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Editor, *eJournal USA*
IIP/PUBJ
U.S. Department of State
301 4th St. S.W.
Washington, DC 20547
United States of America

E-mail: eJournalUSA@state.gov

About This Issue

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At a meeting in the White House with his economic advisers, President Barack Obama speaks to the press on April 10, 2009.

In hindsight, the bubble in the U.S. housing market, the first indication of what would become a global financial crisis in the fall of 2008, should have been obvious. The prices of houses had risen beyond the salaries of many ordinary Americans, but the availability of new, riskier mortgage products fueled the rush to home ownership. What's more, the inflation in their real estate values had many homeowners feeling wealthy. Historically in the United States, housing prices had always gone up. So what went wrong?

And how did the failure of one sector of the U.S. economy help trigger what many have seen as the greatest worldwide economic crisis since the Great Depression of the 1930s? For this issue of *eJournal USA*, we asked six financial experts to offer their opinions on how the global crisis came about and some of the ways the world will react to this shared problem.

Political scientist Mark Blyth begins by listing six events that had a role in causing the crisis. John Judis, a senior editor with the *New Republic*, then clarifies international currency by examining agreements from the Bretton Woods conference in 1944 to the present-day negotiations among nations.

Charles Geisst, a financial historian, writes that improved computing, 24/7 trading around the globe, and the ease of trading contributed to the problem. "Customers were able to obtain executions for their stock trades with a speed unimaginable in the mid-1990s. The volumes and the appetite for transactions appeared endless." Once asset values began to collapse, the banking and insurance crises occurred within months.

Famed investor George Soros contends that regulation is necessary to limit the growth of asset bubbles. But Soros also warns against going too far: "Regulations should be kept to the minimum necessary to maintain stability." Law professor Joel Trachtman seconds the call for more regulation as well as improved corporate governance. In conclusion, economics professor Richard Vedder describes the history of various international trade agreements and organizations and their role today.

There is no shortage in the world of experts with opinions about the causes of the current crisis and prescriptions for getting out of it, and it's true that a different group of experts might well offer a different set of views from those presented here. What is surprising, perhaps, is how often certain common ideas emerge in these articles: that the nature of markets is cyclical, that global trade relationships are interdependent, and that a modicum of market regulation is a good thing.

— The Editors

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The Global Financial System: Six Experts Look at the Crisis

The End of American Capitalism? Mark Twain, Lake Wobegon, and the Current Crisis

Mark Blyth

President Barack Obama speaks at the G-20 Summit in London, April 2, 2009.

While the type of financial crisis we face today is unprecedented, crises of capitalism are not. They are commonplace.

Mark Blyth is professor of international political economy at Brown University. He is the author of Great Transformations: Economic Ideas and Political Change in the Twentieth Century.

If you draw what statisticians call a time series of the returns to the U.S. banking sector from 1947 to 2008, it is possible to talk with some confidence about the average rate of profitability of the sector over time, the peaks (1990s to mid-2000s), the troughs (1947 to 1967), and the sharp growth of the sector's profitability over the past 10 years. If you then add in the data for the period between August 2008 and April 2009, the entire series, like the banking system it describes, simply blows up. Averages, means, variances, and the like dissolve, so extreme have been recent events. Indeed, when the former chairman of the U.S. Federal Reserve Bank, Alan Greenspan, admits that his understanding of market processes was deeply flawed, and when the current chairman, Ben Bernanke, says that we face the greatest

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Federal Reserve Chairman Ben Bernanke testifies before the U.S. Congress.

crisis since the Great Depression, we should probably take it seriously.

And serious it is. With a grossly diminished $1.3 trillion in assets and as much as $3.6 trillion in liabilities, coupled with a halving of the stock market, the U.S. financial system is either severely stressed, insolvent, or, worse still according to some, at the end of its tether. The end of capitalism has been declared many times before. And yet, to paraphrase American writer and humorist Mark Twain, reports of its death have been greatly exaggerated.

The U.S. capitalism that will emerge from this crisis will be different from the highly financialized consumption-driven and trade-imbalanced version that we developed over the past two decades. It already has changed insofar as Wall Street proper no longer exists. But what people tend to forget is that we have been here before. While the type of crisis we face today is unprecedented, crises of capitalism are not: They are commonplace. It's just that this one has hit the United States rather than another region of the world. But we have been here before and have survived, mainly because the present is not a copy of the past. Remembering this tempers the expectation that U.S. capitalism has run its course.

The Lake Wobegon Problem (where everyone is above average)

While there are surely many plausible candidates — ranging from the bonus culture of banks to Chinese savings and German parsimony — to blame for the crisis, focusing on the immediate present may mask a deeper set of causes. Putting this crisis in proper perspective requires that we begin almost 30 years ago with the unexpected marriage of unlimited liquidity and limited asset classes. Six processes came together to get us where we are today.

First, beginning in the 1980s, the world's major financial centers deregulated their domestic credit markets and opened up their financial accounts. This "globalization of finance" resulted in a spectacular growth in available liquidity as previously isolated markets became intertwined. Second, this liquidity was given a huge boost with the growth of new financial instruments, particularly techniques of securitization and the increasing use of credit derivatives. Third, given this growth of global liquidity, long- and short-term interest rates began to fall precipitously. In 1991 the U.S. prime and federal funds rates (and thus global interest rates) began their long decline out of double figures to historic lows.

Fourth, given these changes, the commercial banking sectors of these now finance-driven economies became increasingly concentrated. Available bank credit skyrocketed at the same time as the privatization of former state responsibilities, especially in pensions, encouraged the growth of large non-bank institutional investors, all seeking "above-average" returns since their jobs depended upon beating some benchmark average, usually the annual return of the Standard & Poor's 500 or an index of their sector's performance.

Fifth, the U.S. current account deficit climbed to historically unprecedented proportions of the gross domestic product. The United States was effectively borrowing between 3 and 6 percent of GDP each year for more than 20 years, and borrowing at such low interest rates seemed to make money free given the growth rates that we grew accustomed to.

Sixth, and perhaps what facilitated all of the above, was a deep seated ideological change that took place in the United States between 1970 and 2000. Namely, markets came to be seen by politicians, pundits, and the public as self-regulating wonders that could produce ever higher risk-free returns if only the state's blundering and inefficient regulations could be swept away, which they were by obliging politicians of both parties. Add all this together and you have a financial sector that is both dependent on continually finding above-average returns at the same time as it becomes an increasingly large and important part of U.S. gross domestic product.

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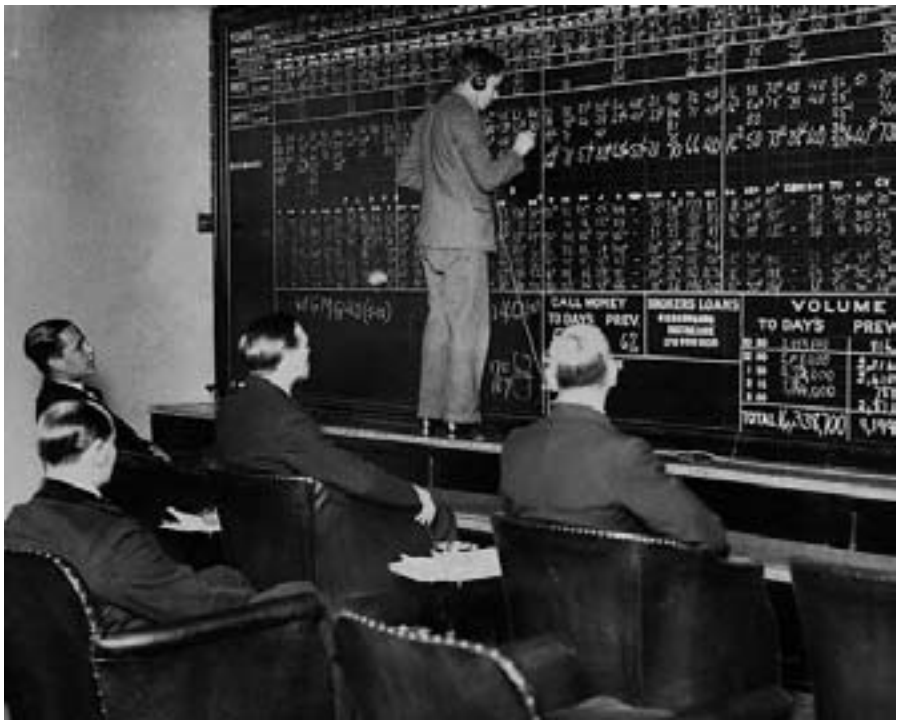
Container ships with imports from Asian countries are unloaded at New Jersey docks.

