An economy of buccaneers and fantasists

Weapons of mass financial destruction

Last month a major US hedge fund, Amaranth Advisors, lost more than half its assets in a week, speculating on natural gas prices. The company proved correct the chief worry of such major financial institutions as the World Bank and the International Monetary Fund: that financial reality is now out of control.

By Gabriel Kolko

GLOBAL financial structure is far less transparent now than it has ever been. A few decades ago daily payments for foreign exchange transactions were roughly equivalent to the capital stock of a major United States bank; today they exceed the combined capital of the top 100 US banks. Financial adventurers constantly create new products that defy nation states and international banks. This May the International Monetary Fund's (IMF) managing director, Rodrigo de Rato, deplored these new risks, which the weakness of the US dollar and the US's mounting trade deficits have greatly magnified.

His fears reflect the fact that the IMF has been in both structural and intellectual crisis. Structurally, its outstanding credit and loans have declined sharply since 2003, from over $70bn to a little over $20bn, leaving it with far less leverage over the economic policies of developing nations, and a smaller income than its expensive operations require. The IMF admits it has been "quantitatively marginalised" (1). Many of its problems are due to the doubling since 2003 of world prices for all the commodities (oil, copper, silver, zinc, nickel, etc) which are traditionally exported by developing nations. So developing nations have been able to bring forward repayment of their debts, further reducing IMF resources.

Higher prices for raw materials are likely to continue because rapid economic growth in China, India and elsewhere has created burgeoning demand that did not exist before, when the balance of trade systematically favoured rich nations. The US has seen its net foreign asset position fall, whereas Japan, emerging Asia and oil-exporting nations have become far more powerful over the past decade and have become creditors to the US. As US deficits mount, with imports far greater than exports, the value of the dollar has declined, falling by 28% against the euro between 2001 and 2005.

The IMF and World Bank were also severely chastened by the 1997-2000 financial meltdowns in East Asia, Russia and elsewhere. Many of their leaders lost faith in the anarchic premises, inherited from classical laissez-faire economic thought, which had guided their policy advice until then. Intellectually both institutions are now far more defensive and concede that the premises that led to their creation in 1944 are hardly relevant to the way the real world now operates. Our "knowledge of economic growth is extremely incomplete," many in the IMF now admit, and it now needs "more humility". The IMF concedes that the international economy has been transformed dramatically si nce then and, as Stephen Roach of bankers Morgan Stanley has warned, the world "has done little to prepare itself for what could well be the next crisis" (2).

The nature of the global financial system has changed radically in ways that have nothing to do with virtuous national economic policies that follow IMF advice. The investment managers of private equity funds and major banks have displaced national banks and international bodies such as the IMF. In many investment banks, buccaneering traders have taken over from more cautious and traditional bankers and owners. Buying and selling shares, bonds and derivatives now generate higher profits, and taking far greater risks is now the rule among what was once a fairly conservative

branch of finance.

Profits, real or not

Such traders are rewarded on the basis of profits, fictitious or real, and routinely bet with house money. Low interest rates, and banks eager to lend money to hedge funds and firms that arrange mergers and acquisitions, have given such traders and others in the US, Japan and elsewhere, a mandate to play financial games, including making dubious mergers that would once have been deemed foolhardy. In some cases, leveraged recapitalisations allow the traders to pay themselves enormous fees and dividends immediately, by adding to a company's debt burden. What happens later is someone else's problem.

Since the beginning of 2006 investment banks 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 likelihood of defaults among highly leveraged firms — "living dangerously" as the head of Standard & Poor's bank loan ratings section put it. "Observers are predicting a sharp increase in defaults among highly leveraged companies," the Financial Times noted in July (3).

But there are fewer legal clauses to protect investors, so lenders are less likely than ever to compel mismanaged firms to default. Hedge funds, aware that their bets are more and more risky, are making it much more difficult to withdraw the money with which they play. Traders have "reintermediated" themselves between traditional borrowers (national and individual) and markets, further deregulating the world financial structure and making it far more susceptible to crises. They seek to generate high investment returns and take mounting risks to do so.

This March the IMF released Garry J Schinasi's well-documented book Safeguarding Financial Stability (4), giving it unusual prominence. The book is alarming, and reveals and documents the IMF's deep anxieties in disturbing detail. Deregulation and liberalisation, which the IMF and proponents of the Washington consensus (5) have advocated for decades, have become a nightmare: they have created "tremendous private and social benefits" (6) but also hold "the potential for fragility, instability, systemic risk, and adverse economic consequences".

