Living Dangerously: Lessons of Recent Global Meltdown

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1. Background

This paper aims at addressing the issues related to the recent financial crisis that has been experienced by the global economy. Finance capital is no longer a nation based qualescence of bank and industrial capital, as defined by Hilferding in 1914. Finance capital now-a-days is based on sucking in finance from all over the globe and investing in all over the globe. This feature of finance capital developed in post Bretton Woods era when the developed economies of the world came under floating exchange rate with convertibility of currency in both current account and capital account in the international Balance of Payment (BOP) of a country.

After the collapse of Bretton Woods order, finance capital was increasingly operating under freely floating exchange rate, mainly in the developed hemisphere of the globe. In the developed capitalist countries, following the introduction of the freely floating exchange rate in the foreign exchange market, all the restrictions on movement of capital were gradually withdrawn. To trace the history, after the collapse of the Bretton Woods order when USA suspended convertibility of dollar against the fixed exchange rate of 35 dollar per one ounce of gold, fixed exchange rate regime was replaced with freely floating exchange rate in international transactions which ultimately led to full capital account convertibility. Removal of all restrictions on movement of capital took place with respect to the US economy in 1974. UK adopted the same practice in 1979. Germany followed suit in 1981 and restrictions on capital movement were removed all over European Union (EU) by 1988. Following this, the economies became open and there developed new features of the global financial order.

With full capital account convertibility of international currencies the nature of investment by the commercial banks went for a sea change. Investments were now being done mainly through multinational organizations. The number of multinational organizations increased to more than 37,000 by early 1990s. With 170,000 affiliates, these organizations, which were chiefly based in 14 major developed countries, were now the chief clients of the commercial banks. Initially, many such investments were of the nature of Foreign Direct Investment (FDI). The stock of FDI reached a level of 2 trillion dollar by 1992. There had been Foreign Portfolio Investments as well. The banks were taking care of both such operations at the international level. Since the requirement of loan capital for the MNC led mega projects had been high, the logical next step was the merger and acquisition of big banks. Again, in the investment market, investing in the financial instruments including the foreign exchanges gradually became a practice of the investment banks. With increasing competition in the money market, thanks to globalization, the commercial banks also started functioning as investment banks as well.

In USA the commercial banks were legally separated from investment banks under GLASS-STEAGALL Act since the days of New Deal of 1930s. This system of financial regulation was introduced as a check to bank run. This eroded in the USA in the post Bretton Woods era largely due to pressure from large bank and their allies in the Fed,

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Treasury, Congress and the White House. Now this has become the order in many of the developed countries. The banking system of these countries now-a-days does not remain regulated by the respective central banks, i.e., there is virtually no Public Regulation. There are now basically two types of regulations. One is Self Regulation. Banks develop their own risk management system. There exists a loose international norm known as BASEL Capital Adequacy Norm. But this has no regulatory power to monitor the functioning of banks. On the basis of BASEL Capital Adequacy Norm, banks now develop their own risk models to estimate how risky their assets are and how much capital they should hold to back these assets. No wonder that banks started working under high leverage which in fact was the main reason for the global meltdown in 2008. The banks of course engage outside agencies (such as Moodys, Standard and Poors, Fitch, etc) for rating the bonds on which they would invest. These agencies are supposed to serve as gate keepers of liquidity. But these agencies usually compete against one another to get business. As a result, they might endorse their clients' design of working under high leverage. This in fact was the *modus operandi* of the US bond rating agencies as the banks were investing in US home loan market which collapsed in 2008. In fact, these agencies were responsible for allowing sub-prime lending by the commercial banks which we will discuss later. The accounting firms also play key role in financial regulation. But the problem with the accounting firms is that they might also suppress the proper information in the balance sheet of the company, as it happened in case of ENRON scandal.

