Conference
SOCIAL POLICY AS IF PEOPLE MATTER
Adelphi University, Garden City, New York. November 12, 2004

Unemployment, Diminished Welfare and the Role of Financial Institutions: Dangerous Bunglers Seeking Certainty

Draft Paper by Jocelyn Pixley, University of NSW, Sydney.

Introduction

Thirty years of rising poverty, unemployment, casual jobs and declining wages have gone hand-in-glove with the rise and rise of global finance. 'The Economy', according to the forecasters who grease and oil it, is a turbulent engine understood only by them. It is often buoyant but, regrettably, national or regional bits keep on crash landing while others get 'lift-off'. All are a source of intense speculation, a situation not unlike volatile financial eras of the 1920s and earlier.

And as before, the social ends which economic life is meant to serve are routinely censored: in fact the only long-term views about the future of 'people' are directed against the elderly. If elections remind us how the political world manipulates our fears and plays on memory-loss, in comparison, the finance world is a contagion of Alzheimer's where tomorrow is all that matters. Occasional 'bright' employment stories seem unbelievable to our people-oriented minds. With IT at our fingertips, it takes a second to find job-seeker to job-vacancy ratios (around 20 to 1 – at best - over the past 30 years in much of Anglo-America). The 'lash of unemployment' is made up of armies of prime age men, along with female and male teenagers, who roam the streets with little chance of a long-term future beyond marginal, fragmentary jobs. They are the creation of low inflation policies, now unravelling even for the finance sector. It wants more 'reform', more privatisations, but since the future is unimaginable, inflation is as likely as debt-deflation.

The 'D-word' is unmentionable to those who believe inequality to be the gas and oil of 'The Economy', whereas Keynesian full employment policy-makers argued and demonstrated how inequality was damaging in every respect. Meantime, the biggest export industry in some countries is the corporate export of jobs. The skilled and professional people who remain employed have no time for what they do best: practice their crafts. Each is doing the work of five, answering emails, filing audits and wishing they could work less (Martin & Pixley, forthcoming). This is counted as rising productivity. In the world of corporations and bureaucracies the situation deepens. My university 'self-insures': everyone has forgotten the insurance bust and bail-out – only a year ago in Australia – and instead blames the internal auditors who forbid a student excursion, or the lawyers who sue medical specialists for recompense, now that the insurance industry assures or ensures us so much less (Heimer, 2002).

This paper asks one question: What is there to show for these years of financial 'reform' other than hardship for so many people <u>and</u> self-deception

about untold dangers within the financial world? Remedies seem all too remote. Governments should introduce cautionary, more socially just policies, but many are pessimistic. They argue the financial sector seems totally powerful and nothing will happen unless forced by calamity. That may be so, but evidence drawn partly from my new book shows finance to be less a 'power with intent' than an incompetent sector that bungles and lurches from one short-term stop-gap to the next. Hard-headed and obscenely wealthy, this sector increasingly relies not on caution on the flimsiest emotions of distrust.

1. The issue of finance

After a generation of relative calm, global finance brought instability back to the world. To briefly recount, 1975 was a key date when the few regulatory controls on financial flows began to unravel in earnest. Before then, some democratic control was exerted to maintain precautionary measures. Global financial institutions – in ill-repute from the 1930s – also lost their international banking networks and ties during World War II; few tried to evade laws against 'Trading with the Enemy' (with some prominent exceptions). Afterwards, in the Bretton Woods agreements and Keynesian fiscal policy, full employment was an aim and welfare states expanded: this was the old meaning of the word reform. In this world, Central Banks like the Fed and the RBA were charged with achieving full employment as well as price stability. Interventionist policies sought to alleviate economic uncertainty and its attendant shocks. The current anti-inflationary policies which disbanded full employment and the welfare state are an attempt to reduce the uncertainty of money's value as a financial asset. What high finance cannot publicly admit is that uncertainty is not only inevitable in economic activity generally but is magnified in finance because money is based on a trust that is inherently problematic.

This uncertainty is unavoidable and comes with grave consequences. Even Federal Reserve Chairman Greenspan admitted this, behind closed doors in 1996: 'product price' inflation can be conquered only at the cost of price–earnings ratios going 'through the roof'. Recurrent speculative booms bring debt-deflation in their train, historically a common phenomenon.

How does money rest on trust? Money is a three-way relation between creditors, debtors and 'society', a relation in which Central Banks historically emerged to play a key role. This is barely understood these days. Private banks tend to lend aggressively with loose credit in good times (umbrellas on a sunny day), only to recall and stall during failures (just when needed most). In 1947 an Australian Prime Minister, Ben Chifley attempted to nationalise banks for that very reason, particularly since they had resisted supervision by a central bank. It was literally by default, namely the nineteenth and twentieth century bank disasters, that forced the creation of Central Banks which would hold reserves and set the interest rate they charged private banks. Only a government bank could foster an abstract trust in money as a public good, a believable token beyond money's role as a private commodity created from claims and credits. It is complicated by involving two circuits between public

and private: public and private debtors are governments, taxpayers, entrepreneurs and us debtors. Private creditors are bondholders and private financial institutions that lend to governments and entrepreneurs: these banks are the 'gatekeepers of development' in Schumpeter's words (Pixley, 2004: Chapter 1).

