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The Shadow Banking System in the United States

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BY

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Abstract

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In 2008 the United States suffered a devastating economic collapse. Millions of Americans were unemployed; families lost their homes; and long time businesses were forced to shut down. These events put the United States into an economic depression so deep that the country has yet to fully recover. The crisis was not a natural disaster but varieties of private sector agents such as banks and hedge funds were responsible for its efficient cause. Even though the housing and stock bubbles were generated largely by market forces rather than by government policies, the US government policies and institutions also played a significant role in framing the frequency and severity of the financial crisis. Beside the housing market bubble, the collapse of the shadow banking system played a significant role in framing the financial crisis of 2008. My aim in this paper is to analyze in detail as to how the shadow banking system and the corporations and markets that fall under its regulatory umbrella, were able to grow so immensely and what made them vulnerable to failure.

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INTRODUCTION

Lehman Brothers was the fourth largest of the Wall Street investment banks and the oldest. It had survived repeated financial panics around the turn of the 19th century and thrived during the Great Depression. It had over $600 billion of assets and vast, intangible trading relationships with every other major firm in finance.[1] It was, almost everyone agreed, "too big to fail". And yet it did fail. On Monday, 15 September 2008, Lehman Brothers filed for bankruptcy, the biggest in American history. Large U.S. financial institutions in distress have almost invariably been prevented from declaring bankruptcy by being acquired by other large institutions (often with the intervention of the U.S. government), but Lehman was explicitly allowed to fail. This was only the beginning of a truly global financial and economic crisis that marked the end of one of the greatest financial expansions in history. By mid – 2009, millions of Americans were unemployed, families lost their homes, long time businesses were forced to shut down and major bank and non-bank financial institutions collapsed one after another, leading to a severe economic collapse through out the world.

These events put the United States into an economic depression so deep that the country has yet to fully recover. Various scholars view the origins of the crisis either in the US housing bubble or in regulatory reforms, particularly the deregulation of the financial sectors since the 1970s. Clearly the crisis was not a natural disaster but varieties of actors and institutions were responsible for its causes. Even though the housing and stock bubbles were generated largely by market forces rather than by

[1] See Chapter 18 in The Financial Crisis Inquiry Report (2011) for detailed explanation of the rise and fall of Lehman Brothers.

government policies, the US government policies and institutions played a significant role in conditioning the possibility of the financial crisis.

> The financial crisis of 2007 and 2008 was not a single event but a series of crises that rippled through the financial system and, ultimately, the economy. Distress in one area of the financial markets led to failures in others areas by way of interconnections and vulnerabilities that bankers, government officials, and others had missed or dismissed (Financial Crisis Inquiry Commission 2011, 27).

It is also very important to look at the crisis from the broader historical context because by ignoring to do so, the above interpretations largely fail to account for the underlying historical causes of the current crisis.

My aim in this paper is not to understand as to why these corporations, such as Lehman Brothers, were allowed to fail but instead analyze in detail as to how the shadow banking system and the corporations and markets that fall under its umbrella, were able to grow so immensely and what made them vulnerable to failure. Beside the housing market bubble, the collapse of the shadow banking system played a significant role in framing the financial crisis of 2008. We all know that the crisis that began in the US quickly spread as a contagion to the rest of world. However the institutional framework of the shadow banking system that was vulnerable to the crisis tendency of capitalism was not necessarily the same through out the world. For the purpose of this paper my research strictly focuses on the financial crisis in the US.

There has been numerous amount of work already published on the housing market and the stock bubble, so it would be kind of repetitive to discuss the same issues here, rather my aim is to understand the shadow banking system, which generated a massive amount of revenue up until the 2008 crisis and the significant role it played in triggering the crisis. The question I raise in this thesis is: how is it possible that the shadow banking system was able to grow and flourish to such a huge extent? In order to answer my question, it is not only important to look at the immediate causes behind the growth of the shadow banking system but also understand the material and formal causes that conditioned the possibility of its emergence. The evidence I use to answer this question is based on existing theoretical literature by various scholars, who have approached similar subject matter in a variety of different ways and produced their casual analyses. The remainder of the paper is organized as follows. Section I offers literature review of work of few scholars and their understanding of the financial crisis. Section II describes what shadow banking system is and how it operates. Section III examines the role of financial modernization in the growth of the shadow banking system. Section IV analyzes the regulatory framework put in place after the Great Depression and the justification behind deregulation. Section V looks at the formal cause which refers to the neoliberalism ideology and the pervasive effects on ways of thought and political-economic practices in the US and rest of the world. Finally, Section VI concludes the paper, which offers justification for stricter regulations going forward in order to prevent another catastrophe such as this one.

LITERATURE REVIEW

When the current economic crisis struck it was common to hear politicians and pundits refer to it as “the worst economic crisis since the Great Depression” (Solomon 2010, 132) and on many levels they are correct. Nassim Taleb called the current crisis “Black Swan – a storm out of an almost cloudless sky, unexpected, unpredicted, falling on a world thinking and acting on the assumption that such extreme event were things of the past, and that another Great Depression could not occur” (Skidelsky 2009, 3). We all know that the crisis originated in the banking sector and to understand the crisis we need to focus on the sources of banking failure. The most popular explanation was “the failure of banks to ‘manage’ the new ‘risks’ posed by ‘financial innovation’ ” (Skidelsky 2009, 3). Skidelsky in his book *Keynes: The Return of the Master* discusses the causes of the crisis and claims that it was caused due to technical failure of risk management models and proposes two theories, ‘money glut’ and ‘saving glut’, as an explanation of deeper causes of the crisis. The ‘money glut’ theory is a conservative one which states that the Federal Reserve had kept the ‘money too cheap for too long’ thus allowing the asset bubble to get pumped up till it burst. The ‘savings glut’ theory is based on Keynesian view, which state that the rise in the interest rates in 2005 that brought the housing boom to an end causing the American economy to collapse. He further claims that the real cause behind the crisis was not the bankers, credit agencies, regulators, central bankers and the governments but the system of ideas, which gave rise to the crisis. Skidelsky is correct in arguing for a careful appraisal of the ideas that served as foundations for the policies that led to the deepest economic crisis the world has seen since the Great Depression. He further suggests that we need to return back to the Keynes theory in order to bring change.

Paul Krugman in his book *The Return of Depression Economics and the Crisis of 2008* talks about the worrying return of an intellectual orthodoxy which he identifies as 'depression economics', namely the belief that what occurs on the demand side of the economy can be ignored in favor of a fixation with the supply side. He states that it is common to blame deregulation as a cause of the crises specifically the 1999 repeal of the Glass-Steagall Act, which allowed commercial banks to get into investment banking business and thereby take on more risks (Krugman 2009, 163). But the crisis in most part, hasn't involved problems with the deregulated institutions that took new risks. Instead, it has involved risks taken by the new finance corporations that were never regulated in the first place. He states that we need to relearn the lessons that our forefathers were taught by the Great Depression. According to him the basic principle of the new regulatory regime should be clear: "Anything that has to be rescued during a financial crisis, because it plays an essential role in the financial mechanism, should be regulated when there isn't a crisis so that it doesn't take excessive risks (Krugman 2009, 189). Krugman's preferred course of action is to return to Keynes's focus on the demand side of the economy. It is only by increasing spending and lowering interest rates that we can avoid inflicting unnecessary suffering on people who through no fault of their own experience recession.

On the other hand authors Foster and Magdoff (2009) in their book *The Great Financial Crisis: Causes and Consequences* provide a Marxist perspective on the crisis by arguing that since the 1960s, mature capitalist economies have transformed their economic activity from production to finance – the ‘financialization of monopoly capital’ – in an attempt to escape the underlying condition of prolonged stagnation. The recent crisis is therefore interpreted as a “general crisis of financialization, beyond which lurks the specter of stagnation” (Foster and Magdoff 2009, 99). The analytical framework applied by the authors is based on ‘stagnation-financialization’ theory developed in 1960s and 1970s by American Marxist economist Paul Baran, Paul Sweezy and Harry Magdoff. Foster and Magdoff apply this theoretical framework to their analysis of the 2008 financial crisis. They state that the macro dynamic of the American economy is driven by the activity of monopoly capital, which generates a tendency towards stagnation. In a mature economy with increasing productivity and an associated growing surplus, the capacity of the system far outpaces effective demand. According to them we have entered a new phase, monopoly-capitalism, in which financialization provides a set of tools to help monopoly capitalism to reproduce itself. This leads to the trend of debt buildup and increasingly serious financial bubbles. In their view the financial economy has provided an outlet for the concentrated surplus of corporate and individual wealth, but the financial system has become increasingly complex and leveraged. The growth of new and increasingly complex financial instruments provides a way to expand money capital but no matter how much financial sector expands; it won’t be able to overcome the stagnation of the production sector. They further claim that if the underlying root cause of the crisis is stagnating wages and a lack of opportunities for productive investment, then reregulation will not solve the problem. Reregulation of finance will only help to stabilize the financial system. They suggest that without a fundamental reorganization of society to meet social needs rather than profit, it would be impossible to get rid of the permanent stagnation and crisis tendency of monopoly-finance capitalist.

Beside the macro-economic policies, increased lending in the mortgage market and increased speculation in other financial markets, which were some of the immediate causes of the financial crisis; it is common for scholars and economists to blame Neoliberal ideology as a root cause of the crisis and the continuing economic instability. Neoliberalism has become an over-used word in our everyday speech but in spite of the looseness with which it is used, it does capture an ideological and economic phenomenon of considerable historic significance. In *The Crisis of Neoliberalism* authors Duménil and Lévy (2011, 22) precisely examine what ‘neoliberalism’ means and its likely fate in the wake of current difficult economic times. They are very clear about what they mean by ‘neoliberalism’ and define it not as an ideology but as a “social order aimed at the generation of income for the upper income brackets, not investment in production not, even less, social progress. They provide a detailed account of recent financial crisis based on the statistical relevant data and emphasizing the explosion in financial instruments in the building up of the crisis and argue that neoliberalism should not be looked as a theory which was designed to improve the economy but instead as a class strategy designed to redistribute wealth upwards towards an increasingly narrow fraction of individuals. To substantiate their claim they apply a different form of class analysis. Abandoning the Marx’s more theoretically oriented abstract distinction between capitalist and workers, they use a different trichotomous schema that distinguishes three groups: Capitalist (CEO’s, senior executives and owners), Managerial (upper wage earners, managers of corporations, officials in government administration), and Popular (lower wage earners) classes. They claim that the displacement of the Keynesian settlement by neoliberalism took place as a result of a new dominant social alliance between the capitalist and managerial classes, overthrowing the alliance between the managerial and popular classes formed in the wake of the depression of the 1930s under the Fordist type of political economy. "Neoliberalism is, thus understood as the expression of the restoration of the power and income of capitalist classes" (Duménil and Lévy 2011, 55) and it "expresses the strategy of the capitalist classes in alliance with upper management, specifically financial managers, intending to strengthen their hegemony and expand it globally" (Duménil and Lévy 2011, 1). According to them the way out of the crisis is by forming a new alliance between the managerial and popular classes, which will then lead to the re-establishment of managerial power in the non-financial sectors against that of capitalist classes.

