DRAFT, SUBJECT TO REVISION, COMMENTS WELCOME, r.wade@lse.ac.uk

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THE DEEP CAUSES OF THE FIRST-WORLD DEBT CRISIS, AND THE CASE FOR FINANCIAL RESTRUCTURING

Robert Wade

ABSTRACT

The current first-world debt crisis is generally said to be rooted in pockets of the US financial system. This essay finds deeper causes in the global financial architecture which has enabled US policy makers to run the economy for the past decade spending 5 to 7 % more than it produces. The US has reaped large benefits, including fast growth, low unemployment, and easy financing for US military activities in Iraq and elsewhere, even with tax cuts. Moreover, the same mechanism has also helped to generate fast growth in much of the rest of the world. No wonder Alan Greenspan said, before the current crisis began, "I would place the US current account [deficits] far down the list" of imbalances to worry about.

The essay identifies two zones of the world economy – one with substantially fixed exchange rates, linking the US deficit economy with the Asian surplus economies, in a system popularly known as Bretton Woods II, the other with floating exchange rates. The different dynamics of both zones tend to the same result: large and persistent current account deficits and surpluses, which constitute a force for financial instability in the world at large. Now that the US credit bubble is bursting, Greenspan's assertion looks like a major misjudgement.

The essay also finds deeper causes of the crisis in the feedback from political conditions to economic conditions. The feedback suggests a worrying parallel between today and 1929, which reinforces the Bank for International Settlement's statement of June 2007, "Years of loose monetary policy have fuelled a giant global credit bubble, leaving us vulnerable to another 1930s slump."

The last section proposes a number of policy changes at national and multilateral levels designed to reduce the chances of repeat crises, including tighter "capital management techniques".

As of late March 2008 it remains difficult to fathom the outlook for the global economy. The financial crisis looks to be still contained to the US and some parts of western Europe, with little impact south and further east. There are still optimists who say that the crisis is just a blip even in the US, like a muscle strain for a champion athlete which will be cured with a bit of rest and physio – provided governments do not rush in with heavy-handed regulation.[1] The optimists emphasise that the US has not had a single quarter of *falling* output so far, the Federal Reserve has taken timely and decisive action to cut short-term interest rates, the Congress has rushed through a $150 bn. Keynesian stimulus package. And they say that countries with current account surpluses and well-capitalised banking systems, including China, India and Latin America excluding Mexico, will continue to grow well. Their fast growth will generate a "reverse coupling", limiting the slowdown in the crisis-affected countries.[2]

But the optimists are a dwindling band. The pessimists see the current crisis as more like a heart attack for a 60 a day smoker, which is unlikely to be resolved by the policy equivalent of cutting down from 60 cigarettes a day to 30; that is, by rate cuts and easy money. A recent prominent convert is the head of Deutsche Bank, Joseph Ackerman, well known as a true believer in the autonomy and efficiency of markets, who said in late March, "I no longer believe in the self-correcting nature of markets. It pains me to say something like this". He said that governments must join with central banks and market participants "to stop this meltdown". [3]

The pessimists stress three trends in particular. First, many banks in the crisis-affected countries are facing losses and falls in the value of their collateral, forcing them to restrict credit. Second, property prices are falling and still have a long way to reach historic trends. Third, inflation is rising around the world, especially in food and energy.

On the other hand, for these trends to make a cataclysmic event – some pessimists are talking of the worst world financial crisis since the Second World War -- the global economy would need to get trapped in two interlinked vicious circles. The first is between the financial economy and the "real" economy, when tightening credit, falling asset values feed through into lower consumption and investment, which feeds back to worsen financial conditions. The second is debt-deflation circle, when rising savings leads to falling prices, which raises the burden of debt and induces households to save even more.

[1] The metaphor comes from Larry Elliott, "Crude awakening for capitalism", Guardian Jan 28, 2008, 24.
[2] Chris Giles, "Cracked foundations: a financial crisis spreads slowly into the real economy", Financial Times, Mar 19, 2008.
[3] Quoted in William Pfaff, "Adam Smith betrayed", 24 Mar 2008.

So far, it is difficult to know whether either of these nasty conditions has taken hold. On the positive side, bank lending has not fallen significantly, and the price of credit for credit-worthy companies has not risen significantly. On the other hand, some of the banks' present lending represents their enforced bail-outs of their own off-balance sheet investment vehicles, so the fact that overall bank lending has not fallen significantly does not mean banks are not cutting back lending to the real economy. The evidence is mixed.

What is clear is that forecasts made one week are being torn up the next week. Part of the uncertainty comes from the fact that we know much less about the consequences of house price falls than about falls in other kinds of assets; and few people are confident about how much further house prices will fall in the US and other economies (though Goldman Sachs is predicting a fall in US house prices from peak to trough which is the biggest since the Great Depression). It is also unclear whether defaults on debt for commercial property, credit cards and automobiles will pick up, putting more strain on banks; whether banks will shore up their balance sheets by restricting credit to financial firms before restricting credit to the mainstream corporate world, in which case Wall St and the City of London will be hit well before Manchester and Colorado. And it is unclear whether the falling dollar will generate big exchange rate movements, including a big one-off revaluation of the Chinese yuan.

The current crisis should be understood in the context of the much higher frequency of financial crises around the world since the breakdown of the Bretton Woods economic architecture in the early 1970s (the architecture based on tight financial regulation, limited private international capital flows, fixed exchange rates, and the international currency -- the US dollar -- limited in supply by a fixed value in relation to gold). Financial crises have occurred in parts of the rich world every three to four years for the past two decades. For example, Japan in the 1980s first boomed and then bubbled, to the point where the property market valued the land of the Imperial Palace in the middle of Tokyo at more than the land of California; the bubble popped in 1990 and Japan languished at near-zero growth for the best part of a decade. Sweden had a banking crisis between 1990 and 1993 which cost some 6 percent of GDP to recover from. [4]

In the emerging market economies, 94 countries experienced at least one severe currency crash between 1990 and 2003. Capitalist East and Southeast Asia boomed and then bubbled through the 1990s, producing the East Asian crisis starting in 1997. China's monetary problems have been getting out of control, and now inflation is hitting 9% according to official figures (higher by unofficial figures).