One major consequence of all these was the creation of new instruments in the financial market, such as Hedge Funds, Private Equity Funds, etc. This is called un-regulated Shadow Banking System. In the USA and also in many developed countries these are working under no regulatory system. The system therefore was now suffering from flaws which might turn investments very risky and the risk might be global because the financial system has globalised following removal of restrictions on capital movement. The risk has accelerated in recent years, thanks to the spread of IT based operations. The system became risky also because the importance of FDI in the portfolio of total international transaction had declined sharply during the recent days. Cross border value adding activities mainly through risky investments in purely financial and mostly speculative channels had become the order of the day. Typically these are the operations of the investment banks but, as we have pointed out earlier, there has been a gradual erosion of the regulations and the separation between commercial and investment banking are very thin now-a-days. Moreover, loan business is typically being replaced with investment in marketable securities and bonds. Major emphasis now-a-days is on risky business that might fetch better return for the investor. Since the competition is global, all the investors are now mobilizing funds from all over the globe (through pension fund, mutual fund, etc) and investing them globally in risky businesses which include business on risks with interest rate and exchange rate movements. New instruments known as exchange traded instruments (interest rate futures/ options, currency futures /options, stock market index futures/ options) and over the counter instruments (interest rates swaps, currency and cross currency interest rates swaps) along with other derivative instruments (Caps, Callers, etc) are being developed for finding lucrative investment channels for the pension funds and mutual funds in which the household sector invests out of their individual small savings. As the Third World countries are also opening up for international investment, the investment market for finance capital has increased. It is now a global phenomenon in the true sense of the term. The point that should however be noted is that with globalization of finance capital there has taken place globalization of uncertainty and volatility in the capital market. This is so because the investment through risky instruments has also been globalised.

2. Recent Crisis: Role of US Dollar

Given this background, we shall now discuss the specific features of 2008 financial crisis. This crisis first took place in the USA. We would argue there is a structural problem with the US dollar, the major international currency, which needs to be understood first. To explain this point, a digression to basic economic theory is necessary. With freely floating exchange rate, typically the exchange value of a currency would be determined by the forces of demand and supply of the concerned currency in the international money market. On the demand side of the international currency, the factors that play important role are import requirement, transfer of capital abroad, private remittance to abroad and the factors such as foreign currency required for foreign travel. On the supply side of foreign currency the factors which are important may be noted as export, foreign investment in the country, private remittance from abroad, etc. Under full convertibility of currency the exchange rate of the currency of a particular country might devalue if there is a current account deficit in the international BOP which is not being balanced by capital account surplus i.e., the surplus in the form of net sales of asset, in the form of stocks, bonds, loans, FDI and reserve maintained by the central bank (FED in case of the USA).

For quite a long time USA is maintaining a huge current account deficit in its international BOP. Thus during the accounting year 2007, the year before the recent collapse of international financial market, the current account deficit of the USA had been $ 731200 m, being the highest in the world. This implies that USA was running a huge deficit in its current account that comprises the net BOT and net factor income from abroad plus net unilateral transfer from abroad. The major deficit was in trade account (goods account). In fact, out of $ 731200 m, the BOT deficit in goods account had been as high as $ 697000 m. According to text book economics, this should lead to depreciation or devaluation of dollar unless adequate provision is created in the capital account of the USA. The reality is that dollar remained the strongest international currency in spite of such huge BOT deficit by compelling the other economies to create adequate provision in the current account of the BOP of the USA so that dollar is not devalued.

How could it be possible? We shall argue that USA creates adequate provision in its capital account so that the huge deficit in its BOP is met without depreciating dollar, by utilising the new global financial order to its fullest for sustaining the international price of dollar. The US engineered global arrangement now-a-days is that the confidence on dollar matters much in maintaining the existing global financial order. Every economy including China has a stake in dollar. This has been developed by the USA by designing a policy in which every major economy has gradually been roped in. The economic cost of this policy is the crisis at the local as well as at the global scale. We shall explain this point as we discuss below the economic rationale of the recent crisis in US home loan market that led to recent global meltdown.

From 1999 to end 2006 US financed a stream of large current account deficit by borrowing 4.4 trillion dollar from other currencies which was 85 per cent of the net borrowing worldwide. The USA does not attract much FDI now-a-days. Thus, in 2007, the year before the US economy faced financial crisis at un-precedented level, the amount of current account deficit in goods account was 665 billion dollar. This was not balanced in its capital account by FDI inflow or by its own stock of other currencies earned by export. The amount of FDI that USA attracted on that year was in fact, (-)145 billion dollar and the BOT balance in goods account was (-665) billion dollars. There was no devaluation of the US currency because there was sufficient inflow of dollar in the US economy itself in other items of the current account. *The inflow of dollar that supported the exchange rate of US dollar basically came in the form of net portfolio investment and foreign investment in US treasury bill.* These two taken together had been of the order of 660 billion dollar, which was roughly the same as deficit in goods account in the BOT. This is what happened in 2007. But there are evidences to argue that this is the typical reality of the contemporary US economy. USA is mobilizing huge foreign fund for meeting current account deficit basically under US Treasury Bill account and in the area of short term portfolio investment in order to meet the deficit in BOT.

