

CRISIS AND DISTRIBUTION: A BRIEF HISTORICAL NOTE¹

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The subject of this note is the institutional aspects of finance – in particular, the role of global finance and external markets in the decades leading to the current crisis. For me, the key to understanding this crisis is seeing through the games that financial institutions play and the effects those games have on economies and people. One need only look at Greece for an example of the damage that has and is being done as we speak. Indeed, one reads about the negative impact of financial institutions in the newspapers every day.

My intent is to go back in time to place this crisis in a historical context, beginning in the 1960's and moving forward, picking out salient features of financial crises and their distributional aspects as we move along. The seeds of this crisis were planted in the 1960's. At that time, the central banks of the major industrial countries decided to allow their commercial banks to have operations in external (so-called euro) markets that function outside national borders and are not governed by rules and regulations. Central bankers may not have been aware that a new Wild West of banking was being created but, as it turned out, the growth of the external market had an enormous effect on banks' ability to maneuver, because it allowed them to escape the reach of central banks.

At the end of the 1960's and of the golden era of capitalism, lawmakers may have been resting a bit on their laurels after several decades of strong and effective regulation. For example, there were ceilings on interest rates banks and other depository institutions were allowed to pay which boosted the effectiveness of monetary policy when central banks attempted to tighten the growth of money and credit by raising interest rates. But in the late 1960's, U.S. banks operating in the unregulated external market reacted to Federal Reserve tightening by using deposits not subject to rate ceilings for lending into the U.S. Thus a policy that was meant to have a contractive effect led to an expansion in the availability of credit. The banks' ability to thwart its policy drove the Fed to raise its prime rate as high as 7.5% - an unprecedented level for interest rates at that time. The successful attack on this critical element of regulation - ceilings on interest rates charged by banks, widely used by central banks throughout the world - marked the beginning of the deregulatory era.

The inflow of bank lending into the U.S. in the late 1960's and early 1970's exacerbated existing strains within the Bretton Woods system and a major result of its collapse in 1971 was the privatization of the international payments system. Where central banks had been the organizations that handled international monetary transfers, the private sector now took their

place. The shift of international payments to the large, multinational private banks gave a boost to international speculation and its profit-generating potential. Initially, the game involved speculation in the currencies of major developed countries. Countries threatened by appreciation and loss of competitiveness responded by amassing international reserves. In 1971 alone, when the dollar was under attack, international reserves increased by 65%. It is worth emphasizing that the growth in reserves in the 1970's was driven by the increase in holdings of developed countries as well as OPEC members.

International reserve growth in the 1970's was the unintentional beginning of pro-cyclicality in monetary policy. Central banks seemed unaware that they were dealing in interest-bearing credit instruments rather than gold - that when they bought dollars in foreign exchange markets and invested them in U.S. government securities, their repatriation of the funds expanded credit in the U.S. domestic market. While the intention of foreign central banks was to increase the value of the dollar, their actions had the opposite effect as a rapid increase in borrowing fed inflation in the U.S. and further weakened the dollar. Partly as a result of this misguided policy, the 1970's was a decade of inflation, driven by central bank intervention in currency markets and the investment of international reserves in U.S. government debt.

One of the standard features of financial crises in the post-Bretton Woods era is the destabilizing effects of capital flows - the tendency of both private and public cross-border investment to flow uphill from regions where it is scarce to regions with excess capital. But the flow of funds into the external market often has damaging effects within a national economy. For example, all the additional funds flowing into the U.S. in the 1970's appeared to originate from outside the domestic market. Much of it was, however, the result of what was called "round-tripping". In other words, a substantial share of the funding for these inflows was drawn originally from capital-starved regions in the U.S., funneled into the unregulated external market and then returned to the U.S., either loaned back into the U.S. or disbursed as offshore loans to U.S. residents. Round-tripping earned the multinational banks a higher rate of return than could be earned by booking loans in the regulated domestic market.

There were anecdotes at the time about a rash of so-called "strip-mining" in upstate New York. Chase Manhattan, the bank most featured in the media, was offering a better return on interbank placements than small banks could earn on local lending. Chase then transferred the funds abroad for lending in the external interbank market and for currency speculation. Another bank in New Orleans that was examined at the time was found to have half of its deposits invested overseas through Chase Manhattan. Unsurprisingly, the bank did not do much lending in the community with the result that deposits started drying up, and the bank

failed. But the neighborhood also failed, clearly outlining the distributional effects of this global set-up in this case.

