THE GLOBAL FINANCIAL BREAKDOWN:
Precipitating Factors and Underlying Causes

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How and Why Did We Get in to this Mess?

What has precipitated the current crisis is the build-up and bursting of the real estate bubble in the USA.

Asset bubbles are not new, they are a recurrent phenomenon in all markets and all countries and all times, e.g. the tulip bubble in Holland in 1637, the South Sea Bubble in England in 1720, the bubble in the shares of Mississiippi Company in France in 1721 the stock market bubble in the USA in the 1920s, the commercial real estate bubble in Canada and the USA in 1989-90 (Reichman Brothers & Donald Trump), the dot.com and technology bubble of 1999-2000 and the stock market bubble in Greece in 1999.

What creates bubbles?

1) easy money (protracted monetary growth and low interest rates);
2) investor psychology (irrational expectations and self-fulfilling prophesies);
3) greed coupled with ignorance
4) the introduction of new technology and innovations which creates the impression that we live in a new paradigm (e.g. the securitization of bank credit, i.e. mortgage backed securities and derivative instruments such as structured products, CDOs) where the old rules no longer apply
5) period of protracted economic growth;
6) lax, insufficient or outdated regulation or supervision
7) underlying systemic and structural imbalances and weaknesses

What makes this bubble different?

1) It took place in the largest economy in the world (USA accounts for 25% of global GDP)
2) USA is the main pillar of the global financial system
3) USA is a capital importing country with huge current account deficits and a growing foreign debt which means it has had to borrow most of this money from the rest of the world, hence the bursting of the bubble is having global impacts, not just limited to the US financial system
4) The US dollar serves as the world's money, therefore it impacts all other currencies and international capital flows

5) Because of its role as the world's money, monetary policy in the United States is transmitted to all other countries, thus transmitting its effects as well
6) Because of globalization, all economies of the world have become more interconnected than ever before through trade, investment and capital flows
7) Is the biggest bubble in history, even bigger than that of the 1920s equities bubble which led to the stock market crash of 1929 and in turn the Great Depression
8) Real estate mega bubble was accompanied by a smaller though still sizeable bubble in stocks, at a time when exposure to stocks had reached the highest level in history
9) Real estate bubbles had formed in other countries as well such as Britain, Ireland, Iceland, Spain, Italy, Greece, the Baltic countries, the Gulf countries in the Middle East, Russia and China thus magnifying the global nature of this crisis

What facilitated and enabled the twin bubbles in real estate and stocks to reach the magnitude and extent they did?

1) The stock market meltdown of 2000 threw the US economy into a recession, which the Fed tried to counteract by cutting interest rates and shifting to an expansionary monetary policy stance.
2) The terrorist attacks of 9/11, which shocked the economy and necessitated an even more aggressive easing on the part of the Fed and other central banks in the world.
3) The slow recovery in the US economy in 2002-2003 and the deflationary scare that necessitated a prolongation of the monetary easing.
4) The ill-advised War on Iraq that necessitated the solidarity, cooperation and complicity of monetary policy authorities in the USA and other Western countries and burdened the US government with additional and increasing spending and fiscal borrowing.
5) The growing US current account deficits, which greatly increased the amount of money the US was borrowing from the rest of the world.
6) The reluctance and resistance by exporting countries to adjust exchange rates higher against the US dollar thus contributing to the trade imbalances facing the world.
7) The development of new financial derivative instruments that facilitated the securitization and distribution of mortgage and other debt both nationally and internationally, These instruments are known through a variety of names such as collateralized debt obligations (CDOs), asset-backed securities (ABSs) and sub-prime securities along with credit default swaps (CDSs) which provided insurance on fixed-income instruments such as conventional bonds and structured products.