While Duménil and Lévy focus on analyzing the relationships among class fractions and between classes in order to explain and understand neoliberalism as a new type of political economy, Harvey (2007) stays with Marx's categories of capital and labor. In his book *A Brief History of Neoliberalism* he states that in order to understand neoliberalism it is very important to look at "the political-economic story of where neoliberalization came from and how it proliferated so comprehensively on the world stage" (Harvey 2007, 4). He discusses both the intellectual roots and the political career of the ideas that resurrected the market as the impersonal regulator of economic life once 'embedded liberalism,' the regulatory regime of the welfare state, became a barrier to expand accumulation. The two main arguments Harvey puts forth in this book are (1) that there exists an intense relationship between the theory and practice of neoliberalism and (2) neoliberalism is essentially a vehicle for the restoration or formation of capitalist class power at the expense of the working classes throughout the bulk of the world. He analyzes the external and internal forces, which have compelled states to turn towards neoliberalism and the ways in which Marx's concept of 'primitive accumulation' is highly applicable to the neoliberal era of capitalism. He calls it "accumulation by dispossession" – the centralization of wealth and power in the hands of a few by dispossessing the public of their wealth or land. Harvey certainly reminds us that the neoliberal revolution could not start overnight, but instead would be a process and a development of organic left alliance, involving workers and racial, ethnic and gender minorities, necessary to break out of this neoliberalism. Overall Harvey favors a system where limited market freedom and profit is replaced by a broader set of freedoms, more open democracy, greater social equality, and greater justice in the economic, political, and cultural realms.

All of the above authors make a valid case in explaining the root causes of the 2008 financial crisis and how neoliberalism came to power. However since my aim in this paper is to understand how the shadow banking system was able to grow so immensely, I strongly follow Duménil and Lévy and their class alliance approach. The shadow banking system was not quiet existent before 1980s and has suddenly boomed since then. Looking at the expansion of the shadow banking system from the context of Duménil and Lévy's class alliance strategy, I argue that the growth of the shadow banking system indeed expresses the strategy of the capitalist classes aimed to strengthen and restore their financial hegemony.

Chapter I: WHAT IS THE SHADOW BANKING SYSTEM?

One of the biggest challenge facing scholars in the analysis of the financial crisis is defining what shadow banking system is. There is no firm definition yet but broadly it can be said that the shadow banking system consists of finance corporations that "look like banks, act like banks, and borrow and lend and invest like banks, but—and here's the important part—are not regulated like banks" (Roubini and Mihm 2010, 1343). According to Gorton and Metrick (2010, 261-262) the shadow banking system performs similar functions as the traditional bank, but the names of the players are different and the regulatory structure is light or nonexistent. The system includes finance corporations such as investment banks and financial products such as Money Market Mutual Funds (MMMFs), sale and repurchase agreements (repos), asset-backed securities (ABSs), collateralized debt obligations (CDOs) and asset-backed commercial paper (ABCP) to name a few.

A traditional bank would borrow money on short-term basis generally in the form of deposits "lent" to it by depositors such as you and me and these deposits make up the bank's liabilities, as at any time if the depositors requests for their money, the bank has to be prepared to return it. However, the banks don't just hold onto these deposits; they lend them out in form of mortgages and other long-term investments. So basically the traditional banks borrow money from the deposits they receive, lend it out in form of loans and make profit through the interest they charge (Roubini and Mihm 2010, 1343). But it's not as simple as it sounds: even though the bank's liabilities are liquid (deposits), its assets are illiquid (tied up in various investments that cannot be turned into cash right away). Now on any normal day this is not a problem as the chances of depositors rushing to bank and withdrawing their money all at once is very unlikely. But as we know from past experience, that occasionally they do precisely that and the Great Depression is a haunting experience of what happened when panicked depositors rushed to the bank. To avoid such bank runs, the congress created the central bank in the United States – the Federal Reserve System (Fed) in 1913, which acted as the lender of last resort to the banks.

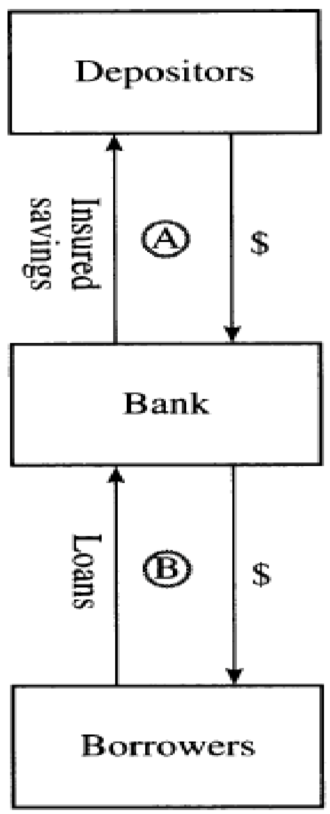

Figure 1: Traditional On-Balance-Sheet Intermediation[2]

[2] Figure 1 obtained from *Regulating the Shadow Banking System* by Gorton and Metrick 2010, page 263.

But the creation of the Fed was not enough to avert bank runs and sharp contractions in the financial markets in the 1920s and 1930s. So in 1933 Congress passed the Glass-Steagall Act, which among other changes established the Federal Deposit Insurance Corporation – FDIC (Financial Crisis Inquiry Commission 2011, 29). With the deposits insured, the depositors don't have to withdraw their funds when the solvency of the bank comes into question. However these protections came at a cost to the participating banks, as they had to give up some of their freedom to avoid the problem of moral hazard. They gave in to regulation and supervision in form of controls on their liquidity, leverage, and capital, which limited how much profit they could make (Roubini and Mihm 2010, 1365). But not everyone in the banking industry was interested in security and stability, many of them who joined the financial services industry from the 1980s onwards figured out that they could make tons of money as long as they were willing to take the risk without the government's safety net. They realized that there were ways to conduct banking free of not only regulations but also of the protections afforded ordinary banks and thus began "the game of 'regulatory arbitrage', the purposeful evasion of regulations in pursuit of higher profits" (Roubini and Mihm 2010, 1394). This hunt for larger profits eventually gave rise to the shadow banks.

"Conventional banks, which take deposits and are part of the Federal Reserve System, operate more or less in the sunlight, with open books and regulators looking over their shoulders. The operations of non-depository institutions that are de facto banks, by contrast, are far more obscure" (Krugman 2009, 160). The deposit insurance poses a challenge for institutions with large cash holdings such as pension funds, mutual funds, state and municipalities, etc. which lack access to safe, interest-earning, short-term investments. The shadow banking system hence serves to provide solution to such investors by providing maturity, credit and liquidity transformations in form of off-balance sheet lending.

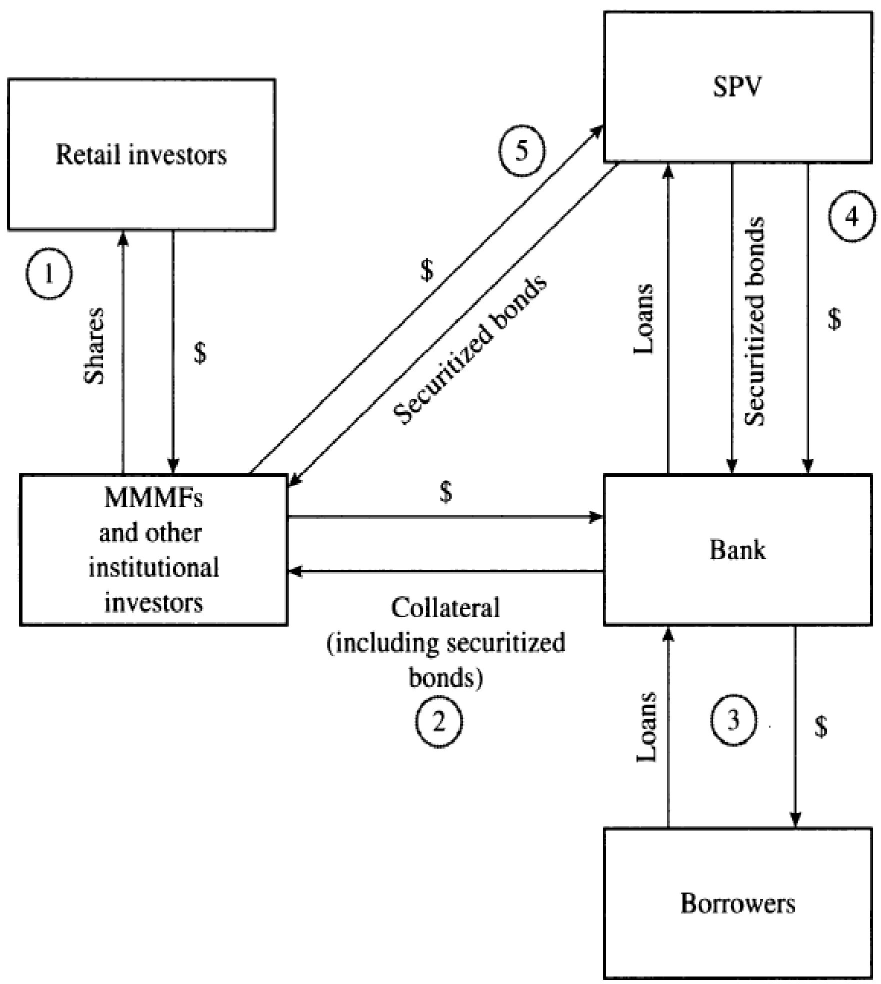

Figure 2. Off- Balance-Sheet Intermediation in the Shadow Banking System[3]

In a traditional bank, depositors transfer money to the bank in return for credit on a checking or savings account, from which they can withdraw anytime. The bank then lends these funds to a borrower and holds this loan on its balance sheet to maturity. In a

[3] Figure 2 obtained from *Regulating the Shadow Banking System* by Gorton and Metrick 2010, page 264.

shadow banking system, the process is slightly different. In order to achieve protection similar to that provided by the FDIC, an institutional investor receives collateral from the bank and this transaction takes the form of a repo. Example: an investor deposits $X and receives some asset from the bank as collateral, the bank then agrees to repurchase the same asset at some future time for $Y. The percentage (Y-X)/X is called the repo rate and is like the interest rate on a bank deposit. Generally the total amount deposited will be a little less than the value of the asset used as collateral and this difference is called a "haircut."[4] The step that moves this type of financing off the balance sheet of the bank is when the loans are pooled and securitized.