The Limits of Lake Wobegon

The problem with chasing a moving average is that it continually gets bid upwards. Here we run into a problem of asset classes: the limited number of categories of assets from which investors can seek above-average returns. There are only a few such classes around: equities (stock), cash (money market), and fixed income (bonds), to which one can add real estate and commodities. If equities, bonds, and money market instruments are regarded as reciprocal investments within a class, then stock markets, relatively underpriced in the early 1990s, became the obvious place to go for such returns. The massive volume of liquidity in its search for above-average returns first flooded U.S. equity markets and quickly thereafter hit global stock markets during the middle to late 1990s.

Once that particular bubble burst, most spectacularly in East Asia, neither bonds nor fixed income alone would provide the above-average returns that the markets — and all of us who depended on them — now expected. The next stop for investors was therefore the ill-fated dot-com bubble, and thereafter the next most obvious asset class, real estate — hence, the global housing boom, which began just as the dot-com bubble popped in the late 1990s. By 2008 this housing bubble had run out of (good) borrowers, in part owing to Federal Reserve Chairman Greenspan's raising of interest rates in the mid-2000s. The result of looking for a new return was that the remaining class of assets, commodities, became the next bubble, with oil quadrupling in price and basic foodstuffs rising between 40 and 70 percent in a little over a year. However, with the exception of oil, these were small markets, too small to sustain such volumes of liquidity, and these bubbles burst quickly. The commodity market collapse combined with losses in the subprime sector of the mortgage derivatives market triggered the current crisis.

Although it is referred to as the "subprime crisis," it is perhaps better described as a subprime trigger for a systemic crisis caused when all these factors came together through financial actors' risk management practices. While



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On Black Friday in 1929, investors watch the chalkboard as stock values plummet.

banks and other financial firms have sophisticated models for managing their various risks (credit, liquidity, and the like), those same technologies can create instabilities in markets by either blinding their users to tail risks, which causes a channeling of risk into common portfolios across asset classes as everyone hedges the same way, or by linking assets together in a search for liquidity as positions are unwound as banks de-leverage. So what is rational for one bank can create systemic risk for all banks as asset positions become serially correlated on the upside and the downside of the bubble.

Once the entire banking system had loaded up on mortgage derivatives and credit default swaps, the crisis was just waiting to happen. It came when losses at several major U.S. banks triggered the fall of Lehman Brothers, which in turn caused massive losses in systemically linked markets, particularly the massive credit default swaps market. Liquidity dried up, and the crisis had begun. How it unfolds from here is really anyone's guess, but does this mark the end of American capitalism? There are several reasons to think that this is not the case, and that Mark Twain's injunction still stands.

Mark Twain and Three Reasons to Be Hopeful

It is worth noting that while Federal Reserve Chairman Bernanke said that we faced the greatest crisis since the Great Depression, he did not say that we face a crisis as big as the Great Depression. Twenty to 40 percent unemployment, a collapse of world trade, ruinous competitive currency devaluations, absurd tariff levels, and the collapse of democracy were the reality of the Great Depression across the world. We face challenging times in the current crisis, and there is always the possibility that things could get much worse, but things are nowhere near this severe. This gives me reason for optimism regarding Twain's observation, mainly because there is a huge difference between the world of the 1930s and the world that we live in today. Time's arrow means that we always "live it forward," such that the conditions of the present are never the same as the conditions of the past. Three of those conditions that pertain today and that are different from those of the 1930s give us the opportunity to avoid the mistakes of the past.

The first lesson learned is that lessons can be learned. We are not doomed to repeat the 1930s precisely because we can reflect upon how bad the 1930s were and how actions taken to protect ourselves individually in this period made us all worse off collectively. Those lessons learned made states across the world build automatic stabilizers into their economies in order to stave off collapses in consumption that would lead to protectionist and nationalist demands in the event of an external crisis, and to rely on multilateral cooperation to forestall obvious policy errors. One can legitimately argue that different countries learn different lessons. Hence, the Germans are worried about the inflationary consequences of the spending the Americans want the Europeans to undertake to avoid the unemployment that the Americans fear. But the point of meetings such as the G-20 is to air those differences and find room for policy agreements. The question is one of balance between stimulus and regulation, and both sides of the Atlantic know that they

need to find common ground to move forward.

My second reason for optimism derives from the new MAD. During the Cold War, we spoke of "mutually assured destruction," in which the United States and the Soviet Union had so many nuclear weapons that one side could not destroy the other without destroying itself. Swap "mutually" for "monetarily" and you get the new MAD — "monetarily assured destruction" — which exists between China and the United States. One consequence of the financialization of the U.S. economy was that we managed to get China to swap real goods for paper, and a terrible rate of return on holding the paper, for more than 20 years, in the course of which the Chinese (and other East Asian economies) built up astonishingly large trade and current account surpluses. Essentially, without anyone ever making such a wager formally, the United States made a one-way bet that we could run our economy on finance in a global division of labor in which China made the goods in return for dollars that would be lent back to us so we could consume their products. That system has also come to an end. China needs to consume more and the United States needs to produce something besides mortgage derivatives, and both sides know this. Getting there will be painful, but the alternative, monetarily assured destruction, where the dollar is dumped and the exchanges collapse, is another individually rational and collectively disastrous policy that all parties know, this time around, to avoid.

Third, another ideology has failed. The belief that markets are uniquely good and self-regulating entities, while states are always and everywhere bad and overregulating monstrosities, is a recurring nightmare in the history of capitalism. The 1930s taught us that this belief in markets and self-regulation was fallacious and gave us the Keynesian era of regulated finance and welfare states. The 1970s, the other crisis period of the 20th century, taught us that Keynes was wrong and that open markets and unregulated finance were the way to go. That system, what might be called neoliberal globalization, was the system that just blew up. So what will be the lesson learned this time?

The lesson still to be fully learned from this crisis is that markets and states are always and everywhere mutually overlapping, constitutive, antagonistic, and generative. Capitalism as a system thrives best in an environment of prudential regulation provided by states, and U.S. capitalism is no different. The precise balance between state and market is a political question to be decided by different states. But that there needs to be a balance is something that most states, even the United States, now accept.

So Mark Twain's injunction stands. Reports of the death of U.S. capitalism are exaggerated and will likely remain so as long as we are willing to learn that lessons from the past can indeed be learned. ■

The opinions expressed in this article do not necessarily reflect the views or policies of the U.S. government.

Debt Man Walking

John B. Judis

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In 1944, the United Nations Monetary and Financial Conference at Bretton Woods, New Hampshire, decided that the dollar would replace the British pound as the accepted global currency.

Economists know the fatal flaw in our international monetary system — but they can't agree on how to fix it.

John B. Judis is a senior editor at the New Republic *and a visiting fellow at the Carnegie Endowment for International Peace.*

The past few months have been a crash course in the abstract and obscure instruments and arrangements that have derailed the world's economy. From mortgage-backed securities to credit default swaps, the international monetary system is in big trouble.

For decades, the United States has relied on a tortuous financial arrangement that knits together its economy with those of China and Japan. This informal system has allowed Asian countries to run huge export surpluses with the United States, while permitting the United States to run huge budget deficits without having to raise interest rates or taxes, and to run huge trade deficits without abruptly depreciating its currency. Quite a few bankers, international economists, and high officials such as U.S. Federal Reserve Chairman Ben Bernanke think this informal system contributed to today's financial crisis. Worse, they fear that its breakdown could turn the looming downturn into something resembling the global depression of the 1930s.

The original Bretton Woods system dates from a conference at a New Hampshire resort hotel in July 1944. Leading British and American economists blamed the

Great Depression and, to some extent, World War II on the breakup of the international monetary system in the early 1930s, and they were determined to create a more stable arrangement in which the dollar would replace the British pound as the accepted global currency.

The dollar became the accepted medium of international exchange and a universal reserve currency. If countries accumulated more dollars than they could possibly use, they could always exchange them with the United States for gold. But with the United States consistently running a large trade surplus — meaning that countries always needed to have dollars on hand to buy American goods — there was initially little danger of a run on the U.S. gold depository.

Bretton Woods began to totter during the Vietnam War, when the United States was sending billions of dollars abroad to finance the war and running a trade deficit, while deficit spending at home sparked inflation in an overheated economy. Countries began trying to swap overvalued dollars for deutschmarks, and France and Britain prepared to cash in their excess dollars at Fort Knox (the United States' gold depository). In response, President Richard Nixon first closed the gold window and then demanded that Western Europe and Japan agree to new exchange rates whereby the dollar would be worth less gold, and the yen and the deutschmark would be worth more, relative to the dollar. That would make U.S. exports cheaper and Japanese and West German imports more expensive, easing the trade imbalance and stabilizing the dollar.

