Governing by Trope? Markets, Ideas, and Monetary Crises in a Global Financial Order

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As this paper is very much an experiment in ‘pushing the boat out,’ the usual disclaimers apply with more force than usual. Please do not attribute to me anything from this paper without my permission - I will deny everything!
Introduction:

This paper explores the importance of ideology and power in the construction, and maintenance of international financial markets. I wish to analyze why it is that financial markets have become, and are increasingly likely to become, more crisis prone as they become more integrated. Furthermore, given that such a system is by definition inefficient, the question becomes how can such a system come about, and how can it be sustained? These questions will be answered in three stages. First, through an examination of market actors’ expectations which revisits Keynes’ ideas concerning how businessmen may actually think on a micro level, and how this impacts upon how markets work on a macro level, it shall be demonstrated that financial market equilibria are inherently unstable. By providing a mechanism for shifting from one equilibrium to another which stresses the power of economic ideas as integral parts of financial markets, this paper will argue that the shared ideas of market agents both coordinate market behavior, and yet also cause market crashes.

Second, the paper will examine how such a system came about, whose interests it serves, and how the present system ultimately rests upon the political power and intellectual dominance of the ideas of finance. This is demonstrated through three cases studies; the fall of the Bretton Woods institutions in the 1970’s, the deregulation of US domestic financial markets in the 1980’s, and the growth of derivatives markets in the 1990’s. The third part of the paper will argue that the governance of financial markets in the future will prove to be much more problematic than in the past precisely because of the unstable nature of these new institutions and the political power of the financial interests who support them. Thus, despite present schemes to ‘design a new architecture of finance,’ the role of government in such a system will be increasingly reduced to verbally reaffirming market conventions in the hope that this will produce stability, in other words, to the exercise of ‘government by trope.’

¹ The increasing periodicity of crises is not in doubt. If one defines financial crises as abrupt changes in the nominal exchange rate coupled with abrupt reverses in the current account, then there have been three ‘waves’ of crises in the 1990’s, or one major currency crisis every 19 months. In contrast, Kindleberger
A Funny Thing Happened on the Way to the Market...

By way of introduction, consider two curiosities. Over the past fifty years or so the portrayal of businessmen (particularly financiers, rentiers, and other such ‘invested’ interests) within economics has swung from one extreme to the other. In the Keynesian worldview businessmen were seen as being rather myopic, easily ‘spooked,’ prone to irrational behavior, etc. By the late 1970’s this view had changed dramatically. Indeed, one of the starkest but least remarked upon contrasts between Keynesianism and the theories which displaced it; first monetarism and then rational expectations, was the portrayal of businessmen within these new theories. In contrast to Keynes, Friedman’s ‘adaptive expectations’ saw businessmen as ‘dumb in the short run but smart in the long run,’ while the work of Muth et al. completely overturned the Keynesian view and portrayed businessmen as hyper-smart information processors who, except for random disturbances, could never be fooled by government action and whose decisions could be improved upon by any external agency.

What are we to make of this shift in economic thinking? Perhaps businessmen had become much smarter by the 1970’s? Or perhaps something a little more political was going on? After all, while the Keynesian view implied that leaving the job of investment and growth to business was equivalent to letting the lunatics to run the asylum, the latter view argued that business, once freed from the ‘inefficient shackles’ of government regulation, would turn sand into gold. It is perhaps unsurprising then that having this latter view of business as the frame averaged out the periodicity of financial crises over the last two hundred years until 1980 as one every seven years.

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2 As this paper deals with the politics and dynamics of financial markets, it is therefore concerned with investors. As such, the terms, business, financier, investor, and rentier, will be used interchangeably.

3 As the question Keynes was once asked by a journalist demonstrates. “If businessmen are as stupid as you make out, then how come they can turn a profit?” Keynes replied, “simple, they compete against other businessmen.”


through which policy is discussed would rather obviously benefit business more than the former view. Hence it is perhaps not unreasonable to assume the current system is designed as it is, given what I shall term below the market’s “selbstbespiegelung,” because it reflects the preferences of financial interests and enables such interests to realize their preferences.⁶

Our second curiosity is rather different. In a review of George Soros’ *The Crisis of Global Capitalism*, Barry Eichengreen takes Soros to task for arguing that economists see “their discipline as one which assumes that individuals are hyper-rational and markets are characterized by stable equilibria.”⁷ Eichengreen argues that contra Soros’ portrayal of economics, economists such as Akerlof and Stiglitz have never believed in such simplicities, and to prove his point argues that within the field of financial economics concepts such as “information cascades,” “payoff externalities,” and “mimicking behavior,” testify to the sensitivity of real economists to non-ergodic processes and market-failures. As such, Soros’ critique is misplaced.⁸

Now, undoubtedly Soros doesn’t know as much economics as Eichengreen. And yes, we can recognize that there are many economists who have broken with the simple and deterministic rational expectations frameworks of the early 1980’s - policy irrelevance proposition and all the rest.⁹ However, this recognition simply begs more questions. First of all, one can argue that concepts such as ‘information cascades’ and ‘mimicking’ and even ‘rational panic’ are merely epicycles designed to reconcile the neo-classical version of general equilibrium theory with its inability to explain instability and financial crises.¹⁰ Second, and what is more interesting for the purposes of this paper, is that while Eichengreen’s critique may be right, it may also be irrelevant.

⁸ Eichengreen “The Crisis of Confidence...” p. 10
⁹ But let us not forget how dominant these views were in the early 1980’s, and later still, and how ‘sensitive’ economists such as Stiglitz ended up being marginalized at more orthodox institutions.
¹⁰ As such, rather than constituting some kind of Lakatosian progressive problem-shift, such secondary hypotheses may well be degenerative ad hoc moves.
If we consider that Soros has been playing the currency markets for twenty years, and then acknowledge with Eichengreen that Soros is ignorant of the latest advances in economic theory, why then should we expect these new and more nuanced ideas to have any impact on what Soros, or anyone else, actually does in financial markets? Or to put it another way, Soros may not know the theory of how markets work, but he does know how to work in markets. Given this, the way Soros and other agents like him think markets work must in fact shape how markets work as it is their own actions which constitute them. In short, while modern economics can model how market’s behave with a plethora of different theories and assumptions, if we want to explain market outcomes then the point is surely to understand how businessmen actually think about markets, rather than model what’s going on ‘as if’ it is in accord with the latest theory. Thus despite Eichengreen’s undoubtedly correct protestations, such ‘modern’ theories may be of little use in understanding the processes at work within markets if the market participants themselves are either ignorant of the theory, or worse still, if they operate on an entirely different basis altogether.\(^{11}\)

This paper, is an attempt to flesh out the consequences of these two observations; namely, that the way financial market actors behave may be fundamentally different from that portrayed in theory, and that such agents have a vested interest in promoting a particular type of financial order. In order to make these claims we should first consider how markets are supposed to work, how they ‘see themselves’ so to speak, and then offer an alternative understanding.

**Part One: Markets’ ‘Selbstbespiegelung’\(^ {12}\)**

Since the late 1970’s macroeconomic theory has argued that causal accounts of the behavior of aggregates, for example, ‘financial markets,’ must be grounded in convincing causal accounts of the behavior of individuals. More specifically, ‘credible’ theories must be

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\(^{11}\) One can justify this with the famous Friedman “as if” hypothesis. However, such an ‘instrumentalist’ move, philosophically speaking, does not really carry much water.

\(^{12}\) Approximately, “the arrogant view one has of oneself in the mirror.”
supported by models which are generated from the main assumptions of neoclassical economics: that individuals are self-interested maximizers and that markets clear. The necessity of this move, it was argued at the time, lay in the fact that Keynesian models assumed that “people had no knowledge of the economic system and did not perceive any interrelationships between the (hypothesized) variables.”\(^\text{13}\) Consequently such individuals must be in some sense be ‘deluded’ all the time. Given that being ‘deluded’ all the time is very expensive, especially if one is making margin calls, one would expect market agents to correct these mistakes.

