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Global inequality as one of the root causes of the financial crisis: a suggested explanation

Photis Lysandrou

Abstract

The global financial crisis was caused because the volume of toxic assets in the financial system had grown to the point where the system could no longer cope. The dominant view among heterodox economists is that this point of critical mass was reached because of various failures in the financial system. This paper puts the accompanying view that the toxic assets were created largely in response to external pressures, a principle source of which was global inequality: while income inequality was an important factor behind the supply of those assets, wealth concentration was a major factor behind the demand for them. The policy implications of this analysis are that income distribution and wealth ownership have to be more equitably structured if global financial crises are to be avoided in the future. This is not to exclude other proposals for making the financial system more transparent and accountable. The point, rather, is that these proposals are insufficient on their own. No matter how radical the re-structuring of the financial system, as long as there remain external pressures on it to create products or to indulge in practices that are harmful to it, such products and practices will continue to be introduced and financial crises will continue to occur.

Keywords: financial crisis; income inequality; wealth concentration.

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Introduction

It is the dominant view among heterodox economists that the root cause of the global financial crisis is to be found in the structure of global finance rather than in the structure of global inequality. Although it is widely acknowledged that inequality contributed to the financial crisis, it is also widely assumed that its deeper origins are to be traced back to the financial system itself, to its scale, to its organization and, above all, to its incentive structure. This ranking of the crisis-causing factors in order of priority is reflected in the ranking of crisis-solving measures: while some heterodox proposals for preventing future financial crises include redistributive measures, it is the demands for scaling down and restructuring the financial system that are invariably placed at the top of the policy agenda.

One explanation for this state of affairs concerns the question of inequality: insofar as this receives any attention at all in the analysis of the financial crisis, it is income inequality, the uneven distribution of incomes across different groups of people, which is the focus of that attention while wealth concentration among the top income groups is barely mentioned. Income inequality must of course figure in the recent growth in the markets for asset-backed securities given that the majority of the backing loans were extended to the household sector and given that one of the likely driving forces behind the steep rise in the household demand for credit in recent decades was the slow growth in real wages relative to the growth of profits. However, it cannot on its own explain the growth of these markets and certainly not that of the market for structured credit securities that was at the epicentre of the crisis in 2007–8. The individuals receiving the loans that were at the base of these financial products may have belonged to the poorest sections of the American population, but the fact remains that the construction and distribution of these complex products involved the willing participation of a wide range of financial institutions all of which profited handsomely. It is because this fact has left such a deep impression on economists that so many of them have little hesitation in laying the major blame for the crisis at the door of the banking system.

The interpretation of events put forward here is different. The system certainly overreached itself in creating and distributing structured securities that turned out to be highly toxic, but it did so partly because of the external pressures placed upon it to supply those securities. A major source of those pressures was the enormous concentration of wealth ownership, which was the flip-side of the widening gap between wages and profits. Just as wage earners typically faced the problem of how to make up the shortfall between current income and consumption, so did immensely wealthy individuals typically face the opposite problem of where to store their wealth. This problem became increasingly acute as the continued accumulation of private wealth came up against not only the physical constraints on various non-financial assets but also the institutional constraints on the global supply of financial assets. The

rate of growth of this supply may have been high relative to the growth of world output but not relative to the growth in the global demand for securities as evidenced by the drop in yields across all security classes in the years just before the outbreak of the crisis. Under pressure from their clients to 'search for yield', institutional investors turned to the banks for a solution to their dilemma. Faced with this pressure to create extra securities in order to absorb the overspill of global demand, the banks responded by breaking the established rules of lending and by resorting to highly unconventional methods of securitization. Of course a great deal of money was made out of the millions of subprime and other non-conforming borrowers whose mortgages provided the raw material from which the high-yield collateralized debt obligations were constructed, but in the end it was not only greed or complacency that drove the banks and their associates to break the established rules of finance but also the attempt to create securities with sufficient enough extra wealth storage capacity to accommodate the huge build-up of private wealth. The clear implication that emerges from this line of argument is that, if future financial crises on the scale of the recent one are to be avoided, overriding priority must be given not only to closing the gap between incomes and profits but also to achieving a more equitable distribution of the world's wealth.

The structure of this paper is as follows. The second section looks at the factors behind the supply of the subprime-backed securities. The third section looks at the factors behind the demand for these securities. The fourth section discusses some policy implications. The fifth section concludes.

The supply of CDOs

In 1980 the world's financial stock stood at \$12 trillion,¹ a figure that was just above that for world GDP. By 2006, the world's financial stock had grown to \$167 trillion, a figure that was now about three and half times that of the world GDP figure of \$48 trillion. The chief factor responsible for this more rapid growth of finance relative to material output was the issuance of public and private securities. Subtracting bank deposit money from the total financial stock outstanding at the end of 2006, this left \$111 trillion worth of ordinary 'ground-level' securities (those issued by governments and corporations, the cash flows on which are serviced directly out of their revenue streams) and \$11 trillion worth of asset-backed or 'first-tier' securities (those issued by banks, the cash flows on which are serviced by the interest payments on various types of loans). There was, in addition to these two securities stocks, an estimated \$3 trillion worth of collateralized debt obligations (CDOs) outstanding at the end of 2006, which were essentially 'second-order tier' securities (structured financial products created by pooling mortgage-backed securities, mainly comprising those backed by subprime and other non-conforming mortgage loans, with other asset-backed securities as collateral). The use of various credit enhancement techniques (including those of over-collateralization, subordination and insurance) in the

construction of these products was supposed to have made them safe. However, when the delinquency rate among US subprime borrowers began to rise sharply in the wake of the increases in the federal funds rate from late 2004, not only did these sophisticated techniques not prevent a resulting fall in the prices of CDOs, they actually helped to accelerate the rate of that fall by virtue of having helped to make these products too opaque and hence too difficult to value accurately. It was the panic caused by the unexpectedly rapid collapse of the CDO market that led to the breakdown in trust between the large commercial banks (many of whom owned or sponsored investment vehicles that were directly exposed to this market), a breakdown that proved to be catastrophic in that it was the catalyst setting in motion a liquidity-solvency crisis spiral which eventually culminated in the paralysis of the whole financial system.

