

FINANCE CAPITALISM LATE 20TH CENTURY STYLE: CONTAINING INTERNATIONAL INSTABILITY. .

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1. Introduction

A truth about financial markets and relations that is especially relevant for our times was stated by Heracultes some 500 years before the beginning of the common era: "You could not step twice into the same river; for other waters are ever flowing on to you." We are now in a crisis of the world's financial structure in which the features of the structure that will rule in a multipolar world are just emerging. One dominant element that will determine the structure of finance in the next era will be the way the financial crises of the international debtors is resolved.

Change is the dominant characteristic of economies. Thus even though the financial crises of the 1980's have features that make them similar to those that occurred earlier, there are differences that matter. Heracultes' remark is an apt guide to understanding the problems that the international financial order now faces.

One anomaly that shows us that history does not repeat is worth pointing out immediately. The crisis for Mexico and the notorious failure of the Penn-Square Bank in

Oklahoma took place at approximately the same time, mid-year in 1982. The two crises led to large losses by United States banks and strong interventions by the Federal Reserve, the Treasury and the deposit insurance organizations to contain the repercussions of these crises. (Cite giordidni Goldman Sachs)

These crises occurred while the United States was in a recession. The result should have been an even worse recession, if not a depression. Instead an expansion, which was still going on as 1987 ended, began in November 1982. The power of appropriate government intervention to affect the course of events has never been better demonstrated than in the second half of 1982. (this paper is an exercise in applying the Financila instability hyppothesis to problems of international economics.

The crises of mid year 1982 marked the end of the Federal Reserve's experiment with practical monetarism and began an era in which crisis containment became the main concern of the Federal Reserve and its cooperating agencies.

The repercussions of the experiment with monetarism have stretched out in time. The "failure" of the Continental Illinois Bank of Chicago in late 1984, which required massive refinancing, was one repercussion of the Penn-Square affair. The Latin American debt problem which surfaced in 1982 has been a major producer of negotiations, refinancings and restructurings over the past five years. It

has led to the the great and not so great American Banks taking major losses.

The combination of a loose fiscal policy and a tight monetary policy that characterized the era of pactical monetarism and which continued even after the Federal Reserve became accomadative led to a combination of portfolio diversification and flight to the dollar that led to a rise in the dollar relative to other currencies that led to an enormous deficit in the United States trade account as well as a "deindustrialization" of the United States.

The experiment with monetarism was a factor in setting up the Latin American debt crisis. The high dollar interest rates that resulted from the 1979 decision to have monetary policy target the money supply led to the floating interest rates on Latin American becoming so high that the exchange earnings were insufficient to pay interest on the outstanding debts of many countries. Furthermore the high United States interest rates as well as the extrapolation of the appreciating dollar was an incentive to capital flight. This situation was exacerbated by the recession of 1980/81 and the incomplete world recovery that followed. Rather than recognizing that either interest rate concessions or a writing down of debts was required, the creditor banks papered over the difficulties by making a large scale capitalization of interest into debt available.

International Ponzi finance was one outcome of the experiment with practical monetarism.

This use of debt to pay interest, rather than for the acquisition of assets that hopefully will be productive, is one of the roots of the continuing debt crisis. The losses that the great mega-banks took in 1987 should by every standard for good banking have been recognized in the early 1980's. By procrastinating the debt problem became worse, not better.

In the colorful language describing the relation between payment commitments on debts and cash receipts that I have used elsewhere, the Latin debtor countries became "Ponzi" financing units as a result of the high interest rates that ruled when the Federal Reserve was fighting inflation with monetarist weapons. In the same terminology the objective of the current negotiations should be to tailor the financial relations among countries so that hedge financing becomes dominant: This may mean that short term international debts need to be restricted to the financing of trade. Furthermore these debt need be so structured that they can be wiped out by surrendering title to well specified assets. (Short term credit needs to become commercial credit.)

One lesson of the recent past is that there must be a way to wipe out debts by transforming debt into ownership interest. This means that sovereign debt has only a limited

place in the liability structure of a country. If sovereign debt is part of the international debt of a country it is vital that the debt be denominated in the home currency. Furthermore to protect themselves, the owners of such debt must look for markets in which they can transform their sovereign debt into asset based debt.

The expansion that began in the United States in November 1982 is peculiar in that it sailed and continues to sail through a wide array of financial market disruptions that may be unprecedented in their size and extent. Furthermore, in spite of the financial disarray in the United States, the expansion has been more vigorous in the States than elsewhere. The reason for this peculiar behavior is that the the Federal Government has been more engaged as a stabilizer and expander of profits and its agencies such as the Federal Reserve have been more involved as a lender of last resort than during earlier periods of financial instability. (Cite Goldman Sachs again)

As is evident from the neglect by the United States of its growing international indebtedness, the United States Government's main aim has been to achieve short term prosperity. Issues of long term stability and growth have largely been ignored. The so called supply side bias in policy during the 1980's has not been effective in raising United States savings and investment ratios.