By imposing a temporary tariff, Nixon succeeded in forcing these countries to revalue, but not in creating a new system of stable exchange rates. Instead, the values of the currencies began to fluctuate. And as inflation soared in the late 1970s, the system, which still relied on the dollar as the universal currency, seemed ready to explode into feuding currencies.

Bretton Woods II

That's when a new monetary arrangement began to emerge. Economists often refer to it as "Bretton Woods II," but it was not the result of a conference or concerted agreement among the world's major economic powers. Instead, it evolved out of a set of individual decisions — first by the United States, Japan, and Saudi Arabia, and later by the United States and other Asian countries, notably China.

Bretton Woods II took shape during President Ronald Reagan's first term. To combat inflation, Paul Volcker, then the chairman of the Federal Reserve, jacked interest rates above 20 percent. That precipitated a steep recession — unemployment exceeded 10 percent in the fall of 1982 — and large budget deficits as government expenditures grew faster than tax revenues. The value of the dollar also rose as other countries took advantage of high U.S. interest rates. That jeopardized U.S. exports, and the U.S. trade deficit grew even larger as Americans began importing underpriced goods from abroad while foreigners shied away from newly expensive U.S. products. The Reagan administration faced a no-win situation: Try reducing the trade deficit by reducing the budget deficit, and you'd stifle growth; but try stimulating the economy by increasing the deficit, and you'd have to keep interest rates high in order to sell an adequate amount of Treasury debt, which would also stifle growth. At that point, Japan, along with Saudi Arabia and other OPEC (Organization of Petroleum Exporting Countries) nations, came to the rescue.

At the end of World War II, Japan had adopted a strategy of economic growth that sacrificed domestic consumption in order to accumulate surpluses that it could invest in export industries — initially labor-intensive industries such as textiles, but later capital-intensive industries such as automobiles and steel. This export-led approach was helped in the 1960s by an undervalued yen, but, after the collapse of Bretton Woods, Japan was threatened by a cheaper dollar. To keep exports high, Japan intentionally held down the yen's value by carefully controlling the disposition of the dollars it reaped from its trade surplus with the United States. Instead of using these to purchase goods or to invest in the Japanese economy or to exchange for yen, it began to recycle them back to the United States by purchasing companies, real estate, and, above all, Treasury debt.

That investment in Treasury bills, bonds, and notes — coupled with similar purchases by the Saudis and other oil producers, who needed to park their petrodollars somewhere — freed the United States from its economic quandary. With Japan's purchases, the United States would not have to keep interest rates high in order to attract buyers to Treasury securities, and it wouldn't have to raise taxes in order to reduce the deficit. As far as historians know, Japanese and American leaders never explicitly agreed that Tokyo would finance the U.S. deficit or that Washington would allow Japan to maintain an

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At a U.S. Senate hearing in 1945, foreign currency is displayed.

undervalued yen and a large trade surplus. But the informal bargain — described brilliantly in R. Taggart Murphy's *The Weight of the Yen* — became the cornerstone of a new international economic arrangement.

Over the last 20 years, the basic structure of Bretton Woods II has endured, but new players have entered the game. As *Financial Times* columnist Martin Wolf recounts in his book *Fixing Global Finance*, Asian countries, led by China, adopted a version of Japan's strategy for export-led growth in the mid-1990s after the financial crises that wracked the continent. They maintained trade surpluses with the United States. And instead of exchanging their dollars for their own currencies or investing them internally, they, like the Japanese, recycled them into Treasury bills and other dollar-denominated assets. This kept the value of their currencies low in relation to the dollar and perpetuated the trade surplus by which they acquired the dollars in the first place. By June 2008, China held more than $500 billion in U.S. Treasury debt, second only to Japan. East Asia's central banks had become the post-Bretton Woods equivalent of Fort Knox.

Upsides and Downsides

Until recently, there have been clear upsides to this bargain for the United States: the avoidance of tax increases, growing wealth at the top of the income ladder, and preservation of the dollar as the international currency. Without Bretton Woods II, it is difficult to imagine the United States being able to wage wars in Iraq and Afghanistan while simultaneously cutting taxes. For their part, China and other Asian countries enjoyed almost a decade free of financial crises. And the world economy benefited from low transaction costs and relative price stability from having a single currency that countries could use to buy and sell goods.

But there have been downsides to Bretton Woods II. A nation could conceivably blackmail the United States by threatening to cash in its dollars. Of course, if a nation such as China actually began to unload its dollars, it would jeopardize its own financial standing as much as it would jeopardize America's. But economists Brad Setser and Nouriel Roubini argue that even the implicit threat of dumping dollars — or of ceasing to purchase them — could limit U.S. maneuverability abroad. "The ability to send a 'sell' order that roils markets may not give China a veto over U.S. foreign policy, but it surely does increase the cost of any U.S. policy that China opposes," they write.

In Japan, China, and other Asian countries, there has also been a downside to the grand bargain. The surplus dollars gained from trade with the United States have not been used to raise the standard of living, but rather have been squirreled away in Treasury securities. Writes Martin Wolf: "China has about 800 million poor people, yet the country now consumes less than half of GDP [gross domestic product] and exports capital to the rest of the world."

Of more immediate concern, Bretton Woods II contributed to the current financial crisis by facilitating the low interest rates that fueled the housing bubble. Here's how it happened: In 2001, the United States suffered a mild recession largely as a result of overcapacity in the telecom and computer industries. The recession would have been much more severe, but, because foreigners were willing to buy Treasury debt, the Bush administration was able to cut taxes and increase spending even as the Federal Reserve lowered interest rates to 1 percent. The economy barely recovered over the next four years. Businesses, still worried about overcapacity, remained reluctant to invest. Instead, they paid down debt, purchased their own stock, and held cash. Banks and other financial institutions, wary of the stock market since

the dot-com bubble burst, invested in mortgage-backed securities and other derivatives.

The anemic economic recovery was driven by growth in consumer spending. Real wages actually fell, but consumers increasingly went into debt, spending more than they earned. Encouraged by low interest rates — along with the new subprime deals — consumers bought houses, driving up their prices. The "wealth effect" created by these housing purchases further sustained consumer demand and led to a housing bubble. When housing prices began to fall, the bubble burst, and consumer demand and corporate investment ground to a halt. The financial panic quickly spread not only from mortgage-backed securities to other kinds of derivatives, but also from the United States to other countries, chiefly in Europe, that had purchased these American financial products.

And that's not all. As American demand for Chinese exports has stopped growing, China's economy has begun to suffer. China would experience the equivalent of a recession, with repercussions throughout Asia. More importantly for the United States, China would no longer have the surplus dollars to prop up the market for U.S. Treasury bills.

Needed Adjustments

The consequences could be even more dire. In the past, countries in recession could count on countries with growing economies to provide outlets for their exports and investments. The hope this time is that economic growth in Asia, and particularly in China, can backstop a U.S. and European recession. China depends on exports to the United States, and the United States depends on capital from China. If that special economic relationship breaks down, as it seems to be doing, it could lead to a global recession that could morph into the first depression since the 1930s.

Policy makers have to recognize that while Bretton Woods II is not the product of an international agreement, it is not a "free-market" system that relies on floating currencies, either. Rather, it is sustained by specific national policies. The United States has acquiesced in large trade deficits — and their effect on the U.S. workforce — in exchange for foreign funding of our budget deficits. And Asia has accepted a lower standard of living in exchange for export-led growth and a lower risk of currency crises.

China, Japan, and other Asian countries — either on their own or with prodding from the Obama administration — will also have to play a part. Indeed, China may have already begun to do so by announcing last fall a $586 billion stimulus plan of public investment in housing, transportation, and infrastructure. If China plows its trade surplus back into its domestic economy, it will increase demand for imports and put upward pressure on the yuan, reducing China's trade surplus with the West.

This kind of adjustment — in which the United States commits itself to reducing its trade deficit, and China, Japan, and other Asian countries move away from their strategy of export-led growth — is what many American policy makers favor. But there is also growing sentiment, particularly in Europe, that beyond these measures, the world's leading economies have to agree on a new international monetary system — or at least dramatically reform the existing one. British Prime Minister Gordon Brown has explicitly called for a "new Bretton Woods — building a new international financial architecture for the years ahead." Brown would strengthen the International Monetary Fund so it functions as "an early warning system and a crisis prevention mechanism for the whole world." He would also have it or a new organization monitor cross-border financial transactions.