Indeed, modern macroeconomic theory argues that people do indeed invest in being correct. However, the models proposed go much further than this and suggest that “economic agents are completely aware of the ‘true’ structure of the economy, that is, the form of the equation and the size of the coefficients in the econometric model which govern it, and make full use of this in forming their expectations.”\(^\text{14}\) If this is the case, then while we can expect individual market participants to make mistakes, systematic mistakes by markets are impossible because the structure of the market itself is seen as both invariant and known to agents in the market themselves.\(^\text{15}\)

In financial markets, given that all agents (supposedly) share the same model of the economy, if there are no large information asymmetries, agents’ expectations about possible future states of the economy should converge, and such convergence should encourage stability, not instability, in markets.\(^\text{16}\) Given such convergence, instability, as witnessed by the policy pronouncements of the IMF after the East Asian Crisis, can only result if agents act on poor information.\(^\text{17}\) Stability in such a system is therefore achieved by reducing barriers to the

\(^\text{13}\) Michael Bleaney *The Rise and Fall of Keynesian Macroeconomics* (London: Macmillan 1985) p. 142
\(^\text{14}\) Bleaney *Rise and Fall...* p. 143
\(^\text{15}\) Which is oddly reminiscent of the Ricardo/Say postulate that while there may be a failure of demand in one market, there can never be a failure of demand in all markets simultaneously so long as prices (qua information) are allowed to adjust freely.
\(^\text{16}\) Expectational convergence is a function of the combination of the efficient markets hypothesis with the fundamental theorem. These postulates are discussed below.
\(^\text{17}\) See for example the remarks of Stanley Fischer, First Deputy Managing Director of the International Monetary Fund, at the Midwinter Conference of the Bankers Association for Foreign Trade, Washington D.C. January 22nd 1998, and the Testimony of Federal Reserve Board Chairman, Alan Greenspan, before the House Committee on Banking and Financial Services, January 30th 1998.
‘natural’ convergence of expectations by promoting increased transparency and better information through market integration.

As Eatwell notes, underpinning this ‘selbstbespiegelung’ are four ideas; ‘rational expectations,’ the ‘fundamental theorem,’ and the ‘efficient markets’ and ‘natural rate’ hypotheses.\textsuperscript{18} The fundamental theorem argues that competitive markets produce Pareto efficient equilibria. The efficient markets hypothesis holds that given competitive markets “financial assets embody the true value of their real counterparts, creating an environment in which individuals trading in these assets can make Pareto efficient decisions.”\textsuperscript{19} This plus rational expectations (and expectational convergence) means that volatility in asset prices will decline, and in the absence of changes in the fundamentals, free and integrated markets will yield superior economic performance to regulated markets, with employment and output being produced up to the ‘natural rate.’

These four ideas “present a picture of economic efficiency being dependent upon free markets for goods, labor, and finance, and a minimalist state. Market liberalization is accordingly beneficial because it involves the removal of market distortions, which are \textit{by definition} inefficient.”\textsuperscript{20} Given this, the modern theory of markets holds that financial liberalization, both domestically and internationally, is the ‘true’ engine of growth. If the allocative distortions of credit and currency controls are removed it is held that capital will be free to move to its highest (and most efficient) return where better products and services will be created through competition, and where profligate state finances will be ruled \textit{ultra vires} through capital flight.

Given all this, it’s rather difficult to see how such a world could ever produce instability of the type which brought us the East Asian crisis absent large exogenous changes in the fundamentals, and even then, with a good informational architecture, such shocks should be quickly absorbed by the market. However, it seems that pervasive instability can occur in the

\textsuperscript{18} John Eatwell \textit{International Financial Liberalization: The Impact on World Development} (UNDP Discussion paper Series Number 64 1996) p. 9

\textsuperscript{19} Eatwell \textit{International Financial Liberalization} p. 10
absence of changes in fundamentals, even given an environment of good information.\textsuperscript{21} Moreover, if markets really did behave in this way, then we would have a great deal of difficulty in explaining not just market meltdowns and contagions, but also simple market processes such as Bull and Bear positions.\textsuperscript{22}

In short, the economic theory which financial markets take as their ‘selbstbespiegeling’ presupposes a fixity of market structure and behavior which is based upon assumptions which are seldom, if ever, found in the real world.\textsuperscript{23} After all, if the natural rate ‘bobs around’ all over the place, if the conditions of the fundamental theorem and the efficient markets hypothesis (perfect competition, perfect information, no externalities) are never satisfied in real markets, and if market agents have far from rational expectations, then perhaps it is time to construct another understanding of market agents’ behavior.

\textsuperscript{20} Eatwell \textit{International Financial Liberalization} p. 10, Author’s italics.
\textsuperscript{21} Although, models of currency-crises admit this possibility they are at a loss to explain it. So-called ‘second generation models’ posit a tension between domestic and international monetary commitments, but add the proviso that both the probability and cost of defending against a crisis increases as a function of the suspicion that the exchange rate will not in fact be defended. This gives rise to multiple equilibria where these ‘suspicions’ and their ‘trigger points’ are not related to movements in domestic fundamentals, but are instead a function of either ‘herding,’ where information costs lead investors to take each others movements as signals, or ‘contagion effects,’ where ‘international herding’ precipitates a reaction out of proportion to any movement in the underlying variables. See for example Maurice Obstfeld “Models of Currency Crises with Self-Fulfilling Features” \textit{European Economic Review} 40 (1996) pp. 1037-1047, and Stephen Morris and Hyun Song Shin “Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks” \textit{American Economic Review} June 1998 pp. 587-597. However, the problem with both sets of models is twofold. They either posit a relationship between expectations and fundamentals which does not seem to be borne out in practice, or they posit pure self-fulfilling behavior and yet offer no explanation as to why a crisis will occur, that is, what triggers this behavior. As Krugman notes, this leaves us “in the familiar terrain of ‘sunspot’ dynamics in which any arbitrary piece of information becomes relevant if market participants believe it is relevant.” (Krugman “Currency Crises” Paper Prepared for an NBER conference 1997 p. 8). The seeming ‘randomness’ of the conclusions of these models is perhaps why, despite the attempt by the IMF and the Treasury and the Fed to tell a story concerning ‘fundamentals’ and developing in effect an ‘official account’ of the East Asian crisis after the fact, practically none of the explanations offered have invoked any existing models of currency crisis by way of explanation. Instead a variety of ad-hoc factors; crony capitalism, moral hazard, deteriorating export performance, high debt-equity ratios, and of course, insufficient transparency, were all blamed instead.

\textsuperscript{22} After all, if the same information is both available to all and interpreted the same way, why would some market actors be ‘Bearish’ and some ‘Bullish?’ See Christopher Torr \textit{Equilibrium, Expectations and Information: A Study of the General Theory and Modern Classical Economics} (London: Polity Press 1988) pp. 41-44

An Anarcho-Keynesian View of How Markets Really Work

Arguably, the most fundamental insight of Keynes' *General Theory* was that the state of the economy is largely a function of expectations and that these expectations were non-rational. While it is acknowledged that Keynes made some remarks about ‘animal spirits’ and ‘beauty pageants,’ it is generally considered that he offered no systematic theory of how such subjective dynamics effect market processes. This view is incorrect. Keynes offers us at least the beginnings of understanding of how these processes operate.

There are two parts to Keynes, or rather two steps in his understanding of how capitalist economies work. The first step is mechanical, that being the discussion in the *General Theory* of the concepts of effective demand, the multiplier, interest rates, etc. The second step is that seemingly incongruous part of the *General Theory* entitled ‘the state of long term expectation,’ which is for Keynes primarily psychological, and perhaps even non-rational. These two processes between them link the micro behavior of investors to the macro outcomes of markets.

The first step is the stuff of economic textbooks and need not concern us here. The ‘second step’ is seen most clearly in Keynes’ only published ‘reply to his critics.’ In his February 1937 *Quarterly Journal of Economics* article Keynes had little to say about the mechanical ‘first step’ elements of the *General Theory*. Instead, Keynes chose to focus upon the role of beliefs and knowledge in the economy. Keynes argued that “we have, as a rule, only the vaguest idea of any but the most direct consequences of our acts. Now the whole object of the accumulation of wealth is to produce results, or potential results, at a

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24 Excuse the term, but I could hardly call this ‘Neo-Keynesian’ as it has nothing to do with menu costs and the like.

25 Those who read Keynes through Samuelson or in the Neoclassical tradition may find this claim surprising. I would merely ask the reader to refer to the following passages of the *General Theory* to accept the plausibility of this argument. See John Maynard Keynes *The General Theory of Employment, Interest and Money* (New York: Harcourt Brace and World 1936) pp. 89-112, 135-164, 245-257 and 372-385.

