

## **Trade Unions Combat the Global Financial Crisis**

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In August 2007, banks in the United States suddenly seemed to realize that they had been lending money to borrowers who had no means to repay the loans they had contracted, and that the real estate purchases which these loans financed were worth far below the market value. They drastically cut back on new lending, even to those whom they previously would have considered highly reliable borrowers.

The very rapid tightening of credit markets meant that most consumers and business could no longer obtain loans from their bank or other financial institution to make major purchases or investments. Financial experts on Wall Street, in the US central bank (the Federal Reserve System) and at the International Monetary Fund (IMF) were quick to assure that the “credit crunch” was only a passing problem limited to the US “subprime” mortgage industry. The problem, they said, would be resolved through some adjustments carried out by the financial institutions themselves, and would have only a minor impact on the rest of the world and even the rest of the US economy.

The global trade union movement, which for years had been warning about the potential destabilizing effects of a largely unregulated financial system that allowed global speculation to dominate the industry, was much more pessimistic. Trade unions had also called attention to the growing inequality that unregulated corporate-led globalization has created, and that had contributed to an inherently unstable and unviable global economic system.

By late 2008, it was clear that the trade union movement and its allies were right and the apologists of deregulated global finance were wrong. The “credit crunch” of 2007 expanded into a full-blown meltdown of the US finance sector in September 2008, which rapidly spread to financial collapses in several other countries, and by late 2008 it was clear that the global economy had entered into a severe economic crisis. In January 2009 the IMF predicted that, for the first time since the Second World War, the global economy would contract in 2009, with serious recessions affecting many regions of the world.

On the basis of these forecasts of economic recession, the International Labour Organization (ILO) predicted that the number of unemployed in the world could be as much as 50 million higher in 2009 than in 2007, before the start of the economic crisis, and the number of “working poor” could increase by up to 200 million. For the Latin America-Caribbean region, the ILO

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predicted that unemployment could increase from 7.3 per cent in 2008 to as much as 8.3 per cent in 2009, while the rate of working poor, defined as those earning less than US\$2 per day, could jump from 17 per cent in 2008 to over 20 per cent in 2009.

Contrary to other financial crises of the past fifteen years, which took place in developing or transition countries or regions such as East Asia, Russia, Brazil, Turkey or Argentina, the 2008 crisis began in the largest and most advanced economy, the United States, spread to other industrialized economies, and then to the rest of the world. The fact that the recession began in the “centre” of the global economy has meant that countries whose economies are the most integrated into the global financial and economic system have been most strongly affected. Thus, the IMF predicts that in 2009 the Asian countries of China and India, both of which have maintained capital controls and largely protected their financial institutions from foreign firms, will be affected by the crisis to a much lesser degree than the countries of Central and Eastern Europe, now well integrated with the economies of Western Europe. Within Latin America, the IMF expects that Mexico will suffer negative growth in 2009 because it is heavily dependent on exports to and financial flows from the US, now in recession, whereas Brazil will maintain positive, though slow growth, because it is less dependent on the US market.

### **The speculative bubble bursts**

For several years, the global trade union movement has called attention to the risks to global economic and financial stability created by exotic new financial instruments based on derivatives or nebulous assets. Investments in these instruments are often totally unregulated and do not even appear in the balance sheets of the financial institutions which have made them. In statements to the IMF and World Bank, the international trade union movement for over a decade has been advocating measures to limit speculative capital movements, including an international currency transactions, or Tobin, tax.

In recent years, with the explosion of the new unregulated financial instruments, the ITUC and Global Union Federations pushed for the initiation of a process to create international frameworks for comprehensive financial regulatory reform that would cover commercial and investment banks as well as private equity funds, hedge funds and related financial activities. In June 2007, the ITUC published a detailed report, entitled *Where the house always wins: Private Equity, Hedge funds and the new Casino Capitalism*, about the damaging effect on “the real economy” of the unregulated financial instruments and reiterated its call for global regulation of these exotic financial instruments.

Well over a year before the global financial collapse of 2008, the ITUC warned in its report on private equity and hedge funds that:

“The present surge in leveraged buy-outs ... is part of a speculative craze that day by day lowers the standards and raises the prices... This is creating a bubble. Like all other speculative bubbles – from housing to stock markets – it will burst at some point. The debt leverage presently undertaken by private equity and hedge funds represents a great risk to the stability of financial markets. Many funds are so heavily loaded with debt that they risk defaulting if market conditions change... [T]his may start a domino effect with detrimental consequences for the major financial markets... New, innovative regulation is seriously needed.”

