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The End of the American Model

Why the Financial Crisis in the USA Marks a Turning Point in History
Heribert Dieter

The model of a largely unregulated banking and financial services industry subject only to loose controls has been discredited by the current crisis. The American government sees itself obliged to put together rescue packages worth billions of dollars to prevent the collapse of the financial system and ensure the creditworthiness of the USA towards foreign creditors. A new model of organisation for financial markets must be developed in the years to come in order to prevent the emergence of speculative bubbles and a global financial crisis such as we are experiencing today. Europe has a key role to play in this.

The bad news from the USA just seems to keep coming. So far there can be no talk of a relaxation of the crisis, let alone a resolution of it. First the world's two largest financial-services enterprises, Freddie Mac and Fannie Mae, were taken into de facto public ownership; and now the world's largest insurer, the American International Group (AIG), also belongs to the American state. The government will in future be in control at the centre of the capitalist system. Its plan to take over ailing loans of up to 700 billion dollars may come as a relief to those who wish to pass responsibility for their malinvestments to the state. Fundamentally, however, this step amounts to a declaration of failure by those who long praised the merits of a deregulated, *laissez-faire* financial sector.

The past two decades were marked by the dominance of Anglo-Saxon financial markets. Ultra-liberal positions held sway and many OECD countries considered it desirable to model their financial markets along the lines of the USA. Since the end of the Bretton Woods system in the early 1970s the USA and other Anglo-Saxon-influenced countries have pursued a policy of sweeping deregulation and liberalisation of the financial sector. This model has now failed. The Bush government, which started out as a purist champion of unregulated markets, leaves the next American leadership with an enormous re-privatisation exercise and an even huger budget risk.

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The Long Road to Subprime

A point often overlooked in the current discussion is that the American subprime crisis, which originated in the investment category of low-quality mortgages, is by no means an isolated event. From the mid 1990s at the latest, numerous experts warned time and again of the excesses of the financial markets, but this did not elicit any distinct reaction in Washington or the capitals of other OECD countries. Alan Greenspan, Federal Reserve chair of many years' standing, expressed his concern at irrational excesses on the American financial markets as early as 1996. Respected institutions such as the Bank for International Settlements also repeatedly spoke out in this vein. But the admonitions went unheeded. A contradiction emerged between Greenspan's warning calls and the monetary policy of the Federal Reserve Bank that he himself had shaped.

There are several reasons for this. One important factor is the close connection between the financial markets and American politics in terms of their personnel. The US economist and free-trade advocate Jagdish Bhagwati penned a highly regarded article in 1998 criticising the "Wall Street-Treasury Complex," i.e. the close connection between financial markets and the Department of the Treasury. They cooperated closely over the years, and this was also reflected at senior staff level – both the present treasury secretary Henry Paulson and several of his predecessors moved from leading positions on Wall Street into government.

Equally as important as these personnel connections are the great concessions that the American Federal Reserve made to the interests of Wall Street. The Federal Reserve's policies in the Greenspan era contributed considerably to today's crisis. Financial market crises were cured again and again with an extremely lax monetary policy. The Federal Reserve put large amounts of liquidity at the disposal of the financial markets, thus creating the impression that these enjoyed the patronage of the American government.

Greenspan protected the financial markets from the consequences of their own mistakes on several occasions. He applied his rescue measures for the first time in 1987 after share prices fell 22.6 percent on 19 October. In the years that followed, the Federal Reserve reacted to turmoil with relief programs time and time again – after the first Gulf War in 1991, the Mexico crisis in 1994–95, the Asian crisis of 1997-98, the crisis of Long Term-Capital Management (LTCM) in 1998, the bursting of the dot-com bubble in 2001 and the terrorist attacks of September 11, 2001. The kind of crisis confronting the USA today is thus by no means entirely new. What is much more crucial is that the Federal Reserve's instruments for rescuing financial markets no longer work because they have been conclusively overstretched. The house of cards has simply become so big and instable that its collapse cannot be prevented by a policy of low, real interest rates and ample liquidity supply.

