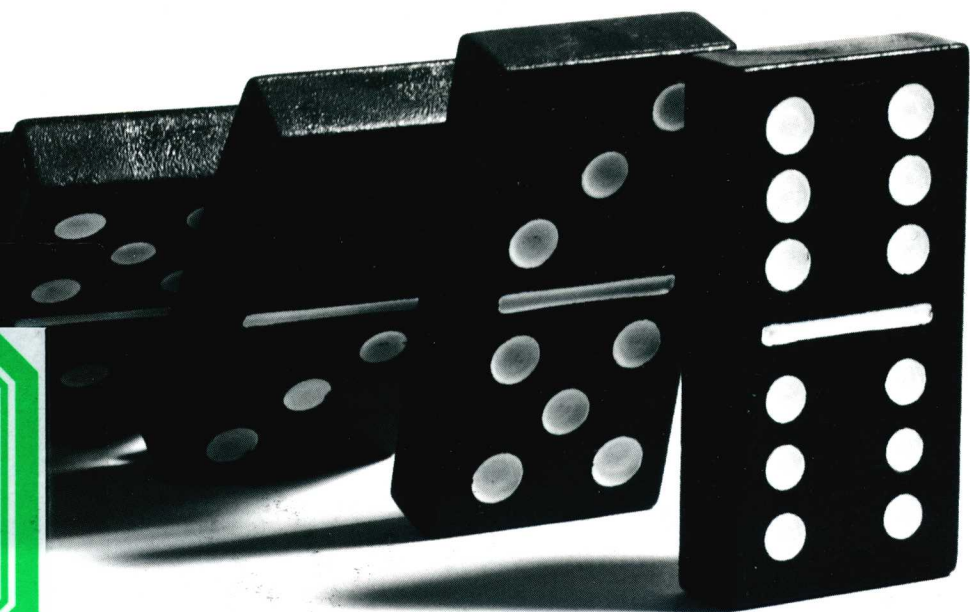


THINGS FALL APART

From the Crash of 2008 to the Great Slump



Ramaa Vasudevan



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First published in 2013 by



SAGE Publications India Pvt Ltd
B1/I-1 Mohan Cooperative Industrial Area
Mathura Road, New Delhi 110 044, India
www.sagepub.in

SAGE Publications Inc
2455 Teller Road
Thousand Oaks, California 91320, USA

SAGE Publications Ltd
1 Oliver's Yard, 55 City Road
London EC1Y 1SP, United Kingdom

SAGE Publications Asia-Pacific Pte Ltd
33 Pekin Street
#02-01 Far East Square
Singapore 048763

Published by Vivek Mehra for SAGE Publications India Pvt Ltd, typeset in 11/15 pt Times New Roman by Diligent Typesetter, Delhi and printed at Saurabh Printers Pvt Ltd.

Library of Congress Cataloging-in-Publication Data Available.

ISBN: 978-81-321-1098-9 (HB)

The SAGE Team: Rudra Narayan, Shreya Lall, Nand Kumar Jha, and Rajinder Kaur

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Abbreviations

ABS	asset-backed security
AIG	American International Group
AIGFP	The AIG Financial Products
CDO	collateralized debt obligation
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
FDIC	Federal Deposit Insurance Corporation
FSMA	Financial Services Modernization Act
GDP	gross domestic product
GSTC	Goldman Sachs Trading Corporation
ISDA	International Swaps and Derivatives Association
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
LTCM	Long-Term Capital Management

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MBS	mortgage-backed security
MLEC	Master Liquidity Enhancement Conduit
PASOK	Panhellenic Socialist Movement
SEC	Security Exchange Commission
SPV	Special Purpose Vehicle
TARP	Troubled Asset Relief Program

Preface

This book is meant for anyone who is interested in understanding the structural roots and continuing consequences of the crisis set in motion by the crash of financial markets in 2008. The literature on the crisis is huge and expanding, and this book offers, I hope, an accessible gateway to exploring this vast literature. The writing of this book has been shaped and enriched by many friendships and I have incurred more debts in the process than I could possibly enumerate.

The seed of this book was, in a sense, sown years before the collapse of Lehman and in fact years before I came to the United States. My engagement with the theories of capitalist crisis began in the 1990s, when among a host of other issues, the imminent crisis of capitalism was the subject of heated and passionate debates with friends in India. I cannot even begin to name the people or chronicle the deep impact these debates had when I was trying to make sense of the crisis that unfolded more than a decade later. I hope that all those friends will find something of value in this book.

This book is dedicated to C.V. Subba Rao and Sudesh Vaid, friends and mentors, who shaped and nurtured my intellectual and political development. My deepest regret is that they are not alive to read this book.

Duncan Foley played a critical role in the development of my understanding of dollar hegemony and the international monetary system. My profound intellectual debt to him, however, goes far

beyond that. Anwar Shaikh and his long-standing engagement with capitalist dynamics and crisis has been a source of inspiration. Gerard Dumenil, whose work (with Dominique Levy) on the crisis blends a rich statistical and historical account with a penetrating analytical perspective, has also shaped the perspective of the book in profound ways.

It was wonderful to have Deepankar Basu as a colleague and friend during the dramatic events of the 2008 Crash and be able to talk through what was happening on practically a daily basis. I am especially grateful to Shailaja Fennel without whom the book would never have got written! Shailaja also read and critically commented on the first draft.

