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Crisis, Dollar and Shadow Financial System

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Crisis, Dollar and Shadow Financial System

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Abstract: One of the biggest concerns in the course of the current financial crisis is the role of the dollar and its hegemony in exchange transactions on a global level. The financial operations of the parallel or shadow financial system cannot be comprehended without understanding financialization and securitization. "Too big to fail, too big to rescue" expressed the size of the "over-the-counter" derivatives market. Institutional investors are responsible for the sovereign debt problem and the solution to the crisis. The dollar as the international general equivalent of the shadow financial system is of tremendous importance in today's world.

Keywords: derivatives, financialization, financial system

JEL Classification Codes: G15, G21, G23

During the last four decades the financial shadow system has been penetrating all the monetary circuits around the globe. Not only has the internationalization of capital been significantly strong but the profits of the financial actors have improved their power over the productive and circulation spheres. The actual financial crisis is the expression of the destruction of this monetary power concentrated in hedge funds, pension funds and the banks that have been deemed "too big to fail, too big to rescue." Indeed, the question will be if we are really in front of a paradigm change or trying to go back to the Bretton Woods Monetary Financial Agreements seven decades ago. Therefore, there is an imbalance that exists between the general equivalent and other currencies. The dollar, as an international interchange money, store value and credit instrument, since the postwar period has been the international hegemonic general equivalent. The international financial system transformation, from a traditional banking system to a financial shadow system, based in the dollar as

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a general international equivalent, induce not only the financial innovation, the enormous american dollars around the world and the monetary instability in front other currencies such as the euro and renminbi.

The financial innovation ends in the destructive creation of Shumpeter. Now a new regulation must improve the new conduct of the financial actors but also how the credit money was created. In this paper the author focuses on the different expressions of the financial shadow or parallel system; the imbalances between the different currencies and the dollar; the new regulation law and last but not least, the debt problems in the Eurozone.

Financial Crisis and Hegemony of the Dollar

The Lehman Brothers collapse in September 2008 marks the end of a stage in which the hegemony of the United States through its currency, the dollar, put into question the bases of a financial system based on deregulation and financial liberalization, which allowed the bases to be set for the current economic crisis. There is no doubt that the current crisis has exposed the interests of the large mainly U.S. international conglomerates and their relationship with the Federal Reserve Bank (Fed).

Therefore, it could be affirmed that the first stage of the international financial system encompasses the system regulated by Bretton Woods from 1944 to 1971. The second stage corresponds to the post Bretton Woods financial system, ranging from 1971 to 2008. In light of the evolution of the international financial crisis, a new stage will emerge, based, first of all, on the reordering of the current financial regulations mainly centered on the idea of "too big to fail, too big to rescue," which will question the financial regulations established in the 1990s. This involves the reconstruction of the international financial system with major intervention from the governments and the central banks. Secondly, it involves the policy and resurgence of the International Monetary Fund (IMF) through the G-20 to eliminate the "toxic" financial instruments. Thirdly, it includes the weakening of the euro in response to the increase in the public debt and fiscal deficit, which allowed for a temporary stabilization of the crisis, but that hinders payments to the financial intermediaries, and finally, there is the enormous quantities of reserves in dollars held by the People's Bank of China (PBC), that country's central bank.

In this whole process and over the course of the past few years the question is posed: what possibilities does the dollar have to continue being the hegemonic currency in international exchange? The answer is, beyond a doubt, that as the bases to resume growth are reconstructed, the dollar will continue being the general benchmark. Not only has the Euro put a sword over the economies of the European Union but the United Kingdom has also seen its big banks go under. But, at the bottom, in the course of the crisis what has been made clear is the strength of the financial intermediaries such as the hedge funds and the rating agencies that seek financial profitability more than the productive reconstruction of the financial circuits. In this panorama the strength or weakness of the dollar is the result of the monetary policy of the U.S. Federal Reserve, whose monetary, fiscal, and financial policy seeks to reposition the United States as hegemonic leader in an environment intrinsically tied to the interests of the big financial conglomerates. Beyond the economic reasons and the alternatives to the crisis there is geopolitical positioning of the United States with the dollar as the general international benchmark, strong and powerful.