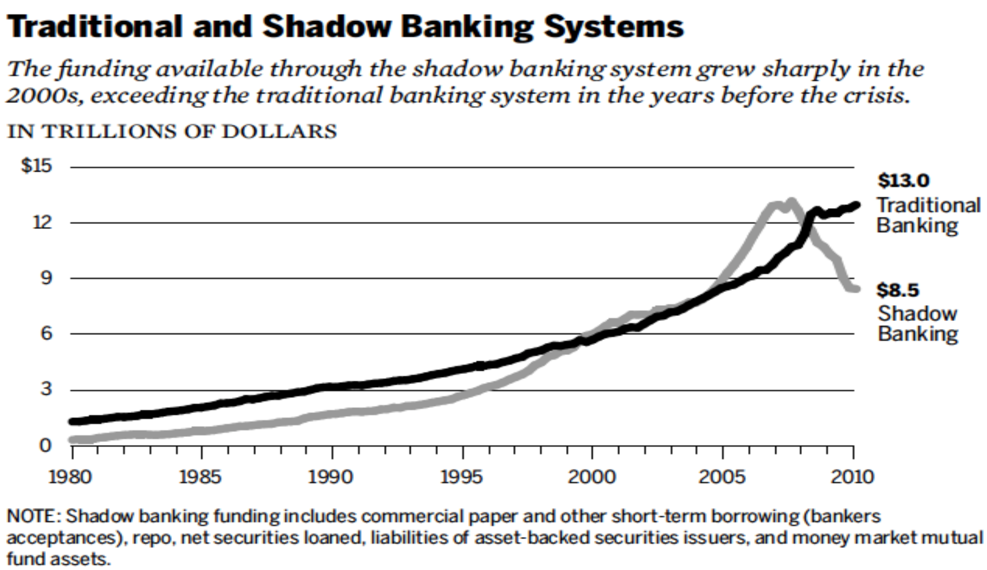

Figure 3: The Growth of the Shadow Banking System[5]

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[4] See *Regulating the Shadow Banking System* by Gorton and Metrick (2010) for a detailed explanation of the off-balance sheet intermediation in the shadow banking system.

[5] Figure 1 Obtained from the Financial Crisis Inquiry Commission Report 2011, Pg. 32. Source: Federal Reserve Flow of Funds Report.

Securitization is the process by which traditional illiquid assets such as landed properties and loans (home mortgages, commercial mortgages) are packaged and sold into capital markets and this is accomplished by selling large portfolios of loans to special purpose vehicles (SPVs), which are legal entities that in turn issue rated securities linked to the loan portfolios (Gorton and Metrick 2010, 270). Securitization is basically a process in which a financial instrument is created by combining various financial assets and then selling different tiers of this financial instrument to various investors.

The shadow banking system has grown rapidly since 1980s and the most dramatic growth had been in securitization. The securitization process can encompass any type of financial asset and promotes liquidity in the market place. The Financial Stability Board (2011, 8) estimated the shadow banking system in the US to have assets of $25 trillion in 2007 and seems to constitute some 25-30% of the total financial system.

Chapter II: FINANCIAL INNOVATION

“Many bubbles begin when a burst of innovation or technological progress heralds the dawn of a new economy” (Roubini and Mihm 2010, 1080). Innovation lies at the core of the capitalist economy. Majority of the world has been institutionalizing capitalist social structure and so does the United States. Capitalism works on the accumulation of capital. “Capital is not a thing but a process in which money is perpetually sent in search of more money” (Harvey 2010, 40). In the recent financial crisis, technological innovation wasn’t driving the housing boom but instead it was financial innovation. Financial innovation are not necessarily a problem as “plenty of financial innovations in centuries past – insurance, for example, and commodity options – have proved their value again and again, enabling market participants to manage and contain risk” (Roubini and Mihm 2010, 1094). However, financial innovations are a bit tricky as it is very difficult to protect them from imitation by competitors. In order to analyze the growth of the shadow banking system, it is very important to understand how securitization, collateral debt obligations (CDOs), repos, money market mutual funds (MMMFs) came into play, cause once the financial institutions learned that such innovations could be a source of large profits, the whole game in the finance sector changed. The increasing pressure to innovate and engage in risky behavior to secure above average returns and earn large sum of bonuses became justification for such innovation as it was no longer possible for banks to earn such returns by simply selling the idea of “mere” 10 percent return on investment. The quest of above-average returns for investors resulted in greater risk-taking through financial innovation. The early successes of JPMorgan and Goldman Sachs in derivatives innovation attracted myriads imitators, including commercial and investment banks, and insurance companies, both domestic and foreign (Guillén and Suárez 2010, 262).

It can be said that this financial innovation was in some ways an attempt to improve the older model of making loans. Many decades ago, a potential homeowner would go to a bank, apply for a mortgage and the bank would lend the money and keep collecting payments on principal and interest. The bank that originated the mortgage, held the mortgage and it was solely a transaction between the bank and the homeowner. This is referred to as the “originate and hold” model and all banks followed this model, at least till the 1970s (Roubini and Mihm 2010, 1094). As explained earlier in the capitalist structure capital is constantly looking for different ways of making more money. So were the banks. They were making very little money on the loans they provided to large corporations as the margin between the cost and interest they charged was miniscule. Faced by competition from nonbanks and their products, they became less profitable and sought to new profit opportunities. Traditional banks slowly started to exit the regulated sector and moved towards the unregulated side where there could maximize their profits.

In 1970s Ginnie Mae put together the first mortgage-backed securities i.e. it pooled mortgages it had originated, then issued bonds on the basis of that pool.[6] As a result instead of waiting thirty years to recover the proceeds from a mortgage it could receive a lump sum upfront from the purchasers of bonds and the investors buying these bonds would receive a certain portion of the revenue stream from the thousands

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[6] As explained in the statement by Cameron L Cowan, partner Orrick, Herrington, and Sutcliffe, LLP, on behalf of American Securitization forum before the Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit, United States House of Representatives during the Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit, November 5, 2003. http://financialservices.house.gov/media/pdf/110503cc.pdf

of homeowners paying off their mortgages (Roubini and Mihm 2010, 1107). This came to be named as securitization. Securitization is basically the creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets. It has grown from a non-existent industry in 1970 to $6.6 trillion as of the second quarter of 2003[7]. Financial institutions and businesses of all kinds use securitization to achieve the immediate value of a cash-producing asset. These were typically financial assets such as loans. In most cases, the originator of the asset anticipates a regular stream of payments. By pooling the assets together, the payment streams can be used to support interest and principal payments on debt securities. When assets are securitized, the originator receives the payment stream as a lump sum rather than spread out over time. Securitized mortgages are known as mortgage-backed securities (MBS), while securitized assets—non-mortgage loans or assets with expected payment streams—are known as asset-backed securities (ABS).

In no time, other government agencies such as Freddie Mac and Fannie Mae along with investment banks, brokerages, homebuilders joined the securitization business. Investment banks typically directed the creation of pools of MBS. To initiate a securitization, they first created what is called a special purpose vehicle (SPV). The SPV is legally separate from the company, or the holder of the assets. Typically a company sells its assets to the SPV. The payment streams generated by the assets can then be repackaged to back an issue of bonds. Or, the SPV can transfer the assets to a

[7] As per statement by Cameron L Cowan, partner Orrick, Herrington, and Sutcliffe, LLP, on behalf of American Securitization forum before the Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit, United States House of Representatives during the Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit, November 5, 2003, page 2. http://financialservices.house.gov/media/pdf/110503cc.pdf

trust, which becomes the nominal issuer. In both cases, the bonds are exchanged with an underwriter for cash. The underwriter then sells the securities to investors. Unlike other bonds, securities backed by mortgages usually pay both interest and a portion of the investor's principal on a monthly basis. Bottom line, everyone got what they wanted with this system. It was a win-win situation.

> The homeowner got a loan, and the mortgage broker and the appraiser earner their fee. The mortgage lender made a tidy profit without having to wait thirty years. The investment bank earned a fat fee for its assistance even as it unloaded the risk of the mortgages onto someone else. And last but not least, the investors who purchased the securities looked forward to receiving a steady revenue stream as homeowners paid off their loans (Roubini and Mihm 2010, 1121).

