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The US Economic and Political Outlook

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The US economy is currently experiencing its worst financial crisis since the Great Depression. The financial crisis started in the home mortgage market, especially the so-called "subprime" mortgages, and is now spreading beyond subprime to prime mortgages, commercial real estate, corporate junk bonds, and other forms of debt. Total losses of US banks could reach as high as half of the total bank capital, which would lead to a sharp reduction in bank lending, which in turn could cause a severe recession in the US economy.

The housing bubble started to burst in 2006, and the decline accelerated in 2007 and in 2008. Housing prices stopped increasing in 2006 and started to decrease in 2007, and have fallen about 15% from the peak so far. This meant that homeowners could no longer refinance when the mortgage rates were reset, which caused delinquencies and defaults of mortgages to increase sharply, especially among subprime borrowers. From the 1st quarter of 2006 to the 2nd quarter of 2008, the total number of mortgages in foreclosure almost tripled, from 1% to 2.75%, and the number of mortgages in foreclosure or at least 30 days delinquent more than doubled from 4.5% to 9.2%. These foreclosure and delinquency rates are the highest since the Great Depression; the previous peak for the delinquency rate was 6.8% in 1984 and 2002. And the worst is yet to come. The "American dream" of owning your own home is turning into an American nightmare for millions of families.

Estimates of the total number of foreclosures that will result from this crisis in the years to come range from 3 million (Goldman Sachs, IMF) to 8 million (Nuriel Roubini, a New York University economics professor, whose forecasts carry some weight because he was one of the first to predict several years ago the bursting of the housing bubble and the current recession).

So far (as of August 2008), there have been about 1 million mortgage foreclosures. Another 1 million mortgages were 90 days delinquent (foreclosure notices usually go out after 90 days), and another 2 million were 30 days delinquent. Therefore, a total of 4 million mortgages were either in foreclosure or close to it at this time. These data make the low estimate of 3 million foreclosures look too low. The reality will probably end up somewhere in between the low and high estimates, with perhaps 5 million foreclosures (which would be roughly 10% of all home mortgages in the US).

Defaults and foreclosures on mortgages mean losses for the lenders. Estimates of losses on mortgages for the financial sector as a whole range from $500 billion to $1 trillion, depending mainly on the number of foreclosures. In addition to losses on mortgages, there will also be losses on other types of loans, due to the weakness of the economy in the months ahead: consumer loans (credit cards, etc.), commercial real estate, corporate junk bonds, and other types of loans (e.g. credit default swaps). Estimates of losses on these other types of loans range from $400 billion to $700 billion. Therefore, estimates of the total losses for the financial sector as a whole as a result of the crisis range from around $1 trillion (Goldman Sachs, IMF) to $1.7 trillion (Roubini). (Actually Roubini's $1.7 trillion estimate is his "optimistic" scenario, assuming 8 million foreclosures as discussed above. He also has a "pessimistic" estimate of $2.7 trillion (!) of total losses, which assume a 25% reduction of housing prices, rather than a 20% reduction, which in turn would result (according to Roubini) in 21 million mortgages with negative equity and 10.5 million foreclosures.) Bridgewater Associates, the second largest hedge fund in the US, has recently estimated a total loss of $1.6 trillion. Everybody's estimates keep getting worse by the month.

It is further estimated that about half of the total losses of the financial sector will be suffered by banks. The rest of the losses will be borne by non-bank financial institutions (hedge funds, pensions funds, etc.). Therefore, dividing the total losses for the financial sector as a whole in the previous paragraph by 2, estimates of the losses for the banking sector range from $450 billion to $850 billion. Since the total bank capital in the US is approximately $1.5 trillion, losses of this magnitude would wipe out from one-third to one-half of the total capital in US banks! This would obviously be a severe blow, not just to the banks, but also to the US economy as a whole.

