

The Global Financial - Production Interplay

Sustainability in Light of the 2007 International Economic Crisis

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The Global Financial System (GFS), in partnership with the Global Production System (GPS), form the bedrock of the international economy. The aforementioned interrelation has seen a dramatic shift in power as a result of accelerated growth in GFS. This paper will examine the changing dynamic of the modern GFS-GPS relationship. Furthermore, the sustainability of the GFS-GPS interplay in a globalized economy will be explored utilizing the 2007-2010 Global Financial Crisis as a medium for investigation. It will be argued that the risks of financial crises are largely outweighed by the benefits of a free-market system. In addition, several key economic events of the 21st century and their impact on the intercontinental financial market will be analyzed. To provide a basis for our circumspective investigation of the balance between financial and production systems, we begin by discussing the origins of financial markets.

The modern markets are rooted in the early trade of commodities. Specifically, "trade in markets may be said to have started when people previously self-sufficient in some rudimentary fashion began to specialize in the various tasks and exchange them with others. This exchange made everyone participating better off."¹ This primitive economy was structured solely around the physical production of goods and services; it was the beginnings of the Global Production System (GPS). The next economic epoch began with the inception of a state-issued currency as a medium of exchange and unit of account.

¹ Chuckman, John, *The Decline of the American Empire and the Rise of China as a Global Power* (Fort Erie: Magpie, 2007).

Transactions, which had traditionally been executed as the trade of hard goods or immediate service, could now be financed by previous sales. Thus, currency had allowed for the accumulation of wealth, as it was a durable store of perfectly liquid value. In this way, the genesis of the financial system occurred with the implementation of legal tender. A result of this developing financial structure was the ability of the individual to make a choice between saving and consumption. At the aggregate level, the choices of a populace between saving and expenditure would have national and international socio-economic ramifications. In his book *The Decline of the American Empire and the Rise of China as a Global Power*, economist John Chuckman, develops this concept:

"The importance of saving is that it funds investment in economic capital. Even a relatively small difference in saving rates between two countries can be quite telling over just a few decades. Those who have saved more will have financed a better or greater capital stock which in turn yields a new level of choice between saving and consumption in the future."²

Over the past decade, US household savings rates have plummeted. In 1990, the average personal saving rate of US households was around seven per cent, but in 2007 it dropped to less than a single per cent.³ Coupled with rising housing prices, American household mortgage debt drastically increased and was a major instigator of the 2007 economic recession.⁴

These concepts of transaction financing and value storage are now core pillars of contemporary financial theory. Following the adoption of common currency, the roots of a comprehensive financial system may be found in the twelfth or thirteenth century. As legal currency was adopted globally and international trade within the GPS grew, a need for forex (foreign exchange) and capital markets arose. The result was a sustained

² Chuckman, John, *The Decline of the American Empire and the Rise of China as a Global Power* (Fort Erie: Magpie, 2007).

³ George Soros, *The New Paradigm for Financial Markets: the Credit Crisis of 2008 and What It Means* (New York: PublicAffairs, 2008).

⁴ Ibid.

period of rapid growth in the financial industry. It was during this period that the first identifiable commodity exchanges and banks were formed. The commodity exchange was a key innovation which interconnected a developing financial system with established production industries. Farmers could now sell the rights to their crops months in advance of harvest thus protecting themselves from a drop in the future price while buyers could protect themselves from the potential of rising costs.⁵ As contracts and transactions over the exchange became more complex, individuals specializing in executing transactions for personal gain developed an entirely new industry around fiscal investment. In this way, a Global Financial System (GFS) developed not only as an abstraction of the GPS, but as an inseparable aspect of a globalizing economy. Consequently, it is economically, politically, and managerially important to understand the interplay between the global production and financial structures. By 2006, this long-term interrelation between GFS and GPS had grown “the economic output of the entire world [to] around \$47 trillion. The total market capitalization of the world’s stock exchanges was \$51 trillion.”

In the twentieth century, the GFS grew at an unprecedented rate. This paper postulates that there were three driving forces behind this rapid growth: industrialization, post materialism, and globalization. As industrialization took hold, production efficiency rose, boosting the output of products. The result of rising supplies and inventories was a corresponding increase in consumer-purchasing power. Further, as the agricultural industry became more efficient, a greater number of people sought jobs in new businesses and developing sectors. A growing middle class followed, and a post-materialist paradigm began to percolate. This new culture desired more than mere subsistence and turned to the free-market for entrepreneurial financing and investment savings. Correspondingly, capital markets began to flourish in the early twentieth century providing opportunities for financing or investment in the form of debt or equity. In these markets the efficient allocation of money, in relatively liquid securities, provided a catalyst for the financial system to grow exponentially.

