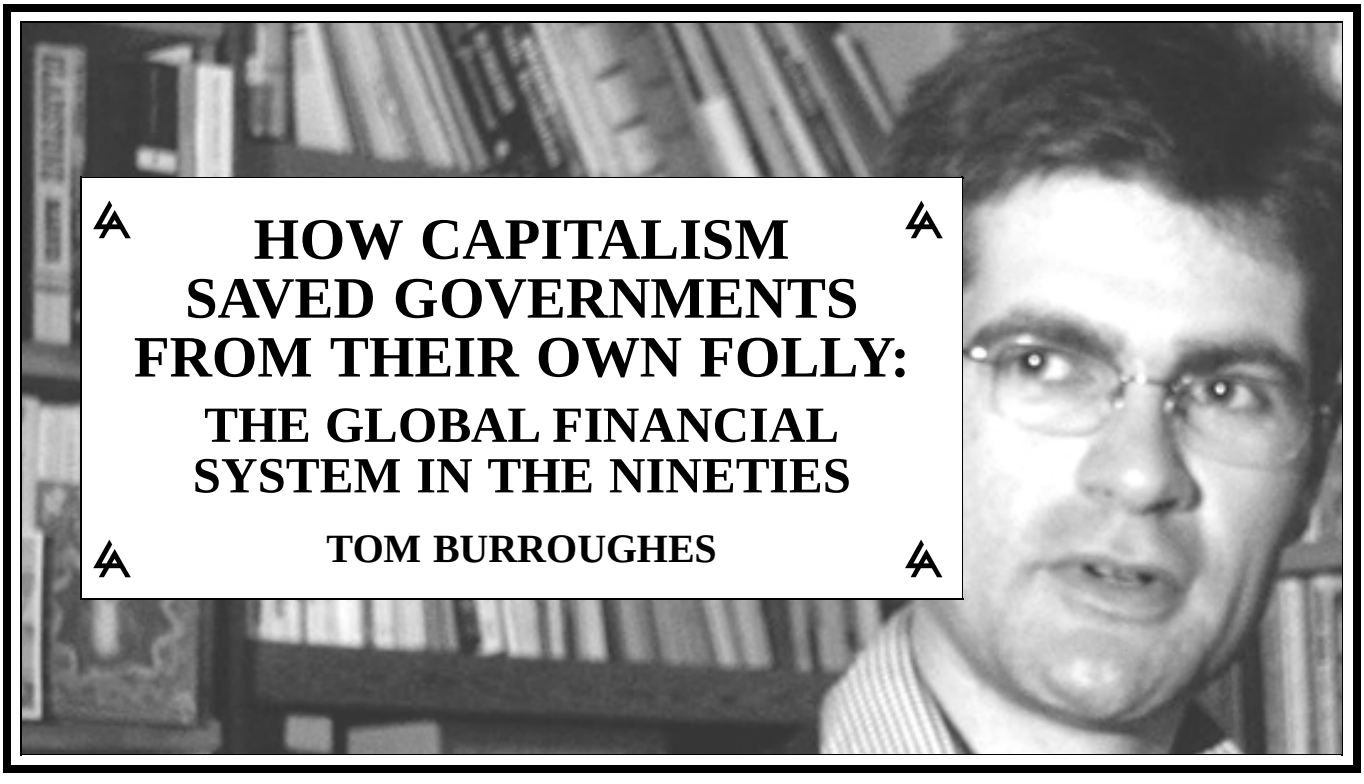

HOW CAPITALISM SAVED GOVERNMENTS FROM THEIR OWN FOLLY:

THE GLOBAL FINANCIAL SYSTEM IN THE NINETIES

TOM BURROUGHES

IT HAS BEEN A ROUGH RIDE

One would have to be very blind to economic developments over the past ten years not to have been aware that some pretty stomach-churning ups and downs have been a central feature of the global economy. Stock markets in Southeast Asia have dived, currency pegs have snapped, inflation soared, and of course these episodes have contributed to the current furore over "globalisation" and the capitalist system,[1] as witnessed by the riots in Seattle, Prague and Genoa.