Government involvement in the United States' economy in the 1980's has taken the form of some very innovative lender of last resort interventions and massive, unprecedented structural deficits. The United States' budget deficit has been a locomotive for prosperity not only in the United States but also in Japan and Europe. It also made the depression in Mexico and in other Latin countries less severe than they would have been if the United States had not been so expansionary.

The United States' global trade deficit beginning in the early 1980's has been large enough to supply the funds required to service third world debts. Unfortunately the trade deficit was not directed to the debtor countries and the surplus countries showed a marked preference for accumulating assets in the United States rather than for consuming domestic and foreign outputs or investing in the poor debtor countries.

A critical innovation in lender of last resort interventions in the period that started in mid 1982 is the overt reliance upon the full faith and credit of the United States to support the financial structure. This is most clear in the current status of the thrifts - the savings banks that historically did not have demand deposit liabilities and which specialized in the financing of housing - and their deposit insurance organization. Not only are many of the thrift institutions bankrupt, but the

"fund" of their insurance organization the Federal Savings and Loan Association is exhausted. The continuing ability of bankrupt institutions to attract deposits depends upon depositors believing that Congress will supply the funds needed to validate their liabilities.

The hope in the case of the bankrupt thrifts is that interest rates on liabilities will fall and asset values will recover so that the nominal financial commitments on their liabilities will be validated. The hope in the restructuring of Latin American debts is that something will turn up that will greatly reduce interest rates, increase exports, induce foreign investment and thereby stimulate economic growth. The thrifts in the United States and the debtor countries are in work out situations, and as most bankers accept, work out arrangements are often devices which enable bankers to realize losses as it suits their business strategy.

Bank failures, financial crises of the debtor countries, the collapse of the oil boom in the States, the farm depression, the collapse of real estate prices, and revealed criminality on Wall Street have taken place over the past five years and have not led to a great depression. A prolonged expansion has been consistent with Financial trauma. The explanation lies in the United States government's involvement as a lender of last resort, which includes the guaranteeing of bank liabilities, and a federal

government fiscal posture that guarantee that the mass of profits denominated in dollars will not collapse.

The late 20th century model of finance capitalism in the United States and the other financing centers is based upon governmental intervention to maintain the nominal value of bank liabilities and aggregate domestic profits. The virus of bankruptcy, and default or restructuring, may affect financial system assets but State power has prevented this from affecting the aggregate nominal value of liabilities.

2. THE ROPESPINNER CONCEIT

I recently read The Ropespinner Conspiracy, a novel by Michael Thomas that deals with the evolution of the financial structure since World War 2. The author posits that the evolution of the financial structure has been such that the economy has become more prone to financial crises and a deep depression. The conceit of the novel is that this evolution could not have been the result of normal profit seeking actions, it had to be the result of some conspiracy to destabilize capitalism. Therefore the author posits that some deep moles well placed in the financial structure have brought this fragility to fruit.

One of the principle moles, Mallory, is the Chief Executive Officer of a leading and innovative New York bank (perhaps modeled on Citicorp) who is often the leading

author of creative restructuring and work out deals. Thomas deals with the nth restructuring of the Mexican debt as follows:

....."Mallory ticked off the terms of the new Mexican credit agreement. The revised agreed debt balance was \$120 billion, including accrued interest. The creditors had agreed to reschedule as follows: half the principal repayments would be deferred for ten years, as would be some portion of interest, which would now run at 12 percent or two points over LIBOR, the London Interbank Offered Rate, the linchpin for pricing international dollar transactions. The IMF would make an additional loan of \$5 billion, half of which would be paid against accrued interest, half of which would be held in escrow against future interest payments.

The Republic of Mexico had agreed to certain concessions Mallory stated. These were: nationwide ceiling on wages; immediate cessation of agricultural subsidies; the unrestricted opening of the Mexican economy to imports and foreign investment; a three year moratorium on land reform and related social programs; a trust fund in which the revenues of the Mexican national oil companies would be sequestered and applied to debt repayments."

.....There were a couple of other pointsthat represented interesting innovative departuresFor one thing, said Mallory, the Mexican Government has agreed to submit its future budgets to this Committee, which has been granted line item veto powers",.... "The other is that, for the first time, the Federal Reserve Board, appreciating the gravity of the situation, has become a party to the agreement." [p. 103 104]

This fictional account parallels what was done to New York city and applies it to Mexico. Creditors consortia taking over a country (or at least its customs) is not an altogether innovative solution; I am sure that historians know many precedents. The fictional solution parallels history in that the architects of the disaster are called upon to resolve the disaster, furthermore these architects profit first from setting up the disaster and then again and again from successive restructurings.