Even though MBS started becoming increasingly popular in the 1980s it didn't gain attention until the 1990s after the savings and loans (S&L) crisis. S&Ls or "thrift" is a financial institution that accepts savings deposits and makes mortgage, car and other personal loans to individual members. In a nutshell what happened with during the S&L crisis was that the S&Ls made long-term loans at fixed interest using short-term money. When the Fed increased the interest rate to reduce inflation in 1979, the S&Ls could not attract adequate capital and became insolvent[8]. More than thousands of thrifts went broke, as they had made a bunch of bad residential and commercial real estate loans that they had kept on their balance sheet as per the "originate and hold" model. Many banks and bankers started believing that had they securitized these loans, this crisis would not have happened. According to them, it would have been better to sell off the loans, make a profit upfront rather than holding on to these loans and taking a risk of them going bad later. "Distributing the loans to those better able to shoulder the risk –

[8] For full explanation of the Savings and Loan crisis see section title *The Savings and Loan Crisis: "They put a lot of pressure on their regulator"* in the Financial Crisis Inquiry Commission Report 2011, Page 34.

pension funds, insurance companies, and other institutional investors – could lessen the risk of a systematic banking crisis. 'Originate and distribute' replaced 'originate and hold' model" (Roubini and Mihm 2010, 1121). The whole idea made sense if the buyers of these securities were able to accurately access the risk inherent in them. But the bank or the firm originating these securities had very little reason to monitor and conduct due diligence to make sure that the underlying loans were going to be paid off. Their main concern was the quantity and not the quality of these loans. The investment banks that directed these pools of securities didn't do their job either cause they intended to sell the bundled loans and hence move them off their balance sheets. Also it could be argued that it was just impossible to figure out the likelihood of defaults on these loans pooled into securities, as very little historical data about subprime mortgages and their default rates were available at that time.

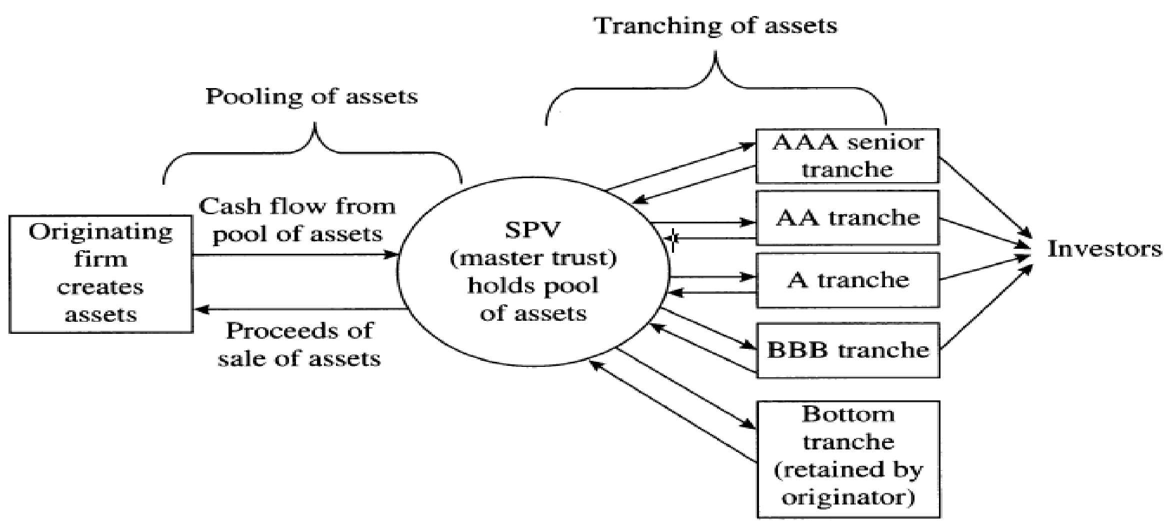

Figure 4. The Securitization Process[9]

[9] Figure 4 obtained from *Regulating the Shadow Banking System* by Gorton and Metrick 2010, page 271.

By 1980s the shadow banking system had started to grow rapidly and the process of securitization started becoming more and more complex. One of the most complex innovations in securitization was the creation of mortgage backed securities known as Collateralized Debt Obligations (CDOs). Now anyone holding a MBS necessarily took on a certain amount of risk, for example if the homeowner defaulted or simply paid up the loan sooner, then the lender would be deprived of the additional interest payments that it would have earned if the loan was paid off on schedule. So to solve this problem the financial engineers on Wall Street came up with a solution – CDOs.

> The simplest CDOs had only three tranches: equity, mezzanine, and senior. The purchasers of an equity tranche got the highest return but took on the greatest risk: if any homeowners in the underlying pool defaulted, the holders of the equity tranche would see losses before anyone else. The mezzanine tranche was less risky, but its purchasers would still suffer losses if a larger percentage of homeowners in the underlying pool defaulted. At the top was senior tranche. While it paid the lowest rate of return, it was supposed to be risk free or pretty close to it. The holders of the senior tranche got paid first and sustained losses last (Roubini and Mihm 2010, 1164).

But this solution was not as elegant as it sounds. This form of structured finance rested on weak foundations. A bunch of risky (BBB rated) subprime mortgages would be bundled into a BBB rated MBS and then sliced into tranches as explained. The senior tranche, which comprised of about 80% or so of the total underlying assets then would be given an excellent rating (AAA). So basically what the CDOs did was transform a completely dodgy, toxic waste into a "…gold-plated security, even though the underlying pool of mortgages was just as risky as it was before" (Roubini and Mihm 2010, 1164). Everything about these CDOs was wrong from the very beginning. First, originators of such instruments were mainly concerned with the volume and not the quality. Second, it was just impossible to calculate the risk of such instruments, because in order to calculate the risk one needs the historical data on how the underlying assets have performed over past business cycles. With most of the CDOs issued on residential mortgages and simply because there hadn't been a mortgage crisis in the past, it was not possible for every financial institution to calculate the risk. Overall, the default probabilities for CDOs were largely underestimated. Third, to maximize profits, originators of these CDOs needed to mass-produce securities, move assets off balance sheet to free up capital and obtain the highest possible rating for a given return level. The whole process of securitization started getting more and more complex. And it did not just stop there. Financial firms started securitizing commercial real estate mortgages, consumer loans (credit card loans, student loans, auto loans), and corporate loans and the resulting bonds (ABS) became so popular, that soon the process of securitizations spread to the rest of the world.

MMMFs, securitization, and repos are key elements of what has been called off-balance-sheet financing. Along with the creation of FDIC in 1933, Congress let the Federal Reserve cap interest rates that banks and thrifts (S&Ls) could pay depositors. This rule, known as Regulation Q[10], was intended to keep institutions safe by ensuring that competition for deposits did not get out of hand. In the 1970s, Merrill Lynch, Fidelity, Vanguard, and others persuaded consumers and businesses to abandon banks and thrifts for higher returns. After the Security Exchange Commission (SEC) abolished fixed commissions on stock trades in 1975, these firms were eager to make more

[10] See https://www.fdic.gov/regulations/laws/rules/7500-1600.html for detailed explanation on Regulation Q.

money and hence created MMMFs (Financial Crisis Inquiry Commission 2011, 29). It can be said that the MMMFs were a response to the interest rate ceilings on the demand deposits due to Regulation Q. MMMFs invested depositors' money in short-term safe securities, which paid higher interest rates than banks and thrifts were allowed to pay. Also the MMMFs aimed to maintain a net asset value of $1 per share, which enabled it to compete with insured demand deposits (Financial Crisis Inquiry Commission 2011, 30). Even though these funds were not backed by the FDIC deposit insurance, they are closely regulated, as they are required to invest only in high-quality securities that seemed to have little credit risk. The consumers liked the higher interest rates the MMMFs offered and they considered these funds to be as safe as a deposit in a bank or thrift, leading to the rise of a key player in the shadow banking system. Assets in MMMFs grew in US from $3 billion in 1977 to more than $740 billion in 1995 and $1.8 trillion by 2000.[11]

Another major shadow bank market that grew significantly was the market for repos or repurchase agreements. In order for the MMMFs to maintain their edge over the insured banks and thrifts, the MMMFs needed safe, high-quality assets to invest in, which gave rise to the booming repo market. Through this market, investment banks could provide (for a fee) short-term financing to large corporations. Large entities (banks and non-banks) hold on to cash for various reasons and would like to have a safe investment that earns interest, while retaining flexibility to use cash when needed. For example: securities dealers would sell Treasury bonds, which had relatively low returns, to banks and other investors, while then investing the cash proceeds of these sales in securities that paid higher interest rates. The dealers would then agree to repurchase

[11] As per Richard C Breeden, interviewed by the Financial Crisis Inquiry Commission, October 14, 2010.

the Treasuries, often the next day, at the slightly higher price than that for which they sold them. This is called a repo transaction, which in an essence is a loan (Financial Crisis Inquiry Commission 2011, 31). The repo transactions made it inexpensive and convenient for the securities dealers to borrow, as these deals were essentially collateralized loans. The securities dealer would borrow nearly the full value of the collateral, minus a small “haircut”. Since repos could be renewed or rolled over frequently they were considered as “hot money” and the lenders could quickly move in and out of these investments in search of higher returns.

All of these instruments – MMMFs, CDOs, and repos – have significantly contributed to the growth of the shadow banking system. The shadow banking system steadily gained ground over the traditional banking sector and actually surpassed the banking sector sometime in 2000. This off-balance sheet financing cycle started to grow rapidly since 1980s and the most dramatic growth has been in securitization. According to the Federal Reserve Funds data, the ratio of off-balance sheet to on-balance sheet loan funding grew from zero in 1980 to over 60 percent in 2007 (Gorton and Metrick 2010, 265). Most economist and scholars would see 2008 financial crisis in US as the outcome of the financialization process as discussed above. The financialization process is tightly linked to neoliberalism and it has changed the way corporations are being run, the behavior of economic agents and the microeconomic and macroeconomic policies pursed by government and central banks. But more importantly it has led to changes in financial regulations – deregulation- the mantra of the neoliberal era.

Chapter III: REGULATORY FRAMEWORK

In order to analyze what factors led to the growth of the shadow banking system, It is important to look into the fundamental changes in the US financial system in the last 30-40 years, as a result of private innovation and regulatory changes, which together led to the decline of the traditional banking system; as well as the post-war economic world order. Until the late 1960s the post-war economic world order was strongly based on the Fordist model of accumulation, the Keynesian welfare state, and the Bretton Woods system (Tauss 2012, 54). By end of 1960s this world order eventually started to erode both internationally and within the US. Rising inflation and falling profits in the production sector and in investment due to rising wages, increasing costs of new technology and intensified international competition, oil-price shocks, and the subsequent re-appearance of financial crises and economic downturns lead to the decline of this consensus in most industrialized capitalist countries including the US (Harvey 2007, 12). The crisis of Fordism was the root cause for the transformation of the post-war hegemonic world order, which resulted in stagnation within the productive sectors of most industrialized capitalist countries and to the process of financialization – increasing transfer of capital to the financial sector (Tauss 2012, 54). The Keynesian policies were no longer proving effective and some sort of solution needed to emerge in order to overcome this crisis.