Schinasi concludes 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 IMF advocate a radical new framework to monitor and prevent the problems that are now enabled to emerge, but any success "may have as much to do with good luck" as with policy design and market surveillance. Leaving the future to luck is not at all what economics originally promised.

Even more alarming is a study, also publicised by the IMF and produced at the same time by establishment specialists, analysing the problems that deregulation of the world financial structure has created. The authors believe that deregulation has caused "national financial systems [to] become increasingly vulnerable to increased systemic risk and to a growing number of financial crises" (7). The IMF shares the growing consensus among conservative banking experts that the world financial structure has now become far more precarious.

As the financial meltdown of Argentina in 1998 proved, countries that do not succumb to IMF and banker pressures can play on divisions within the IMF membership to avoid many, though not all, foreign demands. About $140bn in sovereign bonds to private creditors and the IMF were at stake in Argentina, terminating in 2001 with the largest national default in history. Banks in the 1990s had been eager to lend Argentina money and

they ultimately paid for their eagerness.

When prices soared
Since then, however, commodity prices have soared. The growth rate of developing nations in 2004 and 2005 was more than double that of high-income nations. As early as 2003 developing countries were already the source of 37% of the foreign direct investment in other developing nations. China accounts for much of this growth, which means that the IMF and rich bankers of New York, Tokyo and London have far less leverage than before. After the financial crises in the developing world in the late 1990s, bankers resolved that they would be more cautious in the future, yet their current exposure to emerging market stocks and bonds is as great as ever because of far higher yields in Zambia or the Philippines, and excess cash. “The love affair is back on,” said a bank trader (8).

Growing complexity in the world economy 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 an end to the threat of trade wars. The potential for greater instability and danger for the rich now exists in the entire world economy.

The emerging global financial problem is proving inextricably tangled, with a fast-rising US fiscal and trade deficit. Since George Bush took presidential office in the US in 2001 he has added more than $3 trillion to federal borrowing limits, which are now almost $9 trillion. As long as there is a continued devaluation of the US dollar, banks and financiers will seek to guard their money and risky financial adventures will appear worthwhile. This is the context, but Washington had advocated greater financial deregulation long before the dollar weakened.

There are now at least 10,000 hedge funds, of which 8,000 are registered in the Cayman Islands. However, the 400 funds with $1bn or more under management do 80% of the business. They cannot be regulated. They have over $1.5 trillion in assets and the daily global derivatives turnover is almost $6 trillion (equal to half US gross domestic product). With the economic climate euphoric over the past five years, most funds have won, although some have lost. In the year ending this August, nearly 1,900 were created and 575 were liquidated. Standard & Poor would like to rank their credit-worthiness, but has yet to do so: bigger funds claim to use computer models to make trades, and three of the 10 biggest claim they make purely quantitative decisions.

One of the most serious post-1945 financial threats to the global economy, the failure of the Long-Term Capital Management (LTCM) hedge fund in 1998, involved a firm renowned for its mathematical trading techniques devised by two Nobel prize laureates, Myron Scholes and Robert Merton (9). The combined efforts of Washington and Wall Street prevented a disaster with LTCM, but the hedge funds are now much too big to be saved easily.

In effect, hedge funds, which are extremely competitive, gamble and take great chances; they are attracted to credit derivatives (10) and many similar devices invented with the promise of making money. The credit derivative market was almost nonexistent in 2001, grew slowly until 2004 and then went into the stratosphere, reaching $26 trillion this June. Many other financial instruments are now being invented, and markets for credit derivative futures, credit default swaps (11) and binary options are in the offing.

What are credit derivatives? The Financial Times’s chief capital markets writer, Gillian Tett, tried to find out, but failed. The legend goes that around a decade ago some bankers from JP Morgan were in Boca Raton, Florida, drinking and throwing each other into the swimming pool when they came up with the notion of a new financial instrument that was too complex

to be copied easily (since financial ideas cannot be copyrighted) and sure to make them money.

