Banks, not hedge funds, at centre of world financial crisis

Nick Beams
27 October 1998

Slowly but surely the real story of the hedge fund crisis, which came into public view with last month's bail out of Long Term Capital Management, is starting to emerge. The crisis is not so much centred on hedge funds and their speculative activities; rather it is concentrated in the major international banks.

A report in the October 17 edition of the *Economist* noted that while investment banks were quick to reveal details of their exposure to LTCM and to hedge funds in general, such admissions were beside the point because the real issue was the activity of the banks themselves.

'Many banks,' the article explained, 'have followed similar strategies to Long-Term Capital--but in aggregate, on a bigger scale. According to some reports, whereas LTCM had an exposure of $80 billion to arbitrage between American Treasuries, the banks had $3 trillion tied up in similar bets.

'It was for this reason that the Fed felt it had no choice but to organise the rescue of LTCM, as Mr Greenspan made clear in testimony to Congress. Had the fund gone bust, and its positions been liquidated in a firesale, it would have made banks' bets even more loss-making than they already were. Since these are revalued daily, the banks could quickly have become technically insolvent.'

And in an editorial devoted to the same issue, the *Economist* underscored the dangers to the entire global financial system posed by the collapse of LTCM.

'The reason the Fed intervened was not the losses facing those who had invested in or lent to it, but the fact that many banks had followed similar strategies to LTCM's, and would themselves have been badly exposed had the fund failed. LTCM, you might say, is more typical of banks than of hedge funds. This is what makes its problems so disturbing--and its lessons so important.'

LTCM did not engage in particularly high-risk activities. On the contrary, its investment models were based on the assumption that yields on certain types of securities would converge with those on US Treasuries. If the interest rates on these securities were above those on US Treasury paper, then LTCM investments proceeded on the assumption that they would fall, and vice versa if they were below.

In its editorial comment the *Economist* noted that while it might be pleasant to mock the two Nobel laureates who helped to found LTCM and devise its models, 'much of this mockery clouds the truth'.

'The fund ... did not borrow more than a typical investment bank ... Nor was it especially risky. What went wrong was the firm's risk-management model--which is similar to those used by the brightest and best banks.'

The financial models used by LTCM and, as it now turns out, major international banks, were able to provide protection from financial turbulence, and enable profits to be made from it, provided that financial conditions remained within the parameters of normalcy. But with the devaluation of the rouble and the default by the Russian government on its international debt in mid-August those parameters were breached.

As markets were hit by what the *Economist* termed 'the financial equivalent of several Hurricane Andrews all at once' LTCM's models, along with those of other financial institutions, collapsed.

It was under these circumstances that the US Federal Reserve intervened to organise the bailout of LTCM. As New York Federal Reserve president William McDonough explained in his testimony to the House Banking Committee on October 1, the intervention was necessary because of the 'unacceptable risks to the American economy' which the 'disorderly close-out of Long-Term Capital's positions would pose'.

McDonough emphasised that the Fed's chief concern was not LTCM's immediate backers or the considerable losses they would have suffered, but the effect which a collapse would have on the whole financial system. There was 'tremendous uncertainty' about how far prices would move and a 'likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer. This would have caused a vicious cycle: a loss of investor confidence, leading to a rush out of private

© World Socialist Web Site

credits, leading to a further widening of credit spreads, leading to further liquidations of positions, and so on.'

In other words, with financial markets already reeling under the impact of the Russian default, the Federal Reserve concluded that because the position of banks and investment funds was so exposed, the collapse of LTCM could have set off a full-scale financial meltdown.

While a certain degree of stability appears to have returned to international markets over the past two weeks, none of the underlying problems have been resolved as central bankers and other financial regulators call for measures to restore equilibrium to the global financial system.

Typical of such sentiments were the remarks of the Governor of the Reserve Bank of Australia, Ian Macfarlane, to the East Asia Economic Summit organised by the World Economic Forum in Singapore earlier this month.

Macfarlane began by pointing to the turning point which the Russian default signified and that since August 'we no longer think of an Asian crisis but we now think of an emerging markets crisis or a general world financial crisis.'

He told the gathering that the 'western policy establishment' could no longer believe that the root cause of the problem was the inadequacy of the financial infrastructure and governance of the formerly rapidly growing Asian countries. 'Contagion is a much stronger force than formerly thought,' he said.

'Given the bigger role for contagion, more and more people are asking whether the international financial system as it has operated for most of the 1990s is basically unstable. By now, I think the majority of observers have come to the conclusion that it is, and that some changes have to be made.'

But it was no simple matter, Macfarlane said, to reach agreement on those changes because there were 'still big differences of opinion about how serious the problem is'.

Governments and central banks have all subscribed to the call for a 'new financial architecture' and the development of a new system of international financial supervision. But here the conflicts begin, reflecting the diverging interests of national governments and financial institutions. For example, the call by US financial interests for more accurate financial information and greater adherence to international standards would probably result, if implemented, in the forced withdrawal of major Japanese banks from the international arena as they would fail to meet capital adequacy standards.

While all the banks and investment funds agree with the provision of more up-to-date information in the abstract, they are wary of revealing their true position lest it weaken their position in the global struggle against their rivals.

One of the major sources of instability is that the divisions which once separated banking, investment and speculative activities have become somewhat blurred. Banks, in search of greater profits, organise investments, while companies increasingly seek funds by issuing their own bonds, rather than through loans from the banks. And even central banks, responsible for the stability of the system as a whole, are not averse to engaging in speculative activities. For example, one of the investors in LTCM was the Italian central bank.

The guardians of the international system of finance capital have not only to try and devise a series of measures to prevent a breakdown, but also to assure an increasingly worried international public opinion that the system itself is sound and that problems can be overcome once a new 'architecture' is devised.

But any attempt to present the current turmoil as some kind of accident or aberration breaks down upon closer examination.

A recent article in the London-based *Financial Times* pointed out that a paper prepared for the World Bank identified banking crises in as many as 69 countries since the late 1970s and that in every case the banking system ended up with zero or negative net worth. An IMF paper estimated that three-quarters of IMF member countries experienced 'significant bank sector problems' between 1980 and 1995.

The article noted that while crises have been worst in developing countries they have not been limited to them.

'The US, Scandinavia and now Japan have suffered big financial disasters, each fuelled by property lending. Moreover, events in developing and developed countries have not been independent: the Latin American debt crisis of the early 1980s and the East Asian banking crisis of today were both promoted by over-generous lending from financial institutions in advanced countries. Financial systems are not so much an accident waiting to happen as one that is constantly happening.'

What is also clear from an examination of the historical record is that the 'accidents' are assuming larger and larger dimensions.

See Also:
More questions than answers on hedge fund collapse
[3 October 1998]

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site