8) The development of new financial service providers such as Angelo Morillo's Countrywide Financial Corporation which became efficient and aggressive originators of sub-prime mortgage loans to regional banks, i.e. the development of a "shadow banking" system or "alt".banking system which was new and largely unsupervised and un-regulated.
9) The unquestioned credibility of the US Federal Reserve under Chairman Alan Greenspan and the credibility of the USA and the US financial system as being the most sophisticated, regulated and powerful in the world, capable of doing no wrong (hubris).
10) The inability of investors including the sophisticated credit rating agencies like Moody's and S&P to comprehend the new derivative products that had been introduced which led them to underestimate the risks inherent in the new derivatives instruments they were rating.
11) The deregulation of the US financial system by Robert Rubin, Secretary of the Treasury under President Bill Clinton in 1999 when the Glass Steagall Act of 1933 was repealed and allowed banks to sell securities and vice versa along with the introduction of a new business model in the financial industry. With the new model, banks did not have to hold the loans, and carry the risk inherent in these loans but they could sell them to another entity and earn fees instead, thus transferring the risk of default to a third party. The implication of this shift was to reduce their concern and vigilance over the quality of the loans they were granting as long as there was someone else down the line willing to take on this risk.
12) This new business model and new incentive system that came into place meant that you could make money without assuming the risk, so it led to reckless lending. For example, loan brokers would scout the neighborhoods to find people to buy a house and they offered to find them low cost financing to finance the purchase of the house. It did not matter if the borrower had low or no credit rating, or could prove they had income or ability to pay. Loan brokers earned fees from regional banks by bringing those loans to them. Then the regional banks did not need to care too much about the credit-worthiness of the mortgage borrowers since they had their house as collateral and they didn't plan to hold the loan on their books for too long. Then the regional banks would sell their mortgage loans to the Wall Street firms like Bear Stearns, Lehman Brothers and Citibank and collect fees. Then the large and reputable Wall Street firms would package these loans from all over the country, securitize them and sell them as mortgage-backed securities to the investment public, thus earning fees. Before selling them of course, they would have their new securities rated by credit rating agencies like Moody's and S&P who would collect fees as well. Finally, the US and foreign investors would purchase these securities on the assumption that a) they are backed by quality mortgage loans to credit-worthy US homeowners, b) that real estate prices could not fall

all over the USA at the same time and that since real estate values keep rising over time, they didn't have much risk to worry about and c) they were issued by Wall Street's biggest and most reputable financial institutions and they were rated as investment grade by the most reputable credit rating agencies. The implication of this model is that everybody involved in this process earned fees without assuming any risk. The risk was transferred to the investors of the mortgage-backed securities at the end of the line. The implication of this business model was that nobody down the line had an incentive to question the risk or the assumptions upon which this bubble was being built on because nobody bore the risk and wouldn't face losses if the mortgage loans went bad. Besides, the operant assumption was that although real estate prices could fall in different regions of the United States at any one time, they could <u>not</u> fall in <u>all regions</u> at the <u>same</u> time! As long as US real estate prices continued to rise or at least not fall, this became a one-way bet where everybody made money. Of course, this scheme was doomed to fail at some point because its very success generated a pricing bubble in the US real estate market, which eventually would have to burst as all bubbles eventually do.

13) The thirst of yield-starved and gullibility of investors in a low interest rate environment both in the US and around the world.
14) The inability of common sense economists, analysts and even regulators to stand up to the power and influence of large Wall Street investment banks and
15) The unwillingness of US government policy makers and regulators to take a more prudential and tough approach to these emerging trends in the context of a free-market euphoria and free-market dogma propagated by a radical right-wing regime in Washington coupled with the government's preoccupation with the War on Iraq.

<u>The Root of the Problem: Separating Underlying From Precipitating Causes</u>

Although asset bubbles are a natural and recurrent phenomenon in market economies, if the international monetary architecture upon which national economies and the global financial and monetary system rests is sound, they eventually burst and the after-shock and economic consequences are contained within a limited time span and economic space and result in small impacts on surrounding economies and the rest of the world economy.

The underlying problem which has allowed the U.S. real estate bubble to topple the U.S. financial system and transform itself into a global financial disaster is the current structure and architecture of the international monetary system, which is the bedrock upon which the global financial system and international economy rests.