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[4] Robert Wade and Marshall Auerback, "Bernanke should take bolder action, along Swedish lines", letter, Financial Times, March 13, 2008.

Putting aside the question of whether we are teetering on the brink of the two vicious circles and from there to catastrophe, I shall discuss the causes of the crisis and then the policy question: what should be done by way of tighter regulation? My analysis of causes emphasises the central role of the persistent and large US current account deficit. It distinguishes two zones of the world economy: zone 1 is the US deficit-Asia surplus zone, with substantially fixed currencies; zone 2 is the zone of floating currencies. One of the main points is that in both zones but for different reasons, large current account imbalances tend to persist, and then adjust disruptively, like an earthquake after the build up of tectonic tension. This is a consequence of basic features of global economic architecture.

I. The rising US debt/GDP ratio and the world-wide credit bubble

Most of the commentary on the debt crisis treats it as caused by peculiarities in the US financial system, particularly problems in the sub-prime mortgage market. The attraction of the standard story – its focus on US sub-primes as the root of the problem – is that it pulls attention away from the larger structures of the world economy and from the neoliberal consensus which has dominated politics for almost a generation.

Problems in the US sub-prime market were merely the trigger. The deeper causes lie in a fundamental loss of confidence in the US financial system due to a decade of the US spending 5 to 7% more than it produces, and running up fast-rising current account deficits which require to be financed by fast-rising inflows of foreign capital. Investors have for some years been waiting to rush for the exit at the first sign of real trouble. Several different models of financial crises developed to predict crises in "emerging market" countries showed the US flashing red years ago. The only reason it escaped so long was that it is the US, not Thailand. But no country can be extended credit for ever. Once the trigger was pulled, the underlying fragilities were such as to generate pervasive fear on the part of those holding financial assets, much like what happens in a computer network when people hear that an aggressive virus is loose. The fear spread well beyond the US because many other economies around the Atlantic have also been running large and persistent trade deficits with the surplus producers of Asia.

The long boom which preceded the current crisis – in the last four years world economic growth was the highest in any four-year period for more than 30 years – depended crucially on the international financial system's toleration of huge trade imbalances, and the lack of self-adjusting market mechanisms to curb the trade imbalances.

My emphasis on trade imbalances as an important source of both the boom and the current bust contrasts with the argument of many commentators, who see the US current account deficit as merely the other side of the US's attractiveness to investors in the rest of the world. The best known of these commentators is former chairman of the US central bank, Alan Greenspan, who says in his autobiography, *The Age of Turbulence*, "I would place the US current account account [deficit] far down the list" of imbalances to worry about". Current events show this up as a big misjudgement.[5] It stems directly from Greenspan's faith in self-adjusting markets, his conviction that "markets are an expression of the deepest truths about human nature and ... as a result, they will ultimately be correct".[6]

US economic growth over the past two decades has depended on rapidly rising debt to GDP. Figure 1 shows the trend of US debt/GDP. More debt incurred by government, business and households has allowed more consumption and investment, which generated more employment, consumption and investment in a positive feedback.

During the 1980s and 1990s Wall St bankers captured the US Treasury department, and their lobbyists rewrote financial laws so as to expand the opportunities for risk and profit. The Depression-era Glass Stegal act, which segmented financial markets by preventing banks from owning brokers and insurance companies, was rejected. Banks and non-bank financial firms were given much greater freedom to compete. Wall Street created an "alternative banking system" that relied on complex financial arrangements to bypass regulations designed to keep banks within prudential limits. The unregulated firms in the alternative banking system offered better deals than the more regulated banks, and attracted a growing share of financial business. Commentators celebrated the growth of the alternative banking system for the way it diffused risk, and implied, wrongly, that it thereby reduced risk.

Internationally, the Basel 1 international banking supervision accord was introduced in 1988 in order to set minimum levels of bank capital, and then revised after 1999 with the aim of giving banks more discretion in their capital provision. The Basel 2 accord fits with the larger thrust for financial liberalization, by giving more scope for "markets" to set levels of prudential capital.

Rising US debt had a dramatic effect on the world economy. US GDP accounts for about a third of world GDP, and over-consumption by the US – reflected in the current account deficits – has been the main engine of world

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[5] Alan Greenspan, The Age of Turbulence, ____. See also, Anatole Kaletsky, "Is global finance out of control? No", Prospect, December 2008.

[6] This is Joshua Cooper Ramo's paraphrase, in "The three marketers", Time, Feb 15, 1999.

economic growth for many years. Had the US not consumed more than it produced – and borrowed correspondingly – the rest of the world would have expanded its industrial capacity and employment more slowly. For the past decade the US deficit has been close to the world record deficit for a major capitalist economy (set by Italy in 1924, the year before Mussolini took power). Figure 2 shows the sharp increase in the US external deficit after 1996.

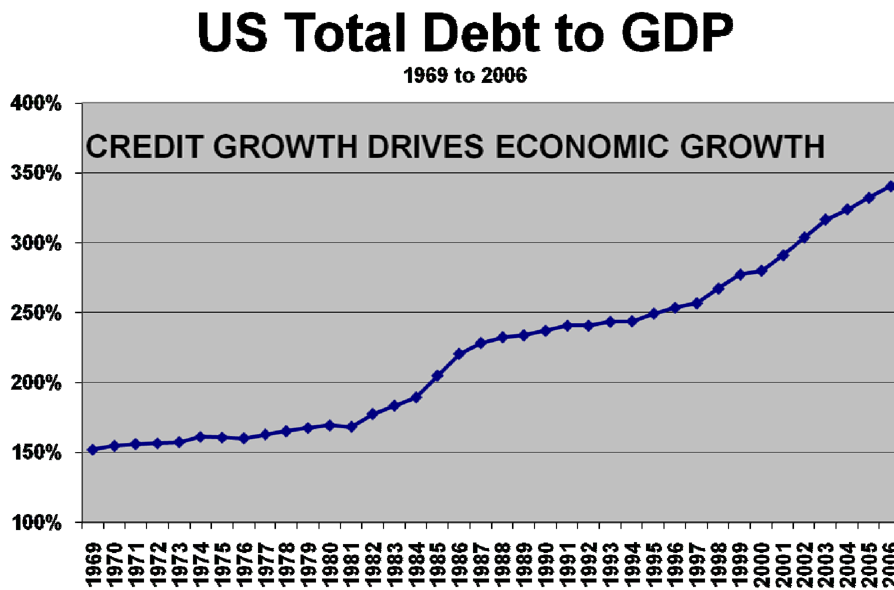
On the other hand, the other side of the US's fast growth of external debt is fast growth of world foreign exchange reserves, most of which are still denominated in dollars. Total foreign exchange reserves have doubled in the past four years, increasing by as much in this period as in the previous century. See Figure 3.