In 1979, the Federal Reserve Bank chairman Paul Volcker adapted a drastic shift in monetary policy by abandoning the Keynesian fiscal and monetary policies with full employment as key objective and instead focused on reducing inflation.

> The real rate of interest, which had often been negative during the double-digit inflationary surge of the 1970s, was rendered positive by fiat of the

> Federal Reserve. The nominal rate of interest was raised overnight and, after a few ups and downs, by July 1981 stood close to 20 percent…This Volcker argued, was the only way out of the grumbling crisis of stagflation that had characterized the US and much of the global economy throughout the 1970s (Harvey 2007, 23).

The emergence of the new system – the shadow banks – starting in 1980s jeopardized the once-dominated traditional commercial banks. Faced by competition from nonbanks and their products, traditional commercial banks became less profitable. They started finding ways for new profit opportunities and slowly began exiting the regulated sector. They pushed their regulators and congress to remove the long-standing restrictions, which prevented them from joining the feverish growth. For most of the 20th century, banks and thrifts accepted deposits and loaned that money to homebuyers or businesses. Before the Great Depression of 1929, these banks, credit cooperatives, etc. were vulnerable to runs, when reports or merely rumors that a bank was in trouble spurred depositors to demand their cash. If the run was widespread, the bank might not have enough cash on hand to meet depositors' demands. Hence to avoid such bank runs and to stabilize financial markets, Congress created the Federal Reserve System (FED) in 1913, which acted as the lender of last resort to banks. However the creation of the Fed was not enough to avert bank runs and sharp contractions in the financial markets and in 1933 the Congress passed the Glass-Steagall Act[12], which established the Federal Deposit Insurance Corporation (FDIC). The FDIC insured bank deposits up to $2,500, that limit was increased to $100,000 by 1980 and was further raised to $250,000 during the

[12] The Glass–Steagall Act – also referred to as the Banking Act of 1933 – not only established the FDIC but also separated commercial banking from securities business.

crisis in October 2008 (Financial Crisis Inquiry Commission 2011, 29). This assured the depositors that they no longer needed to worry about being first in line at a troubled bank's door cause if the banks were short of cash they could now borrow from the Fed. Hence the Fed, acting as the lender of last resort, ensured that the banks simply did not fail from a lack of liquidity.

With these measures in place, Congress restricted banks' lending activities to discourage them from taking excessive risks. Furthermore, Congress also let the Fed cap interest rates that banks and thrifts – also known as savings and loans, or S&Ls – could pay their depositors. This rule know as Regulation Q[13] was enforced to make sure that banks remained safe and the competition for deposits did not get out of hand. The system worked just fine and was stable as long as the interest rates remained relatively steady, which they did during the first two decades after World War II. However, as mentioned earlier, beginning in late 1960s inflation started to increase, pushing up the interest rates. "The rates that banks paid other banks for overnight loans had rarely exceeded 6% in the decades before 1980s, when it reached 20%, but due to Regulation Q, banks and thrifts were stuck offering roughly less than 6 percent interest on most deposits (Financial Crisis Inquiry Commission 2011, 29). This dilemma was clearly illogical for the depository institutions, which could barely compete with the interest rates offered by the shadow banks.

The extensive growth in securitization market and the shadow banks overall, made it quite clear that the traditional banks and thrifts were ill-equipped to keep up with the parallel world of the Wall Street firms. The stagflation of 1970s affected everyone, especially the upper class in the US, through the combination of rising unemployment

[13] See footnote number 10 in previous chapter for detailed explanation of Regulation Q.

and accelerating inflation. The Along with the rise of the shadow banking system arose the power and significance of "…financiers and the CEOs of large corporations, as well as the immense burst of activity in whole new sectors…which changed the locus of upper-class economic power significantly" (Harvey 2007, 31). The upper classes believed that the anti-business, anti-imperialist climate was hindering the recovery out of this stagflation. According to them what was "good for business" was "good for America". In order for them to emerge more powerful and successful and be able to restore their class power, the CEOs of large finance corporations realized that they needed to act jointly rather than individually in the legislative arena. But in order for them to achieve this goal, they needed a political class instrument and a popular base and they therefore sought to capture the Republican Party as their own instrument. As Harvey (2007, 54-55) explains, "During the 1970s, the political wing of the nation's corporate sector' staged one of the most remarkable campaigns in the pursuit of power in recent history. By the early 1980s it had gained a level of influence and leverage approaching that of the boom days of the 1920s". President Reagan's victory in 1980 was a significant step in consolidating the political shift to support the Volcker's turn to monetarism and prioritization of curbing inflations and marking the end to the Keynesian policies of previous decades. The Volcker shock along with the unfolding of Regan administrations government policies in many other arenas gave rise to norm of deregulation.

The upper classes (CEOs, senior executives and owners) along with other critics in favor of deregulation, argued that the regulatory constraints dampened competition and restricted innovation. As the Fed chairman Alan Greenspan years later described, “Those of us who support market capitalism in its more competitive forms might argue that unfettered markets create a degree of wealth that fosters a more civilized existence” (Financial Crisis Inquiry Commission 2011, 34). While the shadow banks had few constraints on raising and investing money, the commercial banks were at a disadvantage due to the regulations they faced, and were in danger of losing their dominant position. The traditional banks kept fighting against the regulations that were still in place, and they and the S&Ls went to the congress to address their grievances. “The playing field wasn’t level, which put a lot of pressure on institutions to get higher-rate performing assets…and they put a lot of pressure on their regulators to allow this to happen” (Financial Crisis Inquiry Commission 2011, 34). Eventually, in 1980, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) repealed the limits on the interest rates that depository institutions could offer on their deposits. Even though this law removed a significant regulatory constraint on banks and thrifts, it was unable to restore their competitive advantage. Depositors wanted a higher rate of return, which banks and thrifts were now free to pay but the interest banks could earn off of mortgages and other long-term loans were largely fixed and could not match their new costs. Even though the deposit base of banks increased, they now faced an interest rate squeeze.

> In 1979, the difference in interest earned on banks’ and thrifts’ safest investments (one-year Treasury notes) over interest paid on deposits was almost 5.5 percentage points; by 1994, it was only 2.6 percentage points…they were basically losing 3 percentage points of advantage they had enjoyed when the rates were capped (under Regulation Q). The 1980 legislation barely helped to reduce the competitive pressures facing the banks and thrifts from the shadow banks (Financial Crisis Inquiry Commission 2011, 34).

That legislation was followed in 1982 by the Garn-St. Germain Act[14], named after Congressman Fernand St. Germain, Democrat of Rhode Island, and Senator Jake Garn, Republican of Utah, which significantly broadened the types of loans and investments that banks could make. This law enacted by Congress in 1982 enabled banks and other savings institutions to compete more readily in the money market. It got rid of the interest rate ceiling that they once had to abide by, authorized them to make commercial loans and gave the federal agencies the ability to approve bank acquisitions. The bill, which was a Regan Administration initiative, was an act aimed to revitalize the housing industry in the US by strengthening the financial stability of home mortgage lending institutions. The act gave the S&Ls broader scope in the mortgage market. Traditionally, they had relied on 30-year, fixed-rate mortgages. In the Garn-St. Germain Act, Congress permitted the banks and thrifts to issue interest-only, balloon-payment[15], and adjustable-rate mortgages (ARMs). For banks and thrifts, ARMs offered an interest rate that floated in relationship to the rates they were paying to attract money from depositors. The floating mortgage rate let the borrowers take the financial risk of the changing interest rates and protected banks and S&Ls from the interest rate squeeze caused by inflation.

This act was also one of the contributing factors of the Savings and Loan Crisis. The S&L crisis was one of the largest government bailouts in U.S. history costing approximately $160 billion (Financial Crisis Inquiry Commission, 36). The S&Ls made

[14] Garn–St Germain Depository Institutions Act of 1982 - PUBLIC LAW 97-320—OCT. 15, 1982 was passed by a margin of 272-91 in the House. See http://www.gpo.gov/fdsys/pkg/STATUTE-96/pdf/STATUTE-96-Pg1469.pdf for the complete version of the bill and http://thomas.loc.gov/cgi-bin/bdquery/z?d097:H.R.6267: to see the bill summary and status.

[15] A balloon payment mortgage is a mortgage, which does not fully amortize over the term of the note, thus leaving a balance due at maturity. The final payment is called a *balloon payment* because of its large size. A balloon payment mortgage may have a fixed or a floating interest rate.

long-term loans at fixed interest using short-term money but when the Fed increased the interest rate to reduce inflation in 1979, the S&Ls were unable to attract adequate capital and became insolvent. More than thousands of thrifts went broke, as they had made a bunch of bad residential and commercial real estate loans that they had kept on their balance sheet as per the “originate and hold” model.

Then, beginning in 1987, the Fed accommodated a series of requests from the banks to undertake activities forbidden under Glass-Steagall and its modification. The Fed Chairman Greenspan and many other regulators supported and encouraged this shift toward deregulated financial markets. They argued that the financial institutions had strong incentives to protect their shareholders and hence would regulate themselves through improved risk management. Greenspan argued that financial “modernization” was needed to “remove outdated restrictions that serve no useful purpose, that decrease economic efficiency, and that… limit choices and options for the consumer of financial services.” Removing the barriers “would permit banking organizations to compete more effectively in their natural markets. The result would be a more efficient financial system providing better services to the public”[16] (Financial Crisis Inquiry Commission 2011, 35). The new rules permitted nonbank subsidiaries of bank holding companies to engage in bank-ineligible activities, including selling or holding certain kinds of securities that were not permissible for national banks to invest in or underwrite. At first, the Fed strictly limited these bank-ineligible securities activities to no more than 5 percent of the assets or revenue of any subsidiary. Over time, however, the Fed relaxed these restrictions and by 1997, bank-ineligible securities

[16] Fed Chairman Alan Greenspan, prepared testimony before the Housing Committee on Banking and Financial Services, *H.R. 10, the Financial Services Competitiveness Act of 1997* on May 22, 1997.

could represent 25 percent of assets or revenues of a securities subsidiary. The Fed also eliminated other firewalls between traditional banking subsidiaries and the new securities subsidiaries of bank holding companies (Financial Crisis Inquiry Commission 2011, 35).