According to Jean Claude Trichet, president of the European Bank, 'the root cause of the crisis was a widespread undervaluation of risk'.² As a matter of description, this view is correct in that the crisis would not have occurred in the form that it did had subprime-backed securities not entered the financial system and caused it to seize up. But the deeper question is: what led so many financial institutions to undervalue risk on so widespread a scale? What explains the 'tipping point', the reason why the banks decided to go the extra mile and create, in addition to the straightforward asset-backed securities, the more complex structured finance securities? The mainstream answer singles out various agency and institutional failures rather than any systemic weaknesses. These failures include: the over-zealous quest for fees and commissions and the concomitant over-relaxation of lending standards on the part of the mortgage brokers and banks originating the subprime loans; the highly leveraged and chronically under-capitalized positions of the banks and of their investment vehicles; flaws in the risk assessment methods used by the credit-rating agencies to rate the various financial products created by the investment banks; and, last but by no means least, the lack of proper oversight of the whole shadow banking system on the part of the regulatory authorities.

While mainstream economists admit that policy errors played a not insignificant role in the financial crisis, these errors tend to be seen as arising out of gaps in an otherwise sound macro-economic policy framework. Heterodox economists by contrast put the blame for the crisis squarely on that framework.³ The contribution to the crisis made by the many agency and institutional failures identified above is not denied; the argument, rather, is that most of these failures have their source in the neo-liberal dogma that economic resources are allocated more efficiently when the chief responsibility for their allocation is taken away from governments and placed with the financial system and with the capital markets in particular. From this perspective, the widespread undervaluation of risk associated with the construction and distribution of the subprime-backed securities was the inevitable concomitant of allowing the securities markets to occupy a more central position in mortgage and other credit lending. There are several variants of this line of argument, but the most popular is that which takes

Hyman Minsky's 'financial instability hypothesis' as its framework, the chief reason being the belief that its characterization of the process which leads banks to make the transition from 'hedge' to 'speculative' and finally to 'Ponzi' forms of financing pretty well captures the sequence of events culminating in the subprime crisis. The hypothesis has obviously had to be amended to reflect recent developments. In its original version the progressive lowering of margins of safety resulted from developments in the real sector: it is stability in that sector that, by virtue of generating overconfidence and a growing laxity in lending standards on the part of the banks, begets instability in the financial sector. In the contemporary versions that take into account both the rise in bank lending to households and the switch from the 'originate and hold' model of mortgage finance to the 'originate and distribute' model, low margins of safety and the potential for instability are built into the financial sector from the outset. To quote Kregel:

In the current crisis, the cushions of safety have been insufficient from the beginning – they are a structural result of how creditworthiness is assessed in the new 'originate and distribute' financial system sanctioned by the modernisation of financial services. The crisis has simply revealed the systemic inadequacy of the evaluation of credit – or, what is the same thing, the undervaluation and mispricing of risk.

(Kregel, 2008, p. 21)

Although the heterodox position on the financial crisis differs from the mainstream position in that it locates the root cause of the crisis in the current structure of the capitalist economic system, the difference turns out not to be as substantial as is claimed when one considers that the structure in question refers to the structure of finance rather than to the structure of inequality. While a number of heterodox economists have drawn attention to the role played in the financial crisis by the rise in inequality,⁴ they have difficulty in giving this role primacy because they concentrate attention on income inequality and this on its own does not have sufficient explanatory power. The slow growth of real wages in recent decades may help to explain the rise in the household demand for bank loans, but not the reason why those loans should have been taken off banks' balance sheets and securitized. The same observation applies to the subprime loans. Widespread poverty can explain the demand for these loans but not the reason why they were reconstituted to form CDOs. Nowhere is the difficulty in giving causal primacy to income inequality manifested more strongly than in the problems facing orthodox Marxist accounts of the financial crisis.⁵ According to the standard Marxist theory, capitalist crises are usually crises of profitability caused by the constraints on the realization of profits arising out of the exploitation of labour. Had the current global crisis originated in the market for corporate equity or in the market for corporate debt, this analytical framework would have commanded a great deal more attention than it has. Unfortunately for this

framework, the crisis broke out in the market for structured credit securities, in other words in that corner of the financial system that had the least connection to corporate profitability. To get round this embarrassment, Marxist theorists have to add to their usual story of a crisis of profitability a supplementary story to do with various failures in the financial sector, but the irony is that, in so doing, these theorists have helped to reinforce the prevailing idea that the origins of the crisis had more to do with a wrong organization of finance than with a wrong distribution of income.

As already noted, what is missing from those heterodox analyses of the crisis that give space to the unequal distribution of incomes across different groups of people is any serious discussion of the flip-side of that inequality, namely the concentration of wealth ownership among one small group of people.⁶ This omission has a crucial bearing on the conclusions reached by those analyses; for once wealth concentration is left out of the picture it is then inevitable that factors intrinsic to the financial system are identified as the major driving force behind the creation of the toxic securities while extrinsic factors are assigned a purely passive role. The moment that wealth concentration is brought back into the picture, however, it becomes possible to hypothesize that it was in fact the extrinsic, demand-side factors which compelled the banks to go beyond the tipping point and supply the toxic securities. The crux of the matter is that, as the proportion of profits that could be reinvested in production continued to fall in line with the widening gap in incomes, so was there a corresponding rise in the need for those surplus profits to find alternative forms of storage. It may at first seem that this need could easily have been met, but the opposite was actually the case due to the fact that the growth in private-sector demand for investable securities, fuelled by the growth in personal wealth accumulated not only from manufacturing profits but also from various other sources, occurred in tandem with the growth in the demand from institutional investors and from governments. Although the rate of expansion of the world's securities stocks was sufficiently high as to be able to accommodate this latter source of demand, it was not high enough to accommodate the additional demand stemming from the private sector and so, to fill the gap, the banks created the structured finance securities. The next section pieces together some evidence in support of this hypothesis.