The fast growth of world foreign exchange reserves raised the level of global financial fragility, analogously to global warming's effects on weather. Central banks accumulate the dollars entering their countries (whether as payment to their exporters or as investment) by creating their own currency out of thin air and using it to buy the dollars, in order to prevent or slow down the appreciation of their own currency when the dollars are exchanged for local currency. The exporters or the sellers of assets keep their earnings in the local currency and deposit them in local banks, fuelling a credit boom.

The result has been a rotating credit bubble, which blows up in one place and bursts, then blows up and bursts somewhere else, moving around the globe. As noted earlier, financial booms and busts have occurred in some part of the rich world every three to four years for the past two decades; and 94 emerging market economies experienced at least one severe currency crash between 1990 and 2003.

As the US current account deficit has reached record proportions in the past several years it has generated arguably the world economy's biggest monetary shock since World War I, when the Gold Standard broke down and set off the flood of credit creation and inflation that ended in the Depression.

Figure 1.



Note: Total debt is the debt outstanding by all groups in the US: government, business and household, i.e. total credit market debt as provided in the Federal Reserve's Flow of Funds data each quarter.

Figure 2.

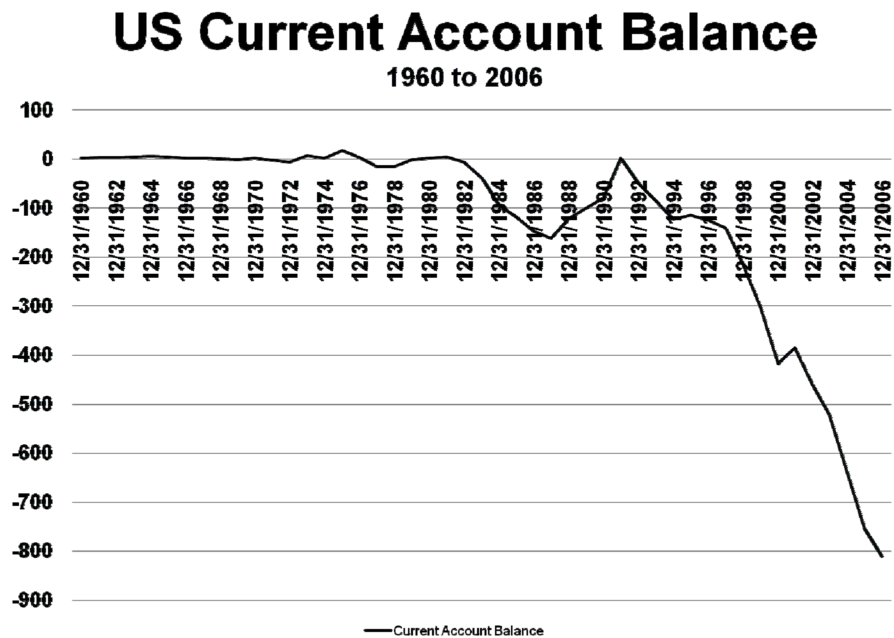
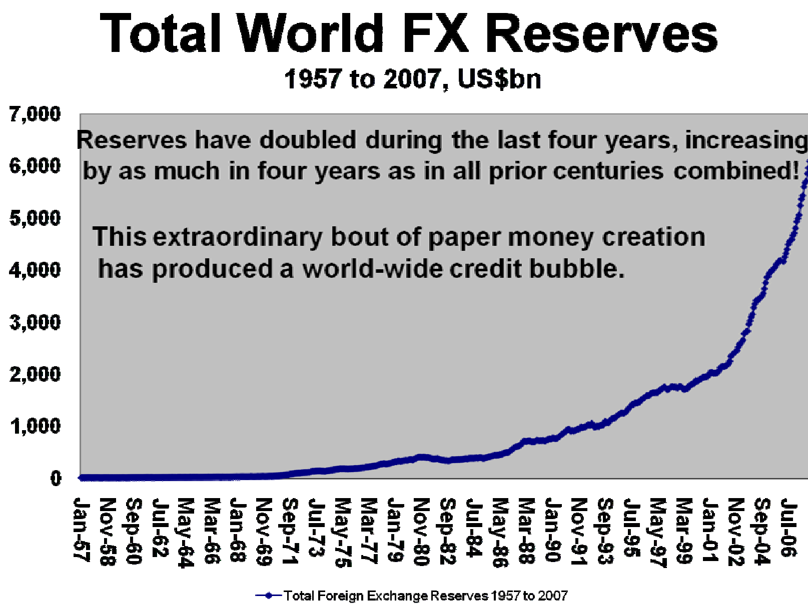


Figure 3.



II. Asian surpluses, the US property bubble, the Iraq/Afganistan wars, and the Tibet protests

The second big driver of financial instability comes into play when the big surplus countries in Asia and the Gulf decide what to do with their escalating foreign exchange reserves. In the build up to the current crisis, the surplus countries invested in ways that helped to blow up asset bubbles in the US; the US asset bubbles supported higher consumption; and higher consumption fed back into higher external deficits.

The US-Asia economy -- which I call "zone 1" -- operates with a system popularly been known as "Bretton Woods II". During the 1990s, while many countries maintained floating exchange rates, Asian central banks, notably China's, linked their currencies to the dollar. Their currencies did not appreciate as their surpluses increased, enabling them to maintain a super-competitive export sector and accumulate large surpluses.

The key point is what happened next. Rather than accumulate dollars which yielded no return, their central banks recycled the resulting surpluses into US assets, in effect providing cheap financing for the US current account deficits. Without Asian creditors acting as "dollar underwriter of last resort", US interest rates would have been higher, risk spreads would have been broader, and the US would not have been able to mount successive wars with little financial strain and no tax increases.

