A NEW ORDER IN THE FINANCIAL SECTOR

WHAT ARE THE CAUSES OF THE DEBACLE?

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In my first remarks here today I am going to focus on the United States and its role in events over the last 40 years which in my view have led us to this crisis. Events originating elsewhere such as the oil shocks which began in 1973 are not mentioned although they obviously have contributed to the progressive economic and financial destabilization of the West. At the next panel at which I will speak I will instead focus on the international picture including the recent G20 meeting in London.

Also I will not dwell here at length on the details of the current subprime mortgage crisis because I believe that other co-panelists will amply cover this. For those wishing to become more informed in this area I suggest in my printed remarks a number of references to give the political flavor of what happened,[1,2] *the mechanics of how loan deterioration occurred*[3] *and the role of American International Group (AIG) and its Financial Products Division in the downfall caused by credit-default swaps.*[4]

ECONOMIC DESTABILIZATION: A WALKING HISTORY OF THE POST-WAR ERA

There is a single lens through which it is possible to obtain a comprehensive view of what has happened: the progressive economic and financial destabilization of the world since the Second World War, and more particularly events since the 1960s.

In writing history the starting point is always important. We could go back, for example, to the Great Depression of the 1930s to which many compare current events.[5] Or perhaps to the Panic of 1907 which led in America to the formation of the Federal Reserve System and the emergence of individuals such as Alan Greenspan and Ben Bernanke who, although unelected,

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[1] "Bill Clinton, Glass-Steagall and the Current Financial and Mortgage Crisis, Part II" <http://thestrangedeathofliberalamerica.com/bill-clinton-glass-steagall-and-the-current-financial-and-mortgage-crisis-part-two-of-an-indepth-investigative-report.html>

[2] "White House Philosophy Stoked Mortgage Bonfire", New York Times, December 21, 2008.

[3] "Understanding the Subprime Mortgage Crisis", Demyanyk, Yuliya and Van Hemert, Otto, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396>

[4] "The Beautiful Machine", "A Crack in the System" and "Downgrades and Downfall", O'Harrow, Jr., Robert and Dennis, Brady, a series of three articles appearing in the Washington Post, December 29, 30 and 31, 2008.

[5] "A Tale of Two Depressions", Eichengreen, B. and O'Rourke, K. H., 2009, In progress. <http://economistsview.typepad.com/economistsview/2009/04/a-tale-of-two-depressions.html#more>.

often wield more power over our economic destiny than presidents, parliaments or other governing bodies.

Instead I have chosen to start in the era after World War II. It was, after all, a period of considerable economic stability, at least in the United States. True, Britain was in the throes of shedding its empire, and Italy and France experienced considerably economic and political instability in the years after the war. The Iron curtain had also descended over Eastern Europe, but almost everywhere the free world was rebuilding from the devastation including former enemies Germany and Japan. And all were doing so against the backdrop of the Bretton Woods Agreement signed by 44 nations in 1944 which was largely the work of John Maynard Keynes of Britain and Harry Dexter White of the United States.[6] This agreement produced extraordinary stability at least in the area of currency.

The United States had pegged its currency to gold at $35 per ounce, and almost all countries outside the Communist bloc had pegged their currency to the dollar. The $35 per ounce figure had been arbitrarily selected by Franklin Roosevelt in January 1934[7] after having begun to raise gold prices from $20.67 per ounce over breakfast. This action was contrary to the advice of every one of his original advisers. His goal in raising the price of gold to the $35 per ounce level was to counter the effects of a 25% deflation of prices that the U.S. had experienced.[8] While his advisers told him that prices would begin to rise only as recovery took hold, his intuition told him that if he would first raise prices that recovery would follow. Whatever he lacked in formal economic training, his instincts were right--1933 represented the low point of the Depression in America, and gold at $35 per ounce was to be the standard until the Bretton Woods era ended many years later.[9]

The stability that this system produced greatly facilitated commerce through the 1960s when cracks in the system began to appear.[10] In 1933 at $35 an ounce gold was expensive; by the 1960s it was cheap. Mines in the U.S. had begun to close or curtail production as early as the 1950s as the cumulative effects of the inflation since 1933 including the inflation of World War

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[6] "Bretton Woods Agreement", Wiggin, Addison, November 29, 2006 <http://www.dailyreckoning.com.au/bretton-woods-agreement/2006/11/29/>.