The most trustworthy, sought-after money is monetised debt, institutionalised in governments' promises to pay from taxation. Here rests the productive power of money, which often involves a benign circuit of plentiful economic activity. Private creditors finance national debt for sound government activities allowing more favourably priced credit to foster economic ventures which a government can tax to repay its debt. But the future is unpredictable - ventures may fail – even from simply appearing 'unsound' - taxes may not be collected and debts may not be repaid (Ingham, 2004: 132-3). Deflation raises the value of debt; defaults exacerbate the slow-down of economic activity.

Money is both a private commodity and public good resting on bonds of trust, however, the close relations between Central Banks and private banks tends to blur their public responsibilities. They were established to be politically neutral providers of technical expertise, the simple mechanics, but Central Bank neutrality is not possible because money relations involve one of the great social conflicts in modern life. As Geoffrey Ingham (1998: 13–14) argues, neither a Central Bank nor any other financial organisation can establish or 'produce at will' the standard and 'substantive validity' of money. In his words, money's 'purchasing power can only be established through the struggle between producers and possessors of both money and goods'. This process is always contradictory, for in achieving monetary stability for the producers of money, instability emerges elsewhere. Instability – debts, Ponzis, unemployment – erupts among producers of goods and services in the household, corporate or governments sectors, or among the dizzy financial sector itself in speculative booms.

The renewed emphasis on money as a private asset (defending it as a 'store of value'), was a slow process of global financial networks rebuilding in the 1960s, starting with Euromarkets. Stability from the hegemonic dollar ended with Nixon's float of 1971 – the Bretton Woods breakdown of fixed exchange rates – and in 1975 when competitive regulations replaced control-type restrictive practices on the NYSE. Currency speculation became a new source of uncertainty for 'non-financial' corporations: now most firms 'dabble' in finance. Corporate raids, starting during that time, changed firms from seeking growth and sustainable activity to a sole aim to increase shareholder value. These raids - now called 'mergers' – became part of the excessive financialising of life. Corporations, despite being mostly self-owning, were to be made directly responsible 'to make as much money as possible' for the owners – insisted Milton Friedman (cited in Bell 1976: 292). At that time, conservative sociologist Daniel Bell (1976: 294–5) opposed this view with words rarely heard these days. He said, 'it is politically and morally unthinkable that [employees'] lives should be at the mercy of a financial speculator'. Yet now they are.

Money is only unique in contemporary times because financial assets have vastly expanded in number and significance. Whether money's form is plastic or electronic, money is still primarily credit, and in this sense all money has long been 'virtual'. It has also been heavily traded in other eras too. Late 20th-century money became unique with the massive and contradictory expansion in the proportion of shareowners (rentiers) and debtors just when the post-war financial controls were unravelling. Low-income working-class customers have only had access to credit from banks over the last fifty years (Davies, 1994: 338). Types of debt expanded in the 1950s, with the growth of home ownership (mortgages) and consumerism, beginning with consumer hire purchase plans and the lay-by offered by retail firms, now fully developed in plastic credit cards. Many employees became shareholders by purchasing private sector financial products. In the Great Depression, when almost entire working populations were plunged into unemployment, shares were owned by a mere 3 per cent of the people. Now, more than half the English-speaking populations own shares today and household debt is also high.

Are these decades of 'reform' a simple victory for the major financial institutions? Inflation-first policies opposed any concern with restoring employment, even measures to support the unemployed with a decent unemployment payment. Financial actors coveted social and national property, eagerly pursuing the privatisation of utilities and collective savings. Government or non-commercial, mutual insurance and pension funds for wage and salary earners were said to 'crowd out' the private sector. But in fact social property undercut the production of private money. Eventually financial speculation took its toll at the dizzy heights as much as for marginalised populations and countries. LTCM collapsed in 1998. Facile 'new economy' explanations – relatives of information society and post-industrial ideas that played down chronic unemployment (Pixley 1993) – tapered off after the April 2000 dot.com crash. More than twenty major monetary, securities and banking crises have occurred since the 1970s with international monetary and national banking crises and numerous individual bank failures (Braithwaite & Drahos, 2000: 135). Which 'great banks' remain? Not Barings or Salomon's, nor Andersens as guardian. The list of calamities and unintended consequences in HIH and Enron, Equitable Life grows, and yet competitive lending continues to rise, property speculation is back, there are fewer controls over financial flows and self-deception in the heartland continues. From forgetting decades of low inflation, the insurance industry miscalculated its promises, which were based on assuming rising inflation, and then tried to tear up promises. Genuine mutual funds and not-for-profit saving societies were modest, dependable forms of collective security: demutualisation raised the competitive selling of individual securities, to fuel the Ponzi schemes of each decade. Yet uncertainty cannot be removed – squeeze it in one place and it re-emerges in another – that is, while uncertainty is imposed on marginal populations, the potential problems for middle-income groups – in contradictory positions as rentiers, debtors and workers – may be more significant.

Now the burden of economic management rests even more narrowly on monetary policy and disguised (and unsound) Keynesian fiscal policies. At the

same time, fewer Central Banks control prudential regulation of banks due to the creation of separate, often feeble supervisory agencies. Domestic bank lending is no longer the only source of funds for large firms, which reduces reserve ratios and the required pool of funds against which reserves must be held (Schaberg, 1998: 209). Post-war economic regulation went together with prudential controls, but now larger private enterprises are 'free' to make imprudent decisions. The possibility that monetary authorities may be unable to meet lender of last resort duties cannot be ruled out. As Hugh Stretton argues, 'the world has no precedent or previous working experience of an international system of pure fiat money [government authorised], privately created, publicly guaranteed, and inadequately regulated' (2000: 707, 691).

