More questions than answers on hedge fund collapse

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US Federal Reserve Board chairman Alan Greenspan has acknowledged that the collapse of the hedge fund Long-Term Capital Management last month could have sparked a major crisis on Wall Street and global financial markets.

Testifying before the US House of Representatives Banking Committee, Greenspan said the $3.6 billion bailout organised by the Federal Reserve Bank of New York was necessary because of the fragility of international markets.

'Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own.'

Greenspan warned that had LTCM been liquidated through a 'fire sale' of its assets this would have resulted in a 'severe drying up of market liquidity'--in other words, a credit crunch that could have rapidly spread, setting the stage for further collapses.

Throughout his statement to the committee Greenspan offered reassurances as to the viability of financial markets. What was remarkable was not the LTCM episode, 'but the relative absence of such examples over the past five years,' he claimed. However his testimony raised many more questions than it answered, the first of these being: how many more LTCMs are there, and will the Federal Reserve be able to organise a bailout when the next one emerges?

Although it was not his intention, Greenspan's testimony itself pointed to the emergence of further financial collapses. He said LTCM had based its transactions on mathematical models that sought to profit from differences between the current price of financial assets and their historical trend. By investing large amounts of capital, borrowed from the banks and other financial institutions, the fund was able to make substantial profits so long as 'normal' conditions applied and the price of financial assets returned to levels predicted by historical models.

But the emergence of a crisis is marked above all by the absence of 'normal' conditions. In the case of LTCM, it assumed that short-term interest rates would tend to rise in the market. However, in the aftermath of the Russian rouble collapse and default in August, there was a rush of capital into US Treasury bonds--the so-called 'flight to quality'--that pushed up prices and sent short-term interest rates to their lowest levels in almost three decades. As a consequence LTCM suffered what Greenspan termed 'stunning losses,' liquidating the majority of its capital base.

There will be many other LTCMs whose predictive models, strategies, or plain guesswork have similarly gone awry as financial conditions have departed from the 'norm'. While no exact figures on hedge funds are available, according to a report published in the *New York Times* their number has doubled from 1990 to the end of 1997 and now totals 4500, while investors' capital has increased six-fold to $300 billion.

But large as these sums are, they are only partially indicative of the potential impact of hedge funds on the global financial system. In the case of LTCM, for example, the $2.2 billion supplied by investors was used as collateral to buy $125 billion in securities that were then used, in turn, as collateral for derivatives transactions worth $1.25 trillion.

While LTCM was one of the more highly leveraged funds, there are others whose operations are of similar scope. And as the LTCM collapse has revealed, they have been funded by major banks to the tune of hundreds of billions of dollars, raising concerns about the stability of the banking system itself.

An editorial published in the October 3 edition of the

British magazine the *Economist* warned: 'It is time to worry about the banks again. They may look tall and solid, but they remain a danger to themselves and others. The world's top economic policy makers, gathering in Washington, DC this weekend for the annual meetings of the IMF and the World Bank, will contemplate this with foreboding. East Asia is in deep recession, Russia has imploded, and Latin America is on the brink. Now, western banks are in trouble too--witness huge losses on emerging-market lending and the blow-up of Long Term Capital Management, a big and well-connected hedge fund.'

No doubt as the impact of the collapse of LTCM widens and concerns mount over the stability of the banking system itself, there will be increasing criticisms of hedge funds and calls for greater information on their activities, as well as demands for supervision and controls.

But such calls miss the most essential point. The real source of the crisis is not hedge funds or even the financial instruments in which they trade, but the economic and social relations of world capitalism. Hedge funds have arisen in an attempt to overcome the uncertainty inherent in a system based on private ownership in which economic activity is subject to the blind workings of the market. Under conditions where interest rates, currency values, stock prices, bond prices, asset prices and all other economic variables fluctuate on a daily basis, the demand arises for financial arrangements through which the risks associated with such fluctuations can be minimised.

In the two decades of national economic regulation that followed the end of World War II, when the activities of major corporations and banks were confined to a great extent to the national economy, the need for such risk minimisation was relatively small. Furthermore, international capital movements were subject to tight controls by central banks and monetary authorities.

However with the ending of fixed currency arrangements in 1973, and the ever-increasing deregulation of international capital movements, economic uncertainty has increased. The size and scope of international financial transactions are now so large that any unanticipated movement in a currency, an interest rate, or a stock price--to name just three of the countless variables--can rapidly turn a profit into a loss.

Hence the conditions are created for the growth of hedge funds--institutions engaged in the buying and selling of contracts that can reduce such risks. They represent an attempt within the framework of the capitalist market economy to overcome the very problems that it creates. But precisely because they are based on the market, the activities of these funds exacerbate rather than mitigate its instability.

Because the variations in economic variables are routinely small, large amounts of capital are needed in order to make a profit. The only sources of such funds are the banks and major financial institutions. Everything proceeds smoothly so long as the movement of economic variables proceeds within an anticipated range. But when a crisis develops, the huge debts incurred by hedge funds become a new source of instability, amplifying the initial disturbance and deepening the crisis.

Karl Marx did not witness the operation of modern-day hedge funds, but his remarks on the development of the credit system from which they originate have lost none of their relevance. The transformation of the capitalist into a mere manager of other people's money by means of the credit system, he wrote, 'reproduces a new financial aristocracy, a new variety of parasites in the shape of promoters, speculators, and simply nominal directors; a whole system of swindling and cheating by means of corporation promotion, stock issuance, and stock speculation.'

And the rise of the credit system had a broader historical significance.

'The two characteristics immanent in the credit system,' Marx wrote, 'are, on the one hand, to develop the incentive of capitalist production, enrichment through exploitation of the labour of others, to the purest and most colossal form of gambling and swindling, and to reduce more and more the number of people who exploit the social wealth; on the other hand, to constitute the form of transition to a new mode of production.'