Because the private equity and hedge funds are overwhelmingly located in countries having supposedly the most advanced economies, their abusive and damaging practices were for the most part ignored by the IMF, even though the Fund has a mandate to practice surveillance over potentially destabilizing financial activities in *all* countries. The developing country group at the IFIs, known as the G24, called attention to this anomaly in October 2007 and urged the IMF to put “as much focus in evaluating [industrialized countries’] vulnerabilities as it does in emerging market economies”. It was only after a change of leadership at the IMF and a further collapse of the US financial sector that the Fund actually began to pay closer attention to the regulatory systems of countries whose financial sectors were supposed to be the most secure and efficiently run in the world.

At the G20 summit held in Washington in November 2008, the large industrialized country governments joined with the largest developing countries to acknowledge: “Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation or take into account the systemic ramifications of domestic regulatory actions.” But by this time, the world economy had already entered into the most serious downturn since the 1940s.

### **The downsides of globalization**

The fact that those countries most integrated into the global financial and trading system are now suffering the most from the economic crisis shows the extent to which the promoters of neo-liberal globalization have exaggerated the benefits while playing down the risks. Many countries that dismantled capital controls, opened up their financial sectors to foreign banks or whose own banking sector engaged heavily in foreign investments, are now paying the heaviest price. Iceland, a small European country that was in first place in the United Nations’ Human Development Index in 2008, is a case in point. The conservative government there had relaxed banking regulations and allowed banks to engage in high-risk overseas investments that were so highly leveraged that the bank’s investment portfolios were, in book value, equivalent to several times the country’s GDP. After the financial system came crashing down, in October 2008 Iceland became the first industrialized country since the 1970s to seek an IMF loan.

Two other European countries, Hungary and Latvia, former communist states that were considered well on the way to joining the club of the “most advanced” economies – among other reasons because they had fully opened up their banking sector to foreign institutions – also had to plead for IMF assistance after near financial collapse. In those two countries, foreign banks had introduced the practice of issuing residential mortgage loans in foreign currencies, euros or Swiss francs, and when the values of national currencies declined in both countries, hundreds of thousands of homeowners found themselves unable to keep up mortgage payments and banks went into insolvency.

The first country in Latin America to request emergency assistance from the IMF during the current crisis was El Salvador, which signed an \$800 million “Stand-By Arrangement” with the Fund in January 2009. El Salvador is one of the Central American countries most dependent on the US economy, to the point that it adopted the US dollar as its national currency.

On the other hand, by February 2009 no country in East Asia had requested emergency assistance from the IMF, because after the 1997-98 Asian financial crisis these countries put in place safeguards to protect their economies from external instability. Some of the countries implemented or strengthened capital controls. Jointly they adopted the Chiang Mai Arrangement, whereby East Asian countries have agreed to share foreign currency reserves should they face sudden shortages, rather than borrowing money from the IMF and having to accept unpopular loan conditions.

No African country has required assistance from the IMF directly related to the financial crisis either. The financial sector in most African countries is not as integrated with global institutions, nor does the financial sector weigh so heavily in African economies. However, many African countries are starting to feel the impact of the decline of prices for minerals and other commodity exports, and most of them had already suffered strong adverse effects from the earlier surge in food prices, which especially hurt people at low incomes.

### **Pressure to dismantle capital controls and privatize pensions**

In the process of integrating their economies more fully into the global economic system, many developing countries gave up important policy tools that could have helped shelter them against the kind of financial and economic instability currently taking place on a global scale. One key instrument has been capital controls, by which countries apply certain restrictions or obligations on capital flows into and out of the country with the aim of limiting damaging movements of speculative capital. The IMF formerly pressured countries to do away with all forms of capital controls but stopped doing so around 2003 when it acknowledged that they could play a positive stabilizing role in some circumstances. However the pressure has continued through negotiations of bilateral investment treaties or trade agreements, during which some wealthy

country governments have demanded that developing countries renounce the use of capital controls as a condition for concluding the negotiations.

The United States, which has negotiated investment or trade treaties with 52 countries, is one of the countries that has pushed for the removal of capital controls. One country that accepted to do so was Mexico, which committed to renounce capital controls when it signed the North American Free Trade Agreement (NAFTA) in 1992. Mexico is currently experiencing a decline in earnings from exports, most of which are destined to the US, as well as a drop in income from remittances (which come mostly from Mexicans working in the US) and an outflow of capital. The government is unable to act against the outflow because NAFTA prohibits it from implementing capital controls. As a result of these circumstances, the IMF expects Mexico to have the slowest growth among all major Latin American economies in 2009.

In contrast, among the largest economic entities in the world, the highest growth in 2009 is expected to take place in China and India, according to IMF forecasters. In both Asian countries, monetary authorities have for years exercised capital controls and in both, the state still plays an important role in the economy. The Chinese government has announced that state-owned enterprises will be called upon to play a counter-cyclical role by accelerating investment projects during the current downturn.