[7] "Lords of Finance, The Bankers Who Broke the World", Ahamed, Lioquat, The Penguin Press, 2009, pp. 472-3.

[8] Ibid., p. 438

[9] The "so-called" bank holiday declared one day after Roosevelt's inauguration in March 1933 closed every bank in America and reopened only those found to be sound is also widely cited as a reason recovery began that year. Ibid. pp 451-456.

[10] A contrary view is expressed in "Gold, Dollars and Power, The Politics of International Monetary Relations, 1958-1971", Gavin, Francis J., University of North Carolina Press, 2003. The author notes the Bretton Woods Agreement was "marked by crisis and chaos, intrusive capital controls and nonconvertibility". To this list might be added hastily-arranged IMF loans and devaluation of the currency of member nations which strayed too far from the mark. However, the crises this system produced tended to occur nation-by-nation and did not systemically affect the financial health of the world as the current crisis has done. In short, the crises produced by Bretton Woods were smaller and, in the author's opinion, were the creaks and groans of a system that was fundamentally working by not allowing countries to create ever increasing debt. Its impact on political events within an affected country, as well as the austerity steps taken, were to create growing controversy, particularly after Bretton Woods ended, and older strictures on borrowing were removed.

II became increasingly felt. At the end of the war, the U.S. had at least 60% of the official gold reserves of the world.[11] But effects of a slowing in mine production combined with the needs of a growing world economy and particularly the weight of U.S. dollar commitments abroad were coming to be recognized. See Figure 1 for gold reserves from 1948 to 2006.

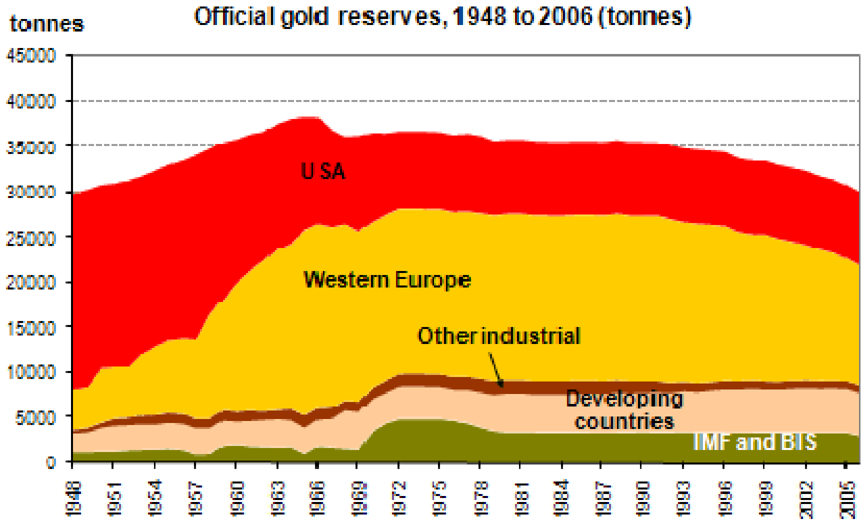

Figure 1 - From the late 1940s forward to about 1972 when Nixon closed the "Gold Window" at the U.S. Treasury, there was a net flow of gold from the U.S.A. to Western Europe as U.S. gold holdings moved from at least 60% of official world reserves to about 20%. After 1972 the relative percentages remained about the same until the 1990s when total official gold reserves began to shrink with most of the shrinkage occurring in European stocks. The amounts held by the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) also rose just before the gold window was closed and has remained relatively constant since 1978. Notice that as the world has prospered since the 1960s that the official world gold reserves have shrunk.

LYNDON JOHNSON AND THE BEGINNING OF SERIOUS FINANCIAL INSTABILITY IN THE UNITED STATES

With gold undervalued at $35 per ounce the inevitable began to happen. Gold outflows began to seriously challenge the ability of the United States to maintain the system. While Johnson, by the end of his administration, had enacted various measures intended to stop the outflow of U.S. gold, these steps were to fail. He also placed the Social Security Trust Fund "on-budget" which had the effect of making the cost of the Vietnam War appear less significant.[12] Thus America's pension system for retirees (although it had never been adequately funded for the long term) became involved with the inflating process even as the pillar of the world's currency system began to falter.

[11] "Gold as a reserve asset-Background and history", <http://www.reserveasset.gold.org/background/>.

[12] "Research Note #20: The Social Security Trust Funds and the Federal Budget", <http://www.ssa.gov/history/BudgetTreatment.html>.