And of course these developments have prompted policy-makers around the world, such as central bankers and politicians, to call for new rules, fresh regulations, taxation on financial transactions like foreign exchange and so forth.[2] Sometimes one hears talk of a New World Order, or New Financial Architecture. Such calls tend to have a clearly statist bent in as much as solutions are often thought to lie with government.

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While such calls have been going out, however, capitalism has already been coming up with ingenious, often mind-bending instruments and techniques to mitigate the worst effects of such volatility and ensure that risks are taken by those institutions best able to shoulder them. In short, capitalism has yet again provided the answers to many of the problems statists think can only be solved by government. The much-maligned financial speculator has once more proved to be the Seventh Cavalry of the financial scene, though it has often been more convenient for politicians to lambast him as a marauding raider instead.

I want to sketch out what some of these market solutions are, why they were developed, as well as look at how governments and state agencies can often cause problems in the first place and make them far worse than would otherwise be the case.[3] (The reader will be reassured to know, however, that I will not delve too far into the "rocket science" of derivatives such as credit default swaps, futures or options, although those who are interested can look at the bibliography below for some insomnia-curing reading.)

A TRIP DOWN MEXICO WAY

Because of its subsequent importance to my analysis, I want to start my resume in Mexico. By the early to mid-1990s, Mexico was experiencing rapid growth but also had severe imbalances in its financial system, in particular, a sharp accumulation of short-term debt. Its currency, the peso, was linked to the U.S. dollar in an exchange rate "peg" system. By late 1994 this "peg" came under severe strain because the dollar at this stage was strong, making Mexico's imports expensive in non-dollar markets like western Europe. Also, Mexico relied to a great extent on short-term debt finance for business investment, rather than equity finance. Investors were

willing to lend money to Mexican businesses precisely because of the dollar peg — the peg gave an assurance of stability. However, when it became more difficult for Mexico to service its overseas debts, the peg came under strain. Mexico's interest rates soared to defend the peso's value, a move which threatened to crush investment in Mexico, making problems worse. Eventually, the peg gave way and the peso freely floated against other currencies and investors panicked, withdrawing billions of funds.

While all this was going on, the International Monetary Fund embarked on a rescue plan for Mexico. The effort was led by the U.S. Treasury Department. In a nutshell, taxpayers' money was used to bail out the Mexican authorities in order to give them time to restructure their debt and return to some form of financial stability. Mexico did indeed recover, and the U.S.-led effort was deemed at the time to have been a great success.[4]

Success came at a price, however. For a powerful message, however subliminal, had gone out to investors around the world. The message was: "If you mess up, dear creditors, then we at the IMF will step in and sort things out." In short, investors learned that in extreme conditions taxpayers' money could be used to shield them from their own lack of foresight and caution. This made for a serious "moral hazard" problem.[5] It meant that investors in other regions were sometimes all too willing to act without looking very hard at the terrain. This gullibility, fuelled by the knowledge that the IMF could step in and rescue a situation, contributed, I believe, to the subsequent crisis in Asia and the former Soviet Union.

THE ASIAN CRISIS

In the summer of 1997 a financial tornado swept through a brace of Southeast Asian economies and a number of them are still struggling to regain financial normality today. Starting with Thailand, and spreading through to South Korea, Malaysia, Indonesia, Singapore, Hong Kong and Taiwan, these economies suffered a variety of crises. Common features were the collapse of fixed foreign exchange rates, massive withdrawals of capital, sharp rises in inflation, and in the case of Indonesia and Malaysia, political and economic upheavals. Some of the causes of these crises were similar to that which hit Mexico, such as the impact on export earnings of a strong U. S. dollar and reliance on short-term debt finance by gullible investors. Other factors were a lack of open and transparent financial systems, corruption, lack of reliable bankruptcy laws, incestuously close links between banks and corporations, and even lack of decent economic data upon which investors could base decisions.

What is notable — libertarians will be glad to hear — is that the economies that recovered quickest and suffered the least were those that practised the most open forms of capitalism, especially Hong Kong. Hong Kong retained its link to the dollar, and had a relatively open financial system, low taxes and a relatively honest government.[6] In contrast, countries like Indonesia which were notable for lacking such virtues were hammered hard in the financial markets.

