

Phantom money

The illusions of the finance sector and global economic meltdown

Radical Randy

The focus of most progressives working for a more egalitarian, fairer world involves combating excess corporate power. This is understandable since corporate rule – the domination of the economy, media and government by big business and the wealthy elites – perpetuates war, environmental degradation, and poverty. That said, there's another even more significant force behind corporations: money.

Money from nothing

Most discussions concerning the banking system focus on the neoliberal deregulated meltdown but there is a far more basic underlying dynamic. The origin of money – the major source of power in the capitalist system – is a mystery to many.

Governments print legal tender but most of the money in our economy is created by banks and other financial institutions, giving them tremendous sway over our lives. The present system of banking has a number of consequences. Banks are only required to keep a small proportion of their depositors' money on hand. The rest can be lent out (e.g. to businesses or for mortgages) with much of the resulting money subsequently re-deposited in this or another bank and most of that loaned out again in an ongoing cycle. Each time this happens, money is lent into existence, effectively created out of nothing as related by Ellen Hodgson Brown in *Web of Debt*. As a result of this fractional reserve system, approximately 97% of the money in our economy has been created by the banks. Repayment of the loan destroys the money lent out as principal but the compounded interest must still be paid. Since the original loan only created debt-money and not the interest, society's members as a whole must scramble to compete in the impossible task of trying to acquire enough money to pay back both.

The requirement to repay more than the original amount of the bank or credit card loan is one of the prime driving forces behind the obsession with economic expansion on our finite planet. David Korten's *Agenda For A New Economy* describes the unfolding process. Only a relentlessly growing GDP can provide the needed demand for the new loans required to create more money to pay the existing interest charge already owed. Even so, the economy is unlikely to grow fast enough to cover these extra interest costs, virtually guaranteeing bankruptcy for some individual or business borrowers and further

concentration of money in the hands of those already controlling it. And, of course, the new loans create new interest charges in an ongoing viscous cycle of debt.

Since many corporations have huge debts due to heavy borrowing, many aspects of their behaviour are dictated by their debt structure. Servicing the debt requires them to grow by constantly expanding operations and increasing sales while decreasing expenditures by cutting jobs and wages. Growth, rather than a steady corporate income, is what leads to increased share price. Even consumers who don't buy on credit may be paying high interest charges since the cost of the item includes all the interest paid by the manufacturers and retailers along the chain to the final buyer, inflating the purchase price.

There are critical implications for nation-states as well. Canada's national debt served as a pretext for the Chretien government's slashing of social programs in the 1990s. The major cause of this ballooning debt (aside from the revenue lost from tax cuts for the rich and big business) were the high interest charges the government was paying on money borrowed from banks and private lenders.

An alternative interest-free method of financing public projects is available. Prior to the '80s, much of the money required by the government was created by the Bank of Canada. Money was generated by making an accounting entry in the same manner as the banks, but unlike the bank-created debt-money, this money is spent into existence as needed, thereby avoiding inflationary pressure. The Bank of Canada could also make interest-free loans to other levels of government.

Let the good times roll

Lending regulations were eased as part of U.S. president George W. Bush's "ownership society." In the decade leading up to the meltdown, the U.S. financial industry spent over \$5 billion in federal campaign contributions and in lobbying Congress to relax rules governing their business. The Glass-Steagall Act, enacted by the American government after the 1929 crash to prevent the mixing of commercial and investment banking, was rescinded with predictable consequences. Following the bursting of the dot-com bubble and post 9/11 jitters the U.S. Federal Reserve dropped its interest rate to stimulate the economy. As financial journalists Larry Elliott and Dan Atkinson write in *The Gods That Failed*, this resulted in increased real estate sales, driving up housing prices. High consumer consumption levels were maintained despite stagnant or falling workers' real wages by borrowing against rising home value. The frenzy to push new mortgages led banks to lend to risky subprime borrowers. These loans were often adjustable-rate, with initially low interest rates skyrocketing after the first couple of years. Banks weren't too concerned about NINJA (no income, no job, no assets) mortgage defaults since they could always sell the foreclosed houses for higher prices in the ever-rising market.

The deregulated banking industry, now free to play on Wall Street, began bundling mortgages, including the sketchier ones, then slicing these bundles into tranches of varying risk. This converted mortgages into financial instruments called collateralized

debt obligations (CDOs) in a process known as securitization. These CDOs were then sold to large institutional investors such as pension and mutual funds by investment banks after paying agencies to certify their level of risk. Thus the traditional link between banks and borrowers was broken, with investors in CDOs having no idea whose mortgage fragment they owned. Convoluted attempts to value these instruments based on risk were mostly guesswork. Additionally, many of the most dangerous CDO tranches, the infamous “toxic waste,” couldn't be unloaded on buyers so the banks retained many of these time bombs, hoping they wouldn't detonate. The Byzantine nature of this setup was further enhanced as outside parties such as AIG collected premiums to ostensibly insure CDOs while in reality keeping insufficient reserves on hand to cover potential losses since housing prices could only go up anyway.

With the hollowing out of manufacturing as jobs were outsourced to overseas sweatshops and slumping profits due to overcapacity Western economies came to be dominated by the much more profitable finance capitalism. The financialization of the economy was driven by deregulation, abolition of controls over capital flow, and the investment of huge amounts of surplus funds in the finance sector. This gave Wall Street, Bay Street, and the other financiers growing power and produced bubbles that decoupled the inflating financial sector from the real economy.