RICHARD NIXON AND THE END OF BRETTON WOODS

On August 15, 1971, President Nixon closed the “gold window” at the United States Treasury which effectively ended the Bretton Woods regime.[13] Gold joined silver--the other monetary metal in America’s original bimetallic currency system--as a commodity actively traded on the futures markets in New York. Indeed, Henry Kissinger traded the first futures contract on gold on the New York Commodity Exchange (COMEX) shortly thereafter. The era of the Modern Futures Market where instruments of finance were to be traded as derivatives on an exchange had begun.[14,15] This was followed shortly by the introduction of futures contracts on currency itself on the Chicago Mercantile Exchange (May 16, 1972) and then futures on interest rate instruments (mid-1970s). This was followed rapidly by a large number of additional futures contracts--and options beginning in the 1980s--to allow commercial firms to hedge and traders to speculate against the increasing riskiness present in the world.[16]

Where once an imbalance in trade was settled in gold by shifting bars of the metal at the New York Federal Reserve Bank, there was now no way to deal with the growing trade disparities except by funding it with debt.[17]

RONALD REAGAN AND NEW THINKING ABOUT FUNDING GOVERNMENT

Armed with the Laffer curve illustrated in Figure 2 and the argument that taxes in the United States were so high that it choked off optimal revenue generation,[18] President Reagan put through a number of significant tax cuts approximating 25% for many Americans in the early 1980s and almost succeeded in putting through a flat income tax rate in 1986.

While the experiment arguably worked in the long run,[19] the immediate result was a great growth in the market for U.S. government debt which had already been at high levels. We were now “driving with the brakes on”, i.e., fiscal policy was fully expansionary with only the

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[13] “Does the End of Bretton Woods Hold Lessons for Today?”, <http://www.smartglobalist.com/archives/current-issue/a-look-back-at-the-end-of-bretton-woods-i >

[14] “Bimetallism”, Encarta Encyclopedia, <http://encarta.msn.com/encyclopedia_761563925/bimetallism.html>

[15] Melamed, Leo, “The Birth and Development of Financial Futures”, Essays and Speeches, <http://www.leomelamed.com/essays/96-china.htm>

[16] The Interbank Market for currency transactions also dates from this period.

[17] Wiggin: “When the gold standard was in force, it was true that the net sum of trade surplus and deficit came out to zero overall, because accounts were eventually settled in gold - and credit was limited as well. In comparison, in today’s fiat money system, it is not gold but credit that determines how much money a country can spend. So instead of economic might being dictated by gold reserves, it is dictated by a country’s borrowing power. The trade deficit and the trade surplus are only ‘in balance’ in theory, because the disparity between the two sides is funded with debt.”

[18] “The Laffer Curve: Past, Present, and Future”, Laffer, Arthur B., <http://www.heritage.org/Research/Taxes/upload/64214_1.pdf>

[19] Although two tax increases were instituted by the first President Bush and later, President Clinton to generate additional income, a budget surplus was achieved in the last 2 years of the Clinton era at tax rates much lower than had once prevailed. Did the Reagan era tax cuts cause this to be possible? The answer is subject to intense partisan debate.

monetary policy of the Federal Reserve left to contain the forces of inflation. There was now seemingly no end of debt.