THE RUSSIAN DEFAULT

If the Asian crisis were not enough, the world's debt markets were rocked to their foundations in September 1998 by the Russian authorities' default on sovereign debt. The rouble plunged, the savings of millions of newly-enriched Russian entrepreneurs were wiped out, and the default raised the serious risk of a dry-up in availability of credit in the major industrialised economies, such as the U.S. One bond dealer told me at the time that "the Russians have inflicted a drive-by shooting on the world's debt markets". The cost of obtaining credit in the West briefly rose sharply in the financial markets and there was a real fear of a credit crunch, a fear allayed somewhat by the decision of the U.S. central bank, the Federal Reserve, to cut interest rates in the autumn of 1998.

MARKETS LOOK FOR SOLUTIONS

Although I will return to the problems caused by the actions of governments and agencies like the IMF, I want to turn to what the markets have been doing to try to mitigate the damage that can be caused when governments and firms default on their debt, as happened in dozens of cases in the crises mentioned above.

The main area where the market has evolved has been in what might be broadly called the credit risk area, particularly concerning the field of derivatives,[7] such as *credit derivatives*.

Credit derivatives come in a variety of forms. One good way to think of them is to draw an analogy with insurance. Credit derivative instruments like default swaps, allow people to buy protection from a bank or other entity in case an issuer of a loan or bond defaults on a payment. For example, if you hold bonds from Ford or General Motors, and those firms fail to make a coupon payment on a bond, you can get a payment on a default swap deal written with an institution like HSBC or Goldman Sachs. There are also products called bankruptcy swaps, where a buyer gets compensated if a firm to whom he has lent money goes bust.

The benefits of this are obvious. Many big investors lend vast sums to all kinds of businesses and the risk that those enterprises may not pay all or some of the money back is a major risk. It is a risk as old as the market order itself.[8] If financial players could not offload this risk, they would have to put capital to one side in case of trouble. Transferring risk means that such capital can be put to earn a return instead.

The most liquid credit derivative at the moment is the credit default swap. A default swap is an instrument akin to an insurance deal. Essentially, the buyer of credit protection pays an annual premium and the seller is obliged to pay a sum equivalent to the value of the debt lost if a default occurs. Banks, insurance firms, reinsurance firms and other players are entering this market, which has been growing since credit derivatives first appeared in the late 1980s. However, the market has only really begun

to grow substantially over the past few years after the markets agreed some common definitions of what these derivatives are and how they should work.

Credit derivatives are big business and as liquidity expands, so they become more and more popular with all kinds of investors looking to hedge their risks or increase exposures to certain kinds of asset. At the moment the busiest area for default swaps, for example, has been in the telecom sector, where firms saddled with heavy debts like France Telecom, Marconi or the Dutch carrier KPN have alarmed investors about their ability to pay back on bonds or loans. Of course, derivatives carry a risk. For a start, we have not yet seen a major example of a bank being simply unable or unwilling to pay out money to credit protection buyers in a massive default. For example, if Argentina were to default on its sovereign debt — a real risk in the summer of 2001 — it is not clear whether credit protection providers would be able to compensate all their clients without some legal challenge. The truth is that no-one really knows for sure.[9]

Derivatives do, of course, allow financial players to increase their exposures to certain kinds of market activity without actually having to pay much money, and this of course raises the question of what happens to that player if a derivative deal goes badly wrong.

All of this is true, but I believe that as long as financial players are aware of the risks they run and know how to handle derivatives, the arrival of this new market should be regarded as a considerable boon to the stability of the world's financial system as a whole. For a start, credit derivatives now allow players to fine-tune the amount of risk they are prepared to take. As with good old-fashioned insurance, it is possible to pass on the risk of default or bankruptcy to people with the skills and aptitude to take it on. A whole speciality is developing in the City of London, Wall Street and elsewhere in the measurement of credit risk. And speculators trying to make money by buying and selling these derivatives are making the market bigger, more liquid, and hence safer.[10] And one should recall that getting protection against risk has been going on a long time. Insurance firms have decades of experience in this field.