In particular, central banks of surplus countries, notably China, have been investing a large part of their growing foreign exchange reserves in US assets of three kinds: (a) bonds of the US government, notably Treasury bills; (b) bonds of quasi-government agencies, like the mortgage lenders Fannie Mae and Freddie Mac; and (c) asset-backed securities issued by the private sector. The shifts of foreign buyers' purchases between these three kinds of US assets help to explain what happened in the US housing market. [7]

In the late 1990s, at the time of the dot.com boom, the US budget was in surplus, and the supply of government bonds therefore fell. So foreign central banks switched purchases of US bonds to quasi-government bonds, especially those of Fannie Mae and Freddie Mac. In response the latter rapidly expanded their mortgage lending and bond issuance, and the US housing market began to boom.

Then with the dot.com crash, the US budget went into deficit again, and the US Treasury engineered a big slow-down in the issuance of quasi-government agencies' bonds, to stop them competing with the US Treasury bonds needed to finance the budget deficits.

By 2004 the US housing market boom was again in full swing, which fed through into high consumption and high economic growth, and thereby helped the re-election of George Bush. The US budget deficit again went into surplus and the supply of new Treasury bills fell.

The foreign central banks then switched their demand to the third category of US assets, asset-backed securities (ABS). The supply of ABS doubled between 2003 and 2004, and doubled again between 2004 and 2005. A large part of these ABS was backed by mortgages issued not by Freddie Mac and Fannie Mae (whose borrowing remained constrained by Treasury) but by private lending companies operating on the business model of raising money to lend by selling mortgages in packages to Wall Street firms. The Wall Street firms managed to get them high ratings from the ratings agencies like Moodys, and sold them on to investors all over the world.

Of course, it was not just foreign central banks which were buying ABS, but also commercial banks, insurance companies, pension funds, and the like, both foreign and domestic. The new demand for ABS, in place of earlier demand for US Treasury bills, helped to turbo-charge the US housing market.

In short, the deep causes of the current crisis include the Bretton Woods II system, whereby central banks of surplus countries recycled the surpluses

[7] Wade, "The financial crisis: burst bubble, frayed model", openDemocracy, 1 Oct 2007, www.opendemocracy.net/trackback/3466.

into US assets, including assets linked to property mortgages. It thereby raised the supply of cheap mortgages and helped to generate rapid appreciation of house prices.

Note also some other consequences of the Bretton Woods II system. One of its costs for the surplus countries was excess monetary growth due to unsterilizable increases in foreign exchange reserves; which fuelled domestic asset bubbles, inflation, and the loss of competitiveness that governments had tried to prevent by suppressing the rise in nominal exchange rates. It also diverted resources into the accumulation of low-yielding foreign currency assets exposed to the risk of large capital losses, at the cost of investment in domestic infrastructure, agriculture and industry.

In China inflation has surged, especially in food prices. Food inflation riots have occurred throughout China during the past year. The February-March 2008 protests in Tibet were presented by both the Chinese government and Tibetan advocacy groups as an event in the long-running Tibetan resistance to colonisation by Han Chinese. Anger at Chinese colonisation undoubtedly fed; but it was hunger and rising food prices – especially fast in February -- which prompted Tibetan monks to start attacking shops which were charging the high prices, shops which were owned mostly by Han Chinese.

The debt-led growth mechanism brought sizable military advantages to the US. The inflow of foreign capital lowered US interest rates and enabled the government to run budget deficits financed by foreign borrowing; and the inflow also sustained the international value of the dollar. Both together made it cheap to expand the US military budget and US military operations abroad without having to raise taxes and cut consumption. During the Cold War administration of Reagan the US military budget peaked at 7% of GDP; the ratio fell during the post-Cold War Clinton administration; and started to rise again in 1999. Under Bush II the ratio has risen steadily to reach more than 5% of current GDP, giving the US a military budget bigger than the military spending of all other countries put together.

Easy financing emboldened the US state to expand its imperial network in the Middle East and Central Asia. The strategic value of oil, leverage over partners and challengers, profits for oil companies, and the benefits of petro-dollars returning to buy US Treasury bills and other assets were all part of the calculation. The Gulf Cooperation Council states are estimated to have exported some $530 bn of petrodollars in 2002-06, of which about $300 bn went to the US, $100 bn to Europe, and only $60 bn to each of Asia and Middle East/North Africa. This is the US's return for its defence umbrella.

III. Perverse interaction between trade imbalances and global financial flows

In zone 1, the Bretton Woods II system enabled huge imbalances to persist between the Atlantic deficit countries and the Asian surplus producers, thanks to the peg between the Chinese currency and the dollar and to other Asian countries' reluctance to allow their currencies to appreciate against the Chinese currency for fear of losing competitiveness.

But the converse does not hold. In the set of countries with floating exchange rates – zone 2 -- exchange rates have not tended to move so as to reduce external imbalances. When exchange rates float and capital moves freely between countries, large current account surpluses and deficits can also persist and then adjust suddenly, perhaps in response to events in specific markets, like sub-primes.

Of course this is not what mainstream theory says. Countries with large current account deficits should experience currency depreciation (falls in both the nominal exchange rate and the real effective exchange rate [REER], which is the most comprehensive measure of the overall competitiveness of countries). The fall in the value of their currencies translates into a fall in the prices of their products on the world market and an increase in their competitiveness; and induces an expenditure switch from foreign to domestic goods. Countries which are running large current account surpluses should experience currency appreciation. Through these exchange rate changes, surpluses and deficits tend to be kept small by the self-adjusting market.

Instead, we often see the opposite: countries with large current account deficits experience appreciation, countries with large surpluses experience depreciation. In other words, exchange rates often move in a way which makes trade imbalances worse rather than better, which raise the potential for disruptive adjustment.

Of the 17 non-minnow countries with the biggest current account deficits between 1996 and 2006, 14 experienced appreciation of the real effective exchange rate (REER) in that period, 3 had no change, and none had the depreciation predicted by standard theory. Of the 7 countries with the biggest surpluses, 5 experienced a depreciation. Japan, Germany and Switzerland, all with big surpluses and adhering to "floating" exchange rate regimes, experienced falls in the real value of their currencies, further lowering the price of their exports on world markets and increasing their surpluses. [8]

[8] UNCTAD, 2007, table 1.6.