Tett was critical of the potential of credit derivatives for causing a chain reaction of losses which could engulf the hedge funds that have jumped into this market. Bankers have become “ultra-creative in their efforts to slice, dice and redistribute risk, at this time of easy liquidity,” she concluded. The Financial Times has in recent months run a series on financial wizardry which has been frankly sceptical of the means and ends of these innovations (12).

One of the gurus of finance, Avinash Persaud, concluded that low interest rates have 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 is no way that hedge funds, which have become intricate in their arrangements to seek safety, can avoid a reckoning and they will be “forced to sell their most liquid investments”. “I will not bet on that happy outcome,” Gillian Tett concluded in her survey of belated attempts to redeem the hedge funds from their own follies (13).

Warren Buffett, Forbes-listed as the second richest person in the world, has called credit derivatives “financial weapons of mass destruction”. Nominally they are insurance against defaults, but they encourage greater gambles and credit expansion, which are moral hazards. Enron (14) used them extensively; they were a secret of Enron’s success and also of its eventual bankruptcy with $100bn losses. They are not monitored in any real sense, and experts have called them “maddeningly opaque”. Many innovative financial products, according to a finance director, only “exist in cyberspace”, often as tax dodges for the ultra-rich (15).

Banks do not understand the chain of exposure and who owns what: senior financial regulators and bankers now admit this. Hedge funds claim to be honest, but those who guide them are compensated for the profits they make, which means taking risks. There are thousands of hedge funds and many collect inside information. This is technically illegal but it happens anyway.

Growing danger

There is now a consensus that all this has created growing financial dangers. We can put aside the persistence of unbalanced national budgets based on spending increases or tax cuts for the wealthy, and the world’s volatile stock and commodity markets which caused hedge funds to show far lower returns in May 2006 than they have the past year. Hedge funds still make plenty of profit but they are increasingly dangerous.

It is too soon to estimate the ultimate impact of the recent and widely publicised loss by Amaranth Advisors (16) hedge fund of more than $6bn, representing over 60% of its assets, within a single week. Amaranth collaborated closely with Morgan Stanley, Goldman Sachs and other important investment houses, which explains why its losses caused such a stir.

The overall problems are structural, and include the greatly varying ratios between corporate debt loads and 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. They also keep companies from going bankrupt when they should. As long as interest rates have been low, leveraged loans (17) have been the solution. Because of hedge funds and other financial instruments, there is now a market for incompetent and debt-ridden firms. When the Ford Motor Company announced last month that it was losing over $7bn annually, its bonds actually shot up 20%. The rules once associated with capitalism, such as probity and

profit, no longer hold.

The problems inherent in speed and complexity are diverse and can be almost surreal. Credit derivatives are precarious enough, but this May the International Swaps and Derivatives Association revealed that one in every five deals, many of them involving billions of dollars, had major errors. As the volume of trade increased, so did the errors. They doubled after 2004. More than 90% of all deals in the US were not properly recorded, but put down only on paper and often just scraps at that.

In 2004 Alan Greenspan, then chairman of the US Federal Reserve, admitted to being “frankly shocked” by this situation. Efforts to remedy the mess only began this June and are far from resolving a major and accumulated problem involving stupendous sums. More importantly, deregulation and financial innovation have led to forms of crucial data that cannot be collected and quantified, leaving both bankers and governments in the dark about reality. We may or may not live in a new era of finance, but we certainly are flying blindfolded.

On 24 April Stephen Roach, Morgan Stanley’s chief economist, wrote that a major financial crisis seemed imminent and that the global institutions that could forestall it, including the IMF, the World Bank and other mechanisms of the international financial architecture, were utterly inadequate (18). Hong Kong’s chief secretary deplored the hedge funds’ risks and dangers in June, and at the same time the IMF’s iconoclastic chief economist, Raghuram Rajan, warned that funds’ compensation structures encouraged those in charge to take risks, endangering the whole financial system. Soon after Roach was even more pessimistic: “a certain sense of anarchy” dominated academic and political communities “unable to explain the way the new world is working” (19). In its place, mystery prevailed. By last month the IMF predicted that the risk of a severe slowdown in the global economy was greater than at any time since 2001, mainly because of the sharp decline in housing markets in the US and much of western Europe; it also included the decline in US labour’s real income and insufficient consumer purchasing power (20). Even if the current level of prosperity endures through next year, and all these people are proved wrong, the transformation of the global financial system will sooner or later lead to dire results.