SAVING THE STATE'S FACE

Of course, libertarian purists might argue that all this is very clever and so on, but are not credit derivatives such as those written against state debt simply allowing investors to shed risks of owning assets which should not exist in the first place?[11] Government bonds, are, after all, debts ultimately backed by the ability of governments coercively to levy taxes, unlike a company's debt. Cutting-edge capitalist products like derivatives make it easier for governments to issue debt in the first place.

A fair point, possibly, but it ignores the fact that we do not, as yet, live in a laissez-faire universe from which the coercive state has been expunged. In the meantime, however, it is good that capitalism can ameliorate some of the worst features of state delinquency, such as Russia's default in 1998. If credit derivative products can shield us a bit from the worst excesses of states like Argentina or Russia, then I am happy to benefit.

A REPORTING PROBLEM

It is also worth pointing out how the market can throw up tools and techniques to deal with things like default risk because it sheds light on the fecund nature of the free market more generally. As an aside, covering this sector as a journalist has reminded me of the need for more libertarian-minded young people to think of financial journalism as a career and hence raise awareness of the market's ingenuity. It continues to stun me how many journalists, even financial journalists, are generally either indifferent or downright hostile to the idea of the market.[12] For example, during a press conference at the British Treasury in Whitehall with UK Chancellor Gordon Brown in 1998, I recall that I was the only journalist in the press pack who even asked how the IMF was trying to overcome the moral hazard problem. The question, if I recall rightly, was received with a smirk. He obviously thought I was a trouble-maker. (He was right.)

SHOULD THE IMF BE ABOLISHED?

In my view a look at how the market has provided for credit risk surely strengthens the case for getting rid of bodies which arguably have contributed to recent crises, since the ability to mitigate risk undermines the need for such bodies. The International Monetary Fund is a particularly good candidate for the boot, not least because in addition to the moral hazard problem already touched upon, the IMF is also capable of giving terrible advice to the countries pleading for its cash. In Malaysia, for example, the IMF pressed for an end to the Malaysian rinngit peg against the dollar, a move which arguably fuelled rampant inflation when the rinngit sank in the foreign exchanges. The IMF seems particularly keen on *austerity* plans, which usually encourage statist governments responsible for the original mess to raise taxes rather than cut spending, and thereby crush entrepreneurship and investment. The IMF is not even shy of lecturing the world's richest country, the U.S., on its policies. In August 2001 the IMF, perhaps taking advice from the Democrat Party, sought fit to criticise President George W. Bush's tax cut, despite repeated evidence from America's history that supply-side tax cuts act as spurs to growth and investment.

Some of this is straightforward empire-building. The IMF needs to justify its existence and its role as international financial nag makes sense in that context. Born in an age of predominantly fixed exchange rates and low capital flows in the 1940s, the IMF now operates in a very different world, where capital flows can be measured in the trillions and dwarf trade flows. Instead of going back to the drawing board, however, policymakers have let the IMF carry on. So, it finds new things to do and say.

So should the IMF be abolished? I think so, because I see no effective way that it can surmount the moral hazard problem. The IMF is not a democratically accountable institution, so if it tries to attach stringent conditions

to its aid, such as fiscal austerity measures, it will inevitably invite criticism from voters. Indeed, the IMF is often attacked as being a hand-maiden of the capitalist order. Yet it is anything but this, since it does not operate in a genuine free market environment.

If the IMF were scrapped tomorrow, this would not mean the end of civilisation as we know it. There is no reason, for example, why major banks could not set up insurance funds of their own in times of crisis; ending the IMF would accelerate the development of market "rescue funds".

There is already some sign that policymakers in the West understand how dangerous the moral hazard problem is. When in early 1995 the ancient British bank Barings collapsed, the Bank of England allowed the bank to fail, rather than spend millions of public funds trying to rescue it. It was a salutary message to other banks that certain institutions can, and indeed should, be allowed to fail.

We should not stop at ending the IMF and similar state or quasi-state bodies. The history of the past few years also shows the risks inherent in a financial system dependent on state-run central banks issuing fiat currency, rather than a genuine private banking system. I believe the ability of central banks to pump liquidity into the system at will or withdraw it on a large scale is contributing seriously to the financial instability of the world.13 A move to free banking would be a step in the right direction in this regard.