But adjustments to the dollar's role are certainly needed. The era of the dollar may not be over, but the special conditions under which it reigned during the last decades are being dashed on the rocks of the current recession and financial crisis. The original Bretton Woods was the product of deliberate agreement and laid the basis for stable growth. A new Bretton Woods agreement will depend a good deal on the choices of the international community. ■

Globalization and the U.S. Financial System

Charles R. Geisst

Speed-of-light technology makes international investing effortless.

Globalization helped fuel the current financial crisis, and it will undoubtedly be employed to help resolve it.

Charles R. Geisst is professor of finance at Manhattan College. His many books include Wall Street*:* A History*, and he is the editor of the* Encyclopedia of American Business History.

In the decades following World War II, the idea of globalization became more and more popular when describing the future of the world economy. Some day, markets for all sorts of goods and services would become integrated and the benefits would be clear. The standard of living would be raised everywhere as barriers to trade, production, and capital fell. The goal was noteworthy and has been partially realized. But recently it hit a major bump in the road.

Globalization has many connotations. Originally, it meant international ease of access. Barriers to trade and investment eventually would disappear, and the international flow of goods and services would increase. Free trade and common markets were created to facilitate the idea. A world without barriers would help distribute wealth more evenly from the wealthy to the poor.

To date, only financial services have succeeded in becoming truly global. Fast-moving financial markets, aided by speed-of-light technology, have swept away national boundaries in many cases, making international investing effortless. Government restrictions have been removed in most of the major financial centers, and foreigners have been encouraged to invest. This has opened a wide panorama of investment possibilities.

This phenomenon is not new. Since World War II, many governments have loosened restrictions on their currencies, and today the foreign exchange market is the world's largest, most liquid financial market, trading around the clock. And there is no distinction made in it because of those national peculiarities or restrictions for

the major currencies. If governments allow their currencies to trade freely, as most in developed countries, then a dollar or a euro can trade in Hong Kong or Tokyo as easily as it does in Dubai or New York.

Cross-Border Trading

Other financial markets quickly followed this precedent. The government bond markets, corporate bond markets, and the equities markets all started to develop links based on new and faster technology. Forty years ago, Gordon Moore, one of the founders of software giant Intel, made his famous prediction (Moore's Law) that microchip capacity would double every two years. New, faster chips were able to accommodate an increasing number of financial transactions, and before long that capacity spawned even more transactions. Soon, traders were able to cross markets and national boundaries with an ease that made the supporters of globalization in other sections of the economy jealous. During the same time period, manufacturers had been promoting the idea of the universal car, without the same level of success.

Wall Street and the other major financial centers prospered. Customers were able to obtain executions for their stock trades with a speed unimaginable in the mid-1990s. The NYSE (New York Stock Exchange) and the NASDAQ (National Association of Securities Dealers Automated Quotations) abandoned their old method of quoting stock prices in fractions and adopted the decimal system. Computers did not like fractions, nor did the old method encourage trading at the speed of light. Customers were now able to trade via computer in many major markets as quickly as in their own home markets. True cross-border trading was born, making financial services the envy of other industries that long had dreamed of globalization.

The results were astonishing. Volume on the NYSE increased from a record 2 billion shares in 2001 to a record 8 billion in 2008. Volume on the foreign exchange markets was in the trillion-dollar equivalents on a daily basis. The various bond markets were issuing more than a trillion worth of new issues annually rather than the billions recorded in previous record years. The value of mergers and acquisitions equally ran into the trillions annually. The volumes and the appetite for transactions appeared endless.

A Traditional Cycle

The U.S. economy traditionally had witnessed long periods of prosperity before slowing down substantially, usually brought to a temporary halt by an asset bubble that finally ran out of hot air. The situation had been replayed many times since 1793, when the first major economic downturn was recorded in New York. Similar problems were recorded at least eight times until 1929. Each boom was followed by a bust, some more severe than others. The post-1929 depression finally ushered in far-reaching reforms of the banking system and securities markets.

Until 1929, these recessions were called "panics." The term "depression" was used once or twice in the early 20th century, but during the 1930s the term became associated exclusively with that decade. The traditional cycle is still in evidence. The recession of 2001 followed the dot-com bust, and many of the day traders who had employed the new computer technology retreated to the sidelines much as their forebears had done in the 19th century. A recession followed, temporarily slowing down the appetite for speculative gains.

The 19th and the 21st centuries had more in common than might have been imagined. After gaining its independence from Britain, the United States had been dependent on foreign capital for the first 120 years of its existence. Until World War I, much of the American infrastructure and industry had been financed with foreign money, mostly in the form of bonds. Americans produced most of the goods and services they needed, but capital was always in short supply until the war changed the face of geopolitics.

The situation remained unchanged until the late 1970s, when the position again was reversed. The U.S. household savings ratio declined and foreign capital poured into the country. Bonds were the favorite again, but the equities markets also benefitted substantially. Consumers, accounting for about two-thirds of the U.S. gross domestic product since the 1920s, bought domestic and foreign goods, while foreigners supplied the capital necessary to finance the federal government and many American industries. The situation persists today, with about half the outstanding U.S. Treasury bonds in the hands of the Chinese government alone.

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The housing boom in the Silicon Valley, California, before the dot-com asset bubble presaged the mortgage crisis of 2008.

The Mortgage Boom

After the dot-com bust and the Enron and WorldCom scandals, it appeared that Wall Street was due to take a breather for lack of new ideas to fuel another bubble. But it was a combination of cyclical trends that reappeared and together fueled the greatest short-term boom yet. Globalization, an influx of foreign capital, and esoteric financial analytics combined with residential housing to produce the most explosive — and potentially destructive — boom/bust cycle ever witnessed in American history.

The recent market bubble was created by the boom in residential housing. Normally, housing follows stock market booms but has not caused them. In the wake of the dot-com bust and the post-September 11 trauma, the situation became reversed. The home became the center of many investors' attention. First-time buyers abounded, and many others clamored to refinance their existing mortgages. The new thing was really an older thing dressed up by modern finance.

This phenomenon was difficult to detect in its early stages. All of the factors that converged to produce it had been seen before. Many were well-known and time-proven methods in finance. Securitization had been used for several decades by the U.S.-related housing finance agencies to convert pools of residential mortgages into securities that were purchased by investors. This provided even more available funds for the housing market at a time that demand was very high after 2001. The new thing on Wall Street became financing the "American Dream" — the idea that everyone should own his or her own home.

Demand for the securitized bonds proved strong, so strong that Wall Street securities houses began cranking them out at increasingly fast speed. Much of the demand came from foreign investors — central banks, banks, sovereign wealth funds, and insurance companies — all drawn by their attractive yields. Dollars were being recycled by these investors, especially central banks and the sovereign wealth funds, from the current account balances they were accumulating with the United States. The money left the United States as Americans purchased imports from foreign producers and found its way back as investments.

Victims of Their Own Success

The mortgage boom began after 2001, and within a couple of years it was in full stride. Demand remained strong for mortgage-backed securities, and soon subprime mortgages, credit default swaps, and other exotic collateral based on derivatives became part of the asset backing. By the late summer of 2007, as short-term interest rates rose from historically low levels, cracks began to appear in this collateral and asset values began to collapse, creating the banking and insurance crises within months. In the past, without the technology, the results would have taken years.

The boom was aided immeasurably by the deregulation of the U.S. financial markets in 1999, officially culminating over two decades of a gradual easing of once stringent rules. The new financial environment it created allowed banks and investment banks to cohabit, something that had not been allowed since 1933. When they began to share the benefits of deregulation under the same roof, older ideas of risk management began to crumble in a greater quest for profit.

The credit market and collateral crisis marks the end of the almost 40-year legacy of the federally related housing agencies and all of the benefits they provided since the social legislation passed during the 1960s. Wall Street, the credit markets, and the U.S. housing industry all were victims of their own success when the markets

collapsed in 2008. Greed, lack of regulatory oversight, and the sophistication of structured finance, which created many of these exotic financial instruments, all played a role in the most recent setback for the markets and the economy as a whole.