Very few people realize this, and those who do are constrained by political or occupational interests to admit so publicly, that the international monetary system rests on a major structural fault line. A shift in this fault line is capable of bringing down all the financial house of cards that have been so carefully stalked upon it. This is an accident that has been waiting to happen. It is not a matter of "if it happens" but a matter of "when and how it will happen". Right now we are in the opening stages of this process where the underlying shake-out has just begun. How long it will take and how it will play out is hard to tell, but one thing is certain, it will end up in the collapse of the current international monetary system which I will call the "Bretton Woods I +" and will be replaced by a new international monetary system, the "Bretton Woods II". What form the new system will take will depend on the willingness and ability of the participating nations to see the bigger picture, to see the longer view and to sacrifice narrow self and short-term economic and political interests for the greater good that awaits and will benefit all nations if this is done right. The basic principles upon which the new international monetary system should be built are not hard to see. In fact, the basic outline for this new international monetary architecture was proposed by John Maynard Keynes back in 1944, at the Bretton Woods Conference which set up the current architecture in the closing days of the Second World War.

What was the Problem with the Bretton Woods System?

The structural fault line I am referring to is a basic design fault in the gold exchange standard that was agreed upon in 1944, which finally replaced the gold standard that had served the world economy in the late 19th century until the break-out of the First World War in 1914. What is this design fault that was built-in the current international monetary system?

The root of the problem is that the world allowed a single country's currency -no matter if that country represented at the time 55% of the global GDP and had become the most powerful nation on earth- to become the world's money, i.e. the world's medium of exchange, store of value and unit of account. The issue is that you cannot build a sound, stable and viable international monetary system on the back of a single country's currency. Rather, the currency that is used as a) the principal reserve asset of central banks where nations store their savings and b) to price and settle all global trade and monetary transactions, should be a truly international currency, wholly third and independent financial instrument, which is made up of the currencies of all countries that compose the world economy and belongs to all countries, so no country should be dependent on an other country's currency, so every country should share in the responsibility and accountability of maintaining the global monetary system, and so that this currency be viewed as a legitimate and impartial standard of monetary value.

The currency that served the world economy so well during its heyday in the closing decades of the 19th century and the beginning of the 20th was not a paper or fiat currency and did not belong to any particular nation, country or person, but was a public good. It was a precious metal, gold and was supplemented by another metal, silver. Gold had served as a means of exchange, store of value and unit of account for many centuries before, starting with the ancient Lydians of Asia Minor who were the first to introduce gold coins around 600 B.C.E. and immediately following with the Greeks and the ascent of the Athenian drachma as the principal currency of the Classical and Hellenistic era. The reason why the drachma and two thousand years later the British pound sterling served so well the world economy of their time, was that the coins were never debased, they contained a constant amount of precious metal. Then when the British issued paper money, the amount of paper money that one could exchange for gold remained fixed and was fully convertible into gold by simply presenting the paper notes to a bank. The reason why the world enjoyed a stable monetary system until the outbreak of the First World War was that British authorities never tampered with the value of their currency, so the world felt comfortable in using the British pound as a gold substitute. This system of full and faithful convertibility of paper money to gold is what is known as the "gold standard". What put an end to the gold standard was the Great War, which forced countries to print paper money well in excess of the amount of gold they held in reserve and made convertibility to gold impossible at the original rate of exchange. Despite this, the then British Chancellor of the Exchequer Winston Churchill made a valiant attempt to restore the convertibility of the British pound to gold and bring the gold standard back in 1925. In 1931 the effort failed, and Great Britain was forced to abandon the gold standard as the world economy plunged into the Great Depression. The breakdown of the gold standard was both a casualty as well as a contributing cause to the Great Depression and by extension to the Second World War as well.

Mindful of the disastrous consequences that a break down in the international financial system, in this case the gold standard, had for the world economy and for world peace, the allied powers decided in the closing days of the War to convene an international conference to decide on what to do and how to replace the old international monetary system based on gold, so that another world depression and another world war will never happen again. They met at the Mount Washington Hotel at the resort town of Bretton Woods, New Hampshire, in the USA in the autumn of 1944. Forty four countries participated in this conference and it was here that the global financial architecture of the post-War period was agreed upon. The agreements that were reached at this meeting are what are known collectively as the Bretton Woods system.