The demand for CDOs

Given the extraordinary growth of ordinary debt securities over the past three decades, it is difficult to see how an excess demand for them could have risen to a point where its effects spilled over into the other debt markets. This difficulty begins to disappear, however, when we consider the scale and composition of the global demand for securities. As shown in Table 1, the four major sources of this demand in 2006 were: (1) the big institutional investors: the pension funds, mutual funds and insurance companies; (2) the commercial

Table 1 Major holders of securities, 2006 (US\$ trillions)

	Total assets	Securities	Alternative investments (inc. hedge funds)	Other assets (cash, real estate, etc.)
1. Institutional investors				
(a) PFs	21.6	17.3	1.3	3.0
(b) MFs	19.3	17.4	0.8	1.1
(c) ICs	18.5	14.8	1.1	2.6
2. Banks	74.4	37.2	—	—
3. Governments				
(a) Reserves	5.4	4.9	0.0	0.5
(b) SWFs	1.9	1.5	0.2	0.2
4. HNWI	37.2	19.3	3.7	14.1

Sources: Capgemini (2007); Conference Board (2008); IMF (2008); SWF Institute (2008).

banks many of whom, in response to the changes in household saving patterns, have moved into the asset management business; (3) governments, mainly comprising those of emerging market economies, who not only held substantial amounts of US treasuries as currency reserves but were increasingly investing in the securities markets through recently established Sovereign Wealth Funds; and (4) high net worth individuals.

Empirics aside, the more important reason why an excess demand for securities is generally considered impossible stems from the idea that the law of supply and demand does not apply in the usual way in the financial markets because prices respond to quantity movements here differently from the way that they respond in the markets for goods and services. To quote from a recent article on the financial crisis published by the Bank for International Settlements, in the real sector

an increase in supply tends to reduce the equilibrium price and is hence self-equilibrating. By contrast, in the financial sector, increases in the supply of funds (e.g. credit) will, up to a point, create their own demand, by making financing terms more attractive, boosting asset prices and hence aggregate demand. In a sense, a higher supply (of funding liquidity) ultimately generates its own demand.

(Borio, 2008, p. 13)

This proposition is put in flow terms; put in stock terms, the proposition is that there cannot be an excess demand for securities because there will always be a corresponding level of supply due to the lowering of the cost of capital. This standpoint helps to explain why the sharp fall in bond yields and the tightening of yield spreads from about 2001 (see Figure 1) were seen as having

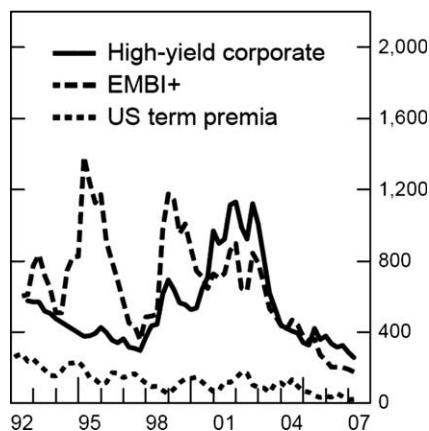


Figure 1 Bond spreads (in basis points)

Source: Borio (2008).

been largely driven by psychological factors: infected by the general atmosphere of optimism and confidence in the real economy that had been stimulated by the years of 'the great stability', investors also became over-confident and hence overly willing to accept lower risk premiums.⁷

The problem with this line of reasoning is its abstraction from the conditions attaching to the demand for securities. While it can be argued that governments and private corporations have always had to comply with certain conditions for their securities to be acceptable to buyers, these conditions have recently been considerably tightened (largely at the behest of the institutional investors who now dominate the major capital markets) with the result that they have a restraining effect on the rate of security issuance. From this standpoint, the recent developments in the global securities markets can be interpreted in a way that identifies them with those that typically occur in the product markets: just as prices of goods or services rise when the physical constraints on organizations prevent them from supplying enough quantities to match demand, so did the prices of securities rise (and yields fall) after 2001 because there were institutional constraints on organizations preventing them from supplying enough ordinary securities to accommodate the build-up of global demand. These institutional constraints were particularly marked in the emerging market economies (EMEs). As shown in Figure 2a, in 2006 the EMEs as a whole accounted for only 14 per cent of the global stock of securities as compared with 30 per cent of world output. Part of the story behind this is that the policy-makers in these regions have deliberately held capital market growth in check because of a continuing preference for alternative, relation-based forms of finance. However, another part of the story is that the establishment of a market for securities that is genuinely deep and liquid requires a legal, accountancy and

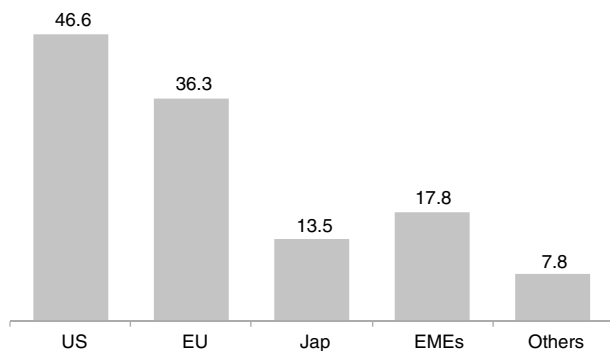


Figure 2a World capital markets: 2006 (US\$ trillion)

Source: IMF (2008).

governance framework that is orders of magnitude stronger and more transparent than that required for the material product markets.