2. Fighting inflation – unemployment, low wages

Few people today are aware of the weaknesses of monetary policy, only its harshness. As in the 1920s, Central Bank monetary rates are politicised (Kynaston 1995: 27) but today only to the extent that many people do understand how the price of money affects mortgage debts or unemployment. It was the bleak 1930s that showed how feeble monetary rate manipulation is in a Depression. Although high interest rates had not prevented the speculative boom of the preceding years in the 1920s, once the 1929 crash occurred, low interest rates were totally ineffective in reviving economic activity. 'In a metaphor that gained currency at the time', said John Kenneth Galbraith (1975: 213), 'monetary policy was like a string. You could pull it, though with incalculable results. But you couldn't shove it at all'. All the interviews I had with informed sceptics tended to agree: targeted fiscal policy (taxes more <u>and</u> less, not always regressive) was as essential and more so, 'sound' government debts and an end to privatisations: these are, correctly, political decisions about which electorates are able to judge.

In comparison, monetary policy is kept mysterious. Nevertheless, at the height of the 1920s boom, speculators gained far more from asset inflation (as they did in the dot com boom) than from higher interest rates, which were supposed to act as a deterrent, despite its impact on employment, defaults and small business. Indeed 'sound' money with chronic unemployment fuelled expectations of 'certainty' - a 'new era' even - which led to that 1929 crash. During depressions, in contrast, a low price of money may still not generate trust, optimism or the entrepreneurial business confidence to borrow, invest or spend in sustainable industries. Thus employment does not revive without 'sound' government investment which could generate 'believable' promises to assuage private bond holders that governments can pay their bonds in future taxes. Instead, bondholders demand their money <u>now</u> and it disappears. Meanwhile people are literally broken by the mighty but foolish banks, by fearful governments' cutbacks and business prevarication – namely lay-offs, heightened competition and outsourcing. It <u>should</u> sound familiar, but few know the second part of the story, whereby inequality creates depressions.

With the renewed dominance of global finance in the 1970s, Central Banks expanded responsibilities economy-wide – reviving that thin but brutal string of monetary policy under the name of 'independence' from elected governments. Whether CBs believed in neo-classical nostrums or not, they

henceforward came under enormous pressure to provide ‘certainty’ – which often included rescuing private banking from their own foolish decisions. Governments do run a hidden Keynesian fiscal policy, but it is directed not to demand management and reviving entrepreneurial ‘confidence’ in production of goods or services (such as government debts for skill development or sound public infrastructure), but to reviving investor confidence at each near collapse. The last thirty years have seen regressive tax and welfare cuts and warfare spending, the benefits of which are still meant to ‘trickle down’, if at all, or else. Karl Polanyi described the last era, from the 1870s to the world wars, when the ‘money power’ pulled the global strings far more effectively than Central Banks ever can with their sole string of monetary policy. Bond holders, as we will see, find national promises from some governments increasingly unbelievable: but meantime, speculation continues, with baleful effects whether in boom or crash.

Each crash has brought private financial demands for a new ‘certainty’. For example, from the 1980s to 2000, Central Bankers’ technocratic worldviews were dominated by seeking the ‘certainty’ of low inflation. Their concerns, as evident in transcribed meetings, were above all to appear credible to financial firms. Thus they worried about what ‘the market’ would ‘think’ about tight labour markets – even though the Fed and RBA were supposedly responsible for full employment - and the unbearable uncertainties that corporations might pass on wage demands in higher prices. Given that corporations by then only aimed for shareholder value (profits not growth), price rises became more, not less likely. Thus Central Bankers forever sought omens of productivity gains from doing more with less, on lower wages. Hence the ‘new economy’ myth was probably behind Greenspan’s defence of the pitiful employment gains of the dot com boom and Wall Street’s politically embarrassing reaction to them (*The Australian*, 12.03.98). One Fed governor even argued inflation was caused by too many people working. Most Central Bankers stressed how ‘polite euphemisms’ were ever more essential in their public statements, and advised against ‘blunt language like “The Bank of X wants the unemployment rate to go higher”’ (Blinder et al., 2001: 31). The ‘markets’ would decipher the spin in the oblique references, while the public remained ignorant, apparently stubbornly opposed to ‘volatility’ (and no wonder).

Inside, Central Banks become fixated on beating wage-price inflation with the lash. Although they also beat the monetarists like Friedman as well, the first battle virtually stopped economic activity. Lyle Gramley, a Governor during Paul Volcker’s time as Chairman of the US Federal Reserve, when interest rates rose sharply in 1979 and again in 1981-2, describes his conviction in the NAIRU. The public was not fooled by the euphemisms either:

> **GRAMLEY:** When you’re there internally making these decisions, you’re well aware of the fact that’s there’s an *enormous* amount of short-run pain involved. People lose their jobs, businesses go bankrupt. Families break up, people commit suicide. You can’t go home at night when you’re involved in something like this, without feeling *deeply* that this is something that has to be done. If you don’t really understand that it *has* to be done you could not do it. At the time we were there, the housing industry was suffering to the point where builders around the country were encouraged by their trade association to get pieces of two-by-four, put their name on the corner, put Paul

> Volcker's name on it, stamp it and send it to the Federal Reserve (Interview 7 March 2002).

Bucket loads arrived and Congressman Henry Gonzales attempted to impeach FOMC members. By 1982, official unemployment rates rose to 11 per cent, the US dollar rose in real value by 60 per cent, rendering US export products uncompetitive: some manufacturing sectors collapsed permanently.