The current crisis originated in banks approving mortgages to low-income clients on a massive scale. It was doubtful from the very beginning whether these homebuyers would be in a position to repay their loans. They would only have been able to do that – even given rising real-estate prices – if their real income had risen at the same time. But that has only been the case in this decade with a minority of less than five percent of the US population. The American financial regulators failed at this basic level: the authorities should have prohibited the allocation of loans to clients without a minimum of income and securities.

But the crisis only reached today's dimensions because of so-called financial innovations. The securitisation of mortgages, in other words the packaging of 3,000 to 10,000 individual loans into one tradeable asset-backed security, allowed the issuing banks to resell the credit risks so as to begin new operations. Between 100 and 300 of these securities were then packaged

by the issuing banks into so-called collateralised debt obligations (CDOs). One CDO could thus ultimately contain between 300,000 and three million individual loans.

As if that was not enough: banks invested in these CDOs through so-called "structured investment vehicles" (SIV) that did not need to be listed in their balance sheets. Without a doubt, banks in America and Europe exploited loopholes in the bank supervision. The regulators tolerated this practice for a long time – the reins were only tightened when the crisis broke out.

The existence of investment instruments exterior to the banks' accounts was no secret. The rating agency Moody's, for instance, published a list of SIVs in late 2006 – without bank supervisors or investors drawing any conclusions. In this light, today's demands that the level of transparency needs to be raised to prevent future crises are hard to back up empirically. These off-the-book activities were not only well-known but were also classified as risky, for example by the Bank for International Settlements.

From the very inception of this complex model it was not clear who bore the ultimate risk in the event of a loan default. The introduction of new forms of financial engineering by no means made the risk go away, as we can now plainly see – it was merely concealed. The American investment banks such as Merrill Lynch, Lehman or Bear Stearns were backed up in this undertaking with reasoned arguments from academia and the political establishment. American public economics in particular supported the assumption that the danger of a financial meltdown could be eliminated by elaborate risk assessment. These models had already failed on many occasions, for example in the Asian crisis in 1997-98 and the collapse of the hedge fund LTCM in 1998. But up until the present crisis, prime movers and regulators of the financial market clung to the idea that the risks could be monitored using highly complex prognostic procedures. The validity of these models was not called into question either in the USA or Europe.

One must not forget that the crisis was exacerbated by accounting innovations. For decades assets were entered at their historical value. Critics complained that this permitted risks to be concealed in the accounting. The innovation was for the valuation to be done at market prices – meaning that assets are listed in the accounts at their respective current market values. Increased transparency was given as the motive for this innovation. However, market participants have admitted that the prime incentive for the altered valuation was actually for staff to have current real profits counted towards their bonuses. Accounting at market prices compels banks to make depreciation provisions even when they do not plan to sell the assets. The Financial Accounting Standards Board Regulation no. 157, in force since November 2007, contributed to the looming crisis in so far as the lower value of assets due to distress sales by third parties have to be reflected in an enterprise's accounts.

Socialising the Losses

The rescue operations by Henry Paulson, US Treasury Secretary, and Ben Bernanke, President of the Federal Reserve Boards, amount to a socialisation of the losses incurred in the crisis. The justification advanced for these measures, which are unprecedented in scale, is that they serve to prevent a collapse of the financial system, which would affect all citizens of the country. This argument cannot be verified. It is obvious, however, that a distinct regulatory role must be derived from the justification given for the rescue operations. If financial institutions such as Freddie Mac, Fannie Mae and AIG are too large for regular bankruptcy proceedings, it is negligent not to put them into a tight corset of regulations. The assembling of a veritable 700 billion-dollar package of measures to protect large parts of the US financial sector from the consequences of its own actions

reveals the failure of both Democrat and Republican governments over the last two decades and the models they have been applying.