Regulations have been a preventive medicine of the international monetary system to keep the financial circuits healthy, both on a national, as well as international level. This is because legislation on regulation and oversight is indispensable to achieve economic growth and the equilibrium among the bank and non-bank institutions. It could be argued that between 1944 and 1971 the equilibrium in the financial markets was sustained effectively and within adequate margins, which facilitated the economic growth of the industrial and underdeveloped countries. The regulatory laws established in the Glass Steagall Act (1933) helped to define the activities of both commercial as well as investment banks in the United States. Similar legislation was enacted in the rest of the countries. The inflection point occurred when the dollar was devaluated in relation to the gold standard in 1971. Since then, the rules of financing had been gradually changing and with this arose new parallel structures to grant, create, and distribute credit and with it, the risk of the recently created financial instruments in the capital markets. This parallel financial system, through structured finances, led to the financial and economic crisis that was as deep, if not deeper, than the crisis of 1929. What does this parallel financial system consist of? How much assets are involved? Could it be regulated? Who would the regulators or the regulatory agency be? What role would the Bretton Woods institutions, especially the IMF be willing to play?

Parallel or "Shadow" Financial System

The parallel financial system is based on the financialization process through which all purchase and sale operations involving credit titles are conducted. One of the challenges of monetary policy and the lender of last resort (central bank) is the enormous liquidity created by the institutional investors whose operations have vastly exceeded banks' traditional operations. Based on the banks' off-balance sheet operations, the bases of the structured finances are established, whose explosive growth ended in the financial crisis. The following section will provide a detailed explanation of the parallel financial system.

The parallel or shadow financial system cannot be comprehended without understanding financialization and securitization. For Girón and Chapoy (2009, 44-45)

> the financialization process corresponds to the purchase and sale of assets or financial securities that can occur in an orderly fashion in the capital market. It is the process through which the profitability of financial capital, through financial innovation . . . moves beyond the regulatory system created through . . . the Bretton Woods institutions (1944). The financial

> markets imposed themselves on the international financial institutions, and a priority emerged for financing through securitization through mutual funds, hedge funds, pension funds, insurance companies and other non-institutional investors that became the actors in world financing.

From a theoretical point of view, the securitization and financialization process, foundation of the parallel system, is intimately related to the Fed's interest rates. The profit cycle of the big conglomerates and the need to avoid a decrease in earnings, had a direct impact on the strong expansion of liquidity and risk. Davidson (2009, 4) points out that the optimism for a strong economy and a small government, was the obvious result of several decades of deregulation and financial liberalization, during which, it just so happened, the government budget was increasingly smaller, with the exception of military spending, with Greenspan, chairman of the Fed, being partially responsible due to his handling of interest rates.

Greenspan, as former chairman of the Fed, in testimony before the Committee on Government Oversight and Reform explained that

> this crisis, however, has turned out to be much broader than anything I could have imagined . . . on the one hand, the enormous liquidity and the fear of insolvency — based . . . in mathematical models and financial experts supported by major advances in computer and communications technology . . . a process that — handled risk with great solvency and a pricing system, whose creators were awarded the Nobel Prize in Economics. Today this intellectual edifice has collapsed. (Greenspan 2008).

The Banks and Institutional Investors

At the beginning of the 1990s, the banking crisis affecting U.S. savings institutions had cost the Federal Savings and Loan Insurance Corporation (FSLIC)[1] some $150 billion. According to Fed regulators, the insolvency of the banks was due to the regulatory policies that limited the activities of these institutions.

This idea was derived from the following hypothesis: (a) the macroeconomic and fiscal policies had seriously damaged the health of the banking industry due to government regulation, and (b) the banking policies were off the mark, since they were based on historical and ideological regulations. Therefore, new regulations were required for the banking industry in the new international financial environment (White 1993, 2).

With the beginning of the 1990s it was anticipated that the large banks on a national level were about to fall into insolvency. In addition to their financial statements being weak, they were very much exposed to highly risky loans (Barth, Brumbaugh and Litan 1990, 13). The banks seemed to be an industry in decline, due to the competition of non-bank institutions that offered similar financial services to those that they were providing. At the same time, the banks continued to crash, and the capitalization of the large banks was still weak.

As a result, there was an urgent need to reform the regulations that prevailed in those years. Traditionally, as part of their assets, banks held the loans granted to their clients until the cycle of the credit had concluded. With the deregulations, what the banks did was to sell the "pool"[2] of their debt to a mutual fund. Subsequently, the non-bank intermediary sold the securities in the secondary market. This is what has been previously defined as a financialization process. A large part of these credits were bundled in the form of synthetic or traditional derivatives.

Derivative Operations

The Bank for International Settlements (BIS) estimated the size of the "over-the-counter" derivatives market[3] as $604,622 trillion (June 2009).