The mechanism can be illustrated with the case of Iceland (though Iceland, being a minnow, is not included in the above figures). Iceland has been running a current account deficit to GDP of more than 20%, which must be a world record for any "developed" economy. The simple theory of flexible exchange rates would predict depreciation. Instead, the krona has been appreciating, showing sustained periods of appreciation and capital inflows, disrupted by short panicky devaluations in 2005, 2006, 2007, and 2008, followed by resurgent appreciation.

Thanks to free capital movements and government monetary policy targeted only at the domestic price level (not also at the exchange rate) Iceland has been receiving a vast speculative capital inflow – called the carry trade -- in search of the large interest rate differential between Iceland and economies like Japan and Switzerland. As of the start of 2008, inflation was running at around 6%. The central bank lending rate was 13%; consumer credit was about 17%. Icelanders were borrowing as though there was no tomorrow. Brokers cruised the country to persuade people to switch existing loans in krona into loans denominated in Japanese yen and Swiss francs, cutting their interest rate on consumer credit from 17% to 6% and on mortgages from 11% to 4%. The narrow streets of Reykjavik are choked with Sports Utility Vehicles bought on credit, much of it denominated in Japanese yen and Swiss francs.

In Iceland and elsewhere, monetary policy – the central bank's changes in the short-term interest rate – has lost its effectiveness. Indeed, rises in short-term interest rates often tend to generate more credit and more inflation by sucking in more foreign credit.

New Zealand is another case in point. Its current account deficit rose from 3 percent of GDP to 9 percent between 2001 and 2006, yet the NZ dollar appreciated. South Africa's current account went from a surplus of 0.1 percent of GDP to a deficit of 7 percent in the same period, yet the rand appreciated. As the earlier figures suggest, Iceland, New Zealand and South Africa are not anomalies.

This is a topsy-turvey world, in which international financial markets push exchange rates in the wrong direction, amplifying rather than reducing current account imbalances. On the face of it financial operators seem to be acting like drunken airline pilots landing their planes in the wrong places. But they are acting rationally. It is the theory of exchange rate adjustment to trade imbalances that is wrong. Where some governments are inflation-phobic and others are trying to stimulate and where capital flows are unrestricted, interest rates in the inflation-prone countries are likely to rise to levels which attract carry trade inflows from low inflation countries in order

to capture the interest rate differentials. The capital inflows countervail the mechanism of depreciation in the presence of a current account deficit.

This mechanism is not new; it has been in place ever since the move to free capital mobility in the late 1970s. What makes the current disequilibria so large is that hedge funds, private equity funds and now sovereign wealth funds have boosted flows to a whole new level. Being largely unregulated, they are able to mobilize such large amounts of capital from banks, pension funds, and proliferating billionaires that their investment in a country with a higher interest rate than the countries from which they are borrowing can itself trigger exchange rate appreciation – and hence almost guarantee them very high returns on their equity. Not only are they "too big to fail"; they are also "so big as to move markets by enough to guarantee their own profits".

Not surprisingly they strongly defend the system which allows them to generate high returns by their own actions and keeps raising the share of capital income in world income. In the US the share of corporate value-added accruing to financial companies was 8 percent in 1982, rising to 16 percent in 2006; while the share of corporate profits accruing to financial companies rose from 5 percent to 41 percent in the same period.

In response to opportunities for fantastic returns in financial operations, financial operators have long since marginalized their former role of creating credit money for lending to companies, or the "real" economy. They create credit money above all for operations within the financial sector itself, for the purpose of arbitraging between asset categories and between national economies. They have a special interest in creating asset bubbles, for in bubble conditions they can generate big profits by (a) borrowing heavily against a small proportion of their own equity, and (b) using borrowed money to arbitrage across perhaps quite small price differentials, going quickly in, waiting for appreciation, going quickly out, taking profits, then repeating. While the word "bubble" carries a negative connotation in everyday speech, financial operators' collective interest in bubbles prompts them to lobby financial regulators so as to avoid action to check bubbles.

In short, in both fixed exchange-rate zone 1 and floating exchange-rate zone 2 large current account deficits and surpluses persist, constituting a chronic source of instability and monetary shocks in the world economy.

IV. The political crisis

In June 2007, the always cautious Bank for International Settlements said in its Annual Report that,

"Years of loose monetary policy have fuelled a giant global credit bubble, leaving us vulnerable to another 1930s slump."

When the BIS bracketed the then just-emerging financial crisis with the 1930s slump it was ringing the alarm bell as loudly as it could. The BIS made its argument on narrowly economic grounds. The feedback from current political conditions to economics reinforces its worries.

The big question about the Great Depression is why an ordinary downturn in 1929 became a Great Depression. [9] Economic historians have tended to locate the reasons in economic factors, such as the growth of unregulated, unsupervised banks in the US during the 1920s followed by a wave of bank runs in 1930 and 1931, combined with adoption of mistaken monetary and trade policies as the downturn worsened.

But international political factors were also important. During the 1920s no state or coalition of states was providing the sort of public institutions for the world economy which Britain had provided before World War I (via the Bank of England, Lloyds, the City, and the Royal Navy) and which the US provided after the onset of the Cold War. At the same time, the global security framework had become flimsy to non-existent by the late 1920s. These conditions played into the hands of nationalists and imperialists, producing a climate of jittery insecurity in the major states, which deterred them from cooperating in international economic institutions and encouraged them to subordinate economic policies to national security concerns. One indicator of this is that trade treaties made in the 1920s were of much shorter duration than previously.

There is no metric with which to compare the "strength" of the international political framework in the 1920s and early 1930s with today's. But it seems plausible that a similar dynamic is at work today as in the earlier period, whereby a frayed international political framework makes it more likely that a series of "mirror crises" in economic and political conditions will tip the current economic crisis into something worse.

