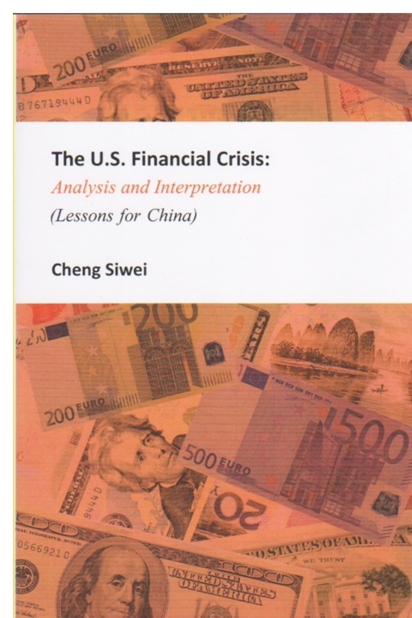
Book Review: The U.S. Financial Crisis: Analysis and Interpretation: Lessons for China

blog admin

***Cheng Siwei** evaluates the effects of China's countermeasures to the financial crisis and identifies the excessive growth of 'fictitious capital', a concept developed by Karl Marx, as its root cause. **Joel Suss** finds that while the author does provide excellent economic policy advice, he does not spell out policies that may shore up credibility and stop panic from spreading.*

The U.S. Financial Crisis: Analysis and Interpretation: Lessons for China. Cheng Siwei. Long River Press. July 2012.



Find this book

amazon Google

The incredible depth of the global economic crisis, beginning in the US in 2007-8, is only exceeded in magnitude by its unexpectedness. How could so many market experts, policymakers, and economists not see it coming? It is no surprise then that in the wake of the biggest economic crisis since the Great Depression many are seeking to draw lessons for the future.

One such person is Cheng Siwei, Chinese economist and former vice-chairman of the standing committee of China's National People's Congress. Commissioned by China's leaders to analyse the origins of the crisis and the channels through which China's economy was impacted, Cheng expanded the report into a book that was also published in English. His book, *The U.S. Financial Crisis: Analysis and Interpretation,* sets out in dry, methodical detail the origins of the crisis in the US and its impact on the global economy, and provides general economic lessons for a Chinese policy-making audience. It has a government-report feel throughout, but is interestingly infused with Chinese Communist Party rhetoric.

Cheng identifies the excessive growth of 'fictitious capital' – a term originating from Karl Marx and defined as financial products, such as securities, that are based on loan capital and the credit system of banks – as the underlying, root cause of the financial crisis. This drove the inflation of the 'fictitious economy' (defined as the total value of the stock market, and the balance of bonds and derivatives) relative to the 'real economy', "enabling its separation from the real economy like a horse free of its reins and eventually becoming a great scourge to the whole of society."

Cheng, in lock-step with other analyses of the financial crisis, argues that this was aided and abetted by a number of specific factors: unwise US government policy that promoted the US sub-prime mortgage market, insufficiently low interest rates set by the Fed, lax attention and action by 'captured' regulators, rating agencies that colluded with banks to make the complex financial instruments appear safe, and perverse incentives within the banks the contributed to short-termism and over-speculation.

Financial institutions were loading up on mortgage-based derivatives that depended on US housing prices continuing to rise. They would often, in turn, use these convoluted assets as collateral to leverage themselves further. Then housing prices began to fall, and so with them all the securities and derivatives on the secondary market. Panic set in and the situation progressed from "a loan crisis to a crisis of liquidity and ultimately to a crisis of credibility."

The bubble in the housing market burst in 2007, triggering the crisis, as defaults began to grow first in the sub-prime category and then for prime borrowers. 2008 saw the Wall Street financial crisis, the government take-over of Fannie Mae and Freddie Mac, the collapse of Lehman Bros and bailout of AIG as liquidity dried up. In 2009 the focus shifted to sovereign debt as the Dubai credit crisis brought attention to potentially weak nations. The spotlight immediately narrowed in on Greece when the finance minister announced an unexpected doubling of the budget deficit in November of that year.

Underlying all these waves is the panic and the loss of credibility (first borrowers, then financial institutions and finally governments), although Cheng only briefly acknowledges the behavioural factors involved and their importance in reinforcing the spiralling descent: "It is my view that a credit crisis is essentially a crisis of confidence and credence, and thus the permanent cure for that is to regain the public's confidence and credence in financial institutions and systems as well as their government." Whilst he does provide excellent economic policy advice on the whole; such as a central bank that takes into account asset prices and not only inflation, the need to protect against excessive debt build up and speculative secondary markets, and avoidance of government interference in property markets, Cheng does not spell out policies that may shore up credibility and stop panic from spreading and from deepening contractions. Similarly, he acknowledges the problem of moral-hazard within banks and identifies short-term payment structures as a problem but does not provide specific policy solutions, some of which are actively being discussed in western financial centres today.

This book also noticeably lacks insight into the political dimensions of the crisis. The year 2010 saw not only the worsening of the European sovereign debt crisis but also the political ramifications both within countries (the street battles and rising violence in Greece, the Indignado movement in Spain, Occupy and the Tea Party, etc.), and between them, the potential disintegration of the EU and a budding currency war being prime examples. By some accounts, the Arab spring was at least partly triggered by global economic conditions. Cheng Siwei focuses solely on the economic implications and draws lessons for economic policy, rather than also interpret the political failings and consequences.

Readers who are already familiar with the crisis and lessons that have (and have yet to be) learnt may want to skip this book. Beyond a detailed analysis of the US financial crisis, it is interesting only because of its China-centric frame. The reader may appreciate, especially after reading the final chapter, "Six Balances and Scientific Development", that much effort has been made to align the text with and appease government appetite. It provides broad economic policy suggestions without getting specific, it appeals to Marxist theorists with the reliance on the argument that the 'fictitious economy' grew excessively, and it is devoid of any discussion of potential political consequences of a financial crash. For a country such as China – which many believe to be repressive and illiberal - this should be a top area of concern.

Joel Suss joined the LSE PPG in January 2012 and is currently an MPA student. Hailing from Montréal, Canada, where he earned a BA in Political Science from Concordia University, Joel has worked in the most recent Canadian federal elections campaign for the New Democratic Party (NDP), now the official opposition to the government. He is primarily focused on public and social policy, welfare inequality dynamics and institutional reform. Read more reviews by Joel.