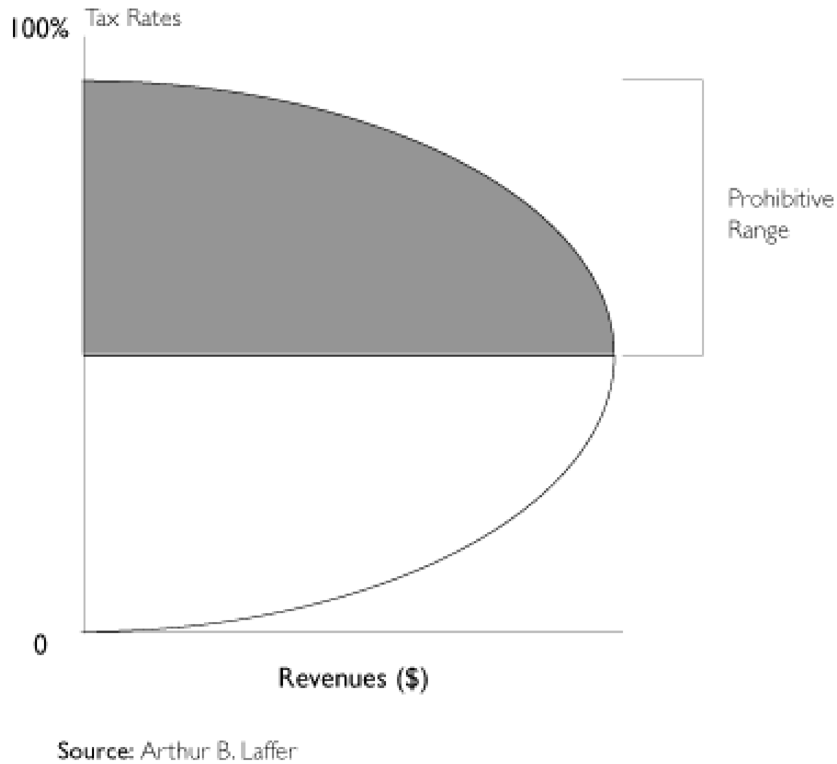

Figure 2 - The Laffer curve depicted above is taken from footnote 18 and shows the familiar parabolic shape exhibiting $0 tax revenues at a tax rate of 0% and $0 tax revenues at 100% tax where it is felt that all motivation to work would vanish. The upper "prohibited range" is where a tax raise would result in less government revenue while the area below this would yield greater tax revenue as tax rates were increased. The curve is shown as symmetric about the bottom line of the prohibited range (at 50% tax rate) while any real Laffer curve would probably exhibit skewness such that peak revenues would occur at something other than a 50% tax rate.

BILL CLINTON AND THE END OF GLASS-STEAGALL

In 1999 the Glass-Steagall Act which had separated commercial and investment banking in the United States since the New Deal was repealed when Clinton signed the Gramm-Leach-Bliley Act.[20] The fear had been that investment banking which is risky by its nature would pull down commercial banking, and that it would cause customers of commercial banks to be pressed into the purchase of securities including those sold by the investment arm of their bank. Within a decade the world was to have a chance to assess the accuracy of that judgment.

Also from the Clinton era is the Commodity Futures Modernization Act of 2000 which marked the end of the beginning for derivatives regulation in the United States[21] banning as it did

[20] See footnote 1.

[21] Public Law (106-554), December 21, 2000.

any attempt by the Commodity Futures Trading Commission to regulate any derivative instruments beyond futures.

GEORGE W. BUSH AND THE CURRENT DILEMMA

Victor in a tragically divided election, George W. Bush came to office believing that lower taxes would result in greater government revenues as an article of faith. It was Laffer redux--without strong evidence that the tax reductions of the Reagan era had not already pushed the tax rate to the lower portion of the Laffer curve where reduced tax rates lower government revenues. In fact, the Bush reductions appear to have done just that as 2003 and 2004 "on-budget" revenue shortfalls produced the greatest government deficits in world history (more than 1/2 trillion dollars each year) and have stubbornly persisted in that area *without counting the "off-budget" war in Iraq*.[22] This was, of course, before the events of 2008/9 where further extraordinary expenditures have been made in the Troubled Asset Relief Program (TARP) program to save the banks and other financial institutions. See Figure 3 for a humorous view of an earlier government intervention in a time of financial crisis, albeit from 1934.

Figure 3 - The cartoonist has captured the sentiments of many Americans both now and then although the names have changed as well as the xenophobia toward communism which was an issue in 1934 when 25% of America was out of work. Communist still exists and a fear of the power of China--not the U.S.S.R.--still exists although it is their economic power and not their military might that impresses us now. Today it is the "poor" nations that lend to the "rich".

But other events quickly followed: the war in Iraq, the decision in 2002 to lower the standards to qualify for subprime mortgage loans[23] with the subsequent huge growth in the subprime

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[22] Source: Congressional Budget Office data

[23] See footnote 2.

mortgage market, the 2004 repeal of the Net Capital Rule for the largest investment banks[24] which permitted debt/equity leverage to grow at failure to over 30-to-1 for Bear Stearns and Lehman Brothers as well as the end of the uptick rule for short selling.[25] So much for control of margining, so much for control on short selling: the great market reforms from the 1929 Crash and the subsequent Great Depression were now largely just history. Figure 4 shows the ratio of bank equity to assets since 1840.[26]