Evidence of the fragility of interstate cooperation, at least beyond Europe, is not hard to find. The G7 states have been strikingly uncooperative in their response to the current crisis. As one observer remarked, "We are witnessing one of those instances when the monetary authorities are not cooperating with each other." He went on to suggest that the US Fed was needlessly creating hardships for Europe by the speed and scope of its monetary easing – delaying taking more direct action to recapitalize or close banks, thereby delaying the day of reckoning and "exporting the US's problems by adopting policies that … weaken the dollar".[10]

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[9] Robert Boyce, The Great Interwar Crisis: Why There Were Two World Wars, Not One, and Why Understanding the Crisis May Help Us Avoid a Third, manuscript, London School of Economics, Jan 2008.
[10] Charles Wyplosz, "The Fed is delaying the day of reckoning", Financial Times, 13 Mar 2008, 37.

The IMF is in deep crisis, being almost bankrupt and facing big staff cuts. The WTO's Doha Round is on life-support. The US and the EU are competing to form regional/bilateral trade and investment agreements, by-passing the WTO and twisting the arms of their "partners" to get them to accept trade and investment liberalization and intellectual property protection much more stringent than could be negotiated through the WTO. The UN is even weaker than before, thanks to the efforts of the US in replacing Kofi Annan, who sometimes stood up to the US, with a Secretary General who could be relied upon not to.

Meanwhile, the G7 and G8 states are trying to have their cake and eat it too by incorporating rising developing countries at the top table of world governance in a second-class citizen kind of way. This is the formula known as the G8+5, where five leading developing countries (Brazil, India, China, South Africa, Mexico) are invited to participate at the G8 summits in a tightly constrained way. They are invited to fly half way around the world in order to join the G8 heads of government (or the G7 finance ministers) over a lunch followed by a few hours of discussion, and then go on their way. The formula is not viable.

The US's capacity to lead in multilateral fora has been seriously compromised by the wars in Iraq and Afghanistan, which have plunged its moral authority to rock bottom in much of the world. Economically, the US's "fundamentals" are much weaker than in, say, 1990, due to excessive borrowing and excessive spending. The US is now vulnerable to countries on the other end of the US trade deficit coordinating the application of financial pressure on the US for strategic purposes. Foreign policy discussion in Washington is full of references to a China-Russia axis threatening the US, and indeed, China and Russia are firmer friends today than for many decades, and relations with each other are far warmer than either US-Russia or US-China relations. [11]

In short, the international financial crisis is occurring at the same time as the international political-economic framework seems to be weaker than it has been for a long time, making a concerted inter-state response more difficult.

V. Policy lessons

The following discussion deals with lessons for regulatory policy (not monetary and fiscal policy); some at national level, some at multilateral level.

[11] The Russia-China friendship is not just driven by elites. Many Russians now see China as their closest partner, and the number of Russians who see China is a friend is more than double the number who feel the same about the US. Jonathan Steele, "The Sino-Russian embrace leaves the US out in the cold", Guardian 12 October 2007.

1. The financial system must be brought under tighter control

The current crisis is a "natural experiment" to test the "efficient market" theory of financial markets, or at least the conclusion drawn from the theory in favour of radical financial deregulation. The trigger of the current crisis was located in precisely the *least* regulated part of the credit market, the market for the new kinds of mortgages, and many people, including Alan Greenspan, celebrated the growth of this market as an example of the innovative capacity of unregulated finance.

The efficient market theory overlooks the way that the interconnectedness of the financial system puts many financial firms at risk from the failure of one. Central banks rightly have to rescue banks whose failure might have this consequence, as in the case of Northern Rock and Bears Stern. But such rescues carry the risks of imposing a heavy burden on the taxpayer and of giving financiers a one-way bet, whereby they keep the profits but pass the losses on to others. [12]

The quid pro quo for a public safety net is closer regulation covering all the types of financial organizations able to obtain emergency financing from the central bank, including investment banks as well as commercial banks. The regulation has to be aimed at the two main kinds of risks these organizations run – to be reckless with their own capital, and to defraud poorly informed customers.

Rules about how much capital must be held in reserve are the best response to the first of those risks. Investment banks in America need to be put under the same capital-adequacy controls as commercial banks, and the law must not allow any banks to circumvent such controls through off-balance-sheet vehicles. (I say more about capital-adequacy controls below.)

Consumer protection rules, as already applied by the UK Financial Services Authority, are the best way to deal with the second sort of risk. The subprime debacle in America suggests that its consumer protection rules need to be reviewed or their enforcement tightened.

There has been talk of regulating salaries and bonuses in the financial sector. The argument is that the present system gives financial wizards an incentive to navigate their companies from bubble to bubble, by providing stellar rewards when the investment strategies do well but putting a floor on their losses when they go bad. One way to do this is to make financiers' remuneration contingent on the performance of their investments over

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[12] Bill Emmott, "We must clamp down on the City's high rollers", Sunday Telegraph, Mar 23 2008.

several years, releasing their remuneration gradually. [13] But it is difficult to see how this could be done outside of the context of a national incomes policy.

Other desirable and practical regulatory changes include a lower limit on the percentage of the house purchasing price that can be advanced, with the aim of reducing the share of credit going to the housing sector and curbing momentum towards housing bubbles.

The scope of financial regulation should also be widened, so as to give regulators more information about system-wide risk exposures, which have become much more opaque due to the recent wave of financial innovation. For example, regulators should be authorized to rule out products whose risk characteristics cannot be easily verified by a third party. And in terms specifically of over-the-counter (OTC) derivative products, contract law should be changed so as to say that OTC products which are not registered – registered in a way which reveals information about their risk characteristics – shall have no force in law; so that if one party to the contract defaults the other party cannot sue in a court of law.

Another area that needs attention is regulators' conflicts of interest with regulatees. For example, the US Federal Reserve is the overall regulator, but other public agencies have responsibility for regulating specific kinds of financial organizations involved in mortgage lending, agencies like the Comptroller of the Currency and the Office of Thrift Supervision. Remarkably, these agencies receive fee revenue from the firms they regulate.[14] Critics have long argued that the agencies often treat the regulated organizations as constituents to be protected rather than regulated, and the fact that the agencies receive fee revenue from the firms they are meant to regulate helps to explain their protective stance.

2. Ratings agencies should be more closely regulated

The crisis has highlighted related conflicts of interest involving the ratings agencies, like Moody's. The rating agencies' AAA ratings to complex securities containing sub-prime mortgages enabled the securities to be bought by blue-chip investors. But the agencies have a built-in incentive to over-rate because they get fee revenue from the firms whose securities they rate. The stronger their reputation for giving high ratings the bigger their market share and the bigger their fee income (up to some limit, above which their over-rating reputation undermines their credibility).