Finally, the Graham-Leach-Bliley Act (GLBA)[17] passed by the Congress on November 12, 1999 repealed the parts of the GSA (Glass Steagall Act) that separated commercial banking from the securities business. It also repealed the parts of the Bank Holding Company Act of 1956 that separated commercial banking from insurance business. Thus, the GLBA permitted single holding companies to offer banking, securities and insurance, as they had before the Great Depression. It slowly but steadily removed the long-standing restrictions and helped banks break out of their traditional mold and join the frantic growth of the shadow banks. As a result, two parallel financial systems of enormous scale emerged. “This new competition not only benefited Wall Street but also seemed to help all Americans, lowering the costs of their mortgages and boosting the returns on their 401(k)s. Shadow banks and commercial banks were codependent competitors. Their new activities were very profitable—and, it turned out, very risky” (The Financial Crisis Inquiry Report 2011, 28).

If the shadow banking system was growing so rapidly, then what caused its downfall? Why did the safe, liquid assets suddenly appear to be unsafe, leading to run? As we know the crisis was not caused by one particular sector but due to failure of multiple sectors, which were interconnected to each other in some way or another. A

[17] The Gramm–Leach–Bliley Act (GLB), also known as the Financial Services Modernization Act of 1999, named after congressman Phil Gramm (Republican of Texas), Jim Leach (Republican of Iowa) and Rep. Thomas J. Bliley, Jr. (Republican of Virginia) was signed into lay by President Clinton. See http://www.gpo.gov/fdsys/granule/STATUTE-113/STATUTE-113-Pg1338/content-detail.html for complete version of the bill.

shock to the home prices had an adverse effect on the subprime mortgages and in turn the ABSs linked to subprime mortgages quickly started loosing its value. The shock spread to other asset classes since entities based on short-term debt were unable to roll over the debt or faced massive withdrawals. The run on the shadow banking system was essentially a run on short-term debt and the repo market and MMMFs stood in the center of all this. As Gordon and Metrick explain that the core problem in the financial crisis was the breakdown of the shadow banking system, which in turn was caused due to run on repos. The panic started to build up when depositors involved in repo transactions with banks feared that the banks might fail and they would have to sell the collateral in the market to recover their money, most likely at a loss. As a reaction, investors started increasing repo haircuts. An increase in repo haircut is similar to a withdrawal from the issuing bank. As Gorton and Metrick (2010, 279) explain:

> Think of a bond worth $100 that was completely financed in the repo market with a zero haircut. A 20 percent haircut on the same bond would require that the bank finance $20 some other way. In effect, $20 has been withdrawn from the bank. If no one will provide financing to the bank through new security issuance or a loan, the bank will have to sell assets. In the crisis, withdrawals in form of increased repo haircuts caused deleveraging, spreading the subprime crisis to other asset classes.

The fall of the shadow banking system was due to the run on various forms of short-term debt like repos, MMMFs, etc. that were believed to be safe and “money-like” but later were found to be poorly collateralized. Just before the crisis hit, these funds held liabilities of troubled financial firms such as Lehman Brothers. Upon failure of Lehman Brothers investors were concerned that these funds won’t be able to maintain their implicit promise of $1 net asset value. Like explained earlier, these funds were not guaranteed by the FDIC. Hence investors started to withdraw their funds, faced with massive runs these entities were forced to sell assets at fire-sale price. [18] The scale of long-term risky and relatively illiquid assets financed by very short-term liabilities made many of the financial products and non-bank finance corporations in the shadow banking system vulnerable to a classic type of bank run, but without any sort of safety net to protect the investors. This bank run was similar to that during the Great Depression, only difference is these “banks” took on a new form (Gorton and Metrick 2010, 280).

So like many others I wonder why the shadow banks were never regulated? If “the essential feature of banking is the provision of ‘money’, that is, a medium that can be easily used to conduct transactions without losses to insiders” and “throughout the US history the main aim of the government and policy makers has been to provide a regulatory structure that ensures the existence of such medium of exchange and avoids systematic banking crises” (Gorton and Metrick 2010, 281), then what changed? Why were the regulations that were put in place to save the US economy from suffering another blow like it did during the crisis in 1929 were deregulated? One of the main reasons for not regulating these banks was the combination of the capitalist economy structure along with the neoliberal thinking based on the belief that financial markets are efficient and self-regulating. The Regan administration took this political and ideological thinking and turned it into mainstream thinking; that even the presidents that followed him were unable to undo any changes and had no choice but to continue with this process of restoration of class power.

[18] Fire sale refers to selling goods or assets at heavily discounted prices. Fire sale originally referred to the discount sale of goods that were damaged by fire; it may now refer to any sale where the seller is in financial distress. In the context of the financial markets, fire sale refers to securities that are trading well below their intrinsic value, such as during prolonged bear markets.

Chapter IV: Theory and Practice of Neoliberalism

We all are living in the age of neoliberalism. It strongly influences our daily lives, the economics, politics, ideology and culture. In less than a generation, neoliberalism has become so widespread and influential and so deeply intermingled with major aspects of life that it has become difficult to assess its nature and importance. However for both intellectual and political reasons, it is necessary for us to understand what neoliberalism really is, its roots and where it is headed. Also it is important to keep in mind that it is impossible to define neoliberalism from a purely theoretical side as it favors a wide range of social, political and economic phenomenon at different levels of complexity. At the basic level it is a theory and practice of contemporary capitalist political economy, which “proposes that human well-being can be best advanced by maximization of entrepreneurial freedoms within an institutional framework characterized by private property rights, individual liberty, free markets and free trade” (Harvey 2006, 145). It is the role of the state to create and secure an institutional framework necessary for such practices and also set up other functions that are required to secure private property rights and to support freely functional markets. And if markets don’t exist than the state needs to create them. But above all, once these markets are created state interventions in the markets should be extremely limited.

Historical analysis of neoliberalism requires a multi-level approach, as its roots are long and varied depending on the field of discussion. Neoliberalism integrates insights from a range of sources such as classical political economy of Adam Smith, neo-classical economics in the late 19th century and 20th century, etc. and their influence increased tremendously with the breakdown of the postwar Fordist type of political economy: the ‘golden age’ of rapid growth and expansion up to the late 1960s, the collapse of the Bretton Woods international monetary system in the early 1970s, and the erosion of political support for the so-called ‘Keynesian compromise’ in the mid 1970s. “The collapse of the alternatives provided space for the synthesis between conservative views and the interest of the US elite and their minions. The cauldron was provided by the aggressive populist conservatism of Ronald Reagan and Margaret Thatcher, and the broth was tendered by finance – that had become hegemonic worldwide after the ‘coup’ led by the chairman of the US Federal Reserve System, Paul Volcker, in 1973” (Saad Filho and Johnston 2005, 2). In just a matter of time, by power and by force, neoliberalism became the dominant market thinking, not only in the US but through out the world. It became part of a hegemonic project concentrating power and wealth in elite groups around the world. For the purpose of this paper, I examine neoliberalism, its birth and its purpose from the Marxist school of thought in the US. From a Marxian perspective, neoliberalism is a ‘new social order’ in which the power and income of the upper fractions of the ruling classes – the wealthiest persons – was re-established through finance during the structural crisis of 1970s (Duménil and Lévy 2005, 9).

After the Great Depression and World War II, US faced great pressures to control capitalism’s excesses and establish basic welfare guarantees for its citizens. The restructuring of state forms and international relations after World War II was designed to prevent a return to the catastrophic conditions that had so threatened the capitalist order in the great slump of 1930s. To achieve this, some sort of class compromise between capital and labour had to be constructed. As Liberal scholars Dahl and

Lindblom argue in their text published in 1953 that both capitalism and communism in their raw forms had failed. The only way ahead was to construct the right blend of state, market, and democratic institutions to guarantee peace, inclusion, well-being, and stability (Harvey 2007, 10). These changes were made possible by world governments' coordinated control of international trade and capital flows under the Bretton Woods Accord of 1944, which helped keep economic forces from subverting public sector growth (Centeno and Cohen 2012, 319). The US government became substantially larger and more economically influential as it increased social spending, public investment, enterprise ownership, and market regulation while also maintaining large peacetime militaries. During the mid-twentieth century, almost all advanced industrial capitalist nations, including the US, embraced interventionist or state-regulated capitalist national economies and enjoyed steady growth, stable prices and rising equality. But the state-regulated capitalist systems began to face strain by late 1960s – stagnant economic growth and stagnant growth of productivity and profit. In the US, worker productivity kept declining and trade deficits kept on growing, international over-supply of US dollars materialized creating speculative financial pressures that damaged Euro-American relations and eventually led to the collapse of the Bretton Woods Accord in 1971 (Centeno and Cohen 2012, 319). With the collapse of the Bretton Woods fixed exchange system, the midcentury capitalist system in the US lost an institutional mechanism by which it coordinated with other countries its control over international capital markets during the 1950s and 1960s. Starting from the late 1960s and certainly by the early 1970s, the institutional backbone of the Fordist political economy had eroded, first in the United States, followed by other advanced industrial capitalist economies in Western Europe.

The increased competition at global level between the manufacturing sectors of the most industrialized countries led to over-capacity and over-production. Japan and Western Europe emerged as potential challengers to the dominant position of U.S. transnational corporations.

> The increasingly competitive environment, in turn, began to decrease profitability in manufacturing all across the world between 1965 and 1973 and resulted in the 'long downturn'. The intensified competition at the global level triggered an accelerated introduction to new technology by individual capital holders in their pursuit of relative surplus value. The advancing mechanization of the labor process and the growing expenses for machinery and technology, in turn, further contributed to the decline in profitability (Tauss 2012, 55).

The growing political and social power of organized labor in industrialized countries also led to the crisis of Fordism. During the boom in 1950s and 1960s, well-organized and powerful trade unions had gained significant wage increases and eventually the growing wage rate began to bring down productivity and profits. With the introduction of new technology, real wages and weakened labor movements were brought down.