3. Bubbles and crashes! – and their costs

Although 'sound' money was restored on the backs of millions of people, thereupon began a major wave of collapses elsewhere, starting with the Mexican financial crisis of 1982 and the S&L industry's crisis. The cost of bailouts and tax cuts (to revive investor confidence after Volcker virtually shut down the economy) all contributed to the 'staggering Federal debt' and Reagan budget deficits of the 1980s (Kaufman 2000: 199). Warfare Keynesianism, savage welfare cuts - with tax cuts to the corporate sector - were widely emulated. Thus Thatcher had her Falklands war, in crisis from deep unpopularity, exacerbated by the Mayor of London's black flag strategy, which raised the 6 million or so daily unemployment rate just across the Thames at Westminster. Deficits soared again under Bush Senior, and the Tory Party nearly vanished after the 1990 housing boom burst in their own heartland. Clinton became prey to bond traders and Greenspan's pro-market orientation; Tony Blair embraced 'Third Way' and Australian Labor Party policies. Despite the previous regional debt-defaults and financial crises, the line against Clinton remained either cut-back the Democratic health plans and welfare further, reign in public debt, or else. After controlling inflation (and the dollar flight) as 'the cure' and route to Central Bank credibility, the bull market ran and ran until 2000.

One person laid out the effects of speculative booms in the 1996 September meeting of the Federal Open Market Committee. Governor Lindsey[1] gave a striking warning:

> **MR. LINDSEY**: … What worries me … is that our luck is about to run out in the financial markets because of what I would consider a gambler's curse: We have won this long, let us keep the money on the table. You can see the early signs of this. It includes real estate appreciation in the Hamptons, Connecticut, and Manhattan. BMW and Mercedes both had their best summer in history in the United States. …. Unfortunately, optimism is ripe in the markets. Excessive optimism is also necessary to justify current levels of IPO activity and valuations of highly speculative stock. … this emerging bubble is … real. As a survivor of the so-called Massachusetts miracle …, I can attest that everyone enjoys an economic party. But the long-term costs of a bubble to the economy and society are potentially great. They include a reduction in the long-term saving rate, a seemingly random redistribution of wealth, and the diversion of scarce financial human capital into the acquisition of wealth. As in the United States in the late 1920s and Japan in the later 1980s, the case for a central bank ultimately to burst that bubble becomes overwhelming. I think it is far better that we do so while the bubble still resembles surface froth and before the bubble carries the economy to stratospheric heights. Whenever we do it, it is going to be painful, however (FOMC 24 September 1996: 24 –5).

[1] Governor Lindsey, a former Harvard economics professor, was a Fed appointment of President Bush senior; he later served as President G. W. Bush's chief economic adviser 2001 – 2002.

Lindsey's attribution of luck is an attempt to dampen FOMC confidence; no investment firm will get out while stock prices continue to rise (as 'getting out while the going is good' is countered by competition from other firms), therefore, the Fed should act. After a long round up by the Chair, Greenspan turns to Lindsey:

> **CHAIRMAN GREENSPAN**: We have a very great difficulty in monetary policy when we confront stock market bubbles. That is because, to the extent that we are successful in keeping product price inflation down, history tells us that price-earnings ratios under those conditions go through the roof. What is really needed to keep stock market bubbles from occurring is a lot of product price inflation, which historically has tended to undercut stock markets everywhere. There is a clear trade-off. If monetary policy succeeds in one, it fails in the other. Now … it is not obvious to me that there is a simple set of monetary policy solutions that deflate the bubble. We do have the possibility of raising major concerns by increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it. My concern is that I am not sure what else it will do. But there are other ways that one can contemplate. ((FOMC 24 September 1996: 30–1)

As we know, Greenspan ignored the prospect of tightening margin loans, clinging to monetary policy. It highlights the weakness of Central Banks in failing to stare down financial markets. But let us consider the role of investment banks and ask who played the key role in 'irrational exuberance'? Many tried to blame the financial press for the boom (eg Robert Shiller). It only deflected attention from stockbroking and investment banks. For example, in Zürich, a financier I interviewed agreed that press standards were very low:

> **FREY:** There are very, very few exceptions among them, probably two British, the *Financial Times* and *The Economist*, but the rest of the financial press, also in this country, are not of a high credibility. But this is, to be fair, mirroring a phenomenon, which I call 'the financial peepshow'. I do not know any other industry that is so person-oriented, so story-oriented as is the financial industry……
> … I mean, clearly the investment banks earned most of the money, in that time, with ideas and yes indeed, they had the vested interest in talking it up. So I would rather blame the investment banks leading the new issues, setting up the new markets, than the financial press or Wall Street. What is Wall Street? Wall Street is the marketplace. Do you blame the marketplace for the bad salad you get? It's probably the man who sells you this salad on the marketplace, who is to be blamed that it's rotten (Interview, Zürich, April 4, 2002).

Investment banks run a 'peep-show' seeking minute-by-minute gossip, or any information about quality of promises and omens of the future. The market is merely the point of sale. If vendors are concocting a Ponzi with producers of new financial 'products', public exposure needs stern regulators. The old Fourth Estate ideals of vigilant, informed journalists and media proprietor support – 'deep pockets' – to pay for libel suits, are also diminishing.