[13] Martin Wolf, "Why regulators should intervene in bankers' pay", Financial Times, 16 Jan 2008.
[14] Edmund Andrews, "Plenty of warning of subprime storm", International Herald Tribune, Dec 18, 2007, p.1

Moreover, the rating agencies have developed a profitable line of business advising clients on how to structure financial products – which they then go on to rate. This too constitutes a blatant conflict of interests.

Again, the rating agencies rely on the Wall Street underwriters to perform the necessary "due diligence" on risky mortgages and on the borrowers backing a given security – because securities law does not require the ratings agencies to do their own due diligence. They assign ratings on the basis of information provided by the Wall Street firms -- which have a direct financial interest in securing high ratings so that they can sell the securities quickly and expensively.[15]

At the least, the ratings agencies should be paid by someone other than seller, and should not be allowed to sell advisory services. Perhaps they should be paid by the buyers of the securities.[16]

3. *Create a "mixed economy" in banking and finance*

The banking and finance sector should be reformed so as to create a "mixed economy" in banking and finance, with some financial firms having a large component of public ownership, or at least public guarantees. These firms would operate more like public or private utilities than as profit-maximizers, with public as well as private purposes. The financial sector should not be judged according to its rate of return on its capital, as though it is just another sector producing goods and services.

Such a "mixed economy" in finance would promote "best practice" in the private sector, meaning practice which is not primarily about speculation, which does not link management rewards primarily to speculative activity, and which promotes enlightened corporate governance in the banking system. The component supported by public ownership or public guarantees would operate with a trading ethic that does not require them to drop unprofitable borrowers overnight.

One possible model is the cooperative banks of France and Finland. There some of the retail banks own a centralized "wholesale" bank which is financed by the member banks and refinanced by bond issues or by its own deposits; and the wholesale bank ensures that losses on a particular retail bank are socialized among the members controlling the whole operation. Or the wholesale bank could be publicly owned, or publicly guaranteed.

4. Basel 2 needs to be revised

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[15] Saskia Scholtes, "Ratings game that turned into a guess game", FT Sep 29-30, 2007, p.31.

[16] But payment by the buyers raises a free rider problem; if one buyer pays a ratings agency to rate a certain security, other buyers can free ride on that information if it becomes known.

Rules about how much capital must be held in reserve are the best response to the banks' tendency to be reckless with their capital in the expectation of bail outs. But the crisis has thrown up worrying questions about Basel 2, the new international framework for regulating banks' capital, which was formally initiated on January 1, 2008 after some nine years of planning.

Basel 1, introduced by the Basel Committee on Banking Supervision in 1988 and adopted by over 100 countries, aimed to ensure that banks had adequate capital to cover credit risks through the imposition of capital adequacy ratios. The accord required banks to have capital of at least 8 percent of their risk-adjusted loans, and the Basel Committee monitored compliance. It was a blunt instrument, to be sure. Critics said it failed to allow for changes in the relative riskiness of banks' credit exposures over the economic cycle. The number of financial crises in the 1990s and 2000s shows that it by no means curbed credit booms and leveraged speculation. The banks innovated around it by devising new forms of securities and off-balance sheet investment vehicles in order to avoid regulatory oversight.

But the regulators brought many of these problems on themselves, by being lax when they should have been robust. In very few cases of bank over-reach (whether Orange County in 1993, Mexico in 1994-5, East Asia in the late 1990s, Long Term Capital Management in 1998) did the regulators make the banks and their shareholders suffer more than mild consequences. Instead, having allowed these crises to develop, they rushed in with bailouts designed to protect the shareholders.

Basel 2 is based on the argument that the Basel 1 rules were rendered obsolete by new risk management techniques and that the banks themselves were better equipped to guage their own risks. By moving from externally set requirements and external supervision towards industry self-regulation, Basel 2 allows a finer adjustment of capital requirements to risks – or so its champions say. The new framework calls for banks to make their own risk assessments by using both credit ratings provided by the internationally-recognized rating agencies and their own internal risk assessment models. It also calls for more disclosure of information, on grounds that "the market" will police the firms' use of their new discretion if the market has reliable information.

For all the problems of Basel 1, Basel 2 looks like the banking equivalent of the Edsel.[17] Some of its problems are obvious. First, its thrust for self-regulation runs against the principle that anything that is "too big to fail" should be regulated by an external agency rather than let to regulate itself.

[17] Marshall Auerback, "The new Basle Accord: self-regulation run amok", mimeo, January 23, 2001.

Second, the balance of evidence suggests that the new rules will generate cyclicality in regulatory capital requirements and also in actual capital provisions, making them a source of instability in credit markets by encouraging too much credit in upswings and too much contraction in downswings. [18]

Third, the present crisis has shown the dangers of relying on rating agencies' ratings and on banks' own internal risk assessment models. It has highlighted that the ratings agencies tend to over-rate because paid by the sellers, and that the people who operate the banks' internal risk assessment models depend for their pay and prospects on giving rosy numbers for products so complex that no senior manager – and no third party -- could easily verify them.

Fourth, Basle 2 hardly deals with the Over-the-Counter (OTC) derivatives market. Consider the following analogy:

"Imagine that a private company had developed an explosive ten times more powerful than Semtex. Suppose also that this company planned to increase output by 40 per cent per annual, to sell trading franchises through the world and to market the product to all comers. Would not the government take urgent steps to license and regulate this product, perhaps even to the point of nationalising the company? Yet the financial explosives known as derivatives enjoy virtual freedom in every developed country in the world, and in some emerging nations too". [19]

How Basel 2 should be modified is a matter of intense and technical debate. Here the main point is that its deficiencies pave the way for future crises.

5. International Accounting Standards need to be revised

In addition to Basel 2, another big and problematic new rule in international finance is the international accounting standard known as IAS 39, introduced in 2005, which requires banks regularly to revalue their assets at the prevailing market prices (the "mark-to-market" principle). Like the changes incorporated into Basel 2 this rule has advantages over the previous "mark-to-book" rule (value assets at their historical price adjusted for inflation), but it may well intensify cyclicality in financial markets. [20] Under bear market conditions, like those prevailing now, a mark-to-market regime renders a lot of firms technically bankrupt because the resulting writedowns wipe out their existing capital. One simulation study of the effect on EU

[18] Stefan Gerlach and Paul Gruenwalk (eds), Procyclicality of Financial Systems in Asia, Palgrave Macmillan 2006.