The multi-billion-dollar blank cheque for the financial sector and the major rescue operations for the investment bank Bear Stearns, the two financial-services enterprises and the insurer AIG make the bankruptcy of the investment bank Lehman look like a token sacrifice. A rescue operation for Lehman would in fact only have cost a fraction of the resources that the big aid package now demands. It looks very much as if the American government was prepared to accept the bankruptcy of the enterprise to create the impression that it would not yield easily to the financial sector. At the same time, the Lehman bankruptcy was used to ready the population for the subsequent rescue operations.

But the American government must exercise caution not only towards its own citizens but also vis-à-vis financial backers abroad. In the days leading up to the Lehman bankruptcy the financial markets conjectured for the first time about the possible insolvency of the US government. The likelihood of such an event was considered minimal, but even speculation about it is a warning signal of the first order.

The question remains whether the US government's policies are appropriate for preventing the prime movers of the American financial markets from repeating their highly risky actions. Those who are responsible for the greatest financial crisis in history have not yet been brought to account. Several top managers have lost their positions, but they still left with golden parachutes. Several thousand staff of American and European banks have lost their jobs, but the staff of investment banks in particular received extremely high salaries for years. It is of interest to note, as an aside, that Lehman's head office in New York withdrew eight billion dollars from its London subsidiary just a few days before the bank collapsed. Whereas the receivers of the London subsidiary cannot yet even ensure payment of September's salaries, a package of severance payments worth 2.5 billion dollars is being prepared for the New York staff – a gesture to be funded out of the remittance from London.

Rapid Recovery?

The prospects for a rapid recovery of the US economy are rather dim. American consumers will need to put aside a much larger share of their income in future. In view of the steep rise in state borrowing caused by the crisis, both consumers and enterprises will have to save more. The only alternative for the US economy would be to increase overseas borrowing above and beyond the current level of 800 billion dollars per annum. The savings ratio of American households in recent years lay at one to two percent of their income and was thus significantly lower than in Germany, for example, where the ratio has been at over ten percent for years. The Americans will not be able to consume as much in future, and this will diminish demand in the global economy. The collective US citizen, who has been the global economy's "consumer of last resort," will now drop out at least in the medium term.

Despite the last rescue operations the American economy is not yet clear of trouble. There are too many problems waiting to be resolved, including ones outside the financial sector. The US economy has lagged in competitiveness for several years now. Although it is easy to name one or two global market leaders from the United States, the vast majority of enterprises cannot assert themselves against competitors, even with a relatively low-valued dollar. The USA's continuing high foreign trade deficits confirm the superiority of foreign competition.

In some key industries, for example car manufacturing, American producers are fighting a losing battle. The smallest among them, Chrysler, is a niche market player on markets outside America. General Motors and Ford have long been in a state

of crisis and are losing a further share of the market every year; several weeks ago they and Chrysler asked the US government for financial aid to the order of 50 billion dollars. The continued existence of the three big American automobile manufacturers is anything but certain.

It is still hard to tell how many banks will succumb to this severe crisis. Ken Lewis, head of the Bank of America and purchaser of the investment bank Merrill Lynch, expects that half of today's 8,500 American credit institutions will go bankrupt. That would still be less than in the Great Depression of the 1930s, when a total of 11,000 banks had to close their counters. But the individual banks back then were also much smaller than today's.

The expansion of American's national debt as a result of the crisis is no mere trifle. Even though the exact amounts to be shouldered by the taxpayers cannot yet be estimated, it is clear that the US budget is heading for enormous burdens. The deficit will already amount to almost 500 billion dollars in 2009. Given the current gloomy outlook for the American economy, there is no recovery in sight.