Another way in which many developing country governments took part in financial globalization was through dismantling or reducing the scope of publicly run old-age pension systems and forcing workers instead to contribute to private pension systems, which invested the funds in stocks, bonds and other financial assets. Since the 1990s, the World Bank has been involved in pension reforms in 80 countries, and provided financial assistance to 60 of them. The reforms sponsored by the World Bank have generally consisted of creating mandatory privately administered pension funds in partial or total replacement of existing fully public pension programmes. Although in most countries workers were able to choose the administrator of the fund or the type of investment, they did not have the option of maintaining their publicly administered pension. The Bank defended its policy of forcing workers to hand their pension contributions to private investors on the grounds that pension privatization would help the development of financial services firms in those countries.

The World Bank-sponsored assistance from workers to the financial sector came at a heavy price for workers. Because of the financial crisis, all of the privatized pension systems have lost a huge share of their value, resulting in sharply reduced pensions for those who will retire in the near future. For example, the World Bank revealed in a recent paper on “The Financial Crisis and Mandatory Pension Systems” that the returns on Peru’s mandatory private pension funds fell by 48 per cent between October 2007 and October 2008 for those who opted for “growth” portfolios. For those who chose “balanced” portfolios, the drop in returns was 34 per cent. Peru completely privatized its pension system in 1992-93 with the support of the World Bank. In Argentina, where the pension system was privatized in 1994, again on the advice of the World

Bank, pension funds lost 40 per cent of their value over the first ten months of 2008, after which the government decided to renationalize them.

Developing countries that have fully opened up their financial sectors and whose economies have become highly dependent on borrowing and investment from overseas, will likely suffer the most from the global recession. A World Bank report published in December 2008, *Global Economic Prospects 2009* predicted that private capital flows to developing countries would fall by more than half in real terms between in 2009 as compared to the level of 2007: “Net private debt and equity flows to developing countries are anticipated to decline from the record-high \$1.03 trillion (7.6 percent of developing-country GDP) set in 2007 to about \$530 billion (3 percent of GDP) in 2009.”

### **Political decisions to expand the control of the financial sector**

As can be seen in the two examples presented above, it was not the anonymous forces of “globalization” that were driving these developments, but conscious policy choices and economic pressure on developing countries to take measures that ultimately made them more vulnerable to the impact of the financial crisis. In the case of elimination of capital controls, the main agents were the IMF (until it changed its policy a few years ago) and the US and some other industrialized-country governments by way of bilateral investment and trade treaties. In the case of pension privatization in developing and transition countries, the main agent was the World Bank.

Similarly, the rapidly growth of highly risky “structured investment vehicles”, such as mortgage-backed securities, whose meltdown set off the current financial crisis, came about as a result of a political decision. That decision was the US government’s repeal at the end of the 1990s of the 66-year-old Glass-Steagall Act. The legislation, adopted in 1933 at the depth of the Great Depression in the United States, separated deposit banks, whose deposits would henceforth be guaranteed by a federal government agency, from much riskier investment banks. The repeal of the Glass-Steagall Act was initiated by Republican Party senators in 1999 and once signed into law, led to all of the largest banks in the US getting heavily involved in structured investments based on subprime loans and other assets of doubtful value. These investments ultimately resulted in the banks’ near-collapse in late 2008, a collapse which would have occurred if the US government had not offered them bailouts worth hundreds of billions of dollars from the public sector.

The growing “financialization” of the global economy over the past decade, meaning the growing domination of speculative finance over the global economy, has to be reversed. The global trade union movement has put forward several measures to control damaging speculative activities and to put the financial sector at the service of the real economy. These measures include:

- Speculation in commodity markets, which forced hundreds of millions of poor country inhabitants into extreme poverty and starvation in 2008 because of exorbitant food and fuel prices, must be banned
- Tax havens and similar under-regulated offshore financial centres need to be closed
- International financial transaction must be taxed, through a formula such as the Tobin tax, so as to curb massive destabilizing movements of speculative capital
- An internationally agreed framework has to be put in place to strictly regulate all previously under-regulated financial activities, such as derivatives markets, including private equity funds, hedge funds and investment banks, as well as commercial banks
- As part of the reform of the financial sector, priority must be given to social economy by promoting financial cooperatives, community-based banks, mutual societies and similar locally-focused credit agencies

### **Inequality and crisis**

International and national regulatory control over financial speculators is an important part of the strategy to re-establish a viable global economic system, but not the only part. Any strategy to build a viable global economy must address the issue of climate change and the growing inequality that has plagued economic development in the past quarter century. The challenge of climate change will not be dealt with here, except to say that the global economic recession, to which dozens of governments have responded by putting in place massive economic recovery programmes, offers a tremendous opportunity to employ unused productive capacity to make the transition to an economy less dependent on fossil fuels. The “green jobs” strategy can simultaneously put people back to work and ensure the long-term survival of our planet through investments in energy-efficient infrastructure, public transport, renewable energy and environmental protection.