What was decided was to return to the gold standard but in a modified form. Gold was made an official reserve instrument for central banks to store their reserves, but the role of gold was also to be supplemented by the U.S. dollar which would be fixed at a price of U.S. $35 dollars per troy ounce (1 US

dollar = 1/35th of a troy ounce) and only be partially convertible to gold, not for the average person but amongst central banks for official state-to-state transactions only. As Athenian rulers would pledge to preserve and protect the exchange value of their currency and as British authorities had so faithfully done centuries later, the United States pledged to maintain and preserve the convertibility of the US dollar to gold at the agreed upon exchange rate. Since most gold reserves had fallen in the hands of the U.S. government during the war, the US possessed roughly two thirds of the word's supply of gold. There was not enough gold to go around to serve the needs of other countries. Since Europe and Asia's war-torn economies had collapsed and the US dollar had emerged as the most powerful currency in the world and had supplanted the British pound that was now practically worthless following the huge debts that Britain had amassed during the war, the free world had no other choice but to rely on the US dollar for its liquidity, payments and reserve needs. This new international monetary order that came into effect, along with its supporting institutions like the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), now known as the World Bank, is what is known as the "gold-exchange" standard or the Bretton Woods system.

The challenge of the new system was how to provide the liquidity that the free world needed to finance and operate the growing world economy in the post-war period. First of all, the amount of gold was not sufficient to meet the world's growing needs for money and secondly, the United States government was reluctant to share its ample but limited supply of gold with the rest of the world. The only way for the world's war-torn nations to recover and re-build their economies was by exporting more goods than they imported, i.e. run balance of payments surpluses and the only major free standing and prosperous economy that they could do this against was the U.S. economy. This implied that if the new monetary system was to work, the U.S. had to supply the liquidity the world needed, either by transferring gold to the rest of the world or by transferring dollars. Since buying goods and services from other countries was cheaper than building them at home, it became convenient for the US to import more goods than it exported, thus the US quickly settled in the position of running large trade deficits, which it paid by issuing dollars. This turned out to be a mutually beneficial and symbiotic relationship for all parties. For the world economy it was desirable because US deficits provided the liquidity and the dollars they needed to rebuild their war-torn economies. For Europeans, Japanese and South Koreans it meant that they had to work more and consume less and export the rest to reconstruct their economies and accumulate wealth. For Americans it meant that they could buy goods from the rest of the world without having to pay for them, because the rest of the world needed the US dollars to serve as central bank monetary reserves -in lieu of gold- to support their currencies, what is known as the precautionary need served by the store of value function of money, as well as a means of payment to finance the growing volume of international trade and payments, what is known as the transactions need served by the medium of exchange function of money. The implication of this state of affairs

was that as long as the rest of the world economy needed more dollars to serve as a means of exchange and store of value the USA could enjoy a free ride by issuing paper currency and expanding the money supply without suffering the costs of higher inflation and the concomitant rise in interest rates that normally set a limit on how much money a country can print. In effect, Americans could afford to consume more goods than they produced and that since the global demand for dollars kept rising they could also expand the supply of dollars without having to depreciate their currency or raise interest rates, either of which would impose a real cost on the people and force the US to live within its means. As long as this situation lasted the world's economies got what they needed and confidence in the US dollar was maintained. The system served its purpose and every body gained.

This situation could only last as long as the rest of the world needed US dollars to serve as a substitute for gold. Once the needs of the world economy for US dollars dried up, either the US would have to transfer its gold holdings to countries experiencing a surplus in their balance of trade against the US or if it wanted to hold on to its gold holdings it would have to reduce the rate of monetary expansion and balance its payments by increasing exports and reducing imports. In effect, if the integrity of the Bretton Woods system was to be maintained, the US would have to go back to living within its means and earn its way to prosperity the good old fashioned way of working hard, innovating and competing more.