26 It is for this reason that the claim that Keynes lacked microfoundations has always puzzled me.

27 Basically, the size of the marginal propensity to consume appears as the key determinant of whether saving and investment are in equilibrium. Thus, if national income rises so will total expenditure and total saving. Thus Keynes argued that the rate of employment is not determined by the market clearing price of
comparatively distant, and sometimes an indefinitely distant date. Thus the fact that our knowledge of the future is fluctuating, vague, and uncertain, renders wealth a peculiarly unsuitable topic for the methods of classical economic theory...[A]bout these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know.” 28 Given this inherent uncertainty, Keynes notes that “knowing that our own judgment is worthless, we endeavor to fall back on the judgment of the rest of the world...that is, we endeavor to conform with the behavior of the majority or average...to copy the others...[to follow] a conventional judgment.” 29

Keynes arrives at this conclusion because of the inherent uncertainty surrounding forecasting and also because “the most probable forecast we can make...depends upon the confidence with which we make this forecast.” 30 The problem here is that the ‘state of confidence’ rests upon expectations, and for Keynes, agents’ expectations are not naturally convergent as they are in the classical and neo-classical world. Rather than being a convergent reflection of an invariant underlying structure (as the efficient markets hypothesis and the fundamental theorem dictate), agents’ expectations are instead seen as being naturally divergent, and this is precisely the problem. Instead of assuming both convergent expectations and that agents know what the ‘fundamentals’ actually are, Keynes assumes instead that individual investors are myopic and look to each other for signals. Given this understanding, ‘confidence’ is ultimately an intersubjective construction which has at best a tenuous unclear relationship to market fundamentals, nor has it any precise, calculable metric. 31

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29 Keynes “The General Theory of Employment” p. 214. Keynes continues later (p. 222) that “the orthodox theory assumes that we have a knowledge of the future quite different from that which we actually possess. This false rationalization follows the lines of the Benthamite calculus. The hypothesis [which this] leads to [is] a wrong interpretation of the principles of behavior which the need for action compels us to adopt.”
30 Keynes The General Theory... p. 148.
31 This is different from contemporary ‘cascade’ and ‘mimicking’ hypotheses as these are strategies employed by rational agents to overcome information problems.
In order to explain how order is possible in such a random world, Keynes unites confidence and expectations through the concept of ‘conventions.’ Conventions are tacit intersubjective understandings shared by market actors concerning the expected behavior of markets. Market behavior therefore rests upon the coordination of agents’ expectations through the maintenance of dominant conventions. So long as such intersubjectively held conventions regarding the economy are adhered to, then the economy will perform within the parameters of the expected ‘conventional judgment.’ That is to say, there is no truth about markets ‘out there’ apart from the ‘prevailing wisdom’ about markets themselves.\(^\text{32}\) Change thus occurs when expectations diverge, then conventions falter, and only then do markets ultimately fail. Given this understanding of how the economy ‘works,’ the important task for governing the economy becomes shaping expectations so that they conform to expected parameters and this is, I would suggest, where institutions ‘fit-in’ to the story.

If, as institutionalists argue, behavior is shaped by participation within institutions, then institutions must be supplied which are designed to structure the ‘conventional judgment’ necessary for the coordination of agents’ expectations such that stability is produced. For example, during the Keynesian era expectations were seen as divergent and were coordinated through institutions which allowed the formation of the ‘conventional judgment’ so important for realizing market stability. This is why Keynes sought the extension of “the traditional functions of government,” in order to create the common ‘baseline’ of expectations necessary for stability to become endogenized.\(^\text{33}\) Similarly, under the new institutions of global finance, conventions are also coordinated by institutions, albeit institutions of a very different type, and this, to use an overused phrase, is where the politics comes back in.

The ‘problem’ with the Keynesian institutional solution to the problem of market stability was that those interests who sought to resurrect global markets in the 1960’s and


1970’s regarded the institutions of that order as at best ‘market imperfections’ and at worst ‘serious constraints on individual liberty.’ As the liberalization promoted by international financial interests gained momentum, those institutions which previously provided expectational coordination; the Bretton Woods exchange rate mechanism, capital controls, etc., were systematically attacked and dismantled by financial interests.

Unfortunately, the problem with dismantling these institutions was that the Keynesian institutions were based upon the assumption that business’ myopia and expectational divergence were the norm and sought to rectify this state of affairs by supplying expectational coordination institutionally by reining-in certain market practices. The problem now is that the new institutions which replaced these ‘inefficient institutions’ and made global finance possible; IMF mandated capital account convertibility, independent central banks, deregulated domestic markets, exchange rate credibility etc., take long-sighted behavior by business and convergent expectations as a given, and thus seek to coordinate expectations as if they do operate as the market’s ‘selbstbespiegelung’ maintains.34

But what if Keynes was right? What if market agents expectations are naturally short-term, divergent, subject to beauty-pageant dynamics and the like? How will adherence to these new conventions effect market stability? If this is the case, then as global financial integration proceeds it will increasingly affirm a new set of conventions which are singularly inappropriate given the way that markets actually behave.35 As Eatwell argues, guided by these simple conventions, “if the markets believe that higher fiscal deficits result in higher real rates of interest, then so they will” regardless if the fundamentals demand this or not.36 Given these ‘beauty-pageant’ dynamics, as Keynes called them, market opinion will be prone to sudden shifts in confidence.

34 As an example of changing conventions, consider that twenty or thirty years ago better employment figures were seen as a macroeconomic ‘good.’ Now whenever better employment figures are released, markets regard this as bad news and demand an inflation premium or higher interest rates.
35 To list a few of these new conventions; market stability is endogenously generated by rational market participants pursuing their own interests, ‘freeing’ markets is seen as its own source of stability, instability can only come from government interference, macroeconomic stability is best achieved by demonstrating credibility, job growth causes inflation, deficits cause higher interest rates, etc.
Under the Keynesian order such shifts were managed by capital controls and other such institutions as their designers thought business myopic and markets unstable. Now that these old ‘market-reforming’ institutions have been dismantled and replaced by ‘market-conforming’ institutions on the assumption that business is long-sighted and needs no such coordination, the more financial integration continues apace, the less protections there will be against an expectational coordination failure. Further openness and integration will increasingly transmit destabilizing shifts throughout the system as a whole, particularly when the new institutions of international finance are based upon the assumption that such a failure is impossible in the first place, given adequate information. It is because of these factors that market meltdowns have become increasingly likely, and the further the new financial order develops, then more likely it becomes that it will, from time to time, fall into panics and crashes.37

Given that such a system is inefficient, and can hardly be seen to be welfare improving, the question must be asked, how then did we get here? Recently, a number of commentators have began to move away from interpretations of financial market integration which stress exchange rate dilemmas, technology shifts, and transaction costs in explaining the development of the current financial order, and have instead began to explore the politics of global finance.38 In particular, attention has been focused on those groups who stand most to benefit from the current financial environment. If one details the current regime both domestically and internationally as based upon a paramount concern for price stability, a rejection of governmental involvement in the economy, and the promotion of capital account convertibility and capital mobility, then even without invoking the failed Multilateral Agreement on Investments, it is hardly conspiratorial to conclude that global financial interests stand to gain

36 Eatwell International Financial Liberalization... p. 32
37 That is to say, a mania is not necessary first. Hence this argument differs from the Kindleberger/Minksy line on capitalist instability which stresses a sudden increase in liquidity as being the necessary condition for a collapse
most from the current regime, while those groups traditionally protected by the institutions of a previous era; labor and domestic business, shall loose the most.39

Given this, examining how this system was constructed should allow us to answer the second question posed in the introduction, namely, if this system is so unstable, how did we get here and which interests made such a regime possible? However, before being able to explain why the political influence of financial interests are so heavily implicated in this analysis, we must first have a benchmark against which to judge these alternative interpretations. As such, we begin with what one might term the ‘orthodox’ reading of the collapse of the Bretton Woods system and beyond as a benchmark against which to judge the our alternative rendition.

Part Two: The Orthodox Version of the Bretton Woods Collapse

As is well known, the Bretton Woods order sought to reconcile domestic political stability with an international financial order which facilitated trade in commodities thought to be welfare improving rather than welfare diverting.40 The first lesson Keynes and his American counterpart took from the experience of the 1930’s was that international financial interests and their adherence to an “unregulated international monetary system [which]...impose[d] a contractionary bias on all domestic economies” were to be blamed for the collapse of the period.41 The second lesson learned was that such ‘contractions’ did not garner support for capitalism among the lower orders of society as they were forced to bear most of the adjustment costs.