The new development strategy must also make the reduction of inequality a priority objective, because the current economic system that has allowed a privileged minority to grow obscenely wealthy while the majority has seen its living standards stagnate or decline, is clearly unsustainable. The now infamous subprime loans, through which financial institutions in the United States duped millions of homebuyers into contracting mortgages beyond their capacity to pay, were developed in part because stagnating household incomes prevented these families from otherwise acquiring homes. The institutions frequently used predatory practices that would be illegal in some countries, such as offering low initial mortgage payments that (sometimes unbeknown to the consumer) ballooned after the first year or two of the mortgage, in the expectation that consumers would be forced to contract secondary mortgages to pay off part of

the first loans. The mortgages were then packaged and sold as collateralized debt obligations to investors in the US and overseas, with a secure rating granted by complicit bond-rating agencies.

The US financial system was built on a pyramid of individual incentives that encouraged these abusive and destabilizing practices. In the real estate finance sector, for example, the incentives comprised huge commissions and bonuses paid to a series of actors: to the mortgage company agent who sold the mortgage with hidden conditions to the unsuspecting homebuyer; to the mortgage company executive who sold the mortgage to the bank; to the ratings agency officer who gave a secure rating to what was in fact a risky security into which the mortgage had been packaged; and to the bank executive who sold the security to investors such as pensions funds and other financial institutions seeking high returns. These commissions and bonuses were paid, even if the homebuyer at the bottom of the pyramid ultimately defaulted, as millions did. Once the abusive conditions such as ballooning interest payments took effect, and particularly after the housing bubble burst in the United States in 2006, many homebuyers were left with homes whose values were far inferior to the mortgages owed on them.

The perverse incentive system of commissions and bonuses was a cause of the real estate bubble, as people were encouraged to buy homes above their capacity to pay, but many so-called financial and economic experts in the United States heralded the bubble in the real estate sector and in the stock market as genuine wealth creation that benefitted everyone, even as workers' real incomes declined. However growing financial wealth was by no means broadly shared. On the contrary, the explosion of executive compensation and returns on speculative investment on the one hand, and the anti-worker political climate which prevailed throughout most of the past quarter-century on the other, led to rapidly growing inequality in the world's largest economy.

According to calculations by a US "think tank", the Institute for Policy Studies, the top executive officer in the 500 largest companies earned 42 times the average worker's pay in those enterprises in 1980, but this had increased to 344 times worker's pay in 2007. While executive compensation exploded, the national minimum wage was not increased even once to keep up with inflation between 1996 and 2007, and the unionization rate in the US, where workers are routinely dismissed or intimidated by employers when they try to join a union, fell to less than 13 percent. The United States currently has the highest income inequality among industrialized countries, but most other advanced economies have also seen inequality increase in the past quarter century as governments supported business initiatives to make economies more "competitive", for example through measures that reduced taxes on business and made labour markets more flexible.

Even sharper increases in inequality have taken place in many developing countries that used the restriction of workers' rights and the reduction of labour costs as strategic tools for attempting to lower the costs of their exports and achieve higher rates of growth. The foremost example of such a country is China, which, starting in the early 1980s, gradually opened up its economy and enshrined property rights and freedom of enterprise, but simultaneously repressed workers' rights

and dismantled some broadly available social protection programmes, such as public health care, from which workers had benefitted. This export-led growth model largely based on cheap labour certainly contributed to sustained high rates of growth, but also changed China into a highly unequal society. According to statistics published by the Asian Development Bank, by 2004 China had become the second-most unequal society in Asia (after Nepal) according to a measure of inequality called the Gini coefficient, and the most unequal if one compares the level of income of the richest 20 per cent of the population to the poorest 20 per cent.

In spite of the huge foreign exchange reserves that China has accumulated and the measures it has taken to shelter its financial sector from the global financial meltdown, China's export-dependent economy will be strongly affected by the recession in all of its major foreign markets. A resurgence of growth in China requires that it shift from an economy producing mainly for export, to one that builds up a stronger base of domestic consumption. The most effective way for China to achieve a domestic-market focused economy will be through increasing wages for its workers and building up modern and comprehensive social protection programmes. Such a strategy would entail allowing full freedom of association and the right to collective bargaining, which currently do not exist, and providing comprehensive old-age pensions and health care so that workers no longer have put aside a large share of their meagre earnings to save for their old age and in case they become ill.

In China, as in the United States and most other countries, the improvement of workers' wages and of social protection must be an important part of the strategy to build more sustainable productive systems that put the real economy, rather than the interests of global speculators, as the central focus. As was the case in the United States and other industrialized countries during the Great Depression of the 1930s, the struggle against inequality has to be a main pillar of any strategy that seeks to achieve not only a more just distribution of wealth and income, but also a stable and viable economic system.