The differences in capital market size help to put into perspective the reasons why the greater part of the assets managed by US and European institutional investors continue to be assigned to domestic securities. This practice is often construed as evidence of a continuing home or regional bias in institutional asset management, but this argument implies that institutional investors have the option of diversifying their portfolios along geographical lines to a far greater extent than they do but choose not to exercise that option.⁸ The truth is that they have no such option. Faced with severe limits on the amounts of transparent and reliable securities that are available outside their own capital markets, American and European institutional investors have of necessity to concentrate their asset holdings in these markets. This is problem enough, but what greatly adds to it is that these investors face increased competition in these core markets not only from other types of domestic investors but also from foreign institutions and individuals. The scale of the

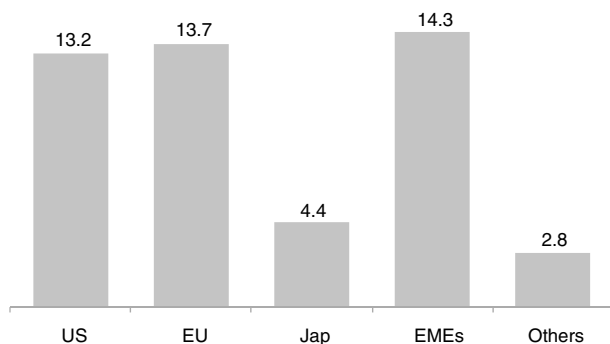


Figure 2b World GDP: 2006 (US\$ trillion)

Source: IMF (2008).

increase in competition from this direction became particularly marked in the period between 2001 and 2006, as was evident in the volume of net capital outflows from the EMEs (see Figure 3a), the major part of which was directed into the US markets (see Figure 3b).

While the observed capital flows in the period up to 2006 were certainly evidence of imbalances in the global economy, as has been pointed out by a number of commentators, there are problems with the claim advanced especially by mainstream theorists that these imbalances were symptomatic of differences in regional behavioural patterns, notably that the Americans were not saving enough and the Asians for their part were saving too much.⁹ It hardly makes sense to single out for special attention a 'savings glut' in the Asian and other EMEs just before the outbreak of the crisis, when at that same time the greater part of the surplus pools of capital in the world were held by US and European institutional investors, banks and wealthy individuals. In retrospect, the observed global imbalances had less to do with behavioural differences than with capital market asymmetries. These asymmetries are substantive but they become even more so when capital market size is measured in currency terms for, while the US dollar market remains the same, the eurozone market shrinks in size in the absence of the UK sterling market and the EME markets simply disintegrate into fragments. Given the preponderant size of the dollar market, it was inevitable that EME governments and private investors would try to squeeze into this market for reserve currency and other investment purposes thereby putting more downward pressure on treasury yields and also helping to tighten yield spreads, and thus in turn forcing domestic investors to search for new sources of yield.

The conclusion that falls out of the above is that the world's investors were victims of a problem that was partly of their own making: having helped to

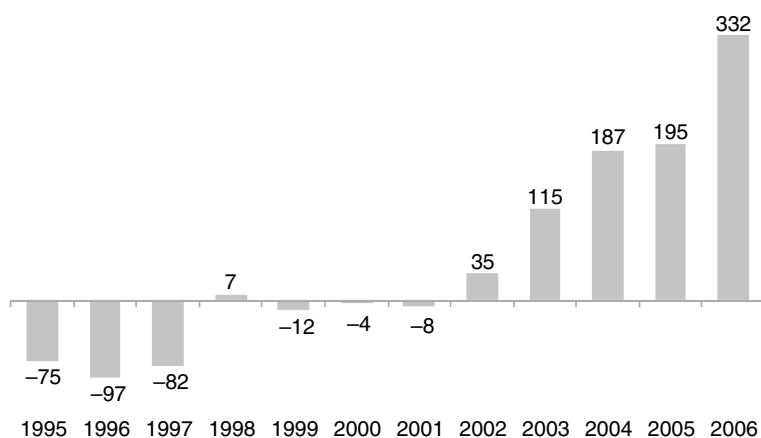


Figure 3a EME net capital flows

Source: IMF (2008).

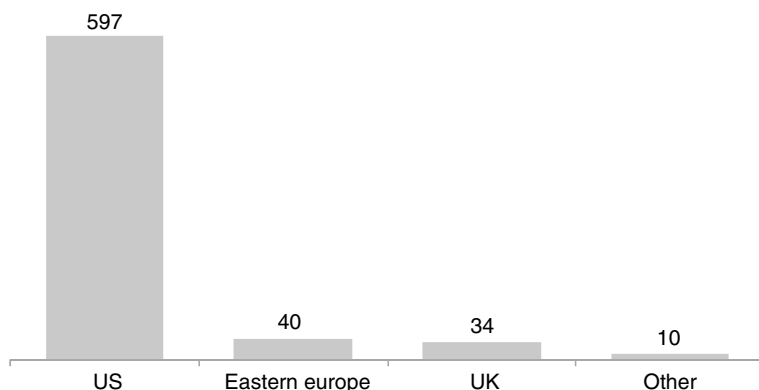


Figure 3b Net capital inflows (average 2001–6)

Source: IMF (2008).

force through stricter transparency, accountancy and governance rules for security issuers in the closing decades of the last century, they then found themselves in the opening decade of this century chasing yield because these rules made it difficult for securities stocks to grow at a rate commensurate with the growth of global aggregate demand. However, the other conclusion to take from the above is that if the excess demand for investable securities was a global problem, the attempts at solving it had to have a more localized character. The observation that it was the US financial markets that were at the centre of the financial crisis has led some commentators to say that it should be characterized as a US crisis rather than as a truly global one.¹⁰ This inference is in my view quite simply wrong. Given the preponderant weight of the US capital markets in the global financial system, and the corresponding international status of the US dollar as the major reserve currency, it was entirely understandable why the world's investors looked to US financial institutions in particular to supply the extra financial products that were needed to absorb the overflow of demand. These were in the first place the asset-backed securities (see Figure 4).