Had it been such that the inflow of foreign fund was low, the supply curve of international currency for the USA would have shifted towards left and the dollar had to be devalued. It is therefore almost a compulsion for the US economy to maintain steady flow of foreign funds in the US economy. The normal answer to this problem is to increase export. But the economic fundamentals in the US economy are such that it cannot increase the inflow of foreign currency to meet the import bill by increasing the export. The inflow can be maintained in the present day US economy only in two ways: by creating a situation in which people have confidence in the stability of the international price of dollar so much so that they deposit their own trade surplus in US treasury bill; the other way to ensure a steady flow of foreign funds is to create a situation so that the return on investment remains profitable in the USA although it does not have comparative advantage in production of goods in an open economy. The USA utilizes both the strategies by carefully designing a policy that suits its purpose. The major international accounts such as petroleum accounts are maintained in dollar because the countries behind euro or other major currencies do not have the political leverage that the USA has developed in post Second World War period. So long as this remains reality, dollar shall have to remain stable for the sake of the global economy. Every country has thus a stake in dollar which is why dollar price has to remain stable even though it is no longer backed by gold. Every country understands this. Dollar is thus considered as the undepreciable medium of international reserve, as good as gold. The medium, which in effect is a national currency, gives powerful advantage to its treasury bill. Many of the third world countries including China deposit their trade surplus in US Treasury bill. The BOT gap in US international trade is largely met by selling a paper, the US Treasury bill which the USA only can print.

But then, the requirement for dollar for meeting the import bill on goods account is still huge, so much so that the USA also needs a profitable investment channel in its own economy so that the foreign funds find USA as a lucrative area of investment. This drives USA to the compulsion of creating profitable investment channels in the US economy, as in case of other economies of the world. Since the real sector of the economy is not strong in the USA because the economy has gradually concentrated on the service industry (high value products), there is no major opening for FDI in real sector of the economy. Some FDI comes in the service industry of the US. But the major financial investment in the US economy is in the financial market itself which ensures a high return. In fact, return on US based financial instruments remained strong for quite a long time which is why it attracted funds from all over the globe. In the mortgage market the securities were bought by the foreign investors by large quantities which is why the collapse of the US mortgage market severely affected the global financial markets thanks to the withdrawal of public regulations over finance capital in the post Bretton Woods era. Typically this is what happened in 2008 when US home loan market collapsed.

To unfold the story, one should recollect that following IT boom, there was a phase of recession in the economy of the USA which the policy makers tried to address by working out a new area of investment that would fetch capital from all over the globe. The targeted area of investment was the market of real estate for which the FED introduced a low interest rate regime. Given that there is excess demand situation in the housing market, by encouraging investment in the housing sector, the economy was supposed to get a booster because of the forward and backward linkage of this sector which the other areas of real sector of the economy (such as steel, cement, market of housing appliances) that might generate further employment. The expansion of the housing market paved the way for lucrative banking business for which the risk was apparently minimum. The prospective buyer could mortgage the property against which the he would get a loan from the commercial bank that entered in the housing sector in a big way. For the commercial bank the business was without almost any risk because in case of default the property can be attached and credit can be realized. As the FED was pursuing the policy of lowering the interest rate (in fact, the FED rate was cut from 6 per cent to 1.5 per cent between 2001-2003) there was a boom in the market. The housing market was operating under excess demand situation. Consequently, there was capital appreciation in housing market that led to various mortgage based operations in the home loan market. Commercial banks started selling mortgaged assets to investment banks. In fact, in many cases, the commercial banks themselves were functioning as investment banks, thanks to the FED policy of ignoring the provisions under CLASS-STAGELL Act. O continue,the investment banks started selling mortgage based securities to various big investors all over the globe. There also developed speculative activities on the securitized mortgage papers including credit default swap, a business in which the insurance company entered in a big way.