Most importantly, the crisis demonstrates the pitfalls of deregulation and globalization. Unfortunately, the appropriate skepticism that must accompany every boom has been missing. Globalization helped fuel the crisis and will undoubtedly be employed to help resolve it. Deregulation will be swept aside in favor of more stringent institutional controls on financial institutions designed to prevent fraud and deceit. It took almost four years after the market crash of 1929 to erect a regulatory structure to separate different types of banks and establish national securities laws. Moore's Law suggests that it will occur faster this time around. The forces that shaped globalization will demand it. ■

The opinions expressed in this article do not necessarily reflect the views or policies of the U.S. government.

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Newspaper headline from the stock market crash of 1929.

MOVING FORWARD ON THE ECONOMY

Barack Obama, President of the United States

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We must lay a new foundation for growth and prosperity … a foundation built upon five pillars that will grow our economy and make this new century another American century: new rules for Wall Street that will reward drive and innovation; new investments in education that will make our workforce more skilled and competitive; new investments in renewable energy and technology that will create new jobs and industries; new investments in health care that will cut costs for families and businesses; and new savings in our federal budget that will bring down the debt for future generations.

—President Barack Obama, "A New Foundation for the Economy," Washington, D.C., April 14, 2009.
http://www.america.gov/st/texttrans-english/2009/April/20090414142247eaifas0.3019068.html

Timothy Geithner, Secretary of the Treasury

We are a strong and resilient country. We came into the current crisis without the authority and tools we needed to contain the damage to the economy from the financial crisis. We are moving to ensure that we are equipped with both in the future, and in the process, that we modernize our 20th-century regulatory system [to] meet 21st-century financial challenges.

—Treasury Secretary Timothy Geithner, Hearing before the House Financial Services Committee, Washington, D.C., March 26, 2009.
http://www.realclearpolitics.com/articles/2009/03/geithner_announces_regulatory.html

© AP Images

Ben Bernanke, Chairman of the Federal Reserve

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In sum, the challenge faced by regulators is to strike the right balance: to strive for the highest standards of consumer protection without eliminating the beneficial effects of responsible innovation on consumer choice and access to credit. Our goal should be a financial system in which innovation leads to higher levels of economic welfare for people and communities at all income levels.

— Federal Reserve Board Chairman Ben Bernanke, "Financial Innovation and Consumer Protection," Washington, D.C., April 17, 2009.
http://www.realclearpolitics.com/articles/2009/04/17/financial_innovation_and_consumer_protection_96048.html

BUBBLES AND PURPORTED BUBBLES

An economic bubble can occur when the price of an asset rises far higher than the item is actually worth. The assumption is that the next buyer will pay an even higher price for the asset. Bubbles can be triggered by inexplicable phenomena (fads or crazes), or kindled by the manipulative actions of individuals or corporations.


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Florida Speculative Building Bubble 1926


Wikimedia Commons

1637 Tulip Mania


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1840s Railway Mania

The Nifty Fifty American Stocks of the Late 1960s and Early 1970s


© Bettmann/CORBIS

1720 Mississippi Company

1920s American Economic Bubble


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1720 The South Sea Company

Tulip Mania

At the peak of the Dutch tulip mania in February 1637, tulip futures contracts sold for more than 10 times the annual income of a skilled craftsman.

Railway Mania

During the British Railway Mania of the 1840s, the newly emerging middle class invested their savings in prospective railway companies; many of those lost everything when the bubble collapsed.

American Economic Bubble of the 1920s

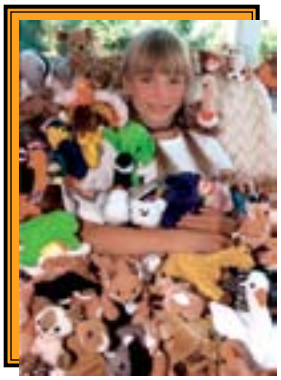
Americans overextended themselves to take advantage of the soaring stock market and expanding credit. When the Federal Reserve raised interest rates, the stock market crashed and the bank panics began.

Florida Speculative Building Bubble

Florida's first real estate bubble was based on outside speculators, easy credit access for buyers, and rapidly appreciating property values for Florida swampland.

The Nifty Fifty American Stocks

Rising prices of stock shares attracted the attention of investors. Additional investment provided buoyancy to the price, regardless of the true value of the asset.



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Beanie Babies 1996

1980s Japanese Asset Price Bubble

Real Estate Bubble

1995 - 2001
The Dot-Com Bubble

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Sports Cards and Comic Books in the 1980s and Early 1990s

© AP Images/ Mark D. Phillips

1997 Asian Financial Crisis

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Spider Man

The comic book speculator market reached a saturation point in the early 1990s and finally collapsed between 1993 and 1997.

Beanie Babies

Stuffed animal Beanie Baby toys were a craze in the early 1990s. Scarcity created increased demand and higher and higher prices..

Dot-Com Bubble

The dot-com bubble of the late 1990s was based on speculative activity arising from the development of new technologies.

Asian Financial Crisis

Large quantities of credit became available, creating a housing boom and pushing asset prices to an unsustainable level.

Revise Regulation: The Theory of Market Equilibrium Is Wrong

George Soros

A Chinese investor reacts as he watches the real-time display of the Shanghai Composite Index in September 2008.

While international regulation must be strengthened for the global financial system to survive, we must also beware of going too far. Markets are imperfect, but regulations are even more so.

George Soros is chairman of Soros Fund Management and founder of the Open Society Institute. He is the author of nine books, including, most recently, The New Paradigm for Financial Markets: The Crisis of 2008 and What It Means.

We are in the midst of the worst financial crisis since the 1930s. The salient feature of the crisis is that it was not caused by some external shock such as the Organization of Petroleum Exporting Countries raising the price of oil. It was generated by the financial system itself. This fact — a defect inherent in the system — contradicts the generally accepted theory that financial markets tend toward equilibrium, and deviations from the equilibrium occur either in a random manner or are caused by some sudden external event to which markets have difficulty in adjusting. The current approach to market regulation has been based on this theory, but the severity and amplitude of the crisis proves convincingly that there is something fundamentally wrong with it.

I have developed an alternative theory that holds that financial markets do not reflect the underlying conditions accurately. They provide a picture that is always biased or distorted in some way or another. More importantly, the distorted views held by market participants and expressed in market prices can, under certain circumstances, affect

the so-called fundamentals that market prices are supposed to reflect.

I call this two-way circular connection between market prices and the underlying reality "reflexivity." I contend that financial markets are always reflexive, and on occasion they can veer quite far away from the so-called equilibrium. In other words, financial markets are prone to producing bubbles.

The Roots of the Crisis

The current crisis originated in the subprime mortgage market. The bursting of the U.S. housing bubble acted as a detonator that exploded a much larger super-bubble that started developing in the 1980s, when market fundamentalism became the dominant creed. That creed led to deregulation, globalization, and financial innovations based on the false assumption that markets tend toward equilibrium.

The house of cards has now collapsed. With the bankruptcy of Lehman Brothers in September 2008, the inconceivable happened. The financial system went into cardiac arrest. It was immediately put on artificial respiration: The authorities in the developed world effectively guaranteed that no other important institution would be allowed to fail.

But countries at the periphery of the global financial system could not provide equally credible guarantees. This precipitated capital flight from countries in Eastern Europe, Asia, and Latin America. All currencies fell against the dollar and the yen. Commodity prices dropped like a stone, and interest rates in emerging markets soared.

The race to save the international financial system is still in progress. Even if it is successful, consumers, investors, and businesses are undergoing a traumatic experience whose full impact is yet to be felt. A deep recession is inevitable, and the possibility of a depression cannot be ruled out.

Counterbalancing the Markets

So what is to be done?

Because financial markets are prone to creating asset bubbles, regulators must accept responsibility for preventing them from growing too big. Until now, financial authorities have explicitly rejected that responsibility.

Of course, it is impossible to prevent bubbles from forming, but it should be possible to keep them within tolerable bounds. This cannot be done simply by controlling the money supply. Regulators must also take into account credit conditions, because money and credit do not move in lockstep. Markets have moods and biases that need to be counterbalanced. To control credit as distinct from money, additional tools must be employed — or, more accurately, reactivated, since they were used in the 1950s and 1960s. I refer to varying margin requirements and the minimal capital requirements of banks.

Today's sophisticated financial engineering can render the calculation of margin and capital requirements extremely difficult, if not impossible. Therefore, new financial products must be registered and approved by the appropriate authorities before being sold.

Counterbalancing the mood of the market requires judgment, and because regulators are human, they are bound to get it wrong. They have the advantage, however, of getting feedback from the market, which should enable them to correct their mistakes. If a tightening of margin and minimum capital requirements does not deflate a bubble, regulators can tighten some more. But the process is not foolproof, because markets can also

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In New York's Times Square, financial news is displayed on the news ticker in September 2008.