On the other hand, if the USA moved to balance its international payments it would cut off the increasing supply of US dollars the world economy needed to finance its growing economic activity and this would result in a shortage of liquidity, rising interest rates, intensified competition and a slowdown in world growth that would also affect the US at home. There was a built-in contradiction in the way the Bretton Woods system was designed, a serious design flaw. If the US dollar was to serve the growing transactions demand of the world economy as a an international means of payment and medium of exchange, the US was obliged to keep its balance of payments in a perpetual state of current account deficit, in effect, the US was prevented from ever balancing its payments. At the same time, if the US dollar was also to serve as an international and credible store of value or reserve currency it meant that the supply of dollars issued by the US could not expand indefinitely against the limited amount of gold holdings it possessed in its gold reserves. By fixing the price of the US dollar at $35.0 per ounce and undertaking to convert US dollars to gold at that price there would not be enough gold left in reserve to be exchanged for all the dollars it had issued. To maintain confidence in the US dollar the US government would have to maintain the peg with gold, to maintain the peg with gold at the pre-set US 35.00 per ounce value, the US government was obliged to limit the growth in the supply of dollars. Thus, there was a built-in contradiction, either the US must increase the supply of dollars to meet its obligations to provide the liquidity the world economy needs to grow and prosper or reduce the growth in the supply of dollars

to the world in order to defend the value of the US dollar and preserve confidence in the dollar as a reserve instrument. This contradiction, inherent in the design of the gold-exchange standard was first pointed out by a Belgian-American economist, Robert Triffin in 1960 and is known as the "Triffin dilemma".

Overdependence on the US Dollar and US Monetary Policy

There is another defect that was built in to the Bretton Woods system. Since the US undertook to make the US dollar a substitute for gold and the primary means of international trade and payment activity, in effect the *de facto* international currency of the free world, the Federal Reserve Board and the U.S. Treasury became the *de facto* central bank of the free world as well. This means that when the US moves to an expansionary monetary policy, the same policy spills over to the rest of the world economy resulting in lower interest rates, economic expansion and perhaps higher inflation. When the US moves to a contractionary monetary policy, interest rates rise all over the world, economic activity slows down and inflation comes down. In a world of fixed exchange rates, which was the case before President Richard Nixon severed the peg between the US dollar and gold in August of 1971, this was a direct and immediate relationship. To preserve fixed currency parities countries were obliged to follow the monetary policy of the US. Since the tumultuous period of exchange rate instability in the early 1970s, the world shifted to a system of floating currencies, where the value of a country's exchange rate was determined by supply and demand in foreign exchange markets. Even though the new system of flexible exchange rates gave governments more power to control monetary policy and activity within their borders and provided them with a modest degree of short to medium term monetary independence, governments are still mindful of the value of their currency in relation to other countries and especially in relation to the US dollar. Thus to prevent their currencies from deviating too far from that of the US dollar and undermining the international competitiveness of their exports, governments cannot afford to stray too far away from US monetary policy not even today. Add to this the increasing role of short-term capital flows which were not such a big factor in the 1950s and early 1960s but have become an exceedingly important feature of the current global financial system, especially so since the ascent of South East Asian economies, including China, the collapse of communism and the globalization of the international economy the last 20 years.

The problem with this picture is that when the US economy is doing well, so is the rest of the world's economy, but when the US economy is doing bad, the rest of the world economy suffers with it as well. Likewise financial innovations coming out of the US economy quickly spread and benefit the rest of the world economy while financial problems or crises of the one we are experiencing today emanating from the US financial system quickly spread to the rest of the world economy as well. In the current environment not only was the financial crisis transmitted to other countries in a lightning speed, their central banks have had to follow the federal reserve in cutting interest rates and even

worse, the contraction has been more severe outside the US especially in those countries that are more export dependent on the US market like Japan and South East Asia.

Dollar Overhang and Excess Liquidity

Although one of the structural defects of the original Bretton Woods system was eventually resolved through the abrogation by the US of their pledge to convert US dollars to gold at the original parity of $US 35.0 dollars (later adjusted to $42 per ounce) and the shifting of the world to a regime of flexible exchange rates, the other defect still remains. The US has been running continuous current account deficits against the rest of the world and financing them by borrowing money. Increasingly, the funds have come from public sources such as the central banks of Japan, China, the South-East Asian Tigers and the oil rich Gulf countries of the Middle East. US dollars held outside the United States now exceed the amount held inside its borders and an overhang of US dollars has resulted. Since many countries want to keep their exports competitive they have been buying the US dollars to prevent the value of the US dollar from depreciating (or prevent the value of their own currencies from appreciating). This build-up of an overhang of US dollars in the world economy has had a number of consequences, both positive and negative.