I would like to open a small parenthesis here and touch on a point that was made earlier in this conference - namely that interest rates rose toward the end of the decade for underlying structural reasons, and that this took place before Paul Volcker became chairman of the Fed. This argument referred to nominal interest rates which rose because of inflation while real rates were, obviously, much lower and sometimes negative. In the early years of Volcker's chairmanship, however, high nominal rates were turned into high real rates as funding for credit was drastically reduced. As a result, the economy suddenly had to shoulder real interest rates above 10% and nominal rates above 20%.

Undoubtedly, rampant inflation in the 1970's was also the result of increases in oil prices. Furthermore, the need to recycle earnings on higher oil revenues became ever more pressing. That process was entrusted to the private sector and the solution was found in lending to developing countries - mainly in Latin America - which were suddenly seen as the new locomotives of the global economy.

This brings me to my second point about the recurrent patterns visible in financial crises up to and including the present: the creation of unsustainable debt followed by a bail-out of the banks. As soon as the debt buildup of developing countries was seen as unsustainable in the sense that the countries could not service their debt, it was followed by immediate collapse. The crisis was generally perceived to be caused by the developing countries. However, it should not be overlooked that it was also a problem of and for the major U.S. banks, nine of which would have become insolvent had developing countries ceased to service their debt in the 1980's.

The next step that followed in this crisis and in many thereafter was a bail-out of the financial institutions. In the case of the Latin American debt crisis of the 1980's, the bail-out was conducted through the re-orientation of their economies toward export-led growth. Their exports were sent to the developed world and the concomitant payments were sent back to banks in developed countries to repay the debt. The distributional impacts were clear and catastrophic. The period is known as the 'lost decade' for Latin America, characterized by searing poverty, malnourished children and all the other harrowing effects of unequal distribution in the wake of financial crises.

The Mexican financial crisis of the mid-1990's demonstrates the particular linkages between Mexico and the U.S. and the public and private sectors. With the onset of the recession at the beginning of the 1990's, the Fed lowered interest rates in pursuit of their customary strategy for dealing with a downturn. This caused an inflow of capital into Mexico from private funds

looking for higher returns than offered by U.S. interest rates. At the same time, the central banks of industrialized countries were cashing in their dollar reserves and selling dollars to buy the currencies of other developed countries in an attempt to dampen appreciation. It was therefore not only private investment, but also developed countries' reserves that were flowing out of the U.S., constraining liquidity in the domestic market and prolonging the recession. But it was the private sector that flooded Mexico with funds, pushing up the Mexican stock market 400% in dollar terms. When then-Fed Chairman Greenspan raised interest rates in 1994, funds began to flow back into the U.S. and Mexico faced an immediate crisis. The so-called 'bail-out' for Mexico benefitted mainly the speculators, while the burden of repaying the lending package put together by Robert Rubin was born by Mexican tax payers in a newly impoverished Mexico.

In this context of U.S.-Mexico relations, I would like to add a note to the earlier discussion regarding NAFTA. As Ilene Grabel points out, companies were allowed to trump governments in the creation of NAFTA. Another part of that story is financial. The NAFTA agreements obliged Mexico to open its economy to foreign banks over a period of five years. While the central bank was authorized to delay the opening of Mexico's financial sector for monetary policy reasons, there was no delay. At the end of the five-year period, the foreign-owned share of the Mexican financial sector had risen from zero to 95%. The result was that credit as a share of GDP failed to regain the level of 1994. Indeed, toward the end of the 1990's, net credit loaned by banks in Mexico was negative because the foreign-based institutions were mostly lending in foreign currencies and lending only to borrowers that could earn foreign exchange through exports. This reflects the primacy of their loyalty to shareholders and thus the need to avoid exchange rate risk and repatriate shareholder compensation in strong currencies. It was not only companies that trumped governments in NAFTA; so did the banks.

The third point about recurrent issues in financial crises relates to practices in the financial sector that directly undermine financial stability, using carry trade and private monetization of debt as examples. As a context for this discussion, it is important to emphasize that carry trade transactions are conducted in an absolutely opaque market; no data or statistics are available and reporting is highly unreliable.

It was in the second half of the 1990's that carry trade became a major investment strategy and was pushed into dominance by the hedge fund, Long Term Capital Management (LTCM). The influence of carry trade on exchange rates is exemplified by the fall of the yen soon after LTCM collapsed. At the time, yen/dollar was the preferred strategy with borrowing in yen at very low interest rates used to invest in dollar assets that carried higher rates. When the transfer was made, the funding currency (yen) was depressed (an outcome to which the Japanese government did not object) and the value of the investment currency (the

dollar) appreciated (an outcome to which Robert Rubin, then a powerful figure in the Clinton administration and advocate for a strong dollar, did not object). After LTCM collapsed, the Yen rose 7% in value in one day in October 1998, and 17% by the end of the year. This made clear the extent of speculation in foreign exchange markets. There was a lull in carry trade activity for a while as traders shied away from what had become a money-losing activity, but it picked up again soon after and moved in different directions. By 2005 carry trade shifted to the periphery and entered emerging markets.