Asset-backed securities (ABS) have been in existence for decades, and yet about one-half of the total stock outstanding at the end of 2006 had been issued in the preceding five years. A key factor behind the sudden rapid growth of the US ABS market was of course the sharp fall in the federal funds rate after the dot.com crash. Most commentators have opted to concentrate attention on the supply-side chain, linking the fall in interest rates to ABS issuance, central to which was the role of property prices: while the property boom that was given impetus by the drop in interest rates helped to stimulate the household demand for mortgage loans, it also gave the banks an added incentive to move further towards the 'originate and distribute' model of mortgage lending as the gains made from fees and commissions increasingly outweighed those made from interest income. However, the demand-side chain

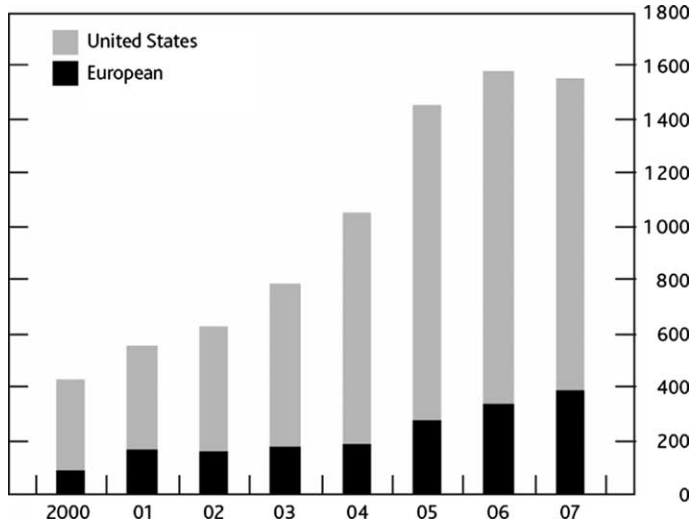


Figure 4 Asset-backed securities issuance (US\$ billions)
Source: Bank of England (2007b).

linking interest rates to the growth in ABS issuance was just as significant, as attested by the ABS spread over US treasuries (see Figure 5). In contrast to the period of the dot.com boom in the mid to late-1990s when a comparatively low ABS spread coincided with a comparatively modest rate of growth in ABS issuance, the fall in the spread after 2001 occurred at a time when the rate of issuance was growing at an exponential rate. In my view, this latter correspondence reflected the heavy build-up of demand for ABS from investors searching for yield, a search made even more urgent by the fall in the yields on US treasuries. Unfortunately for these investors, the pressure of

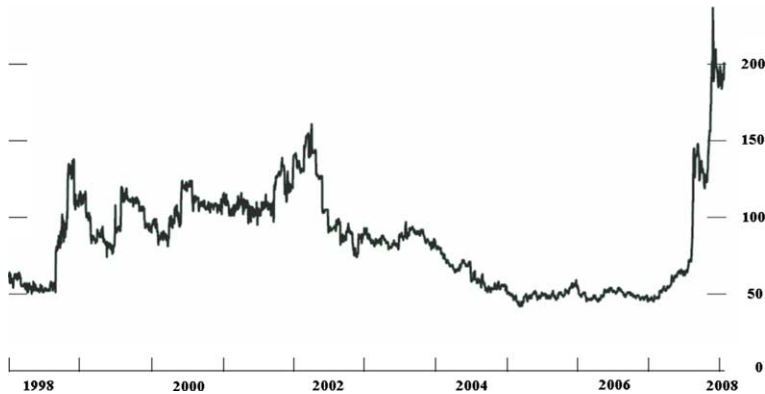


Figure 5 United States: ABS spread (in basis points)
Source: IMF (2008).

aggregate demand in the US ABS market was so great and the consequent ABS spread so low that the problem of yield continued to be an acute one.

It is here that we come to the subprime products. Of the \$11 trillion worth of ABS in 2006, about \$6.5 trillion consisted of residential mortgage-backed securities, of which approximately a third consisted of securities backed by various non-conforming loans. These broadly divided into jumbo loans (so-called because they had an above-average loan to property value ratio), alternative-A loans (alt-A borrowers are just below prime borrowers in that, while having no income documentation, they have a good credit history) and subprime loans (borrowers belonging to the subprime category either have no credit history or an extremely poor one and include NINAs, those with no income and no assets, and NINJAs, those with no income, no job and no assets). The standard explanation for the growth of this part of the mortgage market, which was extremely rapid after 2001 (see Figure 6), starts with the mortgage brokers and banks, who, in order to make commission, gave loans to subprime borrowers on terms that were far too easy, and then moves on to the role of the investment banks and credit-rating agencies who, also eager to make commission, were more than ready to create the sophisticated credit products. This standard explanation then finally ends with a discussion of how trusting and gullible investors were seduced into buying these products. However, just as plausible is the explanation that runs this story in the reverse direction: in the search for yield, investors pressured the investment banks to supply structured credit products in ever greater quantities and, to do this, these banks needed the mortgage originators to take whatever steps were necessary to induce as many subprime borrowers as was possible to take out mortgage loans.

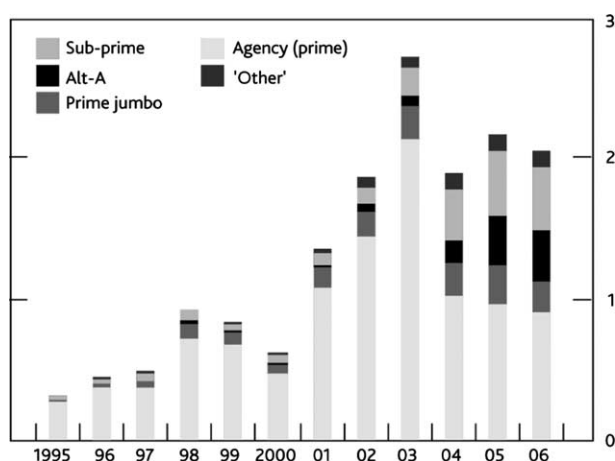


Figure 6 US residential mortgage-backed security issuance (US\$ trillion)
Source: Bank of England (2007b).

