The great unravelling

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It is now clear that the prolonged party for international finance capital is over, at least for now. The US financial structure is crumbling, possibly even collapsing. The collapse of the major Wall Street bank Bear Stearns and the interest rate sops and enormous bailouts that are being offered to financial institutions in the US by the US Federal Reserve are only symptomatic of the wider crisis.

This crisis was created by the unravelling of the real estate boom, which was itself based on dodgy lending practices. Everyone knows that what has already come out is only the tip of the iceberg. The financial crisis has already spread quite dramatically: from "sub-prime" borrowers to "prime" borrowers; from bad mortgage debt to bad credit card debt; and from banks to hedge funds to insurance companies.

There is no doubt that there is much more bad news to come within US markets. And most certainly, given the sheer size of the US system and the complex forms of financial pyramiding and entanglement with other financial structures in different countries, the global financial system will feel the impact.

But meanwhile, the actions of the Federal Reserve – the US central bank – have at one level declared the end of the recent era of freewheeling and deregulated finance. The financial liberalisation of the past two decades across the world was based on two mistaken notions. First is the "efficient markets" hypothesis beloved of some economists and many more financial players, which asserts that financial markets are informationally efficient, in that prices on traded financial assets reflect all known information and therefore are unbiased in the sense that they reflect the collective beliefs of all investors about future prospects. Second is the notion that financial institutions, especially large and established ones, are capable of and good at self-regulation, since it is in their own best interests to do so. And therefore external regulation by the state is both unnecessary and inefficient.

Both of these presumptions are now in tatters, completely destroyed by the waves of bad news that keeps coming from the financial markets, and by the growing evidence of foolish and irresponsible behaviour that was clearly indulged in by large and respectable financial players. It has emerged that unreliable behaviours is not the preserve of a few relatively small fly-by-night operators, but is endemic even among the largest private players in the financial system.

It is also increasingly clear that deregulated financial markets today are characterised by huge conflicts of interest: between the different functions that investment banks have taken on in recent times, between investment banks and regulators, between financial interests and the media, and so on. Financial deregulation allowed financial institutions to take on different activities that were earlier clearly segregated. Thus banks could take on non-bank financial services, and vice versa. It is clear that in terms of the activities of the banks, the integration of broking and underwriting, of proprietary and customer trading, of market research and investment advice, all give rise to huge conflicts of interest within the leviathan investment banks, and these conflicts are seldom or inadequately regulated. As a result, banks can carry on with problematic practices because they make their profits on commissions and fees rather than on actual repayment by borrowers.

Such a situation was obviously not sustainable, and all these undesirable financial practices have now led to an enormous mess in the very heart of capitalism, Wall Street. And this has already required large public resources being made available to save fragile financial institutions, with more spending likely.

So finance capital, which has so far systematically tried to undermine the state and demanded autonomy for all its actions, is now calling to that same state to save finance from itself. But can this occur without the state at least trying to reassert some control over finance?

Not likely, if recent commentators are to be believed. Several American economists, including Joseph Stiglitz and Paul Krugman, have already called for more controls on finance, most of all the separation of different types of financial activity of banks and others. Now the normally free-market-oriented columnist of the Financial Times, Martin Wolf, has comes out even more strongly. In a recent article (March 25, 2008) he states: "Remember Friday March 14 2008: it was the day the dream of global free-market capitalism died. For three decades we have moved towards market-driven financial systems. By its decision to rescue Bear Stearns, the Federal Reserve, chief protagonist of free-market capitalism, declared this era over. Deregulation has reached its limits."

This has significance beyond just the United States. All over the world, the Anglo-American style of financial system and its pattern of financial deregulation has been sold as the definitive model to follow. It already led to financial crisis in Japan and a large number of developing emerging markets but all of these were blamed on internal problems of those countries, such as "crony capitalism". Now, with the implosion of the US financial market, such arguments are no longer possible.

Martin Wolf also recognises this: "If the US itself has passed the high water mark of financial deregulation, this will have wide global implications. Until recently, it was possible to tell the Chinese, the Indians or those who suffered significant financial crises in the past two decades that there existed a financial system both free and robust. That is the case no longer. It will be hard, indeed, to persuade such countries that the market failures revealed in the US and other high-income countries are not a dire warning. If the US, with its vast experience and resources, was unable to avoid these traps, why, they will ask, should we expect to do better?"

In every crisis, the Chinese ideogram states, there is also an opportunity. So in this current US financial crisis there is a tremendous opportunity not only for the US but even more for the rest of the world, to bring back the financial regulation that has turned out to be so essential.

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