There is no excuse for the failure of policy makers to monitor leverage after LTCM. Its collapse made clear just how leveraged the system was. Thirteen U.S. institutions had provided funding that allowed LTCM to borrow about 100 dollars for every dollar of capital and were themselves conducting carry trade transactions through off-balance sheet entities.

But, in the absence of a regulatory crack-down, the financial sector moved forward and learned how to monetize debt to create additional liquidity to boost earnings, by-passing their traditional dependence on central banks to exercise this function. Under this new strategy, a hedge fund (or a hedge fund operation of Goldman Sachs or JP Morgan) borrowed a certain amount of money from another financial institution and pledged securities held on its balance sheet as collateral. With the funding it had borrowed, the hedge fund bought more assets to pledge against further borrowing to expand its proprietary positions. This is how debt and leverage spiraled out of control and created a bubble of debt in the financial sector. Financial sector debt in the U.S. went from about 63% of GDP in 1997 to 113% in 2007. The Bank of England recently published a report claiming that balance sheets of banks in Great Britain rose threefold from 2001 to 2007, and the situation in Iceland was even worse.

Leverage and excess liquidity creation were at the root of the crisis. I will not go into subprime mortgages and the housing markets. That was the preferred channel in this specific speculative game, as opposed to foreign exchange or other markets. In every financial crisis a vulnerable sector - developing countries, governments or households - is pulled into the debt cycle and becomes the group that bears the brunt of the collapse. The instrument involved is the one which that particular sector uses to borrow.

Finally, I would like to talk about the mistakes that brought about this crisis and how they could be avoided in the future. The obvious solution is to regulate the system to moderate leverage and speculation. The challenge is to find remedies that will work and the political will to enforce them. Jose Antonio Ocampo once said he feared the carry trade would go on forever. He thinks that there is nothing to stop it and is rightly concerned about the situation of emerging economies. But, as recent events have made clear, we also have to fear for small developed countries such as Greece.

If there were sufficient political will, there are things that could be done. An important beginning point would be to investigate the crisis from a broad angle, including the Fed in the critique. Some claim the Fed managed the crisis very well. Others strongly disagree to the point of considering the Fed's actions unconscionable. Meanwhile, it is not clear that monetary policy is supporting economic recovery. The Fed readily admits that it has lost control of its policy tool, the federal funds rate, and has discussed replacing it with the interest rate it pays on bank reserves. Their adherence to setting interest rates – clearly an outmoded strategy in a market-based as opposed to a bank-based financial system - reflects the limited vision of current Fed members. They still fail to see that the build-up in liquidity before the crisis could not be managed by a policy tool (interest rates) that, even under the best of circumstances, can only influence the demand for credit; that the housing bubble arose out of the central bank's failure to control the credit supply.

Now this failed policy is draining the flow of liquidity to the economy. Having gotten Congress to agree to pay interest on reserves, the Federal Reserve System is hoarding a trillion dollars of unused bank reserves. These funds will not be injected into the real economy in the near future because creating interest-bearing reserves is one of the ways the Fed now uses to bail out the banking system. It reflects belated and partial recognition of the profound shift away from traditional bank lending to a system in which a substantial share of banks' assets are securities that vary in price daily. Unlike loans that are carried at book value, large changes in the price of securities drain capital and can cause a bank's balance sheet to implode overnight. Thus the major function of these reserves is to protect bank capital. Even though the interest earned on reserves held with the Fed is low, these assets are carried at face value at a time when markets deeply discount the value of banks' other assets. Banks are therefore highly unlikely to use excess reserves to make loans to private borrowers in the near future.

The problem is that now and in the near future, the economy desperately needs credit. I agree with those who point out that credit worthiness has suffered, and that expanding credit for consumption risks creating a new bubble. We do not need to re-invent that old wheel and watch it break again. However, the lack of working capital for small businesses is impeding job creation in the domestic economy and, at the global level, trade credit is sorely needed for the reasons that Jomo Kwame Sundaram and others have talked about today. Indeed, the absence of trade credit was a critical channel for the transmission of this crisis to emerging economies.

Let me finish with a concrete policy suggestion. A question that was raised earlier today was, 'Why isn't the government creating jobs?' In the spirit of my first published study (on the Reconstruction Finance Corporation), I would add: why isn't the government making direct loans? Why do we not revive credit more effectively in the face of this credit crunch? And

why do we continue to provide unproductive support for the oligopoly, the six institutions that now dominate the U.S. financial system? Why do we not let them go?

END NOTES

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