The role played by the hedge funds gives a strong indication that this reverse story is a plausible explanation for the sudden boom in non-conforming mortgage loans after 2001. As can be seen in Figure 7, while the rate of growth of assets under hedge fund management remained fairly steady in the years before 2001, it then started to accelerate appreciably after that date, that is to say, at about the time that marks the start of the subprime mortgage boom. For confirmation that this close correlation between the growth rates for hedge fund assets and for non-conforming mortgage-backed securities is not coincidental but indicative of a causal relation, one need only look at the breakdown of CDO ownership on the eve of the financial crisis (see Figure 8).

Approximately 52 per cent of the CDOs outstanding at the end of 2006 were held by banks, asset managers and insurance companies, while the hedge funds held the other 48 per cent. What explains this ratio? How could the hedge funds hold nearly half of all CDOs when at that same time they held just over 1 per cent of the world's total stock of securities of \$122 trillion? The answer is simple. The basic task of hedge funds is to generate for their clients above-average returns for which they get paid above-average fees. This task became increasingly difficult in the low-yield macro-environment of the early to mid-2000s because no matter how sophisticated the investment strategies used by the hedge funds to generate yield, there were limits to how much could in fact be squeezed out of the existing securities and other asset classes. Thus the hedge funds found themselves in a dilemma: on the one hand, more and more assets were being placed under their management because other investors

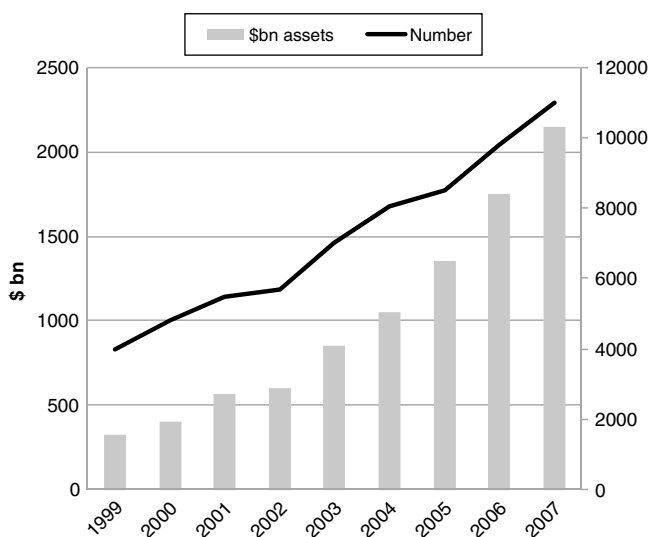


Figure 7 Number of hedge funds and assets under management
Source: Bank of England (2007a).

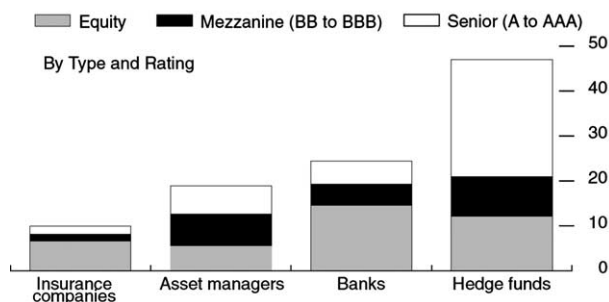


Figure 8 Buyers of CDOs: 2006 (in percentages)

Source: House of Commons (2008).

were finding it difficult to generate yield; on the other hand, the hedge funds were themselves finding it difficult to generate yield. The fact that hedge funds needed to resolve this dilemma helps to explain why they led the search for alternative financial products that could give higher yields, and, when finding that the structured credit products fitted this description, why they led the demand for them. Far from passively accepting the products provided by suppliers, the hedge funds on the contrary pushed the suppliers into providing these products at an ever-increasing rate. To quote from testimony given by Gerald Corrigan of Goldman Sachs at a House of Commons hearing on the financial crisis: 'To a significant degree it has been the reach for yield on the part of institutional investors in particular that goes a considerable distance in explaining this very rapid growth of structured credit products' (House of Commons, 2008, p. 16).

The growth of these products may have been very rapid, but apparently not rapid enough to keep up with the demand for them and so the investment banks had to find other ways of making up the shortfall. One way was by re-securitizing unsold mezzanine and other lower-rated tranches of securities to create CDOs-squared and re-securitizing any unsold mezzanine tranches of these instruments to create CDOs-cubed. According to a recent IMF report: 'These CDOs-squared and structured finance CDOs were created almost solely to re-securitize MBS and CDO mezzanine tranches, for which there was not sufficient demand from investors. Therefore their value added in transferring risk is questionable' (IMF, 2008, p. 59). In my opinion, what is more questionable here is the assumption that the CDOs-squared and -cubed were created purely to transfer credit risk. This may have been part of their function, but their chief purpose was to serve as wealth containers of a particular risk-return vintage. In the universe of debt securities there are only a handful of banks and corporations and about twenty to thirty sovereign governments that have a triple A rating. So when the banks found a way of creating thousands of extra AAA-rated products,¹¹ it was only logical that investor demand would be concentrated on these products, and it was equally logical that, rather than waste any unsold mezzanine and equity tranches, the

banks would collect all of these together to create the additional senior tranches demanded by investors.