The data presented in the book is only a very basic rudimentary and broad-brush empirical picture, and I have drawn from the rigorous research of other economists and scholars. Ariel Resheff and Thomas Phillipe generously passed on their data on banking wages. Hyun S. Shin was extremely helpful and pointed me in the right direction for data on the rise of the broker-dealer. Emmanuel Saez and Thomas Piketty's seminal dataset on income inequality (available on Saez's website) was an invaluable resource.

In the accounts of the unfolding events I have drawn rather extensively, and in more ways that I have been able to adequately acknowledge, from the in-depth reporting and analysis in newspapers, the business press and magazines; in particular the *New York Times*, the *Financial Times*, the *Atlantic*, *Mother Jones*, *Dollars and Sense*, and the *Economist*, as well as the wonderfully insightful blogs—Naked Capitalism Baseline Scenario and FT Alphaville. I have presented the argument about the role and interconnections between financialization and dollar hegemony in writings in the *Monthly Review*, *Review of Radical Political Economics*, and the *Economic and Political Weekly*. A special thanks to Nagraj Adve

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who read through the draft manuscript with painstaking precision, pointing out the numerous places where the arguments were opaque, forcing greater clarity. Sammy Zahran also provided valuable feedback on some chapters.

Without the affection and support of friends—in the United States and back in India—and family—by birth and marriage—this book would have been impossible to write. My husband, Ashok, shared the journey through all the rough patches and moments of discovery, while pulling off the impossible feat of being both unfailingly encouraging about the project and ruthlessly critical while reading through the manuscript!

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Chapter 1

All That Is Solid Melts into Air

If risk is properly dispersed, shocks to the overall economic system will be better absorbed and less likely to create cascading failures that could threaten financial stability. The broad success of that paradigm seemed to be most evident in the United States over the past two and one-half years ... This favorable turn of events has doubtless been materially assisted by the recent financial innovations that have afforded lenders the opportunity to become considerably more diversified and borrowers to become far less dependent on specific institutions or markets for funds.

— A. Greenspan, remarks before the Council on Foreign Relations,
Washington, DC, November 19, 2002

... the low-inflation era of the past two decades has seen not only significant improvements in economic growth and productivity but also a marked *reduction* in economic volatility, both in the United States and abroad, a phenomenon that has been dubbed “the Great Moderation.” Recessions have become less frequent and milder, and quarter-to-quarter volatility in output and employment has declined significantly as well.

— B. Bernanke, remarks at Federal Reserve Bank of St Louis, St Louis,
Missouri, October 8, 2004

In advanced economies, deep recessions have virtually disappeared in the Post World War II period.

— IMF World Economic Outlook, October 2007, p. 173

Blue Ridge Corporation was an investment trust launched with much fanfare in the month of August. One of its attractions was that it allowed investors to swap their portfolio of unwanted stocks for the better-valued stock of this trust. The bulk of the common shares of Blue Ridge Corporation were, in turn, owned by Shenandoah Corporation, a newly minted investment trust set up barely a month earlier by Goldman Sachs Trading Corporation (GSTC). GSTC marked the first foray of Goldman Sachs into the thriving business of investment trusts about seven months earlier. The investment bank had sponsored the trading corporation with an initial issue of a million shares at US\$10 a share. In a booming market, the trust sold 90 percent of these shares to the public at US\$104. Within months the shares had doubled in value, prodded in part by purchases by the trading corporation itself. Goldman Sachs was able to, through this Russian doll structure of investment trusts that sponsored investment trusts, transform its initial 10 percent stake in the GSTC into ever larger pools of capital.

As long as stock prices were rising, the pyramid of trusts reaped huge dividends and the stock of these trusts was lapped up by eager investors, secure in their belief that the investment trusts were privy to knowledge denied to the ordinary investors and could ceaselessly yield returns on their behalf. The investor could borrow from the banks and brokerages that sponsored these trusts, simply by posting these securities as collateral along with a small margin of cash. Such trading on the “margin” allowed the investors to reap the returns of rising prices in a booming stock market by putting up a small portion of the purchase price. In the single month of August, Goldman Sachs issued securities worth more than US\$250 million.¹

The year was 1929.

It was the peak of the stock market boom of the 1920s, and investment trusts were popping up at the rate of one every business day. The value of the stock of GSTC rose to a high of nearly US\$326.² It was of this spectacular promotion by Goldman Sachs that John Kenneth Galbraith wrote, “It is difficult not to marvel at the imagination which was implicit in this gargantuan insanity. If there must be madness, something may be said for having it on a heroic scale.”³

The extent of madness became evident when the value of the GSTC fell to US\$1.75 after the stock market bubble burst in fall of 1929. The collapse in stock prices during the Crash of 1929 led to spiraling effects through the pyramid of investment trusts, bringing down the trading corporation. As stock prices fell, the loans that had funded the margin trades were called in. The frenzy of selling that ensued brought down prices even more precipitously, ruining many who had hoped to make their fortunes out of nothing.⁴

Walter Sachs, one of the Sachs brothers heading the bank at the time, when asked what prompted this frenzied promotion is said to have replied, “I confess to the fact that we were all influenced by greed. We were carried away by the bull market, we thought these values were going to be justified ... and the bottom fell out of everything and we were caught with our pants down.”⁵

Eight decades later, remarkably similar feats of financial ingenuity and unbridled greed have brought about a collapse of financial markets and the prospect of a long slump. Shadowy banking structures and the mad and dizzy rush of massive trades in obscure financial products anointed as quality investment by the high priests of finance, fuelled the housing bubble and the aggressive pursuit of questionable loans in the subprime markets.

The Crash of 2008, when financial markets came to a standstill in the wake of the collapse of Lehman in September, brought this