On the positive side, they have provided the liquidity to finance the growth of the world economy at an unprecedented rate and scale. On the negative side, they have had two malicious unintended effects. The first effect was to create a savings glut that has kept interest rates low and prevented long-term interest rates from rising. Low interest rates frustrated the efforts of the Greenspan Fed to raise interest rates in the 2004-06 period that could have cooled down the housing bubble and help enforce more fiscal discipline in the US.

The second effect was that this overhang of dollars has found its way to asset inflation as opposed to product inflation. Ever since Paul Volker's successful attack on inflation in 1980-81 which taught producers a hard lesson - not to raise their product prices and unions not to demand higher wages- the excessive build-up of US dollar liquidity has been channeled into assets such as real estate, equities, bonds and increasingly derivative and exotic financial instruments. This has increased the frequency of asset bubbles in the world economy, creating the largest bull market in history (1981-2008) as well as the largest housing bubble in history. In addition, since producers knew that product price increases were constrained by inflation-control policies of central banks, they switched to off-shoring production to emerging economies to keep costs low but profits high. This has led to low inflation, falling wages and increased profits, which pushed the profit share of national incomes in developed countries to the highest point in recorded history (18%-20% of national income) and made the rich richer and the poor poorer in developed economies. In short, the second structural defect of our international monetary system has led to the creation of

global trade and financial imbalances that have led to current financial and economic upheaval. Clearly, in the long-run the US cannot afford to run massive current account deficits and other countries run massive current account surpluses without putting the world economy at risk.

Towards a New International Monetary System: Bretton Woods II

The long-term solution, the only equitable, legitimate and lasting solution is for the world to move to a new reserve currency. The new reserve currency that the world needs is a composite currency that serves as a store of value, though not as a medium of exchange. It is a currency similar to the E.C.U. before its conversion to a full-fledged currency, the euro, in the eurozone, and is similar to the special drawing rights (S.D.Rs), the accounting currency used by the IMF and similar to the bancor, the currency proposed by John Maynard Keynes in 1944. This new currency can be made up by the principal convertible currencies of the world today. For example, 25% of the new currency can be composed by the US dollar, 25% by the euro, 25% by the Chinese Renminbi and the Japanese Yen and the balance by the currencies of other leading nations who have freely floating and convertible currencies whose value is determined by supply and demand in foreign exchange markets. The new currency needs to be accompanied with a new world central bank, similar to Keynes's proposed International Clearing Union (ICU) that will determine the global supply of money and ensure that countries cannot build massive trade imbalances which can destabilize the world economic order. In turn, each country can go back to fixed exchange rates and fix the value of their domestic currencies that will serve as the medium of exchange, store of value and unit of account within their national jurisdictions. Such a system will relieve the US of its onerous responsibility of carrying the global financial system on its shoulders. It can more evenly redistribute the weight of the international monetary system among the world's national economies and it will diversify the risks of financial breakdowns and can result in a more stable, sound and lasting international monetary system.

I realize that such a proposal is too ambitious given the geo-political reality of our time and is likely to be dismissed as too utopian to receive serious consideration by policy makers. On the other hand, the current near-breakdown in our international monetary order provides a rare opportunity to re-examine and re-evaluate the present system and to re-build the international monetary system from the ground up on a more solid foundation instead of searching for patch-up and band aid solutions that will treat the symptoms but fail to address the roots of the problem. Moreover, should the current responses prove inadequate and conditions do spin out of control resulting in a complete collapse of the present system, we need to have thought out alternatives to the present system that can provide a basis and direction for rebuilding a new system better suited to the new global realities of our geopolitical and economic world order of the 21st century.

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Comments, feedback and discussion on this paper are welcomed and would be much appreciated by the author.

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