It is obvious that the next US President will have a key role to play in dealing with the crisis. But neither of the two contestants has a particularly profound knowledge of economic policy. A repeat of the 1930s cannot be ruled out. At that time, too, the American economy suffered a severe crisis emanating from the financial sector. The first attempts at stabilisation under President Herbert Hoover further aggravated the situation. In 1930 Congress passed the Smoot-Hawley Act which resulted in a massive rise in the level of American tariffs. The USA had contributed considerably to the outbreak of the global economic crisis and reacted to it with a protectionist trade policy. Between 1929 and 1933 the country's exports and imports shrank by 50 percent.

The rejection of efforts to stabilise international economic relations by the newly elected President Franklin D. Roosevelt's in the summer of 1933 was even more serious. His decision pulled out the rug – the commercial basis – from beneath attempts to restore the international financial system through joint initiative. The recovery of the American economy had priority for Roosevelt; he ascribed little significance to international cooperation in economic policy, or "global economic governance" in today's parlance.

The situation in 2008 reveals alarming parallels. Protectionist positions already played a major role in the primaries, particularly with Hillary Clinton and Barack Obama. It cannot be completely ruled out in view of the magnitude of the crisis that Washington could pursue an insular trade policy. After all, fears about globalisation are widespread in the USA, and foreign players – particularly Asian – are often blamed in a biased way for the American balance of trade deficit.

This divide could deepen further if foreign players subject individual measures of the American government to legal scrutiny. The support given to the American financial sector, particularly banks that operate internationally, could conceivably be judged as undue state subsidisation. Aid for the American automobile industry would be even more problematic, with European and Asian countries almost certain to lodge a complaint with the World Trade Organisation (WTO).

The Perception in Other Countries

The financial crisis weakens America's position in international relations. Its negative consequences for the country's reputation can presumably compare only with those of the Iraq War. The USA is now paying the political price for decades of using aggressive measures to put through liberalisation and deregulation of other countries' financial markets.

A prominent example of this US policy was the Asian crisis, in which Washington played an ignominious role. In particular the supply of liquid assets to South Korea

was cut off in December 1997, which exacerbated the crisis at the time and created annoyance in the country that has yet to subside. The International Monetary Fund (IMF), which is strongly influenced by the USA, compelled South Korea to accept a far-reaching package of conditions, including the obligation to open up the country for direct investment. Tellingly, the analysis of the Asian crisis was shaped to a considerable extent by American pundits who accused the beleaguered countries of "crony capitalism." Correspondingly, the way in which the US financial sector today is being shielded from the consequences of its own mistakes causes bitterness in Asia and other parts of the world.

Furthermore, the Bush government has put through regulations in the free-trade agreements of recent years that have prevented smaller economies from adopting protective measures against inflows of speculative capital. Such rules are to be found in the agreements with Chile and Singapore. Here too the American government put forward the position that it was unwise to force financial markets into a tight corset of regulations.

The USA now has to come to terms with the second severe financial crisis in two decades. In the late 1980s numerous savings and credit banks got into great difficulties; more than 700 banks closed down. That crisis, too, was rooted in excesses in the US real-estate sector. However, in contrast to today's situation, it was not a purely American problem. The rescue operation at the time also cost American taxpayers around 125 billion dollars, but foreign players were virtually unaffected.

The Reform Discussion Gets Under Way

Europe has been taking a much tougher line towards Washington in the last few days. European politicians have rejected the request of treasury secretary Paulson to take support measures of their own for the financial markets. The suggestions of the Italian finance minister Giulio Tremonti go far beyond this rejection – he raised the idea of revamping the Bretton Woods system. One should take note of this suggestion if only because Italy will be holding the G8 presidency next year. The Bretton Woods system devised in 1944 differed from today's system above all in having exchange rates fixed by the state and in placing restrictions on international capital flows.