39 Apologies to free traders everywhere, but the GINI statistics of the top OECD states over the past twenty years show the benefits of this new order is very skewed. See Edward N. Wolff Top Heavy: The Increasing Inequality of Wealth in America (New York: Twentieth Century Fund 1997).
41 Kirschner “Keynes, Capital Mobility...” p. 323
In short, these lessons learned called for a new type of exchange rate system in which trade was ‘in,’ but arbitrage and speculation were ‘out.’ The Bretton Woods system was specifically designed to allow states to achieve this balance. That is, to attain domestic policy autonomy, especially the ability to practice expansionary policies, without having to keep an eye on the exchange rate, and overall, the new regime facilitated these goals by being far more restrictive than the Gold Standard as regards financial flows.

The Bretton Woods institutions worked so long as Europe was financially dependent on America, so long as European currencies were so weak as to be unconvertible, Europe was dependent upon earning dollars. This meant that America could essentially ‘pump-prime’ the global economy by exporting dollars to promote recovery. However, as Friedman is wont to remind us, there’s no such thing as a free lunch. Acting as ‘banker to the world’ had a cost which Robert Triffin realized. If US capital exports were the only thing that was priming the pump for the ‘rest of the West,’ then if the US ceased to run a deficit, the world’s money supply would contract, and deflation, the very thing Bretton Woods intended to avoid, would follow.

The dilemma for the US however was compounded because the dollar was supposed to be convertible into gold at a fixed rate of $35.00 per ounce. However, the Bretton Woods institutions were in fact a paper standard masquerading as a gold standard. As such, the Dollar-Gold exchange rate was sustainable so long as no country actually tried to turn dollars in for gold. However, running a permanent deficit meant that the world supply of dollars increased, and when supply goes up, price comes down, thus creating a discrepancy between the par and market values which opened up arbitrage possibilities.

It is at this point that capital mobility enters the story. In 1963, in an effort to forestall the devaluation of the dollar which would send the whole system into a flux, the US introduced an interest equalization tax (IET). The tax was meant as a surrogate for higher interest rates and were intended to discourage foreign borrowings in dollars. The IET worked quite spectacularly

42 Although he does seem to think that if the state disappears there will be a permanent banquet.
enabling the US to slow the flow of dollars from the US without raising interest rates, which would have pushed the world economy into recession. However, the IET had a rather unintended side effect.\textsuperscript{43}

Beginning in 1958 with a deposit of Russian oil dollars in London, the Euromarkets came into existence. Being neither in the United States nor being the ‘coin of the realm’ of the UK, these ‘Euro’-deposits fell beyond the domestic regulation of both states. Because of this regulatory permissiveness surplus dollars flowed into these ‘Euromarkets’ where they were lent out without worrying about the IET and other regulations. Soon everyone from Italian regional governments to American corporations were borrowing in these deregulated markets, and because of this more dollars flowed into them. The US was happy to let this state of affairs continue as it temporarily eased the Triffin dilemma by providing a kind of international ‘slush-fund’ for excess dollars. However, these booming markets also enabled private finance to use these funds to engage in exactly the type of hot money transactions which the Bretton Woods institutions had sought to eliminate. Given the dollar overhang, the opportunity for arbitrage profits against the dollar and other major currencies was overwhelming and speculation worsened the Triffin Dilemma until the system eventually collapsed.

In its place a regime of free floating rates emerged which had the side effect of shifting foreign exchange risk from the public sector to the private sector.\textsuperscript{44} In this volatile environment global corporations needed new ways to hedge against interest rate and exchange rate risk and turned to the financial sector for answers. As the 1970’s were a period of economic slowdown, states were unwilling to do anything that would worsen economic performance and allowed the private sector to pick up the new market in risk which was necessary for trade to continue. However, in order to do this, financial deregulation on both a domestic and international level would be necessary, and whoever deregulated first would have a strategic advantage in the delivery of these new and very lucrative products of risk management: futures, swaps, and

\textsuperscript{43} See Gregory J. Millman \textit{The Vandals Crown} \textit{(New York: The Free Press 1995)} pp. 82-25, Helleiner \textit{States and the Reemergence...} 83-86
\textsuperscript{44} See Eatwell \textit{International Financial Liberalization...} passim on this point.
other derivatives. After the UK’s trials with the IMF in 1976 convinced the British that Keynesianism was bankrupt and Volker’s ‘Saturday night massacre’ in October 1979 started a global recession, the two main centers of financial power deregulated their markets and over the next decade everyone else followed suit. After all, the market’s new ‘selbstbespiegelung’ told them it was the efficient thing to do anyway.

What’s Wrong with This Story?

Note that this version of the story places all the weight of the collapse of the endogenous economic failure of the Bretton Woods institutions and has the structure of a classic ‘perversity thesis.’ That is, the more governments attempted to reign in markets, the more their indefatigable logic meant that they would burst forth and defeat their regulators. Notice however that only one half of the story has this structure; the Triffin Dilemma. Without the simultaneous increase in capital mobility, which states did not try to regulate, the inevitability of this dilemma might not have been so pressing. This gives rise to two questions. Why did states not attempt to regulate these new flows, (international slush-funds notwithstanding) and who benefited from them? After all, once the Bretton Woods system disintegrated, the financial sector stood to make a fortune from the privatization of risk, and in order to realize this possibility ‘inefficient’ regulations and institutions had to be swept away. The fact that by doing away with these regulations another large fortune could be made could hardly have been lost on financial interests. With these considerations in mind we will now offer a very different version of the end of the Bretton Woods order which stresses the fact that it did not fall of its own accord, but was instead ‘pushed’ by financial interest. Following this, in order to strengthen these claims overall, two other examples will be used to supplement this analysis; the deregulation of the American banking industry in the 1980’s and the growth of derivative markets in the 1990’s.

An Alternative Version of the Bretton Woods Collapse: Capital Mobility as a Weapon
As Helleiner has noted, the Bretton Woods institutions were very much under assault from financial interests since their inception. The *sine qua non* of effective capital mobility is currency convertibility. Until all the major currencies were convertible, financial gains could not be realized. In promoting this end, American financial interests lobbied the state to make the Pound and other European currencies fully convertible as early as 1946, and in part they succeeded. However, rather than restore growth, this resulted in massive capital flight from Europe into the US which precipitated both a European economic collapse in 1947 and the Marshall plan as the first ever tax-payer bailout of financial interests in the Bretton Woods era.\(^46\)

The lessons of the Marshall plan bail-out were not lost on the American state, and further efforts by finance to move towards full convertibility and open flows were resisted. Given this, financial interests tried another strategy; the development of parallel institutions which would work both with, and at counterpoint to, the Bretton Woods institutions. This time however it was British rather than American financial interests who lead the charge. The re-opening of the London foreign exchange and commodities markets made *de facto* convertibility a reality. However, official convertibility was only formally restored in 1958, and then only to current account and not capital account transactions. Nonetheless, what obviated this restriction was the growth of the Euromarkets noted above.

As Helleiner argues, British convertibility had a price in the form of recurrent balance of payment crises which could not be cured by a domestic deflation given the adherence of the British government to ‘embedded liberalism.’\(^47\) As such, the UK needed to reduce Sterling transactions to relieve pressure without reducing the actual flow of goods. The Euromarkets emerged as a mechanism for offsetting financing which ‘reconcile[d] the goal of restoring London’s international position with the Keynesian welfare state and Britain’s deteriorating

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\(^46\) See Helleiner *States and the Reemergence...* pp. 52-58.

\(^47\) Helleiner *States and the Reemergence...* p. 87
economic position.” 48 Meanwhile, as noted already, these same markets allowed American financial interests to avoid regulations such as the IET while allowing the state to avoid making ‘guns v’s butter’ trade-offs over the issue of the deficit.

Taken together, these efforts to promote greater capital mobility had the short run effect of allowing states a way of avoiding painful trade-offs over the goals of embedded liberalism. This is why states did almost nothing to reign-in these activities, despite the fact that they were in effect encouraging those very activities which the Bretton Woods order attempted to outlaw, and the absence of which was the necessarily condition for their existence. Once the Triffin dilemma became apparent, these new parallel financial institutions enabled rather than disabled private financial power, and this in turn allowed financial interests to systematically attack the Bretton Woods institutions, and to turn a profit while doing so.