The boom in the housing market lasted for 4-5 years. International equity was flowing in the US home loan market in a big way which actually served the US economy by providing the necessary fund that would be required in the BOP to meet the deficit in the current account. The problem however is that *the system runs well if housing market operates under excess demand situation*. There would be no financial crisis even if the mortgage fails because the property can be attached and resold (at a premium) and the credit can be realized even with a higher return. But the catch is that the demand must go on growing. If there is a recession in demand, immediately the system will fall. The mortgaged property would not be sold and the securities would become junk. In order to preempt such a possibility the banks were almost on a mad rush for roping in the new buyers which actually compelled the system towards netting in the sub prime borrowers. Netting in the sub prime borrowers was possible because the monitoring in the financial market was weak and the rating agencies were competing with each other for pleasing the CEOs of the banks who had been under the compulsion of finding new borrowers so that there is no demand recession. As the sub prime borrowers entered in the mortgage market, the risk on default increased. The risk was being shifted from the commercial banks to investment banks and from there to the insurance companies who would offer CDS to sub prime bonds against high insurance premium. At macro level, this created problem because monitoring was low or absent. Every body was banking on asymmetry in information. Commercial banks would sell sub prime mortgages to investment banks because they do not know the actual worth of the mortgage paper. The investment banks would go on trading with securities the actual worth of which is not known to the national and international investors in the US security market. The ultimate loser in this case could be the insurance companies selling CDS insurances. This is exactly what happened in the system. As the crisis due to excess supply situation in the housing industry mounted up, every body was shifting the risk associated with mortgage papers. The ultimate losers were the companies that insured these papers. In fact, the crisis in US home loan market in 2008 first came in surface when AIG, a leading insurance company failed to pay 1.5 trillion dollars on CDS claims on sub prime bonds.

Why did the housing market face such a crisis? The basic economic reason is that it could not sustain the excess demand situation for a long time. This was due to a structural limitation of the US economy which cannot create enough demand in the market in a normal way. It is true that the USA is a leading economy of the world in terms of the size of the economy as reflected in the GDP of the country. The GDP of the USA was 14.33 trillion dollars which was higher than any of the economies of the world at that time. *But then, the real wage rates remained stagnant in the USA for quite a long time.* According to US Bureau of Labour Statistics, per capita real average weekly earnings in 1982 constant dollar for all private non farm workers had been 302.52 dollar in 1964. It came down to 277.35 dollar in 1981. Since then, with minor fluctuations it remained almost stagnant around 280 dollars a week. The GDP growth rate on the other hand, was good in the recent years. Even in 2007, one year before the crisis set in, the GDP growth rate of USA was 3.2 per cent. The problem was that the growth was not getting translated in increasing the purchasing power of the majority of the US population. Thus, the growth rate of income for the richest 1 per cent of the US citizens was 11 per cent in 2007. The growth rate for the residual 99 per cent was only 0.9 per cent. This is a situation which should lead to under consumption crisis. This in fact was the reality of the US economy. The purchasing power of the average US citizens was stagnating. The USA however needed inflow of capital in order to meet the BOT deficit, the deficit that USA was maintaining in goods account thanks to the policy of maintaining a credit based economy for the consumers whose economic worth was not improving. The quick solution to this problem was to expand the credit based consumption expenditure further, and this time in the home loan market. This model itself is not sustainable. In order to keep the mortgage based instruments profitable (so that they can attract investment from all over the globe), one must go on expanding the market for home loan. First the rich would be the target for credit expansion. This, in fact, is an area of investment with a low risk of default. But for further expansion of the home loan market, the average and below average consumers with low purchasing power were also to be roped in. This segment was bound to default and the default was bound to lead the system to a collapse of credit based operations. The system has no self correcting mechanism. Thus in case of CDS default the US government had to announce a package so that the system could be bailed out.

The lesson of the US crisis is that one should not be allowed to live dangerously in a globalised world. With dollar as the international currency the USA was placed in a comfortable position so much so that it could run an economy in which the fundamentals were not strong. But then, no economy can go on expanding the consumption base with out meeting the problem of under- consumption by addressing the issues in the real sector of the economy, The USA tried to find a solution simply by credit expansion which ultimately led to a situation where the economy is importing goods that it cannot pay. For any other economy, this would have led to a devaluation of its currency and the imbalance would be corrected automatically. The economy will reconcile with lower level of affluence. The USA never exercised this hard option because the political cost of this is very high; it will not remain super power anymore. It maneuvered such a possibility by taking advantage of its currency which remained the leading international currency even in post Bretton Woods era when the international currency market was being governed by the logic of freely floating exchange rate. This was done by maintaining a steady demand for US dollar in the international money market. The economic consequence was that the USA was to create provision for high yield in investment in US money market. Every crisis that the world financial market is facing nowadays is due to this policy of the USA. Since an alternative financial order based on Euro could not be achieved by the EU even though Germany, the strongest economy of the EU is maintaining a steady current account surplus in its BOP for quite a long time, the world had to bail out the dollar. Dollar remained strong although the US economy faced crisis. The crisis had to be shared by other economies because printers of dollars are living dangerously.

World needs a new financial order in order to save the globe from US-led financial shocks the impact of which in the daily life of the people at large is very high.

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