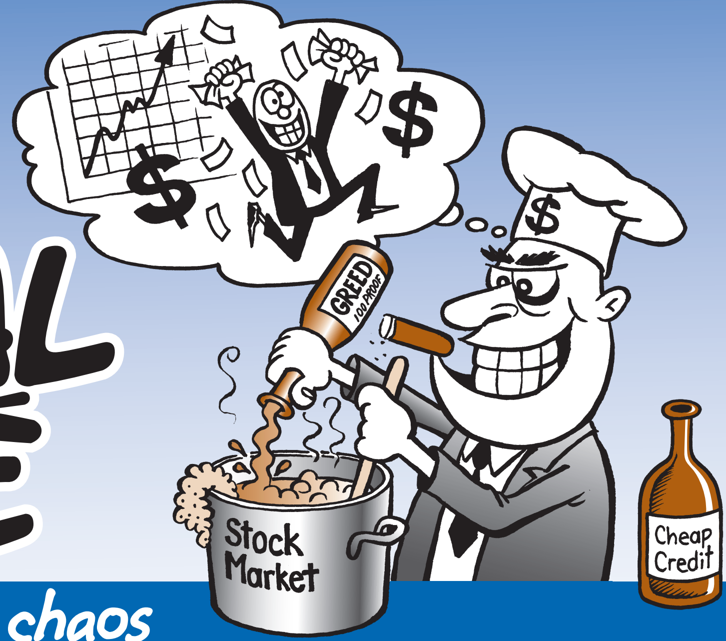
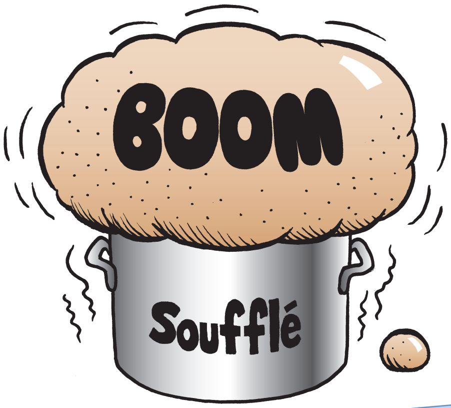
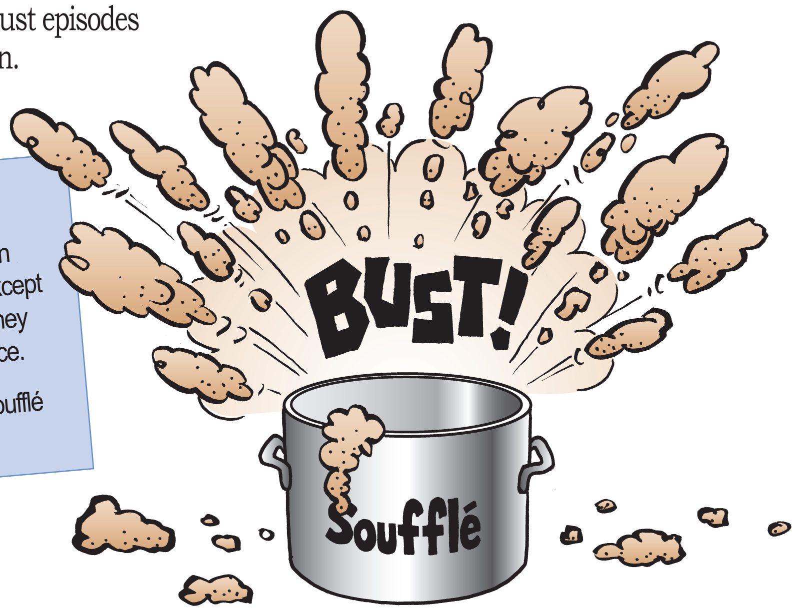
How to make a FINANCIAL SOUFFLÉ



The ingredients of financial chaos



Every few years, the global financial system seems to experience another boom-and-bust crisis. Every crisis has its own specific factors and causes. But there are always a few crucial common ingredients, and a common recipe for "baking" them into a toxic economic surprise! Unless and until we change the recipe, we'll experience these boom-and-bust episodes over and over again.



DEFINITION: *Speculation*

"Speculation" is the act of buying something, and then selling it again, in hopes of making a profit. Nothing is produced. No jobs are created (except for brokers — the middlemen). But it's a quick, easy way to make money — mostly for those who had money to play around with in the first place.

"Buy low, sell high." That's the motto of speculators. Every financial soufflé begins with a good supply of speculation.