Production industries embraced the financial system as an avenue for financing, conventional banking, loans, and venture capital. As the contemporary corporate world developed, the financial system inevitably became a vital and omnipotent facet of all business operations. This interconnection between the two evolving structures continued until the financial system encompassed the corporate world. It now provides a central hub through which capital flows between production sectors. This modern GFS is a complex and expansive network of institutions and regulators acting on a transnational basis. Investment banks, hedge funds, and other asset managers represent the private side of the structure.⁶ On the public side are regulators such as national governments, the International Monetary Fund (IMF), and the World Bank.⁷

With the advent of the internet and rapid communication technologies, the various financial systems of countries can be said to have truly amalgamated into one monolithic global financial structure. This system provides financial fuel for the global production system. This system has taken long-term assets and turned them into highly liquid investment options for the enterprising mind. However, as the world economy has globalized, the risks endemic to the system have become more critical. The various financial crises and economic bubbles set forth in this paper stand as testaments to the severity of a failing in the global financial structure. Such financial crises have very real impacts on the global production structure and by extension countries and the individual. As such, a financial crisis has the potential to be far more severe than an economic recession in most other industries. A brief analysis of financial crises which occurred in the past century will aid in pinpointing these risks.

The outset of the new millennia began a half-decade of steep increases in commodity spot and real-estate prices, as well as a peak in global inflationary rates. Retroactively, this rapid appreciation of asset prices in the early 2000s, in conjunction with a low interest rate policy in the wake of the 2000 dot-com meltdown, can be seen

⁵ Niall Ferguson, *The Ascent of Money: A Financial History of the World* (New York: Penguin Press, 2008).

⁶ Geoff Martin, *Introduction to Political Science Reading Kit* (Sackville: Mount Allison University, 2008).

⁷ Ibid

as a key precursor to the 2007 recession. In his 2008 speech to the Financial Risk Roundtable of the Wyman Institute, Federal Reserve Governor, Frederic Mishkin, conveyed his belief that an asset price bubble⁸ was the foreshock of the recession. "Over the centuries, economies have periodically been subject to asset price bubbles—pronounced increases in asset prices that depart from fundamental values and eventually crash resoundingly."⁹ When the American housing bubble burst in 2007, mortgage defaults and home foreclosure rates spiked. The vast majority of these defaults and foreclosures originated from portfolios of sub-prime lending. Bankers hoping to earn a higher return on investment had leveraged the purchase of large portfolios of sub-prime mortgages.¹⁰ This was to be the first in a series of severe blows to the financial system; the result was widening credit spreads and mounting loan losses.¹¹ The 2007-2010 recession was facilitated by identifiable systemic risk in the GFS. As the financial system deteriorated almost all other sectors in all parts of the globe were affected. When liquidity dried up in the market and consumer demand fell suppliers of both capital and finished goods saw a slump in profit margins. Diminished profit margins lead to increased unemployment, and thus the global economy has spiraled deeper into recession. To fully understand the 2007 recession it is important to recognize that the recession is an amalgamation of the issues faced in a great number of previous market crises.

To begin, the 1997 Asian Financial Crisis bears a great similarity to the current financial upheaval which originated in the United States. In 1997 Thailand decided to let the baht float against the United States dollar. However, Thailand had recently experienced a domestic asset price bubble, and was burdened with massive foreign

debt in the form of economic investment. As the baht devalued and interest rates jumped, it became impossible for Thailand to cover its foreign debts and pay interest on loan investments.¹² In many ways, the Thai economy faced similar challenges as the United States. The American public debt currently stands at nearly 14 trillion dollars. This debt is owned principally by Japan, China and Germany.¹³ The combination of this massive debt, depressed asset prices, and a struggling currency has had massive implications for the global production structure. In its position as the world's largest economy, the fall of both supply and demand from the United States was highly damaging to the global economy. Global markets continued to falter throughout 2008, and the Financial Crisis developed to embody many characteristics of the International Debt Crisis of the 1980s, the 2000s Dot-Com Bubble and even the Great Depression of the 1930s.

