

Has the Storm Broken?

Gabriel Kolko

Gabriel Kolko warned of the 'Crisis of Greed' in Spokesman 92. Here he develops his analysis of the convulsions of global finance.

Contradictions now wrack the world's financial system, and a growing consensus exists between those who endorse it and those who argue 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, we are on the verge of a serious crisis – if not now, then in the near future.

The International Monetary Fund (IMF), the Bank for International Settlements, the British Financial Services Authority, the *Financial Times*, and innumerable mainstream commentators were increasingly worried, and publicly warned against many of the financial innovations that have now imploded. Warren Buffett, whom Forbes ranks the second richest man in the world, last year called credit derivatives – only one of the many new banking inventions – 'financial weapons of mass destruction'. Very conservative institutions and people predicted the upheaval in global finances we are today experiencing.

The IMF has taken the lead in criticizing the new international financial structure, and over the past three years it has published numerous detailed reasons why it has become so dangerous to the world's economic stability. Events have confirmed its prognostication that complexity and lack of transparency, the obscurity of risks and universal uncertainty, especially regarding collateralized debt and loan obligations, will cause a flight to security that will dry up much of the liquidity of banking.

'... Financial innovation itself', as a *Financial Times* columnist put it, 'is the problem'. The ultra-creative system is seizing up because no one understands where risks are located or how it works. It began to do so this summer and fixing it is not very likely.

It is impossible to measure the extent of the losses. The final results of this deluge have yet to be calculated. Even many of the players who have stakes in the countless arcane investment

instruments are utterly ignorant. The sums are enormous.

Only a few of the many measures give us a rough estimate. The present crisis began – it has scarcely ended there – with sub-prime mortgage loans in the United States, which were valued at over \$1.3 trillion at the beginning of 2007, but are, for practical purposes, worth far, far less today. We can ignore the impact of this crisis on US housing prices, but some projections are of a 10 per cent decline – another trillion or so. Indirectly, of course, the mortgage crisis has also brought many millions of people into the larger financial world and they will get badly hurt.

What the sub-prime market did was unleash a far greater maelstrom involving banks in Germany, France, Asia, and throughout the world, calling into question much of the world financial system as it has developed over the past decade.

Investment banks hold about \$300 billion in private equity debts they planned to place – mainly in leveraged buy-outs. They will be forced to sell them at discounts or keep them on their balance sheets – either way they will lose.

The near-failure of the German Sachsen LB bank, which had to be saved from bankruptcy with 17.3 billion euros in credit, revealed that European banks hold over half a trillion dollars in so-called asset backed commercial paper, much of it in the United States and sub-prime mortgages. A failure in America caused Europe, too, to face a crisis. The problem is scarcely isolated.

The leading victims of this upheaval are the hedge funds. What are hedge funds? There are about 10,000 and, all told, they do everything. Some hedge funds, however, provided companies with capital and successfully competed with commercial banks because they took much greater risks. A substantial proportion are simple gamblers; some even bet on the weather – hunches. Many look to their computers and mathematics for models to guide their investments, and these have lost the most money, but funds based on other strategies also lost during August. The spectacular Long-term Capital Management 1998 failure was also due to its reliance on ingenious mathematical propositions, yet no one learned any lessons from it, proving that appeals to reason, as well as experience, fall on deaf ears if there is money to be made.

Some gained during the August crisis but more lost, and in the aggregate the hedge funds lost a great deal – their allure of rapid riches gone. There have been some spectacular bankruptcies and bailouts, including some of the biggest investment firms. Investors who got cold feet found that withdrawing money from hedge funds was nigh on impossible. The real worth of their holdings is hotly contested, and valuations vary wildly. In reality, there is no way to appraise them realistically – they all depend largely on what people want to believe and will take, or the market.

We are at the end of an era, living through the worst financial panic in many decades. Now begins global financial instability. It is impossible to speculate how long today's turmoil will last – but there now exists an uncertainty and lack of confidence that has been unparalleled since the 1930s – and this ignorance and fear is itself a crucial factor. The moment of reckoning for bankers and bosses has

arrived. What is very clear is that losses are massive and the entire developed world is now experiencing the worst economic crisis since 1945, one in which troubles in one nation compound those in others.

All central banks are wracked by dilemmas. They have neither the resources nor the knowledge, including legal powers, to remedy the present maelstrom. Although there is clamour from financiers and assorted operators to bail them out, the Federal Reserve must also weigh the consequences of its moves, above all for inflation. Then there is the question of ‘moral hazard’. Is it the Federal Reserve’s responsibility to save financial adventurers from their own follies? Throughout August, the American and European central banks plunged about half a trillion dollars into the banking system in an attempt to unfreeze blocked credit and loans that followed the sub-prime crisis – an event which triggered a ‘flight to safety’ which greatly reduced banks’ willingness to loan. In effect, the Federal Reserve relied on banks to restore confidence in the financial system, subsidizing their efforts.

Central banks’ efforts succeeded only very partially but, in the aggregate, they failed: banks and investors now seek security rather than risk, and they will sit on their money. The Federal Reserve privately acknowledges its inability to cope with an inordinately complex financial structure. European central bankers are in exactly the same dilemma: they simply don’t know what to do.

But this scarcely touches the real problem, which is structural and impinges wholly on the way the world financial structure has evolved over the past two decades. As in the past, there is a critical split in the banking and finance world and each has political leverage along with clashing interests. More important, central banks were not designed to cope with today’s realities and have neither the legal powers nor knowledge to control them.

In this context, central banks will have increasing problems and the solutions they propose, as in the past, will be utterly inadequate, not because their intentions are wrong but because it is impossible to regulate such a vast, complex economy – even less today than in the past because there is no international mechanism to do so. Internationalization of finance has meant less regulation than ever, and regulation was scarcely very effective even at the national level.

Not only leftists are naïve but so, too, are those conservatives who think they can speak truth to power and change the course of events. Greed’s only bounds are what makes money. Neither existing international institutions – of which the International Monetary Fund is the most important – nor well-intentioned advice will change this reality.