In view of the massive turmoil that the American crisis has caused around the globe, it really must be asked if unregulated international capital flows are sacrosanct. We have seen a whole number of market players misjudge the US real-estate markets, for example the *IKB Deutsche Industriebank* and German regional banks. The assumption that modern financial markets would process information efficiently and send out appropriate price signals can no longer be given unlimited credence today. Classic bank operations, which the British Chancellor of the Exchequer, Alistair Darling, referred to as "good old-fashioned banking," centred around the personal relationship between lender and borrower. This called for an exact knowledge of the local market. In Anglo-Saxon financial markets such as Britain and Australia a different assumption dominated: that successful risk management could be performed more efficiently by independent players – rating agencies as a rule. This assumption has been refuted. The question thus arises whether the Bretton Woods system, which ensured a certain separation of national financial markets through restrictions on capital flows, was not superior to today's unregulated system.

But the experience of recent years gives cause to doubt that there will be any far-reaching reforms. Until now the proponents of unregulated financial markets have always maintained the upper hand. Only a few countries, such as China, still restrict transnational capital flows today. Measures to reduce international financial flows can hardly be expected to come from

the USA because the country would plunge even deeper into crisis without the constant supply of foreign capital.

The Lessons for Europe

Europe has not gained any additional influence in financial-policy discussions over the last few years. The expectation that the introduction of the joint currency would lead to a strengthening of Europe's voice was not fulfilled. Whereas the USA worked hard to put through its positions, Europe concentrated on comparatively secondary discussions (about who should fill the position of the managing director of the IMF, for example). The initiative for intensified monitoring of the financial markets presented by Angela Merkel, Chancellor of Germany, at the G8 Summit in Heiligendamm in 2007 has had little or no effect to date due to resistance from the USA and Britain. Individual players have spoken out in the debate on international financial policy, but – unlike trade policy – Europe does not speak with one voice in financial policy. No significant initiatives with regard to global economic governance have emanated from Europe in recent years.

Europe's speechlessness in this field became evident after the Asia Crisis of 1997-98 – until then the worst financial crisis of the post-war era. The USA set up various commissions to look at the future of the international financial system. One of these commissions – appointed by US Congress and headed by the economist Alan Meltzer – published a highly influential report. The Council on Foreign Relations also looked closely at this complex of themes. No comparable efforts were made in Europe. Until the EU makes efforts to develop European positions, a discussion with the Americans on an equal footing will not be possible.

Remarkable dissent has emerged in the rare cases where influential European figures have conducted a discourse with American politicians. Otmar Issing, chief economist of the European Central Bank until 2006, engaged in a controversial discussion with Alan Greenspan early in the decade, putting forth the view that it was indeed the task of central banks to combat emerging investment bubbles, be they in shares or real estate. Without question, Issing's position is much more convincing today than that of former Federal Reserve boss Greenspan.

The crisis on the international financial markets would be less serious if there were not comparable problems to be solved in world trade as well. The WTO cannot conclude the current Doha Round of Negotiations, and this too is due to the policies of the USA. Bilateral agreements further undermine the WTO. Today's system of global economic governance is being increasingly eroded; both the USA and the European Union bear a considerable degree of responsibility for this. In view of the extent of the financial crisis and the problems of regulating international trade it would be important to approach issues in a multilateral framework. However, there is no strong institution able to regulate global economic relations. The IMF has come under criticism for years, partly because America and Europe have neglected to modernise it comprehensively. An added problem is that the IMF long extolled the merits of precisely those financial innovations that have now led to the crisis. Unlike the Bank for International Settlements, the IMF did not issue any warnings about the abortive developments in the American real-estate sector.

The financial crisis in America marks a turning point in history, whose full significance will probably only be revealed in several years time. It is not clear at present whether there will be a global economic crisis comparable with that of the 1930s. Washington shows very little willingness in this situation to unreservedly discuss a re-organisation of international economic relations. The opportunity is all the greater for the European Union to play a formative role in this debate. If America refuses to engage in the discussion Europe and other

players will have to consider regulatory options without American involvement, as was the case in climate policy with the Kyoto Protocol. A first precondition for a new international financial policies, in any case, is to end the uncritical adoption of Anglo-Saxon models of financial-market organisation.

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