Alarm about the lack of precaution, rarely heard, was sounded by John Bogle (Founder and former Chief Executive of the Vanguard Group), in opening his 2003 Statement before the US House of Representatives Sub-Committee on Capital Markets, Insurance and Government Sponsored Enterprises

(Committee on Financial Services). He notes changes to financial services since World War II:

> The mutual fund industry [of] … 1949 is almost unrecognizable today. … [Then, they] spoke of “trustee,” “trusteeship,” “the investment trust industry,” words that we rarely see today. Over the half-century-plus that followed, in my considered judgment, the fund industry has moved from what was largely a business of stewardship to a business of salesmanship, a shifting of our primary focus from the management of the assets investors have entrusted to our care to the marketing of our wares so as to build the asset base we manage. (John Bogle, Statement to US Congress: March 12, 2003).

The principle of mutual funds being mutually owned by each member survives in very few cases, Vanguard in the USA being notable. Most non-mutual funds and retail funds are highly competitive. They publish monthly performances on the assumption that small investors continually shop around. A similar tale is told in the UK:

> **LAZAR**: This causes lots and lots of problems. For instance, the way in which retail funds sell themselves is to point to the fact that they have funds which invest in the flavour of the month, quite literally. All the adverts you’ll see in the Saturday *Daily Telegraph*, financial section, will be, say, about technology funds: ‘our technology fund’ came top of fourteen tables, ‘our technology fund’ has won this and that practically worthless award … As far as I’m concerned, investment is a matter of what happens over the next ten or twenty years, not what happens over the one month or three months or a year … These people are supposedly professionals, are supposedly thinking in responsible terms about the funds of their clients, and they’re not at all. What they’re thinking about is performance, what they’re thinking about is their own salaries, what they’re thinking about, if they’re senior enough management, is profitability and dividends and bonuses.

This is not to say that the former mutual funds in Britain were ‘perfect’, but competition, performance and managers’ salaries are all-important now:

> **LAZAR (cont.)**: One of the great tragedies is the collapse of the mutual system (such as building societies and mutual insurance), because the mutual system was fuddy-duddy, comfortable and smug … The managers made things very comfortable for themselves, but they also did very good business for their pensioners, and the whole system worked well. It built up large reserves for the very good reason that they were prudent … You could criticise all this as being a sub-optimal allocation of capital, and all that (economic rubbish), but the fact is, it was safe. (4 June 2001)

Global investigations into mutual funds began in 2003, some by Eliot Spitzer in New York, which uncovered abuses where insider investors and fund managers made money at the expense of their everyday shareholders.

In trying to shift the attribution of corruption, finance firms have used various unsubtle defences: the thesis of a few rotten apples or rogue traders or that ‘mum and dad’ investors fuelled the exuberance. The hedge fund, Long-Term Capital Management (LTCM), which collapsed in October 1998 was quickly forgotten. Four years later came the string of scandals in stockbroking and investment firms.

Investment banks and pension funds in turn have immense influence on other firms’ credibility – selling off stock is a threat to companies. Firms that give

confusing signals are punished or threatened by analysts' reports: Telstra's 'Agitated confusion gets on market's nerves'.[2] During 2002 (when analysts might have tempered their sagacity under exposure of their own corruption), competition among French national elites to revive the failed fortunes of Vivendi was criticised for avoiding whether corporate elites can 'buck the market'. The idea that French capitalism could neglect market disciplines of 'le capitalisme sauvage du modèle anglo-saxon' was, *The Economist* anonymously argued, ludicrous. 'Investors will stick with a France Telecom or a Vivendi only if they trust bosses to spell out clearly how they are proceeding – and to do what the markets want. If not, they can take their money elsewhere.' Why investment banks know the future any better than corporations is not a consideration.

4. Lack of Prudential Supervision - Bailouts – LTCM; Indonesia

Central bankers do express concern about their being 'hostage to market sentiment' from 'herding' or financial crises (Blinder et al. 2001: 15). Yet too many are simply concerned about appearances (to ward off public criticism). They say, for example, that Central Banks cannot appear to be 'responding to the whims of the market' because their 'carefully designed strategy, the focal point of their communication efforts, would lose credibility'. They admit 'adjustments' in 'rare circumstances' are necessary - like the 1998 crisis of the elite hedge fund LTCM (2001: 25). What some called the Fed's 'modest but conspicuous' intervention – in arranging for LTCM's private counterparts (major Swiss, US and British banks) to recapitalise the firm, and the FOMC's rapid lowering of rates in three successive moves – was cause, they admit, of many 'concerns' as to whether it had a 'compelling public interest' (2001: 45). LTCM had intimidated major banks (from Merrill Lynch to UBS and Chase) into lending huge unsecured sums while refusing to admit its extraordinary leverage ($US1 trillion):

> **ABELSON:** The interesting thing in that case just reinforces what I say of the level of intelligence and gullibility. It is as high in the most successful people in Wall Street as is it is down below. So LTCM is a very illustrative case, I think (Interview, *Barrons*, New York, September 21, 2000).

Why was this massively leveraged, elite firm of hardened Wall Streeters and Nobel laureates (Merton and Scholes) 'too big to fail'? The FOMC minutes of 28 September 1998 barely mention it (Blinder et al. 2001: 45) however the full transcript, released in 2004, devotes many pages to explanations by McDonough (FOMC Vice Chairman and President of the Federal Reserve Bank of New York), and to numerous questions by members, often simply trying to understand the whole issue (FOMC 28 September 1998: 97 – 119).