Capital Mobility as Weapon: New Instruments and New Ideas

By the mid-1960’s the reemergence of private capital flows were destabilizing the Bretton Woods system as a whole. Liberals such as Milton Friedman took this as evidence that they had been right all along and that any attempt to reign-in the market must fail in the long run. What is less well known is how Friedman and other financial entrepreneurs took advantage of these weakened institutions, partly to turn large arbitrage gains, and partly to destroy the system they long regarded as somewhere between ‘socialist’ and ‘inefficient.’

Friedman’s personal experience is instructive here as a micro level example of how finance actively sought the destroy existing arrangements. 49 In 1967, Friedman, like the rest of the financial world, knew that the Pound was overvalued. Friedman wanted to borrow some Pounds from a Chicago banker and sell the currency short. The problem was that the banker Friedman approached to facilitate this trade refused to lend him the pounds on the grounds that this would be ‘destabilizing.’ Rather perturbed by this infringement upon his basic liberty,

48 Helleiner States and the Reemergence... p. 87
49 The account of Friedman and Memland is drawn on Millman The Vandal’s Crown pp. 97-98 and pp. 109-110.
Friedman complained about this in his *Newsweek* column, which was regularly read by another Chicago banker called Memland.

Memland asked Friedman to write him a paper on why he should be able to trade currency futures, which he obliged, for a fee. Memland then sent this paper to George Schultz, then Treasury Secretary, and argued with Schultz that because Bretton Woods was coming apart “it would create a big era of volatility in currency and interest rates. [Therefore] it seemed you needed a futures market to give an opportunity to everyone to take part in the movement of price[s].”  

Schultz apparently replied “if its good enough for Milton then its good enough for me” and thus the Chicago Currency Futures market opened in May 1972 - just in time to throw the remnants of the old order over the cliff.  

The establishment of a futures markets in currency was quickly followed by futures markets in mortgages, and then in Treasury bills, and then in bonds. The logic of allowing such institutions to operate was indefatigable. The economy was slowing down, inflation was rising, and uncertainty and volatility were increasing over exchange and interest rates and this was harming trade and hence the overall macroeconomic balance. Heightened capital mobility meant that a variety of ad-hoc fixes to the Bretton Woods institutions, such as the Gold-Pool and SDR’s were becoming increasing problematic as private flows simply could make money betting against the existing order. Eventually, by the time John Connolly announced his famous ‘four no’s’ in May 1971, it was far more profitable for private flows to bet against the existing regime than remain within it.

Futures markets exacerbated these stabilization problems by providing risk insurance against market failure, this essentially turning betting against the existing regime into a one way bet. Under such pressure, the old order collapsed and those very interests whose actions had

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50 Memland quoted in Millman *The Vandal’s Crown* p. 109  
51 Millman *The Vandal’s Crown* p. 110  
52 It is worth noting that the solution to the Triffin Dilemma proposed by Triffin himself and adopted at the 1968 Rio conference - SDR’s - did provide a technical solution to the Triffin Dilemma. As long as the growth rate of gold and SDRs kept up with the growth of dollar liabilities, then there is no dilemma so long as one closes down capital mobility. As such, a solution was apparent, but not pursued, which speaks to the strength financial interests even as early as 1968.
led to its demise were now able to offer to business, and to each other, protection against the very thing that these markets themselves had brought about; increased volatility and risk. By betting against the old regime finance resurrected itself, by replacing it, it stood to rule the temple of money once again. However, in order to do this some creative ideas were needed to justify such a radical shift in the structure of world finance, and as Kalecki once wryly noted “[i]n such a situation, a powerful block is likely to be formed between big-business and rentier interests, and they would probably find more than one economist who would declare that the situation was manifestly unsound.”53 Oddly enough, this is more or less what happened.

As was noted above, during this period the image of businessmen underwent a remarkable transformation from myopic ‘herders’ into hyper-smart calculators of risk at the hands of a new generation of economic theorists.54 Rational Expectations theorists argued that given fully liberalized markets and good information businessmen could neither be fooled, nor could their decisions be improved upon by the state. As such, the new order was quite obviously the ‘natural order.’ Similarly, monetarists explained the collapse of the old order by reference to undisciplined politicians running the printing presses over-night, while public choice theorists explained that democracy as a mode of allocation created inflation and yearned for the discipline of gold, or at least a market society of supply and demand rather than votes.55 Even respected econometricians with no obvious political ax to grind began to opine that state sponsored social insurance was a tax, and that the root cause of all economic strife was an

54 See the footnotes listed in footnote five.
55 See for example Milton Friedman Introduction to Dollars and Deficits (Englewood Cliffs, New Jersey: Prentice Hall 1977) or James M. Buchanan and Richard E. Wagner Democracy in Deficit: the Political Legacy of Lord Keynes (New York: Academic Press 1977). As Buchanan and Wagner argued “just as an alcoholic might embrace Alcoholics Anonymous, so might a nation drunk on deficits and gorged with government embrace a balanced budget and monetary stability.” Buchanan and Wagner Democracy in Deficit... p. 159
acute capital shortage which could only be alleviated by an agenda of limiting the state, cutting
taxes, and above all, liberalizing markets.⁵⁶

These new ideas were eventually distilled into the markets’ ‘selbstbespeigelung’ noted
above which justified and indeed promoted the further development of the new financial order
and the new conventions which it is based upon. In the context of the day it could hardly fail.
In this new world, governmental control of markets was seen as at best an outmoded, and at
worst, a dangerous concept. As Parsons argues, “when it came to winning over opinion with
simple common sense solutions, stop printing money (Monetarism), and cut taxes (supply
side), it was a non-contest.”⁵⁷ With these new ideas in full force in everything from
Newsweek to the Wall Street Journal, and with the ideas underpinning the old order
delegitimated and the state in retreat, financial interests set about restructuring the institutions of
finance with these new ideas as their guide and their raison d’être.

The Politics of Finance: The Deregulation Bonanza

As an example of how new ideas and financiers self-interest combined in this period to
construct a new regime, consider the case of American domestic financial deregulation. In
order to realize the profits which would be made possible by the further privatization of risk,
financial interests wasted no time in lobbying for the passage of the Monetary Control Act, a
piece of legislation whose domestic distributional and international regulatory impact was to
prove to be massive.⁵⁸

The Monetary Control Act of 1980 was ‘marketed’ by financial interests as a way of
dealing with a legitimate concern of the banking industry, the cost of maintaining reserves at

⁵⁶ See Martin Feldstein “Social Security, Induced Retirement and Aggregate Accumulation” Journal of
The Public Interest Fall 1973 pp. 3-42
⁵⁸ Concurrent with these changes in financial regulation, the financial sector emerged as the preeminent
political spender in Congress. “For the 1980 elections, incumbent senators and representatives would revive
$2,664,000 in donations from the financial sector. the largest share of that money, nearly $590,000 was
given to the members of the House and Senate banking committees, the people charged with drafting the
the Fed. The Federal Deposit Insurance Corporation (FDIC) mandated that in return for insuring deposits, banks had to maintain a percentage of their assets at the Fed as a liquidity safeguard. The banks were concerned that by the late 1970’s these non-interest bearing credit requirements had risen to 16.5 percent of their total assets. Consequently, the banks argued, by tying-up assets the state was actually adding to the economic slow-down of the period by inhibiting banks’ ability to make more loans at better interest rates. In response to these efforts the 1980 Monetary Control Act was passed. The main provision of the Act, which President Carter hailed as “a significant step in reducing inflation and a major victory for savers,” was to reduce bank’s reserve requirements to 12 percent. 59

However, the Act contained some other provisions which were to provide a massive windfall for financial interests. The original Glass-Steagle Banking Act of 1933 mandated interest rate ceilings on savings and loans institutions as a way of promoting both stability in the banking system and home ownership. The 1980 Act abolished a provision of the 1933 Act called ‘Regulation Q’ that limited the interest rates which could be offered by savings and loan institutions. Regulation Q also restricted the ability of banks to offer interest bearing checking accounts. By abolishing regulation Q it was argued, as it had been argued for the reduction of reserve requirements and for international financial deregulation, that by creating a more efficient market for loans through competition, all borrowers would be better served. After all, such markets were by definition efficient. Once regulation Q was abolished, the large banks began to use thier newly replenished resources to pressure the margins of smaller banks and Savings and Loans. Given that these changes took place in the middle of a credit crunch, local and regional banking laws had to follow suit otherwise firms remaining within these local regulatory structures would be out-competed by those in the new deregulated environment.

