Crisis of Greed

Gabriel Kolko

There has been a profound and fundamental change in the world economy over the past decade. The very triumph of financial liberalisation and deregulation, one of the keystones of the 'Washington consensus' that the US government, International Monetary Fund (IMF), and World Bank have persistently and successfully attempted over the past decades to implement, has also produced a deepening crisis that its advocates scarcely expected.

The global financial structure is today far less transparent than ever. There are many fewer reporting demands imposed on those who operate in it. Financial adventurers are constantly creating new 'products' that defy both nation-states and international banks. The IMF's managing director, Rodrigo de Rato, at the end of May 2006 deplored these new risks – risks that the weakness of the US dollar and its mounting trade deficits have magnified greatly.

De Rato's fears reflect the fact that the IMF has been undergoing both structural and intellectual crises. Structurally, its outstanding credit and loans have declined dramatically since 2003, from over $70 billion to a little over $20 billion today, doubling its available resources and leaving it with far less leverage over the economic policies of developing nations – and even a smaller income than its expensive operations require. It is now in deficit. A large part of its problems is due to the doubling in world prices for all commodities since 2003 – especially petroleum, copper, silver, zinc, nickel, and the like – that the developing nations traditionally export. While there will be fluctuations in this upsurge, there is also reason to think it may endure because rapid economic growth in China, India, and elsewhere has created a burgeoning demand that did not exist before – when the balance-of-trade systematically favoured the rich nations.

The United States has seen its net foreign asset position fall as Japan, emerging Asia, and

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oil-exporting nations have become far more powerful over the past decade, and they have increasingly become creditors to the US. As the US deficits mount with its imports being far greater than its exports, the value of the dollar has been declining – 28 per cent against the euro from 2001 to 2005 alone.

Even more, the IMF and World Bank were severely chastened by the 1997-2000 financial meltdowns in East Asia, Russia, and elsewhere, and many of its key leaders lost faith in the anarchic premises, descended from classical laissez-faire economic thought, which guided its policy advice until then. '…[O]ur knowledge of economic growth is extremely incomplete,' many in the IMF now admit, and 'more humility' on its part is now warranted. The IMF claims that much has been done to prevent the reoccurrence of another crisis similar to that of 1997-98, but the international economy has changed dramatically since then and, as Stephen Roach of MorganStanley has warned, the world 'has done little to prepare itself for what could well be the next crisis.'

The whole nature of the global financial system has changed radically in ways that have nothing whatsoever to do with 'virtuous' national economic policies that follow IMF advice – ways the IMF cannot control. The investment managers of private equity funds and major banks have displaced national banks and international bodies such as the International Monetery Fund, moving well beyond the existing regulatory structures. In many investment banks, the traders have taken over from traditional bankers because buying and selling shares, bonds, derivatives and the like now generate the greater profits, and taking more and higher risks is now the rule among what was once a fairly conservative branch of finance. They often bet with house money. Low-interest rates have given them and other players throughout the world a mandate to do new things, including a spate of dubious mergers that were once deemed foolhardy. There are also fewer legal clauses to protect investors, so that lenders are less likely than ever to compel mismanaged firms to default. Aware that their bets are increasingly risky, hedge funds are making it much more difficult to withdraw money they play with. Traders have 're-intermediated' themselves between the traditional borrowers – both national and individual – and markets, deregulating the world financial structure and making it far more unpredictable and susceptible of crises. They seek to generate high investment returns – which is the key to their compensation – and they take mounting risks to do so.

In March 2006, the International Monetary Fund released Garry J. Schinasi's book, *Safeguarding Financial Stability*, giving it unusual prominence then and thereafter. Schinasi's book is essentially alarmist, and it both reveals and documents in great and disturbing detail the IMF's deep anxieties. Essentially, 'deregulation and liberalisation,' which the IMF and proponents of the 'Washington consensus' advocated for decades, has become a nightmare. It has created 'tremendous private and social benefits' but it also holds 'the potential (although not necessarily a high likelihood) for fragility, instability, systemic risk, and adverse economic consequences.' Schinasi's superbly documented book confirms his conclusion that the irrational development of global finance,

combined with deregulation and liberalisation, has 'created scope for financial innovation and enhanced the mobility of risks.' Schinasi and the International Monetary Fund advocate a radical new framework to monitor and prevent the problems now able to emerge, but success 'may have as much to do with good luck' as policy design and market surveillance. Leaving the future to luck is not what economics originally promised.

The International Monetary Fund is desperate, and it is not alone. As the Argentina financial meltdown proved, countries that do not succumb to IMF and banker pressures can play on divisions within the IMF membership – particularly the US – bankers and others to avoid many, although scarcely all, foreign demands. About $140 billion in sovereign bonds to private creditors and the IMF were at stake, terminating at the end of 2001 as the largest national default in history. In the 1990s, banks were eager to loan Argentina money, and they ultimately paid for it. Since then, however, commodity prices have soared, the growth rate of developing nations in 2004 and 2005 was over double that of high income nations –- a pattern projected to continue through 2008 – and as early as 2003 developing countries were already the source of 37 per cent of the foreign direct investment in other developing nations. China accounts for a great part of this growth, but it also means that the International Monetary Fund and rich bankers of New York, Tokyo, and London have much less leverage than ever.