A further way of satisfying investor demand was through the supply of 'synthetic' CDOs, products created by the investment banks by taking a cash CDO as a reference entity for two credit default swaps entered into simultaneously: on the one side, the synthetic CDO creator would sell protection to the counterparty in return for payments of interest and principal; on the other, the creator would buy protection from the counterparty and pay interest and principal. There were several variations on this theme. For example, cash flows in the credit default swaps would involve only the payment of interest: the 'unfunded' synthetic CDO. Or the reference entity for credit default swaps would be a particular tranche of a CDO rather than the whole CDO: the 'single tranche' synthetic CDO. It has been estimated that by 2006, the year before the crash, the supply of synthetic CDOs had grown to the point where they matched the supply of cash CDOs (see Figure 9) and what is especially striking is that among the leading institutions that had helped to drive this growth were the hedge funds, second only to the banks in the buying and selling of protection (see Table 2).

In view of their massive involvement in both the cash and synthetic CDO markets, it is simply impossible to absolve the hedge funds from all responsibility for the financial crisis. Far from being innocent victims of the crisis as they would like us to believe,¹² the hedge funds on the contrary helped to bring it about by virtue of the strength of their demand for CDOs. However, if the hedge funds must take some responsibility for the crisis in that they were one of the principle conduits through which flowed the pressure on the banks to create the CDOs, then it follows that the world's high net worth individuals must also take responsibility in that they were one of the principal sources of that pressure (see Figure 10). Recall that in 2006 these individuals (who

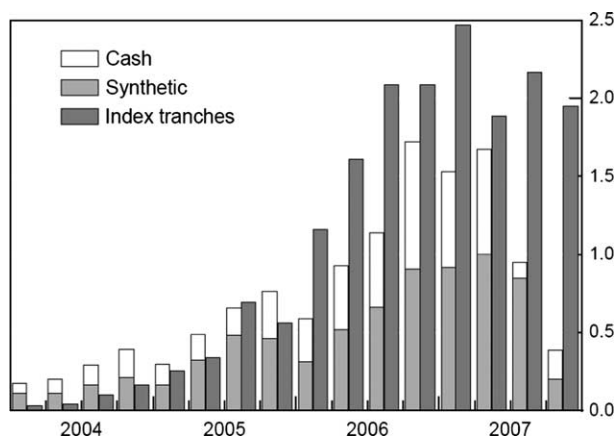


Figure 9 Growth of CDOs: 2003–6 (US\$ trillions)

Source: Borio (2008).

Table 2 Main participants in credit derivatives (as percentage of total)

	Protection buyers		Protection sellers	
	2004	2006	2005	2006
Banks	67	59	54	43
Hedge funds	16	28	15	31
Pension funds	3	2	4	4
Insurance	7	6	20	17
Corporations	3	2	2	1
Mutual funds	3	2	4	3
Other	1	1	1	1

Source: IMF (2008).

numbered 9.5 million or just over 0.01 per cent of the world's population of 6.8 billion) had a combined wealth of \$37 trillion of which more than half, \$19 trillion, was invested in securities.¹³ This was a substantial amount considering that it represented nearly 15 per cent of the total stock of securities outstanding at that time, so substantial in fact that had this amount been available to all of the other types of investor it is doubtful whether the problem of yield would have become as acute as it did. The irony, however, is that, having helped to create the yield problem by virtue of channelling the bulk of their wealth into securities, the seriously rich individuals then continued to be an important source of the pressure on the hedge funds to find ways of resolving the problem. Although their percentage share of the total assets placed with hedge funds fell from 60 per cent to just over 40 per cent in the years preceding the financial crisis as money flowed in from other sources, high net worth individuals still remained by far the largest single group of investors

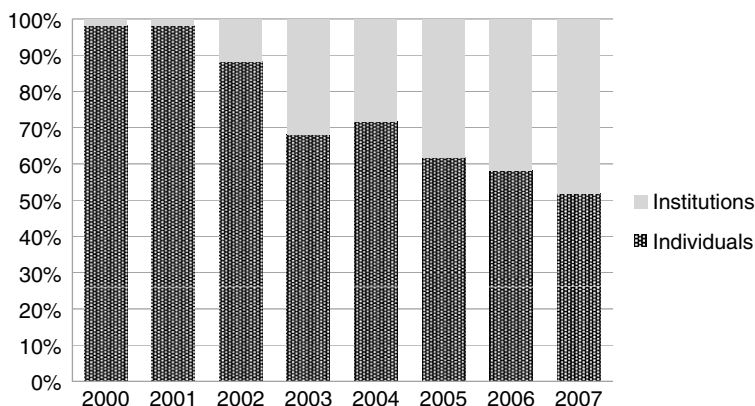


Figure 10 Source of hedge fund capital by share of assets under management
Source: IFSL Research (2008).

in hedge funds. To my mind, these two facts – that rich individuals were the biggest clients of the hedge funds who were in turn the biggest investors in CDOs – provide the vital clue that global inequality was at the root of the financial crisis after all.

In the end, the global financial crisis is about developments at the margin. The crisis did not break out in the markets for government and corporate securities or in the market for ABS. It broke out in the market for structured finance CDOs, products whose complexity and resulting opacity broke all the rules of commodity exchange and which eventually proved to be highly toxic. This development did not occur only because of lapses in particular financial institutions and practices or because of the way that the financial system as a whole is currently organized. An additional causal factor lay outside the financial system, in the global concentration of wealth ownership that had been allowed to reach obscene proportions by the turn of the millennium. Had private sector wealth been more evenly dispersed in the global economy, the pressures on the financial system to artificially inflate existing securities stocks and thus their aggregate wealth storage capacity would have eased sufficiently so as not to force it into creating the toxic securities on the scale that it did. In short, it was because wealth concentration had gone one step too far that the banks out-stepped the limits of the global commodity system thereby triggering its crisis.