Between 1998 and 2009 the assets of the main U.S. banks performed as follows: the largest 25 banks[4] saw their assets increase by 204% while the remaining 422 banks that followed in order of importance posted 51.54% growth in their assets. In relation to derivatives, it should be noted that the 25 largest banks posted 524% growth, while the remaining 422 banks saw their derivatives increase 17.19% in value.

Throughout the period these instruments remained a priority, representing between 60% and 70% in relation to the other instruments such as forwards, options, and credit derivatives. Even in the crisis period between 2007 and 2008 their annual rate of growth diminished marginally and at one point was negative, but they recovered in a short period of time, posting growth at the end of 2008. Meanwhile, forwards posted a negative variation of -28.51% between 2008 and 2009. In the 2000 –2007 period, options registered a downward trend, and their average variation was -5.025%.

Regulation and Oversight Proposals

The plans to capitalize the banks and the strong injection of liquidity, close to $3 trillion (2007–2009), have put the topic of the regulation of the massive operations of the parallel financial system up for discussion. The G-20, the IMF, the UN, the Steering Committee, the Warwick Commission, the Bank for International Settlements, and the main representatives of the central banks have offered their opinions in this respect. But the most controversial opinion may have been advanced by Paul Volcker, designated by Obama to preside over the Economic Recovery Advisory Board; the Volcker Act was sent to the U.S. Senate at the end of February 2010.

Among the most interesting proposals was that of U.S. Secretary of the Treasury Timothy Geithner. He discusses the requirements to capitalize the banks with standardized limits; that there should be sufficient reserves so that the financial groups can themselves absorb the losses; that banks should have enough liquidity to face the solvency risk. Finally, he mentions the need to improve the rules for risk measurement in the banks' portfolios and the capital requirements for their protection against such risks. Strong restrictions should also be imposed on leverage.

The report concerning the financial reform, presented by the Steering Committee, headed by Paul Volcker, contained 18 recommendations (Working Group on Financial Reform 2010). Drafted by the Commission of the Group of 30, the report proposed: (1) redefining the scope and boundaries of the prudent regulations; (2) reforming the prudent structure of the regulations, including the role of the central bank and the implications of the "lender of last resort," as well as the "safety networks" and the need for greater coordination; (3) improving the government's authority, risk management, regulatory policies, and accounting practices, as well as the standards; and (4) improving the transparency of the financial infrastructure agreements.

Euro, Monetary European Union and Central Bank

Was the Euro being well regulated? One of the principal discussions these days is the solvency and regulation of the institutional investors. Financial markets, pension funds and hedge funds have managed their flows in a very profitable business of corruption increasing interest payments not only to governments but to private entrepreneurs. Indeed the deepness of the sovereign debt problem won't be finished until the Central Bank renegotiates the decrease of the total amount of debt and the interest on the external debt service payment. All of the credits must be involved in a long term restructure plan of payments as well. The central bank must act as lender of last resort and improve employment through monetary and financial policies.

During the past four decades, recurring economic and financial crises have emerged on an international level in the capital markets' integrated financial circuits. The current debate on regulations is taking place amid serious concerns over recurring bank crises. The waves of panic that occurred in 1907, 1928, and 2007 go hand in hand with the strong speculation carried out by financial agents such as the banks. It should be asked whether it is important to save the big banks, or on the contrary, could a regulation be sought that strengthens bank and non-bank financial institutions and, of course, the lender of last resort?

Notes

1. The Federal Savings and Loan Insurance Corporation (FSLIC) was an institution that administered the deposit insurance for U.S. savings and loan institutions. The Financial Institutions Reform, Recovery and Enforcement Act abolished the FSLIC in 1989, passing its responsibilities to the Federal Deposit Insurance Corporation (FDIC). The FSLIC was created as part of the National Housing Act of 1934, in order to insure the deposits in saving and loan institutions. One year later, the FSLIC was created to insure the deposits held in commercial banks. It was administered by the Federal Home Loan Board (FHLB). In the 1980s, during the savings and loans crisis, the FSLIC became insolvent. Several times it was recapitalized with taxpayers' money, to the tune of $15 billion in 1986 and $10.75 billion in 1987. However, in 1989 it was again insolvent and was abolished together with the FHLBB, and the responsibilities of the FSLIC were transferred to the FDIC.
2. A pool consists of government and private securities that form a combination of credits or securities, placed for sale to obtain an additional profit.
3. Markets whose transactions are carried out outside the stock exchanges or organized markets.
4. Among the most important of which were Chase Manhattan Bank, Citibank and Bank of America.

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