At the same time, the far greater demand of hedge funds and other investors for risky loans, combined with low interest rates that allow hedge funds to use borrowed money to make increasingly precarious bets, has also led to much higher debt levels as borrowers embark on mergers and other adventures that would otherwise be impossible.

Growing complexity is the order of the world economy that has emerged in the past decade, and the endless negotiations of the World Trade Organisation have failed to overcome the subsidies and protectionism that have thwarted a global free trade agreement and the end of threats of trade wars. Combined, the potential for much greater instability – and greater dangers for the rich – now exists in the entire world economy.

High-speed global economics

The global financial problem that is emerging is tied into an American fiscal and trade deficit that is rising quickly. Since Bush entered office in 2001 he has added over $3 trillion to federal borrowing limits, which are now almost $9 trillion. So long as there is a continued devaluation of the US dollar, banks and financiers will seek to protect their money and risky financial adventures will appear increasingly worthwhile. This is the context, but Washington advocated greater financial liberalisation long before the dollar weakened. This conjunction of factors has created infinitely greater risks than the proponents of the 'Washington consensus' ever believed possible.

There are now many hedge funds, with which we are familiar, but they now deal in credit derivatives – and numerous other financial instruments that have

been invented since then, and markets for credit derivative futures are in the offing. The credit derivative market was almost non-existent in 2001, grew fairly slowly until 2004 and then went into the stratosphere, reaching $17.3 trillion by the end of 2005.

What are credit derivatives? *The Financial Times*' chief capital markets writer, Gillian Tett, tried to find out – but failed. About ten years ago, some J.P. Morgan bankers were in Boca Raton, Florida, drinking, throwing each other into the swimming pool, and the like, and they came up with a notion of a new financial instrument that was too complex to be easily copied (financial ideas cannot be copyrighted) and which was sure to make them money. But Tett was highly critical of its potential for causing a chain reaction of losses that will engulf the hedge funds that have leaped into this market. Warren Buffett, second richest man in the world, who knows the financial game as well as anyone, has called credit derivatives 'financial weapons of mass destruction.' Nominally insurance against defaults, they encourage far greater gambles and credit expansion. Enron used them extensively, and it was one secret of their success – and eventual bankruptcy with $100 billion in losses. They are not monitored in any real sense, and two experts called them 'maddeningly opaque.' Many of these innovative financial products, according to one finance director, 'exist in cyberspace' only and often are simply tax dodges for the ultra-rich. It is for reasons such as these, and yet others such as split capital trusts, collateralised debt obligations, and market credit default swaps that are even more opaque, that the International Monetary Fund and financial authorities are so worried.

Banks simply do not understand the chain of exposure and who owns what – senior financial regulators and bankers now admit this. The Long-Term Capital Management hedge fund meltdown in 1998, which involved only about $5 billion in equity, revealed this. The financial structure is now infinitely more complex and far larger – the top 10 hedge funds alone in March 2006 had $157 billion in assets. Hedge funds claim to be honest but those who guide them are compensated for the profits they make, which means taking risks. But there are thousands of hedge funds and many collect inside information, which is technically illegal but it occurs anyway. The system is fraught with dangers, starting with the compensation structure, but it also assumes a constantly rising stock market and much, much else. Many fund managers are incompetent. But the 26 leading hedge fund managers earned an average of $363 million each in 2005; James Simons of Renaissance Technologies earned $1.5 billion.

There is now a consensus that all this, and much else, has created growing dangers. We can put aside the persistence of imbalanced budgets based on spending increases or tax cuts for the wealthy, much less the world's volatile stock and commodity markets which caused hedge funds this last May to show far lower returns than they have in at least a year. It is anyone's guess which way the markets will go, and some will gain while others lose. Hedge funds still make lots of profits, and by the spring of 2006 they were worth about $1.2 trillion worldwide, but they are increasingly dangerous. More than half of them give

preferential treatment to certain big investors, and the US Security and Exchange Commission has since mid-June 2006 openly deplored the practice because the panic, if not chaos, potential in such favouritism is now too obvious to ignore. The practice is 'a ticking time bomb,' as one industry lawyer described it. These credit risks – risks that exist in other forms as well – seemed ready to materialise when the *Financial Times*' Tett reported at the end of June that an unnamed investment bank was trying to unload 'several billion dollars' in loans it had made to hedge funds. If true, 'this marks a startling watershed for the financial system.' Bankers had become 'ultracreative… in their efforts to slice, dice and redistribute risk, at this time of easy liquidity.' Low interest rates, Avinash Persaud, one of the gurus of finance concluded, had led investors to use borrowed money to play the markets, and 'a painful deleveraging is as inevitable as night follows day … The only question is its timing.' There was no way that hedge funds, which had become precociously intricate in seeking safety, could avoid a reckoning and be 'forced to sell their most liquid investments'. 'I will not bet on that happy outcome,' the *Financial Times*' chief expert concluded in surveying some belated attempts to redeem the hedge funds from their own follies.