The crisis of Fordism also led to a thorough rearrangement and reorganization of the labor process. By late 1960s, the internationalization of production became the principal strategy followed by national capitalist to re-establish the profit rate in the wake of the crisis. And it can be said that it was during this decade that the progression towards post-Fordist model of accumulation began. Low-wage countries around the world opened up to products and financial investments from the advanced capitalist countries. "Exporting capital and segments of labor process to low-wage countries in the developing world led to the ascendency of new international division of labor, in which technological development and innovation is concentrated in a core area, while physical production of goods is moving slowly from the core area…into peripheral areas…periphery production being linked to the core by control mechanisms located in the core area" (Tauss 2012, 56). In the US, the pressure on domestic wages increased due to exacerbated foreign competition and remarkably diminished the capacity of the government to intervene in the economies as a counter-balancing and protectionist force. In the center, the replacement of jobs in manufacturing sector by jobs in service sector led to re-shaping of the structure of the labor force. The transfer of jobs from rich to poor resulted in a decline of wages in the industrialized countries due to increasing global pressure of wage competition. This shift in production to low-wage countries also led to rising rates of unemployment in the core countries.

By the end of 1970s emerged a new post-Fordist global political economy. By incorporating production processes across national borders, the accumulation of capital started to become increasingly transnational. This post-Fordist phase was based on:

> …Enhanced mobility of capital, increasing mechanization of production, heightened use of cheap labor, and the shift of production to low-wage countries in the periphery. Post-Fordism intensified the internationalization of financial, trading, and industrial capital, abolished the traditional corporatist arrangement between trade unions and labor representations, and diminished the possibilities of democratic control and popular participation (Tauss 2012, 57).

Then in the 1970s came the oil crisis. In 1973, the OPEC (Organization of Petroleum Exporting Countries) embargo triggered a sustained economic crisis across the Western world. "It created a price shock that, for the first time since World War II, generated persistent inflation in developed economies" (Centeno and Cohen 2012, 319). In the years following that US currency lost half its value, economic growth rates halved and unemployment rates kept on rising. All this fit well under the dominated Keynesian beliefs at that time, according to which inflation was produced due to an overheated economy and provided a major coup for those who believed in antistate policy views. Policy makers increasingly adopted the view that government interference was the main cause of rough economic situation and the only way to get out of it was by reforming the economy in ways that privileged markets' economic influence over that of the state. Their various views were ultimately formed into a set of liberalization policies called Washington Consensus: fiscal austerity, market determined interest and exchange rates, free trade, privatization, market deregulation, and a strong commitment to protecting private property (Centeno and Cohen 2012, 319). Although US did not perfectly adhere to this policy paradigm and practice was often mixed, it still served to define the general direction and intention of the US government under the neoliberal phase.

But neoliberalism is not just about financial stability. Neoliberalism is a new stage of capitalism that emerged in the wake of the structural crisis of 1970s. "Neoliberalism is a new 'social order', which followed the class compromise of the postwar years, in which capitalist classes restored their powers and income, considerably diminished during the first decades following World War II: a new 'financial hegemony' " (Duménil and Lévy 2011, 2). It expresses the strategy of the capitalist classes in alliance with upper management, specifically financial managers, intending to strengthen their hegemony. The structural crisis of 1970s not only possessed a clear political threat to the ruling class in the US but also made the economic threat to the position of the ruling class evident. As Harvey explains, the one condition of the post-war settlement was that the economic power of the upper classes be restrained and that labour be accorded much larger share of the economic pie. In the US, for example, the share of the national income taken by the top 1% of income earners fell from a pre-war high of 16% to less than 8% by the end of World War II and stayed close to that level for nearly three decades. While growth was strong this restraint seemed not to matter, but when growth collapsed in the 1970s, when real interest rates went negative, and paltry dividends and profits were all that were possible then, the ruling class itself felt deeply threatened economically. The ruling class had to move decisively if they were to protect their power from political and economic destruction (Harvey 2006, 148).

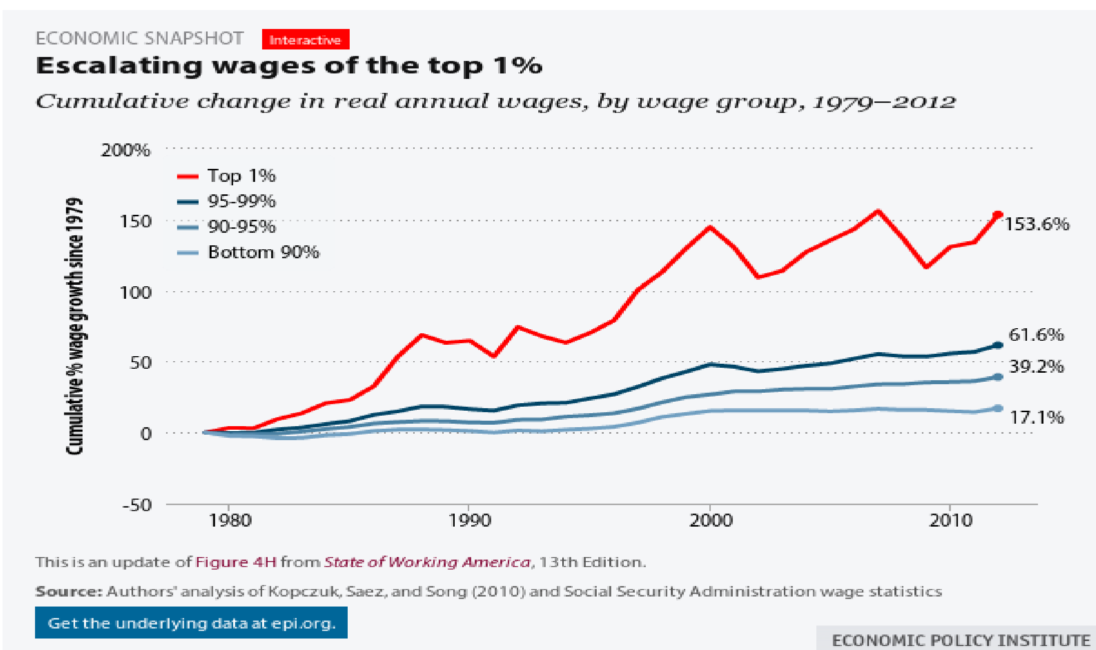

Figure 5: Cumulative change in real annual wages[19]

[19] Figure 5 obtained from article published by Lawrence Mishel "Wages for the Top One Percent Have Grown Far Faster than Those of Other High Wage Earners" on May 29th, 2014 for the *Economic Policy Institute.* *http://www.epi.org/publication/wages-for-top-1-percent-grow-faster/*

Duménil and Lévy go a step further and argue that neoliberalism was from the very beginning a project to achieve restoration of class power to the richest strata in the population. They present clear evidence and show how from the mid-1980s onwards the share of the top 1% of income earners soared suddenly to reach 15% by the end of the century (Duménil and Lévy 2004, 4). Harvey shows that the top 0.1% of income earners increased their share of the national income from 2% in 1978 to over 6% by 1999. The ratio of the median compensation of workers to the salaries of CEOs increased from just over 30:1 in 1970 to more than 400:1 by 2000 (Harvey 2006, 149). This data strongly suggest that the neoliberal turn is indeed a project to restore upper-class power and the theoretical abstract of the neoliberal argument is used as a justification and legitimation for whatever needs to be done to restore class power. If it is indeed a movement to restore class power, how was this done and by whom?

As stated earlier, neoliberalism – the new phase of capitalism – is not just a set of capitalist practices but also the ideological expression of the reassertion of the power of ruling upper class 'finance'. As Duménil and Lévy explain, "the term 'finance' refers to a framework of institutions, interlocked in a complex network; behind these institutions, stand individuals" (Duménil and Lévy 2001, 579). It refers to a set of agents whose interests to some extent coincide. In this section I use the term finance to refer to both corporations, such as the financial system, commercial and investment banks, and individuals, capitalists – folks belonging to the major families of ruling classes, the top of the capitalist pyramid. Also it is important to keep in mind that in a capitalism where ownership and management is basically separated, 'finance' is used to refer to the capitalist owners as opposed to management. One can argue that by grouping corporations and capitalists together is problematic, as each of these refers to multifaceted entities, but since they share broad common interests they can be treated as one for the purpose of general analysis in this paper. The leadership of the active and upper fraction of finance has been quite apparent since the end of the1970s and to understand this movement, we need to look at it from a historical perspective. The return of finance to hegemony was accomplished not only through financialization as previously explained, but also by forming an alliance between the managerial classes and the capitalist classes (Duménil and Lévy 2011, 2).

The framework of modern finance that we know of today did not always exist and hence we need to start at the early stages of its formation, in the late nineteenth century. Prior to that time, a large portion of the activity of finance was associated with financing of public expenses. But a major change occurred at the turn of the century, when new financial frameworks developed, which was closely related to the economy. This transformation occurred during the structural crisis of late nineteenth century, when the US suffered two major crises, one during 1890s, closely related to the deflation following the Civil war, and the other during 1880s following the return to convertibility of the dollar, which was suspended since the war. This period of major instability and crisis in the US followed a previous phase of technical change *á la Marx*, several decades long, in which the progress of labour productivity was only obtained at the cost of the investment of large amounts of constant, in particular fixed, capital, with a downward trend of the profit rate (Duménil and Lévy 2001, 581-582). Under such situation, an important crisis of competition occurred, in which companies attempted to gain protection from the general low profitability levels, through various agreements and this period is well known as the era of cartels and trusts. Two legal innovations that occurred during this phase, which had an important consequence on the US economy were, the Sherman Act (1890), which established the first anti-trust legislation and the new legal framework, which was favorable to incorporations, especially the *holding companies*. The law at that time prohibited any sort of consolidation in which independent companies were organized to share markets, pool profits, etc., but it allow straightforward *mergers*. “A huge wave of mergers followed the crisis of 1890s, just at the turn of the century, establishing a new framework of capitalist institutions” (Duménil and Lévy 2001, 582).