Policy implications

The clear implication that follows from this interpretation of events is that the world's wealth has to be more equitably distributed if global financial crises are to be avoided. To give overriding priority to this policy is not to exclude the many other proposals that have been suggested for making the banking sector and entire financial system more transparent, more efficient and, above all, more accountable. On their own, however, these proposals are insufficient. No matter how radically the financial system is reformed or restructured, as long as there remain external pressures on it to create products or to indulge in practices that are harmful to it, such products and practices will continue to be introduced and financial crises will continue to occur. These external pressures will be removed only when there is a significant re-distribution of wealth, and what this entails as a first step is globally coordinated action in three key areas of tax policy:

1. tax havens: these need to be closed down to prevent tax avoidance;
2. tax structures: these need to be harmonized to prevent any exploitation of differences between them;

3. tax rates: these need to be re-aligned so that the tax burden is again distributed on a progressive rather than regressive basis.

Coordinated government action on taxes is crucial not only because this can help to prevent future crises, but also because it can help finance the resolution to the present crisis. Forced into bailing out the banks through various means including nationalization and the purchase of the toxic assets that they hold, and at the same time desperate to prevent the current recession from turning into a 1930s-style depression, the world's governments have been pumping liquidity into their economies at a high rate. What this means is that the supply of government bonds, which until now have constituted about a quarter of all debt securities, is set to expand to phenomenal levels. Governments are in effect colonizing the future to escape the constraints of the present, but, like all colonizations, this will impose a huge burden.

Governments may pile up more and more claims on their future revenues, but the more that they pile up the higher will be the risk-adjusted returns that they will have to give to investors. Where are these returns to come from? Since there are limits to how much can be raised from low- to mid-income households, small businesses and other immobile taxable units, there will have to be – in the absence of serious tax reforms – deep cuts in key areas of government expenditure, including those of health, education and other social provision. To get the necessary tax reforms implemented will not be easy given the resistance mounted by the wealthy individuals and the large banks and other corporations all of whom can hold up to governments the threat of exit and relocation to an alternative tax jurisdiction. The strength of that resistance can already be gauged by the reluctance on the part of the British government to make super-taxes on bankers' bonuses a permanent measure or by the hesitation in enforcing taxes on non-domiciles. However, the British government along with other governments can be made to implement the above suggested reforms providing strong countervailing pressure is brought to bear on them. Now is the occasion and now is the opportunity for the world's progressive forces to exercise that countervailing pressure.

Conclusion

The global capitalist economic system has a huge potential for generating material growth, but also an equally huge potential for generating inequality. In recent decades it is this negative aspect of capitalism which has come to the fore, and the grim irony is that it was the utter failure and collapse of the communist experiment that has helped to give this development momentum. As things stand, this planet of ours is at a crossroads. It will not survive much longer if the matrix of global commodity relations continues to be structured in

such a way that the overwhelming majority of the world's population is forced to eke out an existence on a fraction of the world's wealth while, at the other end of the spectrum, a tiny fraction of the world's population commands a disproportionate amount of that wealth. If financial disasters do not kill this planet, other disasters, most of which link in some way or other to economic desperation, certainly will. It is for this reason that it is imperative that the global economic system be brought under democratic control and restructured so that it benefits the world's majority rather than its minority. If there is any one positive thing that may come out of this current crisis, it is that it can possibly open the way to establishing that control.

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Notes

- 1 All references to dollars in this article are US dollars (unless otherwise stated).
- 2 Jean Claude Trichet, President of the European Central Bank, *Financial Times*, 13 November 2008. See also Goodhart (2007), the IMF (2008) and the Bank of England (2007b) for similar statements.
- 3 See, for example, Blackburn (2008), Dore (2008), Fernandez *et al.* (2008), Kregel (2008), Randall Wray (2008) and Wade (2008). For a more recent selection of papers that analyse the financial crisis from a heterodox perspective, see the July 2009 special issue of the *Cambridge Journal of Economics*.
- 4 Fernandez *et al.* (2008) are a notable example. See also the contributions of Palma (2009) and Wade (2009) to the *Cambridge Journal of Economics* special issue on the financial crisis.
- 5 Explanations for the financial crisis given from an orthodox Marxian standpoint can be found in *Monthly Review* or *International Socialism*.
- 6 The focus on income inequality ties in with the central preoccupations in macro-economics: thus, if one wants to understand the determinants of the aggregate demand for material goods (consumption or investment goods) as a way of understanding the constraints on growth or on the level of employment, etc., one has to look at the general distribution of incomes across all groups of people. The argument here is that to understand the peculiarities of the financial crisis of 2007–8 one has to look not only at the demand for material goods but also at the aggregate demand for financial securities and for this one needs to focus attention on the concentration of personal wealth among the very top income groups.
- 7 Goodhart, for example, argues that the 'serious under-pricing of risk' at the root of the financial crisis was in large part induced by the way that 'persistent macro-economic stability led many to believe that macro-economic risks had been significantly reduced. The implication was that investment generally, and financial conditions in particular, were subject to less aggregate, macro-economic risk than in the past' (2007, p. 3).

8 The observed regional 'bias' in institutionally held portfolios was one of the principal arguments used by Hirst *et al.* (2009) to suggest that financial globalization is not as developed as is often thought.

9 See, for example, Bernanke (2005) and Wolf (2009).

10 See Thompson (2010) and Nesvetailova and Palan (2009).

11 In a statement to the Council of Institutional Investors in April 2009, Lloyd Blankfein of Goldman Sachs pointed out that '[i]n January 2008, there were 12 triple A- rated companies in the world. At the same time, there were 64,000 structured finance instruments, like CDO tranches, rated triple A'.

12 When the heads of some of the biggest US hedge funds were called in November 2008 to testify before a US Senate hearing on the subprime crisis, they played the role of the innocent victim to the full, saying that they were too trusting in the reputation of the banks that constructed the CDOs and in the reputation of the credit-rating agencies that rated them. For more details, see Lysandrou (2009).

13 These figures understate the degree of wealth concentration because to qualify as a high net worth individual one needs assets to exceed liabilities by only \$1 million, which is not a high hurdle in this age. The truth is that the bulk of wealth is held by what are labelled as 'ultra' high net worth individuals, those with net assets in excess of \$30 million.

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