Thus began a financial race-to-the-bottom which would end in the Savings and Loans debacle, which of course was paid for with another tax-payer bailout.

The combined effects of abolishing regulation Q and reducing reserve requirements was dramatic. First of all, by reducing reserve requirements, the United State’s then six largest banks received a windfall in the form of new interest bearing assets to the value of $14.56 billion.\(^{60}\) Second, by removing interest rate caps on savings and loan institutions, these institutions were forced to take on higher risk loans to remain competitive. Consequently, banks time horizons shortened and the attractiveness of the home mortgage market decreased while the market for junk bonds and other high risk arbitrage instruments increased. Money shifted out of savings and loans type investments and into unregulated money market funds where the returns were much higher, and much more uncertain, with ultimately disastrous results.\(^{61}\)

Furthermore, under the 1980 Act FDIC and FSLIC insurance premiums were increased from $40,000 to $100,000 for every bank deposit. As McQuaid notes, in 1980, 75 percent of US households had less than $10,000 in liquid assets.\(^{62}\) As such, this reinsurance was simply another windfall for finance as the new legislation insured bank deposits, not bank depositors. Consequently, investors with liquid assets could have millions of dollars guaranteed by the government as they could simply store the cash in multiple accounts. As the Savings and Loan debacle would shortly demonstrate, this eventually led to intense moral hazard problems as the entire regulatory structure of the banking industry had now been compromised.

As Grieder notes, rather than promoting the euthanasia of the rentier, as Keynes predicted, the new institutions promoted by financial interests promised the euthanasia of the debtor.\(^{63}\) The original FDIC regulations safeguarded the depositor against bank failure. The

\(^{60}\) Greider Secrets of the Temple... p. 163
\(^{61}\) In 1978 assets in such unregulated funds stood at $9.5 billion. By the end of 1979 that figure had increased to $42.9 billion. By 1982 it had risen again to $236.3 billion. Figures from Robert Bartley The Seven Fat Years-And How To Do It Again (New York: Free Press 1992) p. 224
\(^{63}\) Greider Secrets of the Temple... p. 236
1980 Act effectively reversed this principle and turned this into a commitment that the bank itself would now be insured against bank failure. Consequently, bankers became emboldened and their yield-risk spreads became ever wider throughout the 1980’s and 1990’s. Thus in absolute contradistinction to arguments of made for deregulation and the efficiency of markets, rather than increasing investment in plant and equipment and creating a “bonanza for savers,” banks began to increasingly specialize in new arbitrage instruments, particularly in financial futures, mergers and acquisitions, and latterly, ever more exotic derivatives transactions.64

Given these higher interest rates, banks and large firms with liquid assets could increasingly benefit from the gains to be made from arbitrage activities, so long as inflation was kept under control such that the real interest rate, and thus the returns to their assets, were positive.65 Given that by the time these reforms were made the Fed was already tied into a strict regime of monetary targeting which the markets themselves demanded, financial capital found itself playing a ‘win-win’ game against smaller industrial capital and labor who’s payoffs were strictly ‘loose-loose.’66

Although some sectors of big-business were hurt by the interest rate hikes and that collapse in demand that financial deregulation brought about, the big players, both financial and industrial, began to realize that investment in these new futures markets could both insulate them against the deleterious effect of these policies and turn huge profits while doing so. The new permissive environment encouraged large industrial interests to shift from the production

64 See Bennett Harrison and Harry Bluestone The Great U-Turn: Corporate Restructuring and the Polarizing of America (New York: Basic Books 1988) pp. 53-64 on the growth of futures markets and the turn to mergers and acquisitions by banks in order to cover the heavily exposed positions they were encouraged to take because of the deregulation wrought by the 1980 Monetary Control Act. As a direct consequence of the effects of the 1980 Monetary Control Act, between 1979 and 1983 the total value of mergers and acquisitions was $249.9 billion. Between 1984 and 1988 this figure had leapt up to $880.3 billion. Figures from Jeffry Davis and Kenneth Lehn “Securities Regulation During the Reagan Administration: Corporate Takeovers and the 1987 Stock Market Crash.” in Anandi Sahu and Roland Tracy (eds.) The Economic Legacy of the Reagan Years: Euphoria or Chaos? (New York: Preager 1991) p. 8

65 Hence the inflation fighting fetish of the past fifteen years despite the fact that there has been no inflation to fight. See Kirschner “Inflation…" 66 A regime most accurately described by Paul Krugman as ‘Sado-Monetarism.’ And once targeting was abandoned in 1983, monetary policy did not loosen to any considerable extent until 1985, and by historical standards, the effective real interest rates of the 1980’s and 1990’s were much higher than during the Bretton Woods period. See Blyth Great Transformations chapter seven.
of goods to the purchase of financial instruments. Given this, the new institutions of finance went from strength to strength.

This financial ‘race to the bottom’ domestically was followed throughout the 1980’s by a race to deregulate internationally. Once the US deregulated, just as had occurred domestically, other financial markets had to follow suit as the cost of being a holder-over increased *pari passu* with the number of defectors.67 These changes were reinforced and promoted by the ideational changes taking place in both domestic policy regimes and in international institutions around the world. On the one hand, capital controls, protected domestic credit markets, active macroeconomic management and all the rest, had been outflanked by this ‘globalization of finance,’ while on the other, the ‘discovery’ of the ‘natural rate,’ the costs of regulation, the efficiency of markets etc., meant that there was simply, to use the phrase of the time, ‘no alternative’ to further liberalization. However, two events were soon to occur which would begin to raise doubts about the ability of this new order to deliver the goods; growing concerns about the risk associated with derivatives markets and the East Asian financial crisis.

Although this paper is not the place to go into the East Asian crisis, a brief discussion of the development and current problems of derivative markets is necessary to further highlight the claims made in the first part of the paper concerning both market instability and the current system being the political project if financial interests. From this basis we can address the final issue raised that given such a system, what we can expect to see in the future is a new mode of governance in international finance, namely, government by trope, rather than government by effective regulation.

**There is Such a Thing as a Free Lunch! Hedge Funds and Derivatives Markets**

As discussed above, the reason financial interests sought the end of the Bretton Woods arrangements and the deregulation of domestic financial institutions was partly ideological (they

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67 Helleiner here, I think, implicitly thinks about deregulation this way in that it has the characteristics of a multi-person PD combined with a tipping point game. I don’t know if Helleiner would accept that this is in
represented an affront to their identity as finance capitalists) and partly material (they stopped them making money.) Consequently, the dismantling of these institutions and the development of the parallel institutions noted above presented great opportunities for profit. However, this transfer of exchange rate risk from the public to the private sector itself created greater volatility and risk. In a wonderfully circular response to this new situation, financial interests argued for further domestic deregulation and liberalization as a way of coping with this volatility and developed new products which would guard against it, namely derivatives. As Eatwell put it, “[i]t is clearly true that liberalization has spawned derivatives. It is equally true that fluctuating rates and liberalization have created the demand for derivatives.”

As the new institutions of international finance were spawned in the 1980’s and 1990’s, more and more investors began to trade in derivatives as a way of coping with risk. However, although derivatives transactions are relatively small as a percentage of total capital flows, as we shall see, the systemic risk which derivatives transactions pose by the nature of their composition means that their effects on capital flows can be amplified throughout the system. While derivatives may provide great profits for financial interests who manage risk while they help companies who need to hedge risk, there are still two major problems with this system. First, as argued in the beginning of this paper, if we do in fact live in a world of myopic herders who inhabit a system designed for long-sighted calculators, such risk management strategies may become so complex and so interdependent that the potential to bring down the whole system becomes multiplied. Second, and this is perhaps why addressing the issue of institutional design is so politically problematic, such new technologies allow

fact what he is doing, but this is the way I interpret his work. See Helleiner States and the Reemergence of Global Finance... pp. 146-168 and pp. 195-209
68 Eatwell International Financial Liberalization... p. 18 Derivatives are basically any type of transaction whose value depends, at least in part, upon the value of a related asset or liability. Developed from more the more simple stock options and currency futures pioneered in the 1970's, derivative transactions have become increasingly complex with the introduction of products such as ‘swaptions’ (an option on a swap) and ‘structured derivatives contracts’ (where a dollar denominated structured note - such as Student Loan Marketing Association security - is linked to, for example, changes in the Lira - Yen exchange rate.) The logic behind all such products is the hedging of risk. A product such as the Student Loan security detailed above is predicated upon the assumption that if the Yen goes down, then the underlying security would go
financial interests to throw the risk of market failure back onto the public sector while retaining the benefits of privatized risk.