© AP Images

As global demand for exports slowed, the Chinese pushed forward a stimulus package to increase domestic spending for goods.

be wrong. The search for the optimum equilibrium is a never-ending process of trial and error.

This cat-and-mouse game between regulators and market participants is already ongoing, but its true nature has not yet been acknowledged. Alan Greenspan, the former U.S. Federal Reserve Bank chairman, was a master of manipulation with his Delphic utterances, but instead of acknowledging what he was doing, he pretended that he was merely a passive observer. That is why asset bubbles could grow so large during his tenure.

The IMF: A New Mission

Because financial markets are global, regulations must also be international in scope. In the current situation, the International Monetary Fund (IMF) has a new mission in life: to protect the periphery countries against the effects of storms that originate at the center, namely, the United States.

The U.S. consumer can no longer serve as the motor of the world economy. To avoid a global depression, other countries must also stimulate their domestic economies. But periphery countries without large export surpluses are not in a position to employ countercyclical policies. It is up to the IMF to find ways to finance countercyclical fiscal deficits. This could be done partly by enlisting sovereign wealth funds and partly by issuing Special Drawing Rights so that rich countries that can finance their own fiscal deficits could cede to poorer countries that cannot.

While international regulation must be strengthened for the global financial system to survive, we must also beware of going too far. Markets are imperfect, but regulations are even more so. Regulators are not only human; they are also bureaucratic and subject to political influences. Regulations should be kept to the minimum necessary to maintain stability. ■

Global Financial Trouble: Causes, Cures, Responses

Joel P. Trachtman

A currency trader at the Korea Exchange Bank in Seoul, South Korea, April 9, 2009.

No doubt, economic historians will argue for years to come about the causes of the global financial crisis. The primary causal factor was macroeconomic, but appropriate regulation might have averted or ameliorated the crisis.

Joel P. Trachtman is professor of international law at the Fletcher School of Law and Diplomacy, Tufts University. His publications include The Economic Structure of International Law *and* International Law and Politics.

The global financial crisis has eclipsed Iraq, Afghanistan, North Korea, and other crises as a topic of concern — making these critical threats to global stability seem modest by comparison. Even if our perception is myopic and too greatly focused on our pocketbooks, the global financial crisis is significant, and it has spread to many places around the world. In order to address the current crisis and to prevent future crises — if, indeed, that is possible — it is necessary to understand what caused this crisis. Diagnosis is not easy because this crisis was caused by a complex interaction of macroeconomic mismanagement, incomplete financial regulation, and defective corporate governance. For the same reason, prevention of future crises is not a simple matter.

The financial crisis began in the United States with a housing price bubble and risky mortgages. Mortgages seemed like solid investments while housing prices rose, but looked much less attractive as housing prices declined. And this decline fed on itself, as reduced willingness to lend and foreclosures on mortgages caused further reductions in home prices. Many of the original

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The currencies of the United States and China.

mortgages were securitized, and banks and other financial institutions, as well as investors, eagerly purchased and traded the resulting securities in their never-ending search for high-yielding investments. But the holders of these securities found that their value declined sharply. For financial institutions, the losses on these securities impaired their capital and their ability to do business. This reduced their ability to finance businesses, resulting in a substantial depressing effect on the real economy. The credit freeze is only now showing signs of thawing.

While the crisis began in the United States, it is now global. It became global because the financial system is global, and the financial institutions that engaged in the subprime mortgage business in the United States included both U.S. multinationals and foreign multinationals. In addition, some foreign financial institutions did similar businesses abroad, emulating the U.S. domestic experience. Financial contagion meant that as the first, mostly U.S., financial institutions were threatened with failure, their counterparts around the world were also threatened. Finally, economic contagion through trade and investment has brought a sharp reduction in exports to the United States and in investment abroad from the United States.

The Causes

No doubt, economic historians will argue for years to come about the causes of the global financial crisis. The primary causal factor was macroeconomic, but appropriate regulation might have averted or ameliorated the crisis.

Low interest rates in the United States, Japan, and elsewhere, China's exchange rate policies, and the growth of oil wealth and other wealth in sovereign wealth funds all contributed to excess liquidity, which in turn contributed to the development of an asset bubble. There was a lot of cheap money around, and it needed to be reinvested. Not only that, but because there was a lot of cheap money, investors were constantly seeking increased returns. Those who promised them higher returns could command great followings and fees.

Much of this excess liquidity flowed into U.S. housing. During the run-up to the crisis, U.S. housing had the characteristics of a classic bubble. Those who invested in housing, either as owners or as lenders, looked like financial geniuses. Mortgage lenders could not really lose money because the value of their collateral would continue to rise, forgiving lending mistakes. As legendary investor Warren Buffett has said, "It's only when the tide goes out that you learn who's been swimming naked."

Mortgage lenders were no longer the traditional local savings and loan associations, planning to hold the mortgage loans that they originated until maturity. Rather, these loans were packaged into pools and these pools were securitized, with individual investors and merchant banks trading in and investing in these securities. Therefore, the mortgage lenders often did not take a long-term view and did not worry about the ability of their borrowers to service their mortgages in a financial downturn. The amount of mortgage-backed securities issued skyrocketed beginning in late 2003. The profit model for many financial institutions had changed from one based on interest rate spreads to one based on fees and trading. This changing business model also brought with it changes in compensation — providing bonuses for executives who were able to produce these fees and trading profits.

Securitization required good pools of loans, according to the underwriting requirements specified, and it also often required credit enhancements through insurance or other backing. These mortgage-backed securities, meeting the requirements specified by rating agencies such as Moody's and Standard & Poor's, generally received top credit ratings. The rating agencies competed with one another for business and often relied on historical experience, rather than on forward-looking models that included the possibility of an asset bubble, to determine the creditworthiness of these pools.

The U.S. regulatory structure may be accused of both sins of commission and sins of omission. The

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Former Fannie Mae chief executives testify before U.S. congressional committees, December 2008.

Bush administration sought to extend home ownership to lower-income people through zero-equity lending. Increased capital requirements imposed on U.S. mortgage giants Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) opened the home financing market to securitization by other institutions. The Basel capital requirements provided incentives for securitization, and the expected reduction in capital requirements relating to mortgages under Basel II induced U.S. banks to increase their holdings of mortgage-backed securities. Investment banks were permitted to increase their leverage. All of these regulatory changes may be said to have been driven by the available liquidity and to have accentuated the growth of the mortgage-backed securities market and of its risks. While individual regulators may have seen some of the problems growing, the authorities lacked the political will to intervene strongly.

The corporate governance of many financial institutions was placed under severe stress by the fee and trading-based model, the drive to promote businesses that produced greater profits, the competitive pressure resulting from other firms' risky activities, and the inability to develop a persuasive model of long-term risk. Under these circumstances, shareholders, boards of directors, and senior management were unable to assess and curtail the risk that their institutions absorbed. In congressional testimony in October 2008, Alan Greenspan, former chairman of the U.S. Federal Reserve Bank, stated that "those of us who have who looked to the self-interest of lending institutions to protect shareholder's equity — myself especially — are now in a state of shocked disbelief." This is a stunning indictment of American corporate governance: The mechanisms of corporate governance are insufficient to ensure that executives will manage in the long-run interests of shareholders, rather than in their own short-run interest.

The Cures

Each of the causes of the financial crisis will merit careful consideration in order to prevent future crises. Of course, we need to remember that mere retrospective prevention of crises like those we have already experienced, such as the French military's Maginot Line in World War II, will not prevent future crises. Rather, we must understand the types of structures that cause crisis, and seek to establish mechanisms to see new crises coming and to restructure our regulation to respond.

First, macroeconomic management must be able to identify asset bubbles and to muster the political will to respond. Second, we must be careful to recognize that regulatory reforms often have pro-cyclical motivations: accentuating dangerous phenomena. As we engage in regulatory reform, we must be careful to ask the Warren Buffett question: Will we be seen to be naked when the tide goes out? Third, financial regulation must be understood as a special response to the particular incentive incompatibilities of financial institutions. We must recognize that corporate governance alone can be inadequate to restrain short-sighted management. We also must recognize that shareholders of financial institutions may themselves have inadequate incentives to ensure that financial institutions avoid excess risk: The rest of us may, through deposit insurance and government bailouts, absorb significant components of the risk. This moral hazard often requires a regulatory response.