It is worth citing, because who remembers that gullibility of the global banks a bare six years ago? In discussing the horror behind closed doors in 1998, Alan Greenspan suggested 'the lenders were dazzled by the people at LTCM' such as the Nobel prize winners. He compared a Japanese embezzlement

---

[2] Headline of article by Mark Westfield on Telstra in *The Australian*, May 4-5, 2002. *The Economist*, October 5, 2002 'Le capitalisme sauvage' p 66.

case in New York: ‘What Daiwa exposed is how complex these situations are and how few troops we have to look into them’ (FOMC:1998:107). The Fed did not begin to regulate hedge funds (LTCM included) at all until July this year.

Greenspan had opposed regulation of hedge funds to Congress only weeks before the scandal broke. The Fed’s credibility also became dubious to non-financial corporations, as to whether moral hazard is distinguishable from ‘systemic threat’:

> **DALE:** Take Long Term Capital Management. I’ve heard people in the Bank of England talk about this. The argument is that if a bank like Natwest is going to fail, it poses such a threat to the public financial system that it cannot be permitted to fail. But if some highly sophisticated esoteric player in the market is going to fail, it shouldn’t pose a threat to the whole financial system. Players like that can’t be allowed to be effectively supported just because they make a complete mess of it. Why should they be? I’ve heard many senior industrialists say ‘I ran a major manufacturing company in England. We had huge problems. We were going bankrupt.’ In some cases they went bankrupt. Did the Bank of England come along and say ‘We may have had to let go ten thousand workers’? Why shouldn’t we have been supported? Why should a bank which makes a complete mess of everything be supported? Who draws the line as to what is systemic and what isn’t? (5 October 2000)

Similar issues were also barely heard in the States after LTCM’s collapse. A lone Independent voice at the US Congress inquiry on hedge funds proffered the umbrella theory of banking: ‘What we have here are banks that are willing to lend billions of dollars to … gamble on whether interest rates go up by a half a percent or whether they go down by a half percent.’ As he complained, these same banks ‘refuse to loan money for economic development and job creation in communities all over America’ (cited de Goede, 2001:150).

Back then, headlines about glasshouses and stones (in *The New York Times* in October 1998) crossed a world just then insulted by the IMF’s and US Treasury’s condescension about Southeast Asia’s so-called ‘crony capitalism’ – not about the aggressive investment banks which left the region in chaos. In Indonesia, where a breeding ground for terrorism has since emerged, the experiences of 1997-98 increased homelessness from 7 million to 25 million. Governor Rivlin’s words inside the Fed were critical, at the time. As she said:

> **Ms. RIVLIN:** … I find the world economy both sad and scary. The saddest part is that so many millions of people in developing countries in Asia and Latin America are being thrown into desperate circumstances just at the point when they were beginning to have hope for the long-run future. Many of them have not been in the modern world all that long. They left villages and in many cases their home countries in search of jobs in modernizing economies. Now they are being thrown back into insecurity and a struggle for bare necessities with no idea if or when the economic opportunities for them will reopen. I stress that because I think we sometimes tend to sit around this table and act as though all the losers were investors and high flyers. They definitely are not.
>
> The scary part is that those of us who believe strongly and rightly in the power of capitalism to improve peoples’ lives do not know where the current downslide will end or what we can do that will effectively stop its spreading contagion. We already knew, of course, that when large amounts of capital are moving freely in search of higher

> returns that investors can be victims of their own excessive optimism and then get caught up in a wave of excessive pessimism. We also knew that capital flows were far greater than ever before, that world markets were more interlinked, and that financial movements were more rapid in an age of instant global communications. But I don't think we knew how big an impact that might have. We knew that very clever self-assured people were placing huge bets with other people's money in relationships they could only guess about, that sooner or later some of them would guess wrong, and that the consequences could be serious …. (FOMC 28 September 1998 p 70)

Quest for certainty futile

'Uncertainty continues to run rampant' (Wall Street analyst, October 19, 2001)[3]

Most dilemmas of investment decisions are emotions of impersonal trust because uncertainty is so far-reaching. As another Zurich banker said:

> **CHAN:** I think certainly, the history is that we now have less time for making decisions and therefore we place more trust in experts. People who carry the label "I'm an expert" are trusted. When we have some uncertainty we bring in someone called an independent expert. We don't trust you, but we trust Moody's. You can also have distrust. All you are doing is really just shifting the trust from a direct trust to an indirect trust. That is, "I don't trust you but I trust the stock market. The stock market must be right. These dot com companies are losing money but the stock market is not stupid so they must know something." So I think human beings want trust because it makes our lives a lot easier.
> We don't know the future and we have no time to analyse the facts. There was one thing that came out very interestingly in the collapse of Enron. All the investment analysts, the people we thought were the experts, never even studied the Annual Report because it was too thick, 100 pages – who reads this? Nobody. And they just say because it's so thick and it's signed off by Andersen's it must be okay. I think that will not go away as long as people are under time pressure. As long as you think "I have to make a decision in the next five minutes" and I can prove that I relied on twenty experts, I think we are structurally in the trust business whether we like it or not. (Paul Chan, UBS AG, Zurich Interview, April 5, 2002)

Monetary policy: thin reed whether inflation or debt-deflation

Now, two decades on, the Fed faces deflation much like the Bank of Japan during the 1990s: having squeezed out uncertainty in one arena at the cost of mass unemployment (and more low-wage work), it emerges, as a new Fed governor suggested in 2003, in speculative booms, corporate collapses and a spectre of possible deflation (Bernanke, 2003: 74–5). In 2004, the IMF warned that the Bush Administration's federal debt is a huge straitjacket.