STEP 1

Select an asset with a rising price

An asset is anything that can be bought and re-sold. Real estate. Dot-com internet stocks. Derivatives.

Even flowers. In the 1620s, the Dutch economy was ruined by a speculative episode focused on buying and selling rare tulip bulbs. Driven by speculation, tulips became astronomically expensive — until the crash.

Every speculative episode starts with an asset — any asset — whose price is initially rising, for whatever the reason.

STEP 2

Buy, then sell—and pocket the profit

If the price of something is rising, speculators can make a quick profit by buying it, and then re-selling it. The more you buy, the bigger your profit.

STEP 3

Hope the idea catches on

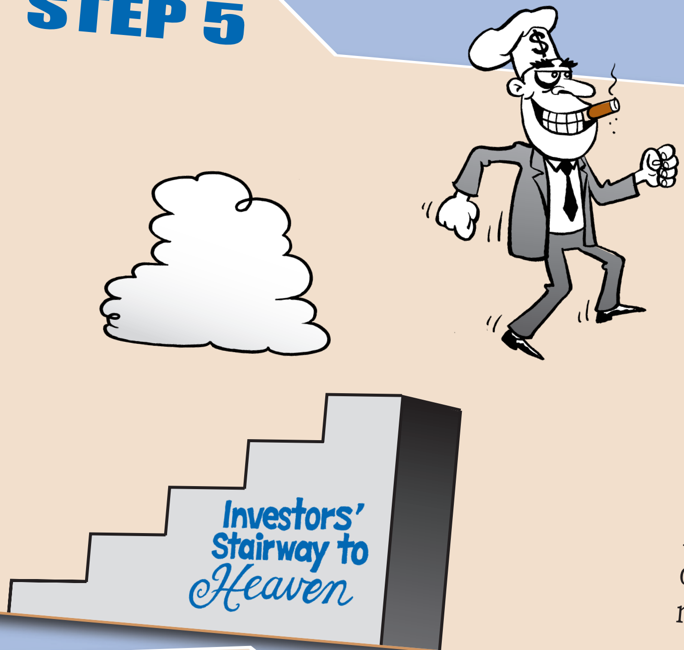
Driven by greed, envy, and competition, more and more investors pile into the market, all hoping to profit from the upswing. This "herd mentality" becomes self-fulfilling. If enough investors believe the asset's price will rise, and buy accordingly, then the price does rise. But it's fueled by mass psychology, not real economics.

STEP 4

Add a big dose of cheap credit

Speculative bubbles could not expand far without the power of borrowed money. Investors borrow heavily to place ever-larger speculative bets. If those bets pay off, then the speculator's profits are amplified. It's very risky to gamble with borrowed money. But if financial regulations are weak, banks will offer the credit anyway. They are also entranced by the lure of quick speculative profits. The more they lend, the higher the price goes.

STEP 5



Don't look down

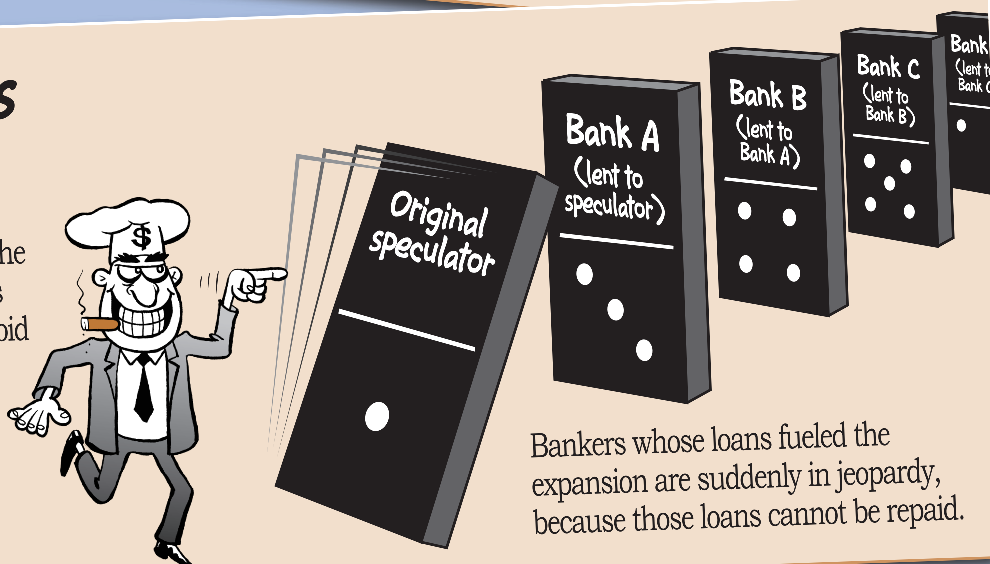
There's one big problem with this recipe: The collective faith of investors is the only thing holding up the price of the asset. If investors doubt this faith, and are no longer confident asset prices will keep rising forever, then prices fall back to earth — and quickly. Every financial bubble is thus followed by an inevitable financial crash.