A great deal of money went from investors in rich nations into emerging market stocks, which have been especially hard-hit in the past weeks, and if they leave then the financial shock will be great — the dangers of a meltdown exist there too.

Problems are structural, such as the greatly increasing corporate debt loads to core earnings, which have grown substantially from four to six times over the past year because there are fewer legal clauses to protect investors from loss –- and keep companies from going bankrupt when they should. So long as interest rates have been low, leveraged loans have been the solution. With hedge funds and other financial instruments, there is now a market for incompetent, debt-ridden firms. The rules some once erroneously associated with capitalism — probity and the like — no longer hold.

Problems are also inherent in speed and complexity, and these are very diverse and almost surreal. Credit derivatives are precarious enough, but at the end of May the International Swaps and Derivatives Association revealed that one in every five deals, many of them involving billions of dollars, involved major errors – as the volume of trade increased, so did errors. They doubled in the period after 2004. Many deals were written on scraps of paper and not properly recorded. 'Unconscionable' was Alan Greenspan's description. He was 'frankly shocked'. Other trading, however, is determined by mathematical algorithm ('volume-weighted average price', it is called) for which PhDs trained in quantitative methods are hired. Efforts to remedy this mess only began in June 2006, and they are very far from resolving a major and accumulated problem that involves stupendous sums.

On 24 April, Stephen Roach, Morgan Stanley's chief economist, wrote that a major financial crisis was in the offing and that the global institutions to forestall it– ranging from the International Monetary Fund and World Bank to other mechanisms of the international financial architecture – were utterly inadequate.

Hong Kong's chief secretary in early June deplored the hedge funds' risks and dangers. The IMF's iconoclastic chief economist, Raghuram Rajan, at the same time warned that the hedge funds' compensation structure encouraged those in charge of them to increasingly take risks, thereby endangering the whole financial system. By late June, Roach was even more pessimistic: 'a certain sense of anarchy' dominated the academic and political communities, and they were 'unable to explain the way the new world is working.' In its place, mystery prevailed. Reality was out of control.

The entire global financial structure is becoming uncontrollable in crucial ways its nominal leaders never expected, and instability is increasingly its hallmark. Financial liberalisation has produced a monster, and resolving the many problems that have emerged is scarcely possible for those who deplore controls on those who seek to make money – whatever means it takes to do so. The Bank for International Settlements' annual report, released 26 June, discusses all these problems and the triumph of predatory economic behaviour and trends 'difficult to rationalise'. The sharks have outfoxed the more conservative bankers. 'Given the complexity of the situation and the limits of our knowledge, it is extremely difficult to predict how all this might unfold.' The Bank does not want its fears to cause a panic, and circumstances compel it to remain on the side of those who are not alarmist. But it now concedes that a big 'bang' in the markets is a possibility, and it sees 'several market-specific reasons for a concern about a degree of disorder'. We are 'currently not in a situation' where a meltdown is likely to occur but 'expecting the best but planning for the worst' is still prudent. For a decade, it admits, global economic trends and 'financial imbalances' have created increasing dangers, and 'understanding how we got to where we are is crucial in choosing policies to reduce current risks'. The Bank for International Settlements is very worried.

Given such profound and widespread pessimism, the vultures from the investment houses and banks have begun to position themselves to profit from the imminent business distress – a crisis they see as a matter of timing rather than principle. Investment banks since the beginning of 2006 have vastly expanded their loans to leveraged buy-outs, pushing commercial banks out of a market they once dominated. To win a greater share of the market, they are making riskier deals and increasing the danger of defaults among highly leveraged firms. There is now a growing consensus among financial analysts that defaults will increase substantially in the very near future. But because there is money to be made, experts in distressed debt and restructuring companies in or near bankruptcy are in greater demand. Goldman Sachs has just hired one of Rothschild's stars in restructuring. All the factors which make for crashes – excessive leveraging, rising interest rates, etc. – exist, and those in the know anticipate that companies in difficulty will be in a much more advanced stage of trouble when investment banks enter the picture. But this time they expect to squeeze hedge funds out of the potential profits because they have more capital to play with.

Contradictions now wrack the world's financial system, and a growing

consensus now exists between those who endorse it and those, like myself, who believe the status quo is both crisis-prone as well as immoral. If we are to believe the institutions and personalities who have been in the forefront of the defence of capitalism, and we should, it may very well be on the verge of serious crises.