Financial organisations and bureaucracies comprise a vast infrastructure of fragile claims and promises between creditors and debtors. Default is never unthinkable; past trust can shatter. Money is created out of promises between public and private debtors. Economic decline can set in ('depression' is an emotional term disliked by today's economic and political leaders). All economic decisions are made in an environment of uncertainty, with profound implications for our understanding of expectations about the future. And this

---

[3] B. Hale 'Anthrax and dismal housing figures' *Sydney Morning Herald* October 19 2001: 28

fragile structure is bonded through trust between huge and remote organisations – an unlikely social bond, perhaps, in the hard-headed world of money although *bond markets*, for example, are one expression of this trust with global ramifications.

Today's Keynesian fiscal policies in disguise, the regressive cuts mentioned earlier, can face several limits. One lies in the global bond and currency markets (Ferguson, 2004: 24-27). The US is financing its balance of payment deficit by selling dollars that are depreciating in value. The Asian central banks (BoJ and of China, Hong Kong and Malaysia) remain buyers to prop up the dollar to maintain their exports to the USA. The conservative Niall Ferguson asks what if the US cannot maintain its position of consumer of first resort and Asian central banks turn to the Euro? Consumption may fall if interest rates rise: this may be due to low saving, dependence on foreign capital and 'fiscal unsustainability' according to Larry Summers. Rising oil prices are another factor. Meanwhile, hedge funds are permitted to play irresponsibly in the oil futures markets, pushing up the price in October 2004. Interest rate rises could impact most on US federal government and US homeowners – because despite their similar heavy debts, large US corporations are hedged (but where Ferguson considers this a comfort, I am less 'certain'). A rate rise can obviously result in a further increase in the US federal fiscal deficit. Alternatively, might the Fed be forced to raise interest rates to keep attracting the bond holders? Only in 2003, Bernanke talked about the printing press and encouraging inflation to ward off potential debt-deflation: clearly no-one knows what to do. Bond holders are concerned about the believability of the US government's 'bond' to repay its loan. But in October 2004, G7 leaders were still trying to pressure the Chinese government to stop pegging its currency, pretending that to be the sole solution to the US debt. It is an embarrassing fallout to Central Banks' desire for credibility in fighting inflation first and last.

A former Governor of the Reserve Bank of Australia, now on the Board of a union-run Industry Super Funds, argues that Central Banks must not bow to the whims of financial institutions, and more importantly, nor should governments. Equally, collective investors can take a very different role:

> **FRASER**: You mentioned share options. Only yesterday I was advocating at an Industry Super Fund board meeting, that we really have a big opportunity here to take a lead, because we have very substantial investments in domestic companies and international companies and from time to time we have a vote. It was only yesterday that I was proposing at this particular board that it was time for us to stop talking about corporate governance, and actually do something. The particular action I suggested that we could do straight away was to instruct all our fund managers to vote against every share option proposal that comes up. There's lots of reasons for that. It offends me that so many CEOs and directors take a large part of their income through share options – i.e. through capital gains which are lower taxed, so it's tax driven. That's one point that's offensive. The second point is that many of these share options are totally without any performance criteria. They're without risk, because they're options they don't have to take up. And thirdly they're not usually expensed in these companies' accounts. There's more evidence now that if they were expensed, profit numbers would be 4 or 5 percent lower than have been recorded. And while I can't prove it, a fourth reason is that I suspect that share options and the drive to hold

> up share prices lie behind some of these WorldCom and Enron debacles that have been going on….
> It's hardly aligning interests when the options don't have to be taken up if things collapse and if appropriate performance hurdles are not in place. And it's not aligning management's interests with shareholder interests when the company is not expensing them and they are inflating the profits that are been recorded. (B. W. Fraser, Former RBA Governor, Canberra June 28, 2002)

The dilemma is that having proclaimed shareholder value, it was partly the pension funds' and mutual funds' own fault. When they insisted on governance - they never required it; they trusted Andersens and sent in management consultants to assuage their distrust. But firms were paying Andersens.

> **FRASER**: Oh it's a mess, but people should get the message that you can't rely on markets alone. (B. W. Fraser, Former RBA Governor, Canberra June 28, 2002)

Conclusion

Let me end on the main points I made in concluding my book. The finance world can never find certainty internally or externally. Emotions are not removable and therefore caution is preferable. Yet, for thirty years global finance has profitably deceived itself that money is a commodity capable of infinite trading for measurable gains. Risk-takers can hedge losses, while the risk-averse allegedly won't lose, they'll simply gain less.

This is unbelievable. Money is not a thing but a promise, a counter-intuitive idea——as economists as diverse as Joseph Schumpeter and John Maynard Keynes insisted. Money involves claims and credits that stretch into a future in which anything can happen. People may joke about 'greed' or 'fear', but the emotion that pervades the financial world is distrust. While financial collapses are recurrent, they are completely unpredictable. Distrust is the sole strategy to suppress the uncertainties of money.

What of those more awkward emotions, 'trust' and 'confidence'? Betrayal of trust and worse, default, brings anger, shame or cynicism; lack of confidence generates widespread anxiety. These highly-charged emotions swirl through the heartlands of finance. Daring risk-taking is less fraught than the future's dull unknowability which is, instead, disguised as 'risk' in impenetrable probability theories.

Trust and confidence are routinely assumed——until luck leads to over-confidence and arrogance, and the 'bedazzlement' of lenders, the banks. Over-confidence results not from making mistakes about probability distributions, as financial experts claim, but from assuming the future is certain. It never is. Over-borrowing creates a spiral of 'Ponzis' beyond the predictions of business-cycle and other economic models. Unknowable, even unimaginable, factors can combine at any time; but investment firms must act constantly. Stability easily collapses but when, no one knows.