In 1978-1979, the dramatic fall of oil prices combined with interest rates reaching 18 percent per year led to a global economic recession from 1980-1981.¹⁴ The result was an inability of debtor states to pay creditors the interest on their debts. In August of 1982, Mexico could no longer pay its foreign debt. Shortly after, similar announcements were made by several other Latin American countries including Brazil and Argentina.¹⁵ These currencies were "sunk" by rapid for-ex option contracts, shorts, and swap transactions; executed by traders capitalizing on a strong U.S. Dollar and unsupported South American currencies. Debt Restructuring Negotiations organized by the IMF, World Bank, Commercial banks, and governments provided new loans to debtor countries and stretched out external debt payments, providing some stability to the crisis. The situation is strikingly similar to the debt crisis faced by Dubai in 2010. The events in Dubai amplified doubts about the ability of

⁸ A price bubble occurs when the price of an asset rises far above its fundamental value.

⁹ Frederic Mishkin, "How Should We Respond to Asset Price Bubbles?" (Speech at the Financial Risk Roundtable of the Wyman Institute Speech, University of Pennsylvania, Wharton Business School, May 15, 2008).

¹⁰ A sub-prime mortgage is a mortgage made out to an individual with poor credit.

¹¹ Soros, *The New Paradigm for Financial Markets*.

¹² Kar-yiu Wong, and Richard Y. K. Ho, "The Asian Crisis, 1997," *Review of International Economics* 10.1 (2002): 1.

¹³ Martin, *Introduction to Political Science Reading Kit*.

¹⁴ Ibid

¹⁵ Barry J. Eichengreen and Peter H. Lindert, *The International Debt Crisis in Historical Perspective*, (Cambridge, MA: MIT UP, 1989).

some European states such as Greece, Portugal, Ireland and Spain to pay the interest on their sovereign debt obligations. A corresponding lack of investor confidence in sovereign debt markets triggered massive selling on global exchanges.

The incredibly rapid sell-off of 2007-2008 is highly reminiscent of the infamous Dot-Com Bubble. In 2000 the P/E (Price to Earnings) ratio¹⁶ of the S&P 500 reached a record multiple of 45, causing many value-oriented investors to exit the market, sinking stock prices and cooling the economy.¹⁷ In 2007 the P/E of the S&P 500 again topped 30, signaling to value oriented investors that the market may have again become overbought, and vast deposits of shares were sold off. The resultant similarity between the Dot-com bubble and the 2007-2010 recession is the nature by which not only asset prices but general equity prices may also bubble, and invariably burst. When equity prices dive, investors become risk adverse and allocate less money for investment. When this happens, liquidity dries up and no longer facilitates strong economic function. In 2008 the P/E of the same index bottomed out near ten.¹⁸ At this time the market-capitalization of the global production structure was eviscerated to pre 1990s levels. This rapid sell-off from an overbought market, in conjunction with fundamental economic weakness drove the world economy into the worst recession since the 1930s.

The similarities between the current recession and great-depression of the 1930s are striking. Notable American economist, Irving Fisher, famously outlined nine principle causes of the Great Depression. They included the distressed liquidation of debt, contraction in the supply of money, a fall in asset prices, a fall in profits, investor pessimism, monetary hoarding and a resultant liquidity crisis.¹⁹ The above are all

phenomena which occurred during the Global Financial Crisis. These large-scale financial upheavals are necessarily the result of interplay between numerous economic failings. These tremors in the financial system have individually accounted for numerous previous financial recessions. Thus, this paper endeavors to generate an understanding of why financial history is inclined to repeat cycles of wild bull markets and subsequent crashes. In order to approach this problem, an intuition for the relationship of the bull-bear sequence to the sustainability of the relationship between the GPS and the GFS must be developed.

The current market wide depression is the result of a failing in the global financial system. With financial markets as the bedrock of the global production structure, a failing in the GFS has tangible ramifications for all industries. Financial crises which intermittently engulf large parts of the world create legitimate fears about the sustainability of such a market-driven global economy. However, financial services are the foundation of every economic activity. Whether a manufactured product or provided service is being offered, the operation of production must be financed at every stage. Thus, it is obvious that the GFS and GPS are inextricably tied. Further, an increasingly globalized system means that weaknesses in one country's financial system can spread quickly to others, influencing all aspects of the GPS and world economy.