Reality is out of control

Reality is out of control. The entire global financial structure is becoming uncontrollable in crucial ways that its nominal leaders never expected, and instability is its hallmark. The scope and operation of international financial markets, their “architecture”, as establishment experts describe it, has evolved haphazardly and its regulation is inefficient — indeed, almost nonexistent (21).

Financial deregulation has produced a monster, and resolving the many problems that have emerged is scarcely possible for those who deplore controls on making money. The Bank for International Settlement’s (BIS) annual report, released in June, discusses these problems and the triumph of predatory economic behaviour and trends “difficult to rationalise”. The sharks have outflanked 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” (22). The BIS does not want its fears to cause panic, and circumstances compel it to remain on the side of those who are not alarmist. But it now concedes that a big crash in the markets is a possibility, and 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. The BIS admits that, for a decade, global economic trends and financial

imbalances have created worsening dangers, and "understanding how we got to where we are is crucial in choosing policies to reduce current risks" (23). The BIS is very worried.

Given such profound and widespread pessimism, vultures from investment houses and banks have begun to position themselves to profit from imminent business distress, a crisis they see as a matter of timing rather than principle. There is now a growing consensus among financial analysts that defaults will increase substantially in the near future. Because there is money to be made in the field, there is now great demand on Wall Street for experts in distressed debt and in restructuring companies in or near bankruptcy.

More about Gabriel Kolko.
Original text in English
* Gabriel Kolko is a historian and author of 'The Age of War' (Lynne Rienner, Boulder, Colorado, 2006) and 'After Socialism: Reconstructing Critical Social Thought' (Routledge, London, 2006)

(1) IMF Survey, New York, 29 May 2006; IMF in Focus, New York, September 2006. (.pdf files) See also : IMF Survey index 2006 page.

(2) Roberto Zagha, "Rethinking Growth", Finance & Development, Washington DC, March 2006; Stephen Roach, Global Economic Forum, Morgan Stanley, New York, 16 June 2006.

(3) Financial Times, London, 17 July and 14 August 2006.

(4) Garry J Schinasi, Safeguarding Financial Stability: Theory and Practice, IMF, New York, 2006. (.pdf file).

(5) The term was coined by the economist John Williamson in 1989 and summarises the recommendations made to states, including tax reductions, free markets, privatisation and financial deregulation. To qualify for IMF loans, governments must implement such measures.

(6) This and following quotes are from Schinasi, op cit.

(7) Kern Alexander, Rahul Dhumale and John Eatwell, Global Governance of Financial Systems: The International Regulation of Systemic Risk, Oxford University Press, 2005.

(8) Financial Times, 27 July 2006.

(9) With assets of only $5bn, LTCM found itself owing some $100bn. The Federal Reserve and Wall Street paid out $3.6bn to prevent the system from collapsing.

(10) As with all derivatives, operators bet on foreseeable risks but in this case it was credit (bonds, debts, etc) that was exchanged.

(11) The seller undertakes, subject to payment of a surcharge, to compensate the customer in the event of a default on payment or simply a deterioration in the quality of its debtors.

(12) Gillian Tett, "The dream machine, invention of credit derivatives", Financial Times Magazine, London, 24-25 March 2006; Financial Times, 10 and 19 July 2006, 14, 24 and 29 August 2006.

(13) Financial Times, 23 and 24-25 June 2006.

(14) See Tom Frank, "Enron: Elvis lives", Le Monde diplomatique, English language edition, February 2002.

(15) Financial Times, 17 July; 31 May; 8 June 2006.

(16) Amaranth, based in Connecticut, incurred huge losses speculating on the price of natural gas. Brian Hunter, the energy trader said to be largely responsible for the gas losses, was later said to have left the company; at the same time, the company's chief executive officer, Nick Maounis, told investors that it planned to get out of energy trading, in which it had previously invested more than half its capital.

(17) With these loans it is possible to buy a company with a very small capital outlay and loans at rates lower than the expected rate of profit.

(18) Global Economic Forum, Morgan Stanley, 24 April 2006.

(19) Ibid, 23 June and 5 September 2006.

(20) Financial Times, 6 September 2006.

(21) Alexander, Dhumale and Eatwell, op cit.

(22) 76th Annual Report, Bank for International Settlements, Basel, 26 June 2006.

(23) Ibid..