The blow to the rest of the economy would happen because the rest of the economy is dependent on banks for loans – businesses for investment loans, and households for mortgages and consumer loans. Bank losses result in a reduction in bank capital, which in turn requires a reduction in bank lending, in order to maintain acceptable loan to capital ratios. Such a reduction of bank lending is commonly called a "credit crunch". Assuming a loan to capital ratio of 10:1 (this conservative assumption was made in a recent study by Goldman Sachs), every $100 billion loss and reduction of bank capital would normally result in a $1000 billion (i.e. $1 trillion) reduction in bank lending, and corresponding reductions in business investment and consumer spending. According to this rule of thumb, even the low estimate of banks losses of $450 billion would result in a reduction of bank lending of $4.5 trillion! This would be a severe blow to the economy and would cause a severe recession.

Banks losses may be offset to some extent by "recapitalization", i.e. by new capital being invested in banks from other sources. If bank capital can be at least partially restored, then the reduction in bank lending does not have to be so significant and traumatic. So far, banks have lost about $500 billion and have raised about $400 billion in new capital, most of it coming from "sovereign wealth funds" financed by the governments of Asian and Middle Eastern countries. So ironically, US banks may be "saved" (in part) by increasing foreign ownership. US bankers are now figuratively on their knees before these foreign investors offering discounted prices and pleading for help. US government officials are not sure what to think about this increasing foreign ownership of major US banks. It is also an important indication of the decline of US economic hegemony as a result of this crisis. However, it is becoming more difficult for banks to raise new capital from foreign investors, because their prior investments have already suffered significant losses.

In addition to the credit crunch, consumer spending will be further depressed in the months ahead for the following reasons: decreasing household wealth; the end of mortgage equity withdrawals (which was very significant in the recent boom); $4 a gallon gasoline, and declining jobs and incomes.

All in all, it is shaping up to be a severe recession. The rate of unemployment for August was 6.1%, and my guess is that it will probably increase to at least 8% and perhaps even higher. This severe recession will result in widespread hardships for millions of workers – loss of jobs, lower wages, intensified pressure in the workplace, loss of homes, etc.

The US economic crisis will cause a world economic crisis. Europe and the UK and Japan already seem to be falling into recession. Many thought that the world economy had "decoupled" from the US economy, but that is turning out to be a false hope. The world economy is somewhat less dependent on US growth than it was a few years ago, but the US economy is still the most important "engine of growth", and a recession in the US will have serious negative effects on the rest of the world, including Latin America.

The high prices of primary products in recent years have been due to both strong growth of the world economy, especially China and India and other emerging countries, and also due to a speculative bubble in which hedge funds have played a prominent role.
However, now that the world economy is slowing down, and much of it falling into recession, prices of primary products will fall, and the speculators will be caught, which will send prices even lower. In this way, the US economic crisis will spread to Latin America and other emerging countries. The "primary product export led growth" of recent years in Latin America is coming to an end.

The government has tried everything to stop the crisis, but so far nothing has worked. Congress passed a $160 billion "stimulus plan" (mainly tax rebates, $600 to each family) to increase consumer spending, and that worked to maintain growth in the first half of this year, but now the rebates have been spent and cannot be spent again.

The Fed first tried traditional expansionary monetary policy (lower interest rates, more lending to commercial banks), but that didn't work. Then the Fed started to improvise with new unprecedented policies: lending to investment banks, and then in March even bailed out an investment bank - Bear Stearns, the fourth largest investment bank in the US.

Then in August, the Treasury took over Fannie Mae and Freddie Mac, the two giant home mortgage companies, who either own or guarantee almost half of the total mortgages in the US, and in the last year have accounted for over 80% of all new mortgages, as other sources of mortgage loans have dried up. The Treasury took over Fannie and Freddie because they were in danger of going bankrupt, and if that happened, then the US home mortgage industry and the home construction industry probably would have collapsed almost completely, which would have dealt a serious blow to the US economy as a whole.

Then in mid-September (last week, as I write), the Fed even bailed out an insurance company – AIG, the largest insurance in the world and also the largest insurer against defaults of financial securities, including mortgage-based securities. The Fed bailed out AIG because it was about to lose its AAA rating from the credit rating agencies, and if that had happened, then the default insurance that banks had purchased from AIG would have been worth much less, resulting in losses for these banks and worsening the credit crisis.