Required Responses

Domestic regulation is often needed when firms do not bear all the risks of their actions or when the people who control firms do not bear all the risks of their actions. Furthermore, international regulation is needed when states do not bear all the risks of their regulatory actions. International externalities may occur through contagion: Financial institutions maintain dense international webs of interbank relationships, and the failure of one bank may hurt others. International externalities may also

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As homeowners default on mortgages, "For Sale" signs pop up on the street.

occur through regulatory competition: When one state reduces its standards, it may increase the short-term competitiveness of its financial institutions, imposing competitive harm on foreign financial institutions. Finally, a U.S. economic slump has repercussions around the world through the mechanism of trade and investment.

What kind of international regulatory response is required? States must take greater responsibility for the solvency regulation of their financial institutions in order to limit the risk of contagion. It may be appropriate for states to agree on the scope of this responsibility.

But this will not be enough. Corporate governance problems that induce firms to take excessive risk must be addressed, either through regulation or through self-regulation by the financial industry. An international regulatory response will be needed to ensure that states do not have incentives to reduce regulation in order to promote the competitiveness of their own firms. The Basel capital regulation was partially motivated by this concern, but much more work needs to be done.

Finally, greater sobriety and humility in macroeconomic management, and greater attention to the concerns of other states regarding national macroeconomic management, will be needed in order to avoid the conditions for asset bubbles or other macroeconomic-based crises. ■

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The Evolving Global Financial System

Richard Vedder

Seamstresses in Mexico sew clothes for the U.S. market.

During the late 19th and early 20th centuries, there was little coordination of international finances. That changed substantially after World War II, and the change is continuing today.

A specialist in economic history and public policy, Richard Vedder is distinguished professor of economics at Ohio University. His books include Out of Work: Unemployment and Government in Twentieth-Century America *and* The American Economy in Historical Perspective.

The prosperity of the world has been immeasurably enhanced by the growth in international economic relations — trading in goods and services, and the migration of labor, capital, and ideas across the planet. The principle of comparative advantage suggests that the wealth of nations is enhanced by each country specializing in those economic activities for which it has low opportunity costs. Yet all this economic activity must be financed, and the stability of the world financial system is critical to the continued growth in world trade. This is complicated by the fact that most nations have their own currency, and that the rules and regulations governing financial transactions vary widely between countries.

During the late 19th and early 20th centuries, there was little coordination of international finances. The world's financial capital was London, and most major trading nations were on the gold standard, meaning financial obligations were settled in currencies redeemable in gold. If a nation used its currencies excessively to buy imports or invest overseas, it lost gold reserves, forcing it to restrict money supply and credit, usually causing deflation. This made the country's exports more attractive and imports less desirable, thereby correcting the balance-of-payment imbalance problem. Many scholars believe the system worked reasonably well between 1871 and 1914.

World War I involved vastly larger international capital flows than ever before, as European nations such as Britain and Germany went deeply in debt, borrowing heavily from other nations, especially the United States. The Versailles Treaty (1919) provided for punitive reparation charges against Germany, which then engaged in hyperinflationary policies that severely damaged that nation economically. An attempt to restore the gold standard in the 1920s was short-lived: Britain left the full gold standard permanently in 1931, as did the United States two years later.

The Great Depression of the 1930s resulted partially from sharply declining international trade caused, in part, by high tariffs. Beginning in 1934, however, nations started to reduce ruinous trade barriers, led by the Reciprocal Trade Agreements Act in the United States. However, return to normalcy in international finance was shattered by the outbreak of World War II in 1939, the most costly war ever fought, which disrupted world trade and led to international cooperative arrangements to facilitate economic stability and growth.

New International Institutions

A large number of major developments between 1944 and 1960 profoundly altered the nature of the international financial system. Concerned about huge deficiencies of hard currencies to pay for goods, services, and the reconstruction of war-torn economies, Britain's John Maynard Keynes and the United States' Harry Dexter White successfully proposed a new international financial order at the Bretton Woods Conference in 1944. The International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) were created.

The IMF would help nations with balance-of-payments problems and with difficulties maintaining reserves consistent with agreed upon fixed exchange rates defined in terms of gold. While the fixed-rate system broke down after 1971, the IMF continues with expanded responsibilities. For example, it has played a key role in averting or reducing national and regional financial crises, serving as a lender of last resort to nations in fiscal stress. The World Bank originally provided loans to war-torn countries to finance reconstruction, although by the 1950s the bank had moved to broader lending to finance new development projects. Although both the IMF and World Bank are headquartered in Washington, D.C. (given America's prominence as a global financial power), these organizations are truly international in orientation and control.

The most important international organization, the United Nations, began in San Francisco in 1945. While not focusing primarily on economic and financial issues,

The European Central Bank in Frankfort, Germany.

© AP Images

Workers walk near a container ship in Tianjin Port, China, March 2009.

those issues have been important to U.N. agencies such as UNCTAD (U.N. Conference on Trade and Development) and UNESCO (U.N. Economic, Social, and Cultural Organization). The principle of international assistance to meet financial strains received a prominent boost with the Economic Recovery Program (Marshall Plan) of the United States (1948-1952), which provided aid to many European nations. The Marshall Plan promoted international cooperation among the recipients of its more than $12 billion in economic assistance in the form of loans. The Cold War after 1945 led to new forms of political and economic regional cooperation as a by-product of the creation of two military alliances, NATO (North Atlantic Treaty Organization) and the Warsaw Pact of nations allied with the Soviet Union.

More direct forms of financial cooperation began, leading to the creation of a system of international financial arrangements. In 1947, the General Agreement on Tariffs and Trade (GATT) began, which provided a framework for a series of negotiations (such as the Kennedy Round and the Uruguay Round) that over the next half century led to dramatic reductions in barriers to international trade, especially in goods and services.

World Economic and Financial Integration

The financial stress of World War II contributed to the hastening of an abrupt decline in colonialism, as literally dozens of new nations emerged. Most dramatic, perhaps, was India's independence in 1947, but large parts of Asia and Africa also became independent nations in the next two decades. This greatly accelerated the need for international financial organizations such as the IMF and World Bank. Each new nation typically had to establish a currency that would gain widespread international acceptance, needed to borrow considerable sums of money from foreign nations despite uncertain abilities to repay loans, and often had to learn to live within the rule of law and the discipline imposed by market conditions. Organizations such as the IMF and the World Bank became increasingly important in facilitating these factors.

The move toward world economic/financial integration was advanced by important new institutions, especially in Europe. A European Payments Union was developed in 1950 to facilitate ways of dealing with the dollar shortage that made international payments difficult. The Organization for Economic Cooperation and Development (OECD) began to collect uniform economic information on major industrial countries, ultimately including nations in Asia and Latin America as well as Europe and North America. Most important was the Treaty of Rome, signed in 1957, creating the European Economic Community (Common Market), which has grown from a six-nation customs union in 1958 to a 27-nation group that has integrated much of its economic structure into today's European Union, including a common currency covering over half the area (the euro) and an EU central bank.

The European effort has been duplicated elsewhere on a much smaller scale, with Asian, African, and Latin American nations moving to integrate their economies more regionally. The Asian Development Bank, for example, is an institution of about 40 nations designed to further the creation and free flow of capital in one important region of the world (making over $10 billion in loans in 2008), while the North American Free Trade Agreement (NAFTA) of 1994 extended the customs union approach to the Americas.

Four further extensions of the world financial system are important. In 1995, the World Trade Organization (WTO) replaced the GATT, and it was given wide authority to

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Foreign currency notes are displayed in a commercial area of Karachi, Pakistan, October 2008.

enforce international standards relating to trade and cross-border financial dealings. The Group of Seven (G-7) was originally a meeting of the finance ministers of seven leading industrial nations, but it has expanded numerically, now encompassing 20 nations (the G-20) that meet regularly to agree on policies governing international economic and financial arrangements. Other, nongovernmental sponsored conferences, especially in Davos, Switzerland, bring together corporate and financial leaders, often sowing seeds for later policy reforms. Finally, a number of multilateral tax treaties have tried to standardize to some extent tax treatment for those engaged in international activities; recently, small tax-haven nations have agreed to modify bank secrecy provisions to deal with tax evasion.

Coordination Is Key

The evolving global financial system has been both a cause and a consequence of the rapid growth in globalization. For most nations, international trade comprises a larger portion of output than a generation or two ago. International capital flows have grown extraordinarily.

