homes, retirement savings and jobs, the need for quality public alternatives in housing and pensions has become evident.

Finally, mass public investment programmes that bolster both demand and productivity are critically needed. For decades many governments have sought to prop up sagging economies with an iniquitous form of 'Keynesianism', namely, encouraging wage earners to bolster demand through increasing their debt. This regime forced wage earners to bear the burden of demand management while helping make financial firms highly profitable. As the current crisis shows, such economic policies have proved to be not only inequitable, but also untenable.

These measures point clearly towards adopting purposive economic management aimed at ensuring equitable economic development as the chief tool for recovery from this crisis. For three decades such intervention has been dismissed on dogmatic grounds. The time is ripe for putting it back on the agenda as the best means to ensure the efficient fulfillment of social needs and balanced economic growth.

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