Similar to the problem encountered in domestic financial deregulation, in derivatives markets the moral hazard problems of borrowers and the lenders become inverted. For example, in a straightforward bank loan the bank assumes the risk of default and thus has an incentive to monitor the borrower, with interest earned as the risk premium. In the case of derivative markets the complex leveraged positions taken by the banks and funds who develop these products and trade them on behalf of their customers threaten to become so destabilizing of the system as a whole that the moral hazard problem is reversed. The customer cannot effectively monitor the supplier because of the complexity of the assets in question, while governments cannot allow the suppliers to fail as their systemic exposure is so great due to the enormous leveraged positions which such products allow the holder to take. Given this inversion, the risk that these interests are supposedly managing is in fact thrown back on the public sector in the form of ad-hoc government sponsored bail-outs anytime something goes awry, which is increasingly the case. Knowing this, financial interests have in fact achieved an enviable position. They can take all the profits from the private management of risk and yet suffer none of the losses associated with it.

For example, the deregulation of domestic markets in the early 1980’s combined with the post-Bretton Woods volatility of this period to persuaded large corporations to use derivatives both as an means to an end - the hedging of risk- and as an end in itself - as a way to make a profit. And indeed, by 1993, according to Dolde, “85.2 percent of Fortune 500 firms use[d] derivative securities, and of those 87.7 percent speculate[d] at least part of the time.”

What has generated concern over these practices are the huge losses which firms, public authorities, and private hedge funds have made by speculating in these products and the

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69 Walter Dolde “Use of Foreign Exchange and Interest Rate Management in Large Firms” (Working paper Number 93-042, School of Business Administration, University of Connecticut, November 1993). p. 1 and 13. Quoted in Millman The Vandals Crown..., p. 158
systemic risk which this poses for the system as a whole. As Keynes put it, “speculators do no harm as bubbles on a steady stream of enterprise. But the position becomes serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.”

The casino, it seems, is well in session.

Throughout the 1990’s a series of high profile losses were reported by large and seemingly responsible companies. Metalgesellschaft lost $1.34 billion dollars and Kashima Oil lost $1.45 billion dollars in 1994. Public authorities such as Orange County lost similar amounts shortly thereafter, while the Queen of England’s private bankers, Bearings, lost an estimated $2.4 billion in similar circumstances. However, what really set the alarms bells ringing was the failure of Long Term Capital Management (LTCM) in 1998. LTCM was a hedge fund. A hedge fund is a private investment pool which uses derivative instruments, long and short positions, and leverage, to generate income for the pools’ members. LTCM, as far as anyone can figure out because hedge funds are not required to report their transactions, made its money on the so-called ‘convergence trade’. That is, betting that interest rates in major bond markets would narrow, and by using a variety of quantitative arbitrage techniques LTCM took heavily leveraged positions such that they could profit from these ‘convergences.’

Unfortunately, LTCM’s strategy was about to run into some serious problems.

First of all, the models they used to chart price movements were extrapolations of the Black-Scholes theorem of option pricing developed by one of the funds founders - Myron Scholes. The basis of the model is the assumption that “price movements follow the same log-normal distribution as the Brownian motion displayed by many physical phenomena.” In other words, LTCM’s model was based upon the same type of ‘Selbtsbespeigelung’ noted

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70 Keynes *The General Theory*... p. 159  
71 Millman *The Vandals Crown*... p. 159  
72 The account of LTCM’s collapse is gleaned from various sources, but especially Barry Eichengreen and Donald Mathieson “Hedge Funds: What do we Really Know?” International Monetary Fund Series, Economic Issues Number 19, September 1999 and Barry Eichengreen et al., International Monetary Fund Occasional Paper 166 “Hedge Funds and Financial Market Dynamics” December 1998.  
73 Eatwell *International Financial Liberalization*... pp. 18-19
above. That in the absence of ‘imperfections and intervention’ movements in the actual market should behave ‘as if’ they were operating in a perfect capital market. Unfortunately, the East Asian Crisis threw the movement of the Yen for a loop and shortly thereafter the markets began to operate in a way in which LTCM’s models could not anticipate.

In early 1998, on capital of $.4.8 billion, “LTCM managed balance sheet provisions totaling about $120 million, implying an average of 25 times capital. At the same time LTCM was managing total gross notional off-balance sheet derivative contracts amounting to about $1.3 trillion” which is approximately 270 times base capital.\(^7\)\(^4\) The nature of derivatives transactions allowed such leveraging because of the characteristics of a product called a ‘total return swap’ “which allow[s] investors to profit or lose from price movements without having to actually purchase them.”\(^7\)\(^5\) Given LTCM’s rate of return was 33.7 percent per annum between 1995 and 1997, banks fell over themselves to give LTCM over 120 times leverage, but unfortunately by September interest rate spreads began to diverge rather than converge. By the 23rd of September LTCM’s capital base had shrunk to $600 million with outstanding liabilities of $100 billion dollars “implying balance sheet leverage of 167 times capital.”\(^7\)\(^6\) Eventually the regulators and 14 major banks were called in by the New York Fed to rescue LTCM.

Once again, given this inversion of risk, the state had no alternative but to do so. Had this been simply a bunch of rich people placing bets one could have argued, ‘without risk there is nor reward,’ and let LTCM go under. However, because of the nature of derivative contracts and the extent of the leverage LTCM was able to achieve, had LTCM went under they could have caused a serious liquidity crisis in the entire global payments system. Alternatively, another scenario could have unfolded. Although derivatives are exempt from bankruptcy provisions, they could have been “sold off \textit{en masse} by their creditors as LTCM was

\(^7\)\(^4\) Eichengreen and Mathieson “Hedge Funds...”p. 10  
\(^7\)\(^5\) Eichengreen and Mathieson “Hedge Funds...”p. 10 My Italics  
\(^7\)\(^6\) Eichengreen and Mathieson “Hedge Funds...”p. 11
liquidated. Had this occurred, such a volume of contracts hitting the market at once could have increased liquidity too much and disrupted the complex interrelationship between underlying asset values and derivative pricing which all such contracts rely on, thus relaying different but equally destabilizing shocks throughout the whole system. Either way, LTCM received all the reward for managing risk, but shared none of the costs for generating it.

As Millman notes, why such markets are particularly crisis prone was seen in early 1994 when the Fed raised interest rates. As is usual under the new conventions of the market, any sign of an economic upturn is treated with dismay by the bond market who immediately demand an inflation premium. Sure enough, stronger than expected growth figures in the last quarter of 1993 were met with a rise in the prime rate from 6 percent to 6.91 percent by the beginning of the second quarter of 1994. Such an increase would be expected to make long bonds rates more attractive. Instead short term rates rose dramatically. This was not meant to happen, and the markets’ reaction was well out of proportion to the change in Fed policy. The reason for this reaction lay, in all things, in the mortgage securities market.

When the Fed raised rates, investors in the mortgage derivatives market would expect mortgage refinancing rates to decline. Consequently, those investors who held mortgage securities as a short-term investment suddenly found themselves with a longer maturity asset. In order to hedge against mortgage securities now that these securities were to be held over a longer term, investors began to sell long bonds short. Thus rather than the raise in interest rates raising long bond prices, the unexpected effect of having mortgage securities hedged with short and long bonds (appropriate when such securities mature quickly) meant that huge quantities of long bonds hit the market at once. Consequently their price fell and interest rates rose far beyond what the Fed intended. What this episode signaled was something rather scary, that “no one really understood how the financial system worked. After all, if an investor in long term treasury bonds could be impoverished by some event in the mortgage derivatives markets,

77 Eichengreen and Mathieson “Hedge Funds...”p. 12. Author’s italics
78 Figures from St. Louis Federal Reserve database at http://www.stls.frb.org/fred/data/irates/mprime
how could anyone predict anything anymore? It seems that LTCM failed to take this lesson on board some four years later. With such institutional complexities and such political power, it is little wonder that reforming finance has proven so difficult. It is issue we address in conclusion.