It's like Wile E. Coyote after he runs off the edge of the cliff: it's only when he looks down, realizing nothing is beneath him, that he falls.

STEP 6

Everyone sells

Once the first nervous investors sell off, fearing the inevitable crash, the herd starts running the other way. Everyone sells out as quickly as possible, trying to avoid losses — but their panic is also self-fulfilling, and causes the losses to be even bigger.



Bankers whose loans fueled the expansion are suddenly in jeopardy, because those loans cannot be repaid.

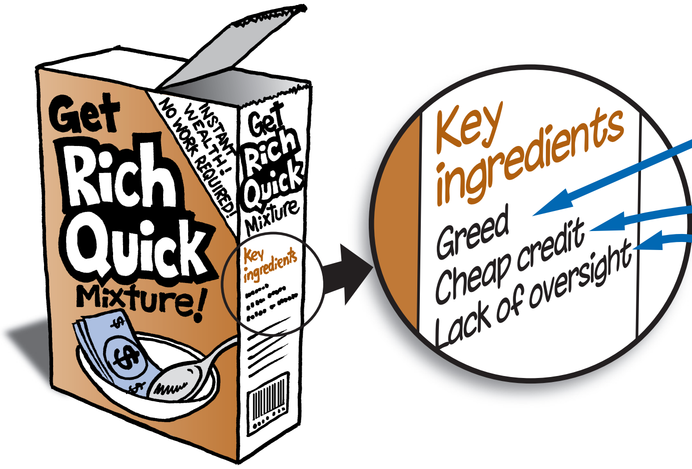
STEP 7

The crisis pours into the real economy

When it's bad, the collapsed soufflé spills right over into the real economy: the part of the economy that produces real goods and services (not paper assets). Banks stop lending. Businesses collapse. Workers who never bet a dollar on the markets (and never pocketed any profits during the upswing) lose their jobs anyway. Their pensions are also in jeopardy: we can't rely on stock markets to provide a secure retirement.

CONCLUSION: *Always check the ingredients!*

Every financial crisis is unique. But they all have three common, dangerous ingredients:



Greed: Investors try to make quick profits by buying and selling assets (rather than doing useful work). Most speculators are rich people who already had lots of money.

Cheap credit: Banks and other lenders seek quick profits, too. They irresponsibly lend huge amounts of easy credit to speculators, when the bubble is expanding.

Lack of oversight: It's up to government to prevent irresponsible, harmful acts, by limiting and discouraging speculation, and regulating banks to prevent undue risk. But our governments gave total freedom to the banks — and instead of discouraging speculation, they actually subsidize it with favourable tax laws!

It's time to change the recipe!

A deregulated profit-driven economy will bake up another financial soufflé every few years. But it always collapses — and it's workers who pay the price. Couldn't we try another recipe? Here's how to get the economy really cooking:

A Recipe for Genuine Prosperity

1. Regulate finance

Banks must lend responsibly, keeping adequate reserves on hand for losses and downturns. The most destructive forms of speculation (like short-selling and hedge funds) should simply be prohibited. We should also expand the role of public banks, rather than relying only on private banks.

2. Tax speculation, rather than subsidizing it

Current tax laws provide enormous subsidies for the profits from speculation (called "capital gains"). They should be taxed just like other income.

3. Reward real investment

It's spending on real capital (both for private businesses, and for public infrastructure and services) that drives economic growth and job-creation, not playing around with stocks, derivatives, and other "paper" assets. Policies should emphasize real investments: in technology, knowledge, infrastructure, and the environment.

4. Invite everyone to dinner

Most of the profits from financial bubbles are captured by a very small elite (who own most financial wealth in the first place). In contrast, real economic growth produces more genuine benefits — but they must be spread more widely, by using minimum wages and collective bargaining to help share the wealth.

The latest global financial crisis was not a random event. It was preventable and predictable. Workers shouldn't pay for a crisis that we didn't cause. And we will fight to change the financial rules, so it never happens again.

CAW TCA CANADA
www.caw.ca

Written by Jim Stanford for CAW. Graphic design and Illustration by Tony Biddle, www.PerfectWorldDesign.ca