Beyond that, institutions such as the IMF and World Bank have been critical both in terms of financing long-term development needs and stabilizing shaky financial systems. Two noteworthy examples are the financial crises of 1998 beginning in Asia but ultimately spreading beyond, especially to Russia, and the 2008 worldwide crisis that has caused significant stress to financial institutions and economies worldwide. In both instances, the IMF and World Bank made important financial infusions in stressed countries such as Thailand and Russia. The development arm of the World Bank makes "soft" loans of around $10 billion annually, for example. Additionally, large-nation central bankers and finance ministers have met and coordinated the provision of credit to ease panic and the potential collapse of major banks, insurance companies, and other financial institutions.

As international economic and financial interaction grows, the need for coordinated rules of behavior becomes greater than ever — uniform accounting rules, international standards of permissible conduct, provision for emergency loans, and the like. No doubt existing institutions will continue to evolve, perhaps into a new umbrella organization encompassing all facets of financial regulation. ■

The opinions expressed in this article do not necessarily reflect the views or policies of the U.S. government.

Glossary

Bretton Woods
A 1944 conference held at Bretton Woods, New Hampshire, that designed the structure of the international monetary system after World War II and set up the International Monetary Fund (IMF) and the World Bank. It was agreed that the exchange rates of IMF members would be pegged to the dollar, with a maximum variation of 1 percent on either side of the agreed rate.

bubble
A situation that can occur when the price of an asset rises far higher than the item is actually worth. The assumption is that the next buyer will pay an even higher price for the asset. Major speculative economic bubbles have been known to occur from time to time, often with ruinous effects. Sometimes they are triggered by inexplicable phenomena (fads or crazes) or are kindled by the manipulative actions of individuals or corporations.

corporate governance
An internal company system — encompassing policies, processes, and people — that serves the needs of shareholders and other stakeholders by directing and controlling management activities with good business savvy, objectivity, accountability, and integrity. Sound corporate governance relies on external marketplace commitment and legislation, plus a healthy board of directors culture that safeguards policies and processes.

credit debt swap
A contract between a protection buyer and a protection seller. The buyer makes a series of payments to the seller and, in exchange, receives a payoff if the bond or loan goes into default (is not paid). Credit debt swap contracts have been compared with insurance because the buyer pays a premium and, in return, receives a sum of money if one of certain specified events occurs.

derivative
A financial contract whose price is derived from underlying assets such as stocks, bonds, commodities, currencies, interest rates, and market indexes. Most derivatives are characterized by high leverage, that is, the investor only pays a small amount of the actual cost of the contract and borrows the rest from the seller or the broker.

dot-com
A company whose operations are Internet-based; its business model would not be possible if the Internet did not exist. While dot-com can refer to present-day companies, it is also used to refer to companies with this business model during the late 1990s.

externality
The side effect of an economic transaction on people who are not involved in it. A classic negative example is the air pollution produced by a power plant.

Fannie Mae
The Federal National Mortgage Association (FMNA), a congressionally chartered corporation that buys mortgages on the secondary market, pools them, and sells them as mortgage-backed securities to investors on the open market. Monthly principal and interest payments are guaranteed by FNMA but not by the U.S. government.

Federal Reserve
The central bank of the United States, which provides the nation with a safe, flexible, and stable monetary and financial system.

Freddie Mac
The Federal Home Loan Mortgage Corporation (FHLMC), a government-chartered corporation that buys qualified mortgage loans from the financial institutions that originate them, securitizes the loans, and distributes the securities through the dealer community. The securities are not backed by the U.S. government. The market value of these securities prior to maturity is not guaranteed and will fluctuate.

G-20
Established in 1999, the Group of Twenty finance ministers and central bank governors from industrialized and developing economies that meet and discuss key issues in the global economy.

International Monetary Fund
An organization set up in 1944 to lower trade barriers between countries and to stabilize currencies by monitoring the foreign exchange systems of member countries and lending money to developing nations.

Lake Wobegon
"The town that time forgot and the decades cannot improve" as described by radio host Garrison Keillor. Over the past 30 years, Keillor has shared with listeners to the weekly *A Prairie Home Companion* the latest news from the little fictional town where "all the women are strong, all the men are good looking, and all the children are above average."

liquidity
The ability of an asset to be converted into cash quickly and without any price discount.

macroeconomics
The branch of economics that deals with the performance, structure, and behavior of a national economy as a whole, as opposed to the level of subgroups or individuals (which is called microeconomics). It is useful in helping determine the aggregate effect of certain policies on an economy as a whole.

margin
The minimum amount of collateral, in either cash or securities, an investor must have in his accounts to trade in certain investment instruments. The margin is also the difference between the market value of an investment instrument and the loan a broker makes to the investor in order to purchase the investment.

securitization
The process of aggregating similar instruments, such as loans or mortgages, into a negotiable security.

subprime loans
Loans for persons with blemished or limited credit histories. The loans carry a higher rate of interest than prime loans to compensate for increased credit risk. Subprime lending evolved with the realization of a demand in the marketplace for loans to high-risk borrowers with imperfect credit.

wealth effect
The tendency of consumers to spend more because they believe they are wealthier. Sometimes they actually are richer (by objective measurement, for example, when receiving a bonus or a pay raise at work), or they perceive themselves to be "richer" (for example, when the assessed value of their home increases, or a stock they own has gone up in price).

World Bank
An organization whose focus is on foreign exchange reserves and the balance of trade.

Definitions are adapted from glossaries at http://www.investorwords.com, http://www.economist.com/research/economics/, http://encyclopedia.thefreedictionary.com, and other Web sources.

Related Books, Articles, Reports, Web Sites, and Videos

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Web Sites

CNN: The Road to Rescue
A collection of news and analysis about the problems with U.S. financial markets.
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Council on Foreign Relations: Global Economy in Crisis
Contains expert briefs; interviews; backgrounders; podcasts; Must Reads; and essential documents, graphs and charts.
http://www.cfr.org/thinktank/greenberg/

Federal Reserve Board: About the Fed
Background information about the Federal Reserve System, which serves as the United States' central bank. Covers the Federal Reserve Act of 1913 (which established the system), the structure of the system, purposes and functions, board of governors, banks, and bank presidents.
http://www.federalreserve.gov/aboutthefed/default.htm

Financial Times: The Future of Capitalism
http://www.ft.com/indepth/capitalism-future

G-20
Web site for the Group of Twenty (G-20) finance ministers and central bank governors. Provides background and frequently asked questions about the G-20; descriptions of working groups; press releases; and publications from summits, working groups, and other activities. Includes links to participating banks and government agencies from member countries.
http://www.g20.org/"http://www.g20.org/

International Monetary Fund: Financial Crisis
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The University of Iowa Center for International Finance and Development: The Global Financial Crisis
http://www.uiowa.edu/ifdebook/issues/financial_crisis/index.shtml
See the timeline:
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World Bank: Financial Crisis
http://www.worldbank.org/html/extdr/financialcrisis/

Videos

Academic Earth: Understanding the Financial Crisis
Lectures from well-known authorities and university professors taped at Yale University.
http://academicearth.org/playlists/financial-crisis

The Ascent of Money (2009)
Director: Adrian Pennick
Running time: 120 minutes
Summary: Niall Ferguson, a professor of history at Harvard University, traces the evolution of money and demonstrates that financial history is the essential back-story behind all history. As he traverses historic financial hot spots around the world, Ferguson illuminates fundamental economic concepts and speaks with leading experts in the financial world.
http://www.pbs.org/wnet/ascentofmoney/

Frontline: Inside the Meltdown (2009)
Director: Michael Kirk
Running time: 60 minutes
Summary: An account of how the United States ended up in the worst financial crisis since 1929.
http://www.pbs.org/wgbh/pages/frontline/meltdown/

I.O.U.S.A. (2008)
Director: Patrick Creadon
Running time: 85 minutes
Summary: Examines the rapidly growing national debt and its consequences for the United States. The film blends interviews with both average American taxpayers and government officials to demystify the nation's financial practices and policies; follows U.S. Comptroller General David Walker as he crisscrosses the country explaining America's unsustainable fiscal policies to its citizens; and interweaves archival footage and economic data to paint a profile of America's current economic situation.
http://www.imdb.com/title/tt0963807/

Maxed Out: Hard Times, Easy Credit and the Era of Predatory Lenders (2006)
Director: James D. Scurlock
Running time: 90 minutes
Summary: When Hurricane Katrina ravaged America's Gulf Coast, it laid bare an uncomfortable reality: America is not only far from the world's wealthiest nation; it is crumbling beneath a staggering burden of individual and government debt. *Maxed Out* shows how the modern financial industry really works, explains the true definition of "preferred customer," and tells why the poor are getting poorer and the rich getting richer.
http://www.imdb.com/title/tt0762117/

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