The novel idea in Thomas' fictional restructuring of the Mexican debt is that the Federal Reserve underwrites or endorses the debtor's liabilities to the banks. The fictional solution is to transfer the Mexican liabilities owed to banks to an agency of the United States Government. In this vision of moles using the proliferation of debt as a device to destabilize capitalism, the specter of introducing Yankee Imperialism through the Federal Reserve guaranteeing Mexican debt is a nice stroke.

The conceits of thrillers are one thing, the existing and evolving structures of international finance are another. Nevertheless the spectre of bankruptcy haunts both the debtor countries and their creditors. International supervision, with more effective power than the IMF or the World Bank has exercised, as a surrogate for bankruptcy is one of the possible resolutions to the crisis. This is what the novel's mischief makers achieve.

Even if we reject the great claims for global capitalism that were extant not so long ago when Reaganism was sitting high in the saddle, it is apparent that the capitalist way of organizing production and the creation and control of capital assets is going to be dominant over the next epoch. The use of sovereign credit has not been an effective device for fostering growth in the poorer countries, it has led to a plethora of non-performing capital assets and financial instruments.

The separation of lenders risk from the success or failure of specified capital assets has meant that banker and financier surveillance and responsibility has been attenuated. The international financial structure needs an equivalent to the clearing of debts by the turning over of assets to the creditor. The spate of international financial crises of the recent past shows that the banking world is truly international, and a series of changes will need to take place that makes the financing of accumulation more nearly equivalent in financier risks throughout the world. Furthermore ways need to be developed to finance economic growth in the poorer countries that are not dependent upon a flow of funds from international financial markets.

2. BALANCE SHEET RELATIONS AMONG ECONOMIES

the centrality of cash flows the natural tendency to develop fragile financial structures the need for a non market intervenor to sustain cash flows and to maintain market values. the division between the domestic cash flows and the international. There would be no Mexican debt problem if the offshore holders of peso liabilities were constrained to accept pesos..at most there would be an exchange rate problem, and the losers would have to take their lumps.

International financial relations take the form of liabilities of institutions or individuals in one economy being assets of institutions or individuals in another. In

such relations the question arises of the currency of denomination of loan contracts. Another

3. THE TIERS APPROACH

The balance of payments of a country can be separated into tiers that reflect the sources of payments and receipts.

4. INSTITUTIONS VERSUS MARKETS FOR FINANCIAL LINKAGES.

In financial markets the relations can be between institutions and units or directly among units.

5. Globalization

The main idea under globalization is that the new technology and the vast proliferation of financial assets without a national home, means that the current practice as to instruments available and services rendered in New York, London, and Tokyo will soon if not already be available in markets such as Brazil and Mexico. In particular the menu of assets available for portfolios in the various countries will be similar and the authorities will be essentially powerless to prevent asset diversification by nationals. Globalization therefore means that each country will have to generate instruments that are attractive for non-national portfolios.

The limitations of international portfolio diversification is a question of information; the importance of local and specialized knowledge. Economic autonomy may rest upon the ability to sustain a small holding traditional economy in the midst of a global financial structure.

6. SECURITIZATION

Securitization involves the creation of a marketable and therefore anonymous instrument on the basis of underlying instruments each of which has a very specific information content. (How do you know the land on which you have a mortgage is not 10 feet under water. "Should cite William Janeway's first law. - "Entrepreneurs lie" and Minsky's corollary, "Bankers lie".)

7. LIABILITY MANAGEMENT

The combination of globalization and securitization means that the liability alternatives available to firms and other private borrowers has increased. The possibility of designing liability structures to conform to a units business strategy has increased enormously. Questions as to whether these changes will increase fragility or whether it will increase resilience needs to be addressed. Wallachs piece about resilience needs to be cited.

8 ECONOMIC VS SOVEREIGN RISK

The prior greater acceptance of sovereign risk and a new awareness of the weaknesses of relying on sovereigns. The alternative is a cash flow based financing, with a fallback to the capture of specified assets - collateral. All kinds of legal problems need to be settled before the full international financing market can be in place.

9. HOMOGENIZATION OF PRACTICE.

It is evident that a new stage of the world economy is about to emerge. Computation, communication, and data retrieval make it possible for a pension fund for Japanese workers to hold mortgages on New York commercial property: there is no reason that this type of activity could not be extended to Mexico, except for legal and stability problems.

10. THE MEANING OF BEGGER MY NEIGHBOR AND FISCAL INDEPENDENCE.

11. THE PARASITIC NATURE OF THE GERMAN AND THE JAPANESE PROSPERITY

12. ACCUMULATION FOR THE SAKE OF ACCUMULATION IS IRRATIONAL

6. Conclusion

M.M>Knights book on Santo Domingo.

PORTFOLIO DIVERSIFICATION AMONG THE RICH COUNTRIES
WOULD NOT SET UP A SUBSTANTIAL SET OF FLOWS--