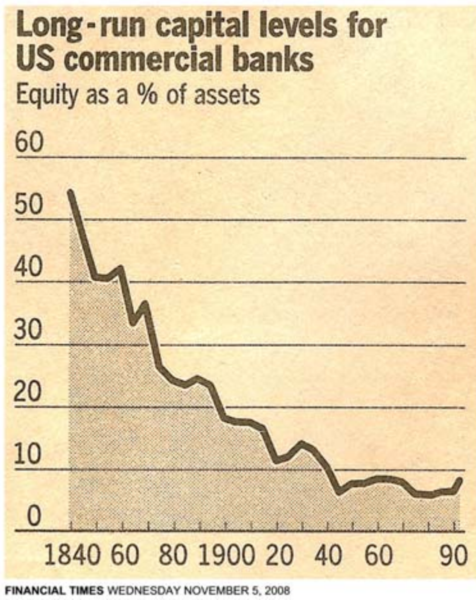

Figure 4 - In 1840 banks lent out only about 2 times their equity while in the more recent period it has ranged from ten to sixteen times (corresponding to 6 to 10 percent on the graph). Bear Stearns and Lehman were at more than 30 to 1 when they failed although they were in a riskier business than commercial banks.

RECAPITULATION

An answer to the questions posed in the program:

Did the crisis result from failed economic and monetary policies? Yes. For a generation these policies have been in direct conflict. As noted, we have been driving with the brakes on for more than 25 years.

Insufficient supervision of the financial sector? Yes. For the past decade, first under Clinton and then under Bush, the regulatory structure which was passed on from the time of the New Deal and its response to the 1929 Crash was systematically dismantled.

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[24] "Agency's '04 Rule Let Banks Pile Up New Debt", Labaton, Stephen, N.Y.Times, Oct. 2, 2008. This article in The New York Times details an action in 2004 of the five members of the Securities and Exchange Commission that led to the current financial meltdown. In approving an exemption favored by the five big investment banks including Goldman Sachs which at the time was led by Henry M. Paulson, Jr. who later became US Treasury Secretary and later headed the US recovery effort, the Commission set the stage for subsequent disaster. The exemption changed the so-called "net capital rule" and allowed the banks to "unshackle billions of dollars held in reserve as a cushion against losses in their investments". It contributed directly to excessive leveraging in mortgage-backed securities and other instruments including credit derivatives which later was responsible for the demise of Bear Stearns and Lehman Brothers, and crippled Merrill Lynch and Morgan Stanley.

[25] Repealed by the SEC on July 6, 2007, this rule had required traders to wait for an uptick in the price of a security before it could be sold short.

[26] Financial Times, November 5, 2008.

Inappropriate regulatory framework? I do not think so. The regulators in the securities market (SEC) and in the derivatives markets (CFTC) just did not, or could not, regulate in the atmosphere that prevailed.

Excessive liberalization of the financial systems and markets? Yes, if by liberalization you mean the removal of regulation.

Did the crises get worse because of the crisis management and decisions by American and European governments? Yes, as to those who managed the American response. The Lehman failure was critical. More than 900,000 derivative transactions in which Lehman was owing to 8,000 counterparties were involved. In retrospect, the rescue effort might have cost far less had Lehman been saved although Federal Reserve Board Chairman Ben Bernanke has insisted there were no options available to prevent its failure. In any case, the termination of Lehman was so disorderly that 10s of billions of dollars were lost that could have been prevented..

Are recently found solutions to save the global financial system appropriate and efficient? They are certainly not efficient but appear appropriate. Unlike in the Great Depression the authorities have assumed the mantle of Central Bankers and supplied amazing amounts of liquidity, albeit by putting all the chips on the table.

And what about the role of the hedge funds? As a founder of a hedge fund and a long-time consultant in the financial industry, they did what you would expect: they tried to make a profit. But because of the absence of meaningful control such as the uptick rule, they helped drive the gods to their knees through short selling: Bear Stearns fell from $85.88 to $2.00 in just 13 trading days before its subsequent buyout by JP Morgan, Lehman fell from more than $15 per share to pennies in a handful of days before it collapsed, Citigroup fell to $0.97 per share before its present recovery, the Bank of America fell to $3.14 per share at its low point, etc.

But these same hedge funds also now stand ready to inject capital into the emerging market for subprime debt just as they did in Latin America in 2001-2.

In summary of all: the current crisis is a predictable result of the volatility that a half century of government policies have produced. If you want to diminish the role of derivatives, you do not need to ban them. Instead, remove the instability and its attendant volatility from the economic and financial system and derivatives will largely retreat from their current prominence.