Inside board-rooms and committees, decision-makers admit they rely on intuition, guesswork, 'gut-feelings'. Informed sceptics brave enough to break

'club rules' of 'no public doubts' beyond the jostling of bulls and bears, say high finance is a world full of the Dickensian character, Martin Chuzzlewit: cynics who rarely see when they are being cheated, because opportunism is their narrow world's only predictable feature. Fearlessness is a prerequisite, so traders who learn fright during a crash are replaced by new ones who know no fear.

Because money-flows are largely unregulated, global finance increasingly holds the democratic process to ransom. Democracy is demeaned since governments are weak handmaidens to finance, too frightened to stand up to the finance sector. Yet bravery among governments is exactly what is possible, because financial institutions have undermined our trust in trust. The public sphere is debased; rarely informed by economic history, financial journalists rely on investment analysts whose sources are past 'indicators' and gossip.

Armies of 'prognosticators' work for the banks, superannuation industry and pension-fund firms, but their success-rate is pitiful. Whoever claims prescience is soon proven wrong. The only reliable calculation is retrospective; it cannot see over today's horizon into the future. It looks in one direction while imagining it can see in the opposite. Analysts and their short-term outlook are overwhelmed by numbers.

Because money permits decisions to be deferred, no-one can know what those decisions will be. Money lies at the heart of the capitalist economy, but it is inherently fraught and unstable. Schumpeter rightly saw banks as the 'gatekeepers of development', but he also maintained they are 'merchants of debt'. In a competitive spiral to sell more debt, they are free these days to make ever more foolish decisions. And, with their prudential and regulatory control reduced, the central banks follow from behind. The only certainty required by the private banks is that their decisions should be validated in the future. They can never attain the certainty of events but rely on expectations, formed with 'distrust strategies' and the convention that the future will resemble the past. When these fail, validation demands bail-outs or scapegoats: governments can refuse both, particularly if enough in the G7 insisted on this.

Social democracy once offered 'freedom from fear' of joblessness or inadequate health care. High finance has entrenched policies based on 'risk' and individual 'choice'. Today's 'reform' only increases the self-deception because emotions cannot be banished from the world of 'rational finance'. In the face of uncertainty, and given the limits of rationality, the appropriate emotions are those of caution not distrust. Reinsuring is hardly assuring these days, and if opportunism is occasionally predictable, events are not. The future can only be faced with emotions, preferably of prudence and precaution. Rather than wait for another dreadful collapse (as in the 1930s), governments can call the bluff: full employment would be a good start. This way policies, as if people mattered in the long and the short term, would be part of that caution.

References

Bell, D. 1976 *The Coming of Post-Industrial Society* New York: Basic Books

Bernanke, B. 2003 'Why the world's central banks must become more vigilant about falling prices', *Foreign Policy*, November–December: 74–5

Blinder, A., Goodhart, C., Hildebrand, P, Lipton, D & Wyplosz, C. 2001 *How Do Central Banks Talk? Geneva Reports on the World Economy* 3, International Center for Monetary and Banking Studies, Geneva, and CEPR, London.

Braithwaite, J. & Drahos, P. 2000 *Global Business Regulation* Cambridge, Cambridge University Press

de Goede, M. 2001 'Discourses of Scientific Finance and the Failure of Long-Term Capital Management' *New Political Economy* 6 (2) 149 – 170

Davies, G. 1994 *A History of Money* Cardiff: University of Wales Press

FOMC, Federal Open Market Committee of the US Federal Reserve System: Transcription of Meeting 24 September 1996 (accessed 17.06.04) from <www.federalreserve.gov/fomc/#calendars>

FOMC, Federal Open Market Committee of the US Federal Reserve System: Transcription of Meeting 28 September 1998 (accessed 17.06.04) from <www.federalreserve.gov/fomc/#calendars>

Ferguson, N. '*The euro's big chance'* Prospect, June 2004: 24-27

Galbraith, J. K. 1975 *Money: Whence It Came, Where It Went* Boston: Houghton Mifflin Company

Heimer, C. A. 2002 'Insuring More, Ensuring Less' in Baker, T. & Simon J. (eds) *Embracing Risk* Chicago: University of Chicago Press

Ingham, G. 1998 'On the Underdevelopment of the 'Sociology of Money'' *Acta Sociologica* 41 (1) 3 –18

Ingham, G. 2004 *The Nature of Money* Cambridge, Polity Press

Kaufman, H., 2000 *A Wall Street Memoir* New York: McGraw-Hill

Kynaston, D. 1995 'The Bank of England and the Government' in R. Roberts & D. Kynaston eds. *The Bank of England* Oxford: Oxford University Press/ Clarendon

Martin, B & Pixley, J. [forthcoming] 'How do Australians feel about their Work?' in *Australian Survey of Social Attitudes 2003: The First Report* Sydney: UNSW Press

Pixley, J. F. 1993 *Citizenship and Employment: Investigating Post-Industrial Options* Cambridge, Cambridge University Press

Pixley, J.F. 2004 *Emotions in Finance: Distrust and Uncertainty in Global* Cambridge University Press.

Schaberg, M. 1998 ‘Globalization and financial systems’ in Baker, D. Epstein, G. & Pollin R. eds *Globalization and Progressive Economic Policy* Cambridge, Cambridge University Press

Stretton, H. (2000) *Economics: A New Introduction* Sydney: UNSW Press