Two distinct terms arose out of these transformations: (1) Corporate Revolution – which refers to the formation of large corporations, backed and controlled by finance. One can argue that there was a ‘merger’ between finance and former industrialist or the industry was taken over by finance. However the issue remains controversial but what is relevant for the purpose of this thesis is the emergence of this new large finance and its relationship to the industry. Finance was at the center of this new economy, controlling credit mechanisms, which were strongly connected to the stock market, and thus the issuance of money. The development of financial and monetary mechanisms during the first few decades of the twentieth century was astonishing. (2) Managerial Revolution – which denotes the transformation of companies/firms, now managed by staffs of managerial and clerical personnel. As Duménil and Lévy (2001, 582) explain that these new procedures of management were tightly related to the Taylorist and Fordist organization on the shop floor, but affected all aspects of the activity of corporations, besides production, trade, management of inventories, liquidity, personnel, etc. During this revolution the distance between the workers and their means of production again widened and their tasks were now being defined by other salaried personnel. The managerial revolution was also responsible for new, more favorable technological innovation.

The early twentieth century was an era of technological trends in the US. This transfer of the managerial functions to the business staff was a matter of concern for the owners. As Duménil and Lévy (2001, 582-583) state:

> What autonomy to follow their own interests were managers able to obtain? How was the maximization of profit rate to prevail as the criterion of good management in conformity with the interest of the owners? Without being Marxists, the contemporary analyst of these new trends realized the importance of this transformation of the capitalist relations of production, since the ownership of the means of production was at issue, and the new class of managers represented a threat to the owner of capital.

Hence in the late nineteenth century there emerged a new configuration of capitalism. The basic feature of this configuration was the separation between ownership and management, and the new role of finance. The first few decades of the century were dominated by private finance, which maintained its control over its own institutions, particularly the issuance of money, price stability and the functioning of the financial system. For example, large New York based banks were acting collectively as a private central bank versus the rest of the financial system. The recurrent crises during that time and the dramatic bankruptcies led, in 1913, to the creation of the central bank: the Federal Reserve. But finance continued to maintain its grip over this institution thus preserving its hegemony.

Then came the Great Depression, which ultimately unsettled this social order, by introducing a considerable involvement of the state in the economy. Finance was unable to prevent the catastrophe from both the angles, of output and financial institutions. Faced by the crisis, it had no choice but to resort to procedures previously used, tending to stabilize the stock market, and to avoid the bankruptcy of financial institutions. As we all know that the situation of the US economy in 1933 was in real bad shape. Banks were closed and only solvent institutions were reopened. Unlike before the financial system was subject to regulation. Under the National Recovery Administration (NRA), the primary New Deal agency established by President Roosevelt, the rest of the economy was divided into 12 subsets, where industrialist and unions' representatives met, under government supervision, to fix minimum wages and prices, and share markets (Duménil and Lévy 2001, 585). The first New Deal was a terrific managerial experiment, however the experiment weakened rapidly in the following years, paving the way to a new social compromise, established during World War II, influenced by theories and ideas of John Maynard Keynes and hence appropriately known as the *Keynesian Compromise.* Understanding this compromise is very important in investigating the main argument I raise earlier in this section i.e. the power of finance. The *Keynesian Compromise* was built on Keynes's major idea, which concerned the balance of power between private initiative and state intervention. He suggested that the state should not interfere with the relationship between managers and finance, and certainly not be substituted for finance. Even though Keynes wanted to gradually eliminate the "rentiers", the weakening interest rate, he was still up for preserving private initiative and management (Duménil and Lévy 2001, 585). However he did not believe in leaving the macro control of the exertion of resources in hands of private sector.

When the *Keynesian compromise* was implemented there didn't exist any other private decentralized mechanism that could ensure full employment and limit the fluctuations in the economy. It was the task of the state to do the same. Hence during this era the autonomy was finance had to be limited in regards to credit mechanisms and the financial operations had to be regulated both domestically and internationally. "This was one of the most remarkable aspect of the Keynes's analysis: the ability to separate analytically public intervention concerning the macro-economy and private initiative at the level of firms and industries" (Duménil and Lévy 2001, 586). As it turned out Keynesianism was invading the authority of finance. The creation of the central bank had already been tough in the US. Finance remained hesitant and was against the views and demands of the Keynesians. It believed in the necessity of regulation, however the controls had to be defined and imposed by finance itself. In spite of all the hesitations, Keynesian framework was still implemented, even though it was constantly questioned. Thus the finance that emerged after World War II was strictly regulated, in particular interest rates and the limitation of the financial activity of commercial banks. The managers of big corporations enjoyed a relative autonomy. Self-financing and loans had become important sources of financing, reducing the dependency of firms on the owners and stock markets. Active macro-policies focusing on maintaining full employment and growth were implemented. This set back of finance in control of the macro-economy also had some important consequences. Companies now could benefit from the declining business-cycle fluctuations. The macro-control of monetary and financial mechanisms also implied a possible resilience to inflation and low interest rates, restraining the transfers of income from borrowers and lenders. This sort of framework evolved during the 1960s. Many analysts predicted during that time the disappearance of crises and poverty and the end of capitalism itself. “Full employment represented an entirely new objective, alien to the traditional functioning of capitalism, since it implied a practical recognition of the right to work” (Duménil and Lévy 2001, 586).

These Keynesian elements were combined with a new advance of social protection such as health and accident insurance, unemployment and retirement benefits. All of this together improved the condition of the workers significantly. However the owners now received a very limited income and their control on the economy as whole started to diminish. The future was now opened to state intervention. Analysts such as J.K. Galbraith signaled the establishment of a new post-capitalist technocratic order (Galbraith 1978). However what some of these analysts underestimated was the aggressive character of capitalism and the importance of class struggle. The upper fraction of finance constantly kept fighting for the restoration of its privileges and dominance. It can be said that the structural crisis, beginning in 1970s, created the conditions for the reassertion of the hegemony of finance. The crisis possessed similar trends to the previous crises during the nineteenth century such as the decline in the profit rate. One of the main factors in the crisis was the 1979 coup – the monetary policy in 1979, which focused exclusively on price stability. The US government and the monetary institutions used the institutions and tools of Keynesianism to establish a quite efficient policy in these respects. It was further “combined to a broad set of other practices such as deregulation, direct confrontation with the workers movement and unions, a policy favorable to large mergers, and a new corporate governance targeted to the interest of shareholders" (Duménil and Lévy 2001, 587). And this when capitalism entered a new phase, the so-called *neoliberalism,* signaling the return of finance to hegemony.

Finance took over the state and institutions of the Keynesian compromise. As a matter of fact, it used the tools of monetary policy and strengthened the control of Federal Reserve on depositary institutions, but changed targets: price stability now came before full employment. Besides the flow of income towards lenders, the rise of real interest rates created rising fiscal deficits. The first decades of neoliberalism, up to the late 1990s, were marked by deficits even larger than during the 1970s. These deficits were used by finance as a tool in the adjustment to its own ends of the state apparatus it has inherited (Duménil and Lévy 2001, 588). In further analysis of neoliberalism, it is useful to distinguish between various sub-periods. The 1980s, the first sub-period, can be described as the transition years with low profit rates and very large real interest rates. In this sub-period the income flowed toward finance through the payment of interest by firms, the state and households. The second sub-period can be identified from late 1980s onwards and during this period the profit rate recovered and real interest rates declined to some extent. Dividends played a major role in the income of finance as a gradually rising share of profits was paid to the shareholders. Even though the channels of the transfer of income to finance were modified between these two sub-periods, the size of the transfer was extremely large.

Besides the argument over deregulation as one of the underlying causes that conditioned the possibility of the crisis, the neoliberal thinking played a big role as well. Neoliberalism, which became the dominant market thinking, not only in the US but also through out the world became part of a hegemonic project concentrating power and wealth in elite groups around the world. As we can see in Figure 5 that not only did the top one percent of wage earners make spectacular wage gains but that the top one percent's gains were far larger than those of very high wage earners just beneath them in the wage hierarchy. The wages of the top one percent of wage earners saw their wages rise by 153.6 percent between 1979 and 2012. Just by examining the data in Figure 5, it is clear that neoliberalism is a 'new social order' in which the power and income of the upper fractions of the ruling classes – the wealthiest persons – was re-established through finance during the structural crisis of 1970s.

CONCLUSION

The main feature of Neoliberalism was to allow the so-called "free market" to rule and to achieve free mobility of capital. Hence from the neoliberal perspective there is no need for regulations as the shadow banking system was considered to be strong and invulnerable to risks. To the Federal Reserve and other regulators, the shadow banking system appeared to provide a safer and more dynamic alternative to the era of traditional banking. From the government and policy maker's point of view, if problems emerged in the shadow banking system, the large commercial banks—which were believed to be well run, well-capitalized, and well-regulated despite the loosening of their restraints—could provide vital support. And if problems outstripped the market's ability to right itself, the Federal Reserve would take on the responsibility to restore financial stability. It did so again and again in the decades leading up to the recent crisis and hence it can be assumed that the Fed could always and would always save the day.

Financialization has created banks or so called banks to become so large, leading to the belief "too big to fail" to be widely accepted. With globalization and the rise of securitization, many large domestic institutions became active participants in global financial markets thus growing even bigger. Each sector came to be dominated by a few large institutions with each institution being so large as to be able to bring down the whole system if it failed. The belief "too big to fail" soon turned to be a myth as the recent crisis proved.

It is common to hear that deregulation was to be blamed as a cause of the crises, specifically the 1999 repeal of the Glass-Steagall Act, which allowed commercial banks to get into investment banking business and thereby take on more risks. But the crisis in most part didn't happen due to deregulation of these institutions that allowed them to take more risk, instead it happened because these institutions were never regulated. As Krugman (2009, 162-163) states:

> *Yet the crisis, for the most part, hasn't involved problems with deregulated institutions that took new risks. Instead, it has involved risks taken by institutions that were never regulated in the first place. And that, I'd argue, is the core of what happened. As the shadow banking system expanded to rival or even surpass conventional banking in importance, politicians and government officials should have realized that we were re-creating the kind of financial vulnerability that made the Great Depression possible – and they should have responded by extending regulation and the financial safety net to cover these new institutions. Influential figures should have proclaimed a simple rule: anything that does what a bank does, anything that has to be rescued in crises the way banks are, should be regulated like a bank.*

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