Summary and Conclusions: Ideology, Power, and Governing by Trope.

This paper has sought to make the following arguments. Despite the markets’ ‘selbstbespiegelung,’ the present system of international finance is inherently unstable and is becoming more so over time. The reasons for this relate back our two opening curiosities. First of all, we can now conclude that businessmen have not in fact become much smarter since the late 1960’s and something far more political did in fact occur than their ‘intellectual rehabilitation’ in economic theory would lead us to believe. Second, we can conclude that Eichengreen’s critique of Soros is in fact right, but irrelevant. All the sophisticated economic theory in the world will not help us understand markets in less than ‘normal times’ if the theories generated have no theory of how ‘abnormal times’ can occur.

Given this, the beginnings of an alternative ‘Anarcho-Keynesian’ understanding of how markets really work was constructed. The point of doing so was to make the point that the conception of business’ behavior which one operates with in theory will heavily shape the type of institutions, regulatory mechanisms, and policies which will be held to promote stability in practice. If one accepts the markets’ ‘selbstbespiegelung’, then the type of institutions of governance needed are exactly those we have today; those which take long sighted rational behaviors as a given.  

However, if one accepts our alternative Keynesian model which suggests that market agents’ are myopic and yet inhabit institutions designed for long-sighted rationalists, then one

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80 Millman The Vandal’s Crown... p. 256
81 And indeed there is a long sighted rationality at work. It’s just that it is political (will the state bale you out?), rather than economic.
is building failure into the system. Given this, our question became “if such a system is inefficient, and possibly dangerous, then how did we get here and whose interests does this serve?” In answering this, this paper has sought to argue through our three cases that the present system, rather than representing an inevitable and apolitical evolution, shows the political power of financial interests.

The ‘interests’ part of this analysis is very straightforward. Under the Bretton Woods arrangements capital mobility was used by private finance to destabilize the old system, a system which they objected to in principle anyway. Once these institutions were dismantled volatility increased and financial interests lobbied successfully for further deregulation. This liberalization lead to a \textit{de facto} transfer of exchange rate risk from public to private institutions and increased volatility further and financial interests were only too happy to cater to this new market for protection against ‘self-created volatility’ using new futures markets and derivatives contracts.

However, the real windfall in all of this was the inversion of the traditional collective action problems inherent in financial regulation. Both the Glass Steagles and Bretton Woods institutions sought to ‘euthanize the rentier’ by hindering speculation, isolating markets, and protecting the borrower/citizen from the profligacy of the banker/financier. By overturning these institutions, by transferring risk from public to private, by insuring deposits rather than depositors, and by using the market’s ‘selbstbespeigelung’ to justify the abolition of regulations which would inhibit market integration and speculative transactions, finance not only made billions, they made themselves too big and too important to fail.

As such, the concern is no longer with the bank’s risk over the borrower, it is with the borrower and the states risk vis a vis the bank. Financial interests have managed to buck-pass the risk of systemic failure back to the local (or global) taxpayer without having the institutions which makes these market failures common challenged in any way. As Palma recently put it, “[while] financial market operators no longer need to jump out of windows...we have moved to the other, absurd, extreme, of having them sometimes magnificently recompensed for their
imprudent and unproductive behaviors. Instead of committing suicide, now they get away with murder.” 82

Ideas are an integral part of this analysis in two ways. First of all, finance constructed these new institutions because they stood to profit from them, but in order to do this they had to convince everyone else that it was in the ‘general interest’ to let them do so. Luckily, in the late 1960’s and early 1970’s when Bretton Woods destabilized there were a plethora of new ideas around which portrayed government and regulation as the problem and businessmen and ‘free’ finance as the solution. These ideas, that inflation fighting and price stability are the only real interests of the state, that growth comes from free and mobile capital, that markets only fail because of informational asymmetries, that ‘rational expectations’ and the ‘natural rate’ mean that state intervention can only ever be harmful etc., were distilled into a theory of markets and market agents’ behavior which despite its manifest empirical failings seems still to be relatively immune to challenges. 83 The second way in which the political power of such ideas is apparent lies in the fact that one of the dominant conventions which govern the market is that the private management of risk is still the best institutional option. Given this, ‘random’ failures can be explained way in an ad hoc manner, but never in a way which implicates markets themselves.

Empirically, these ideas and interests of finance come together in that there can no political attempt to deal with the systemic problem of inverted risk for two reasons. First, because there is no way the state can refuse to bail-out finance given the size of the funds at stake, and second, because there is no alternative point of view given dominant market conventions from which this asymmetry in risk and reward can be addressed. In short, the ability to claim a share of the pie is one thing, the ability to define the recipe for making the pie

83 Even such mild regulatory proposals as a Tobin tax or allowing seriously ‘capital-flighted’ countries to limit capital account openness are met with gasps of horror. Similarly, despite Europe suffering endemic double digit unemployment since the early 1990’s the European project has only one goal, price stability. This is odd when there has been no inflation in Europe for over fifteen years. However, at the risk of pointing out the obvious, it does suit the holders of financial assets to have it that way.
grow in the first place as exclusively yours is quite another, and this is what financial interests have been spectacularly successful at doing over the past over the past thirty years.

Given all this, what then can we expect in the future? Despite all the recent alarm bells emanating from East Asia, Russia, Brazil, LTCM and all the rest, the proposals and practices of reform mooted thus far are incredibly conservative. As Krugman has recently argued, the trouble with proposals for the reform of the international financial ‘architecture’ - aside from the pompousness of the term - “is that it suggests a very deliberate, controlled structure that simply does not exist in a world of fluid capital markets and very limited official control...Whatever system or non-system we now impose will be at best a set of guidelines for policy between crises.”84 What proposals we do find are based upon for greater transparency and information flows, and for uniform accounting standards.85 However, as Rivlin has argued, “for transparency to be useful, people need to actually want to look, and too often those making high profits would rather not hear the bad news.”86 One can also argue on an even more basic level that given the growth rate of the funds involved in such crises, there is a smaller and smaller chance that the state in fact can, either politically or economically, bail them out.

Moreover, none of these ‘reforms’ address the fundamental problem raised in the first part of this essay. That is, such institutional reforms are predicated upon the notion that manias do not occur, panics can be rational, and crashes can be cured by tweaking the informational ‘architecture.’ But what if all this is ideology rather than science? What if Keynes was right about businessmen? If this is the case then none of these reforms will make a blind bit of difference to any of the underlying problems. However, it does give us an insight into what the future governance of such a system may look like.

84 Paul Krugman “Analytical Afterthoughts on the Asian Crisis” mimeo 1999 p. 8
If conventions are as important as we have suggested for producing market stability, and if the current institutions of finance do not adequately coordinate market agents expectations, then when things go awry, one will need some external mechanism to produce coordination and thus stabilize the market. However, if the system is as Krugman suggests, ‘a non-system with little official control,’ then the best we can hope to see is ‘government by trope.’ That is, if markets are conventionally based, then the role of the state in moments of crisis is reduced to shouting out reassuring tropes to reinforce existing conventions.

We have already seen this mode of governance in the Tequila and East Asian crises; declarations that ‘the fundamentals are safe,’ that ‘a rational assessment of risks will produce stability,’ that ‘investors need better information’ etc. By shouting out such tropes states try to stabilize markets. However, shorn of any institutional means to do so in a system as dynamically interlined and complex as the one we currently inhabit, this is probably the best states can do or markets will countenance anyway. After all, from the markets’ point of view, the system is efficient. If it works, they make huge profits, if it fails, everyone else picks up the tab.\textsuperscript{87} As Krugman put it, “you have to admit, its a hell of a way to run a world economy.”\textsuperscript{88}

\textsuperscript{86} Alice Rivlin, Federal Reserve Vice Chair, Remarks at the Hyman P. Minsky Conference on Financial Structure, the Levy Institute, Annandale on Hudson, New York, April 23 1998. Transcript.

\textsuperscript{87} This is hardly an exaggeration when one considers random examples such as the fact that after the outbreak of the East Asian Crash City of London bonuses for 1997 still topped $1 billion. Or, consider that after the debacle at Bearings Bank the senior partners still used the pre-collapse inflated profit figures to calculate their annual bonuses.

\textsuperscript{88} Paul Krugman “Analytic Afterthoughts...” p. 6. Krugman actually said this regarding orthodox contractionary responses to capital flight, nonetheless, it seemed an appropriate sentiment to end on here too.