[19] Peter Warburton, Debt and Delusion: Central Bank Follies That Threaten Economic Disaster. Allen Lane, 1999.

[20] Gillian Tett, "The vicious trap that haunts the debt markets", FT 7 March 2008.

banks found that a "typical" real-estate crisis would cause a 26% fall in banks' capital and reserves under the previous "mark-to-book" accounting rule, and a 54% fall in capital and reserves under the IAS 39 "mark-to-market" rule.[21]

A perverse dynamic is created, in which banks are forced to lower the value of their assets, then have to cut back lending, which forces hedge funds to make asset sales in an ad hoc, opaque manner that adds to the sense of fear, which generates more worries about banks. There is a case for temporarily suspending the IAS 39 while agreement is sought on less destabilizing rules.

5. Capital management techniques should be restored as legitimate instruments of economic management

"Capital management techniques" (to use a broader and more neutral term than "capital controls") should be restored as legitimate instruments of economic management for the purpose of buffering cross-border flows. They can help not only to reduce the risk of excessive capital inflows and outflows, but also to create space for policy experimentation and diversity of political economy regimes.

One proposal combines "trip wires" with "speed bumps". Trip wires (or "early warning signals") are indicators of looming financial difficulty or vulnerability to contagion from another part of the world. One such trip wire might be the ratio of short-term foreign debt to foreign exchange reserves, which would be triggered when the ratio rose to near 100%. Speed bumps are policy responses that alter the behaviour of investors. Policy makers would design trip wires for their economy and link the trip wire with one or more speed bumps, such that if a trip wire was activated there would be a strong presumption that a certain speed bump would go into effect. For example, if there was a danger of excessive outflows (as in Malaysia in September 1998) the speed bump would slow the outflows by either quantitative or price methods.[22]

All this may sound obvious, but in fact the "early warning systems" discussed in the wake of the Asian crisis did not incorporate a link with policies that would constrain the behaviour of financial actors. The justification for making no such link was, of course, the presumption that the information released by the trip wire would itself be enough to correct the behaviour of private actors. But it is quite plausible that in the absence of

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[21] A.Enria et al., 2004, "Fair value accounting and financial stability", European Central Bank Occasional Papers No. 13.

[22] Ilene Grabel, "One step forward, two steps back: policy (in)coherence and financial crises", in Bhumika Muchhala (ed), Ten Years After: Revisiting the Asian Financial Crisis, Woodrow Wilson International Center, Washington DC, October 2007; Gerald Epstein, Ilene Grabel, and Jomo K.S., "Capital management techniques in developing countries: an assessment of experiences from the 1990's and lessons for the future", mimeo, April 2003.

policy speed bumps, the response of investors and others to the information released by the trip wire would be to panic.

Malaysia in 1994 and again in 1998, and Chile in the first half of the 1990s, are the best known examples of capital management techniques being deployed in order to slow down outflows, in the Malaysian case, or inflows, in the Chilean case. The balance of evidence suggests that these controls were effective in stabilizing the economies. But Malaysia and Chile are not alone. Capital management techniques to moderate capital inflows and outflows have also been effectively used in Colombia, Taiwan, Singapore, China and India, and probably others as well.

Of course, the financial sector is strongly opposed to such capital management techniques becoming normal instruments of national economic management. Even as the IMF, post Asia crisis, moderated its earlier demands that its borrowing countries open their capital accounts, the US and the EU have been twisting the arms of their partner countries in preferential trade agreements to open their capital accounts and foreswear any attempt to place restrictions or transaction taxes on capital inflows and outflows.

On the face of it, it is odd that the financial sector opposes such quantitative or price restrictions, because everyone accepts the related rules of circuit breakers in stock markets and regulators having discretionary authority to suspend trading. There seems to be some inconsistency in the acceptance of circuit breakers and discretionary regulatory authority in stock markets, but not of cross-border capital flows.

One standard objection to certain forms of capital management techniques is that they are either easy to avoid or an elaborate international organization would have to be set up to implement them (eg the long-standing objections to a Tobin tax). Whatever the truth of this objection earlier, it is now less compelling because of the establishment of the Continuous Linked Settlement (CLS) Bank in 2002. [23] It is not a bank, but an organization which settles wholesale payments between banks. As of 2005 it was handling more than 50% of total foreign exchange transactions, and the percentage is certainly higher today. It takes a fee on each transaction. In principle it could be mandated to levy an additional fee on transactions involving a specific currency, at the request of the government, or even to stop transactions in that currency. So the organizational platform for certain kinds of international capital management techniques is already in existence. All that is missing is the authority to use it.

[23] See www.cls-group.com.

VI. CONCLUSION

The dynamics of zone 1 – the Bretton Woods II system of fixed exchange rates between the US and Asia, and US external deficits financed by capital from the (Asian) surplus, generating huge increases in credit and debt – constitute one major engine of instability in the world economy. The dynamics of zone 2 constitute another -- floating exchange rates and unrestricted capital movements, generating capital flows which tend to move exchange rates in the wrong direction for reducing imbalances. Tighter regulation of financial markets has to be part of the solution; and also more active management of capital flows, especially by national authorities. Wall Street and City of London lobbies will strongly oppose and they may succeed in stopping more than token efforts; but the crisis makes the intellectual case very strong.

So the silver lining to the crisis cloud is the potential weakening of the long established political dominance of "market fundamentalists", as suggested by Joseph Ackerman's remark at the start. The growing public support for state leadership on climate change is pushing in the same direction. In the context of economic development, the World Bank published a long report in 2005 drawing lessons from growth experience in the 1990s, which declared, at the start, "The central message of this volume is then that there is no unique universal [free market] set of rules". [24] Perhaps even Gordon Brown's government, as it struggles to deal with the financial crisis head-on, will soften its attachment to neoliberal norms.

END

[24] World Bank, Economic Growth in the 1990s: Learning from a Decade of Reform, 2005, p.xiii.