Much of the speculation on CDOs, and the even more exotic derivatives, whose value depended on the performance of other instruments, was financed with borrowed money. The sway finance has over the economy was on display with the gargantuan bonuses for Wall Street bankers even after the debacle. The Canadian financial sector, accounting for over one-quarter of Canadian business profits, had a before tax profit of \$44 billion even during the 2009 slump. The financial media cheered the re-inflation of the post-crash stock market and its phantasm abundance as indicating a recovery even as the real economy continued to circle the bowl. None of this prevented the banks and investment houses from cashing in quite handsomely on the panic and subsequent handouts, particularly in the U.S.

Water's fine, everybody into the pool! (don't mind the sharks)

Britain and many other Western countries followed similar neoliberal relaxations of finance. Iceland, celebrated for its enthusiastic embrace of the new deregulated banking orthodoxy, left its citizens with a per capita debt of \$350,000 after the system imploded. Greece, whose economy collapsed and had its debts taken over by Goldman Sachs investors, spiralled into riots after the government announced cuts to public services and wages and rising taxes to cover the siphoned off revenue. A similar pattern has emerged in several other European countries where workers are expected to pay the price for bankers' greed.

The real estate collapse beginning in 2006 exposed the absurdity underlying the neoliberal “markets know best” fantasy. The banking and financial services bailouts dwarfed those for auto and other industries. Deregulation had created American banks allegedly “too big to fail” without plunging the economy into another depression,

naturally necessitating the bailouts rather than the alternative: nationalizing the banks' assets. The opaque nature of the toxic waste, and the fact that the banks themselves had borrowed for their own investments, led to the U.S. credit crunch. Banks didn't know their own state of financial solvency – let alone that of other banks – and were afraid to loan to each other. The deregulation of banking has worked so well that several European countries had to partially nationalize their financial systems to keep the whole mess from collapsing.

Following the U.S. and worldwide financial meltdown, Stephen Harper virtuously extolled the rock-solid reliability of the Canadian banking system while continuing to deny the need for any stabilizing international bank tax. In reality Canadian banks are far more exposed than Prime Minister Harper would like to admit. An article by Murray Dobbin in the July/Aug 2010 Canadian Centre for Policy Alternatives *Monitor* describes the role of the Canada Mortgage and Housing Corporation (CMHC) in spreading a veneer of stability. The CMHC put up \$75 billion to buy dubious mortgages from the big five Canadian banks, taking them off their balance sheets. In fact, it now fully insures almost all mortgages, eliminating risk to the banks. The Harper government also borrowed billions from the banks to establish a \$200 billion Emergency Financing Framework to provide a line of low-interest credit to cover the banks. Since these measures are classified as “non-budgetary” they appear on the CMHC and Bank of Canada books rather than as federal deficits. According to the International Monetary Fund, of the G-7 countries, only the U.S. and Britain have had higher financial stabilization costs than Canada.

Alternatives to financial insanity

Banks and credit companies provide the service of giving a business or individual purchasing power for required items before they've saved the full amount needed. As we have seen, this function is currently tied to interest charges but this need not be the case. Mark Anielski's *The Economics of Happiness* provides the example of the JAK Members Bank of Sweden. JAK operates as a cooperative owned and managed by its 25,000 members who pool their savings to make interest free loans to other members. Operating costs are paid by loan and membership fees to assure a break-even cost coverage. Unlike most traditional banks, it also emphasizes keeping its members' money invested locally.

The importance of keeping money in the local economy can be seen in Douglas Rushkoff's *Life Inc.* During the European Middle Ages local currencies thrived. Backed by perishable commodities such as grain, these currencies had a built-in motive for rapid circulation in the local economy, in contrast to the more permanent coinage used for long distance trade. This resulted in a great expansion in economic activity and prosperity for communities – at least until national governments took over control of currency. Consolidation of currencies under central control promoted hoarding of wealth, impoverishing much of the countryside. Canada has seen the return of local currencies, like Calgary Dollars or Salt Spring Dollars on B.C.'s Salt Spring Island, which are accepted by businesses within these communities. Since these currencies are only

accepted locally they circulate in the area and the economic benefits of their multiplier effect go to the local populations.

Local Exchange Trading Systems (LETS) represent a way for people in areas of high unemployment or financial scarcity to do an end run around monetary shortages and still provide needed services. Workers earn credits by trading their labour on a community bartering system to 'pay' for work by other members of the network. As Rushkoff reports, the U.S. credit crunch has even resulted in corporations themselves engaging in cashless merchandise bartering, as with the ITEX system.

Fini?

The global capitalist system continues to stagger from one financial walloping to the next like some punch-drunk stumblebum, only to be peeled off the canvas time and again by the world's governments and revived for the next round with another whiff of taxpayer money. Attempts by the U.S. Congress to enact real regulatory reform were quickly watered down by Wall Street's financial clout. The frantic international efforts such as Toronto's G20 Summit to patch up neoliberal capitalism and its counterproductive financial and banking system with a few tweaks and re-regulations are desperate attempts to re-ignite the dying embers of a runaway conflagration that has almost exhausted its fuel supply. Ireland, another poster child for the new world economic order is, with its 85 billion euro rescue fund and imposed austerity package, the latest domino to topple – but undoubtedly not the last.

Money accumulated through financial speculation is conflated with wealth, but it may be more accurately viewed as a debt society is required to pay. Owners of phantom financial wealth have a claim on future real wealth, on actual products and services produced by workers, making the speculative financial system extractive in nature rather than productive. The manic economic expansion and resulting unconstrained consumerism demanded by compounding interest leads to enormous waste and environmental demolition. As Korten writes, the relentless growth demanded by finance capitalism results in "maximizing the rate at which we turn useful resources into toxic trash." The world's economy will never achieve sustainability or stability until our current defective capitalist model of usurious money creation is abandoned or, unable to expand further, undergoes its final ecological collapse. The subjugation of the real economy to the surreal will end one way or another.