Even these unprecedented government interventions did not succeed in reassuring investors. On Wednesday, September 17, the credit crisis entered a new more dangerous phase, in which credit markets almost froze up completely. No one would lend money to anyone, except the US Treasury. Banks would not lend to each other; almost $100 billion was withdrawn in one day (!) from money market funds (which are supposed to be super-safe, but were now being questioned); and there was a massive "flight to safety" of Treasury bonds, which reduced the interest rate on 3-month Treasury bills to O.2%! (shades of Japan).

Then the next day, Treasury Secretary Paulson announced that he would seek authorization from Congress to purchase $700 billion (!) worth of mortgage based securities ("toxic waste") from US banks. $700 billion is a lot of money; it is $2000 for every man, woman, and child in the US, and it is over twice the Federal government budget for all nondefense spending ($315 in 2007). The justification for this bailout is that if these toxic securities are taken off the books of the banks, then they will start lending again, and there will be less damage to the economy as a whole.

As I write, the details of this mega-bailout have not yet been worked out. The most important question to be decided is: *what prices* will the Treasury pay for these securities and how will these prices be determined? The higher the price, the more this will be a bailout of the shareholders of these banks, a bailout that taxpayers will have to pay for. Another important question is whether there be write-downs of the money owed by homeowners on their mortgages as part of this package.

TO BE UPDATED

How will US workers respond to the severe recession that lies ahead? Unfortunately, US workers are not very well organized, and are not very class conscious and militant. Therefore, it does not seem very likely that there will be a strong workers' movement, unless the crisis is very severe.

The crisis is likely to have an especially negative effect on immigrant workers in the US, many from Latin America. Immigrant workers are widely employed in the construction industry (about 2/3 of construction workers in New England are immigrant workers), and the construction industry is now in a deep depression (the number of houses being built has been cut in **half** in the last two years), so many workers have lost their jobs. Remittances back to their families have declined sharply. Immigrant workers are also very important in agriculture, food processing, hotels and restaurants, and as day laborers. 14% of the total US labor force is now immigrant workers.

One interesting and important new development is a new type of organization of mostly immigrant workers (and also other low-wage workers) called **Workers Centers** in most US cities (there are now over 130 centers in over 80 cities; 29 in California and 23 in New York). These centers provide a wide range of services to these workers, including: organizing to increase wages and improve working conditions, legal advising and fighting for immigrant rights, access to health care, and English instruction and other educational classes. They are more like a community organization than a union.

There is a Workers Center in Springfield MA, close to where I live, called "Casa Obrera", which was organized several years ago, and just recently moved into a new two-story building. This Center focuses especially on the construction industry and construction companies that violate "fair labor standards". This Center is also somewhat unique in that it is strongly supported by local unions, especially the construction unions, which is not always the case.

Another new workers' organization in the last 20 years is called **Jobs with Justice**, which attempts to form coalitions between unions and community organizations to fight for economic and social justice, both in the workplace and in communities. They also campaign against the Free Trade Agreement and for immigrants' rights. There are Jobs with Justice coalitions in over 40 cities.

Left political organizations in the US are small and divided, and the challenges are great. I think left organizations should attempt to do the following: (1) clearly define themselves as socialists, whose ultimate goal is the overthrow of capitalism and the creation of a new democratic and egalitarian economic and social order, which will end the exploitation of workers and make possible the full development of all human beings; (2) clearly present a transitional economic program for the US, which would emphasize full employment, decent wages, universal health care, sustainable ecology and equal educational opportunities; and (3) build a new working class party, that would also include broader social movements, such as anti-globalization, environmental, feminists, etc.

It seems to me that the best prospects for socialism in the world today are in Latin America. Latin Americans are electing left-wing governments and are rejecting neo-liberal capitalism, and perhaps moving toward rejecting capitalism period, especially as the economic crisis spreads from the US to Latin America. Indigenous movements are also challenging capitalist property rights and institutions. If Latin American workers take the lead in moving toward socialism, perhaps US workers will follow your lead, especially Latin American workers in the US, with strong ties to their homelands.