A RISKY WORLD

A final point is on risk itself. We see how financial markets are very clever at figuring out ways to handle risk, offload it, exploit it, measure it, even trade it. But what is clear is that one cannot ulimately get rid of it. A crucial lesson of recent market developments is that risk is unavoidable. But the future is always uncertain. An awareness of capitalism's occasional bursts of volatility will ultimately make the system more, not less robust. We cannot escape from risk, so let us learn to enjoy dealing with it, and maybe, get seriously rich in the process.

NOTES

1. There is a growing body of literature on the financial crises in Southeast Asia and on globalisation. Many of these books are hostile to capitalism, though by no means all. A fairly good book on globalisation in my view is *A Future Perfect: The Challenge And Hidden Promise of Globalisation*, by John Micklethwait and Adrian Wooldridge (Random House, London, 2000). The book's strengths are its colourful examples of how global capitalism has benefitted people in unlikely ways. Sadly, the authors retain the view that institutions like state central banks, the International Monetary Fund and the United Nations can still perform a useful service in the world economy.
2. For example, see the current calls for a "Tobin Tax" on foreign exchange transactions. The tax was originally suggested by the Nobel Prize winning economist, James Tobin. The French government, led by Prime Minister Lionel Jospin, has been vocal in support of the idea, although as yet other governments, such as Britain's, have been decidedy cool.
3. See Doug Bardon and Ian Vasquez (eds.), *Perpetuating Poverty: The World Bank, The IMF and the Developing World*, CATO Institute, Washington D.C., 1994. As the title suggests, the authors of the book believe that such supranational bodies as the IMF have made the problems of poverty much, much worse. See also Ian Vasquez (ed.), *Global Fortune: The Stumble and Rise of World Capitalism*, CATO Institute, 2000.
4. See Micklethwait and Wooldridge, page 178-179.
5. Moral hazard concerns how actions by state and non-state bodies, such as insurance companies, welfare agencies and so forth can induce perverse behaviours. For example, too much fire insurance can provoke a rise in arsons, too much deposit insurance can encourage dodgy investments, and so forth. Unlike the IMF, however, insurance companies have a vested interest in trying to figure out the optimal amount of insurance and cannot, of course, rely on taxation as a source of funds.
6. Apologies to anarcho-capitalists, for writing such an oxymoron.
7. A good definition of a derivative is given in a book deliberately pitched at the layman, *Eat The Rich*, by P. J. O'Rourke (Atlantic Monthly Press, 1998): "A derivative is a deal about buying or selling rather than about buying or selling proper. When you own a derivative, what you own is a bargain that you've made. You've promised to pay or charge a certain price for a certain thing to be received or delivered at a certain time."
8. John B. Caouette, Edward Altman, and Paul Narayanan, Managing *Credit Risk: The Next Great Financial Challenge*, John Wiley and Sons, New York, 1998. See page 1. The introduction is a good overview of the growing interest in, and demand for, credit risk products. Much of the book is aimed at the financial professional and too technical for the average reader.
9. Credit derivatives have already been shown to work even where investors dispute the cause of a default, such as that of the U.S. firm Conseco in the summer of 2000.
10. Liquidity can be understood simply as the ability of a buyer or seller of X to do so without moving the overall price of X. If there are only two market players, then a decision to buy or sell will move X very far; if there are a million participants, X will hardly budge. As credit derivatives become more liquid, they also become less volatile in price.
11. This point came up when I discussed the topic of credit derivatives in August 2001 (see front cover info' — ed.). I am grateful to those present for helping me to shape my thoughts.
12. This is based entirely on personal observation and I would love to be proved wrong. Interestingly, some of the best financial reporters are ex-traders who have had enough of the dealing room pressures and have decided to take up the profession. Financial journalists tend, in my view, to be less hostile to capitalism than say, political reporters.
13. The issue of free banking is a massive one and I don't have the space to go into it here. A good place to start is the book edited by Dowd and Timberlake in the bibliography.

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Murray Rothbard, *What Has The Government Done to Our Money?*, Libertarian Publishers, Novato, 1978.

Jonathan Daviews, James Hewer and Phil Rivett, *The Financial Jungle: A Guide To Credit Derivatives*, PriceWaterhouse-Coopers, 2001. Technical, but the introduction is useful for the layperson.