The question is not whether the financial markets have a negative impact, but rather if the increasingly globalized, deregulated state of them can be economically sustainable. Despite the attempts of nations to control their domestic monetary affairs, they remain exposed to the risks of global market forces. The GFS has clearly dominated the GPS, but the volatility intrinsic to the GFS creates associated economic externalities as seen through our discussion of past economic crises. British international political economist, Susan Strange, even coined the term "casino capitalism" to describe the GFS as a metaphor for this volatility.²⁰

Having noted this instability and volatility, it remains in part the thesis of this paper to

¹⁶ Price to Earnings Ratio is the market capitalization of the business divided by its earnings. These usually tend to gravitate to sub-20 levels.

¹⁷ Eli Ofek, and Matthew Richardson, "DotCom Mania: The Rise and Fall of Internet Stock Prices," *The Journal of Finance* 58.3 (2003): 1113-138

¹⁸ Soros, *The New Paradigm for Financial Markets*, 2008.

¹⁹ Irving Fisher, *The Debt-deflation Theory of Great Depressions* (Menasha, Wis, 1933).

²⁰ Peter Dicken, *Global Shift: Mapping the Changing Contours of the World Economy* (New York: Guilford, 2007).

assert that the risk of such failings is greatly outweighed by the benefit of a free, liquid, and largely deregulated financial system. Assistant director of the IMF's research department, Stijn Claessens, asserts that "[the] increased freedom of financial movement has benefited all involved by facilitating trade, enhancing the diversification of assets, and expanding the resources available for development."²¹ The rise of the capitalist world and long-term success of the developing countries such as Thailand, Vietnam, South Korea and Brazil, is a clear indicator of the necessity of an overarching GFS. Such a system provides the opportunity for self-motivated innovators, in free economies, to access financing in order to increase output. The annualized compounding rate of return of the S&P 500 over the past 100 years is above 10 percent.²² This ten per cent return on investment (ROI) includes all recessions, bubbles, and market crashes. Furthermore, this historical trend is self-perpetuated, as competition for financing has built a stronger economy. In this way, the free-market of the GFS has allowed for the relatively efficient allocation of capital around the world. The result is a structure of global production that is financed and owned by a worldwide community. Countries which have chosen to resist becoming members of global financial community have shown lack-luster returns in comparison to those generated under the system.

Russia is a key example of a country which has struggled due to a financially unsustainable and isolated economy. The Soviet government historically "stood in the way" of the growth of new firms through "taxation, regulation, and/or corruption."²³ Although Russia has made few attempts towards creating more globally integrated, free market economy since the

collapse of the Soviet Union in 1991, it has been a difficult process to reverse the damage of the past. Even China, a communist country in name, has taken steps towards an economy open to the Global Financial Structure. The results of China's decision have benefited not only its own populace, but also members of the international community. In 2011, China took over Japan as the world's second largest economy.²⁴ According to the IMF, although China's GDP is still only 40 per cent of the United States', Americans are simply living on "borrowed prosperity, while the Chinese [have] built up an immense reserve of savings."²⁵

It is clear that the rise of the global financial structure to prominence over the global production system has at times been a mercurial path. However, the corresponding returns have been great. As the global financial-production structure becomes increasingly homogenized, financial markets provide volatile but efficient fuel for the global economy. The major challenge that the GFS and its key players now face is the question of 'how to best maximize the benefits of financial liberalization while minimizing the potential risks.'²⁶ In order to capitalize on the prosperity which results from a strong and sustainable GFS, the system must be allowed to function naturally and cyclically without rash bureaucratic intervention. Concomitantly, it is necessary that events such as the 2007-2010 recession, Asian Financial Crisis, Dot-Com Bubble, International Debt Crisis and the Great Depression serve as admonitory reminders of the global implications of the tightening bond between financial and production markets.

²¹ Stijn Claessens, *The Search for Stability in an Integrated GFS* (Washington, DC (1818 H St., Washington 20433): International Economics Dept., World Bank, 2006).

²² "Standard and Poors 500 Index," last modified February 2011, <http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usdof--p-us-l>.

²³ Oliver Blanchard, and Andrei Shleifer, "Federalism With and Without Political Centralization: China Versus Russia," *IMF Staff Papers* 48. Special Issue (2001): 171-79.

²⁴ David Gonigam, "China And Russia: 2 Giant BRICs In The Economic Growth Wall," *Business Insider*. February 14, 2011, accessed February 21, 2011. <http://www.businessinsider.com/china-and-russia-2-giant-brics-in-the-economic-growth-wall-2011-2>.

²⁵ Ibid.

²⁶ Christopher Kent and Jeremy Lawson, *The Structure and Resilience of the Financial System*, (Australia National Reserve, Australia: Pegasus Print Group, 2007).