International Financial Crises in Comparison

Lessons for Managing the Current Crisis

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- The solid framework of the Bretton Woods system and American support via the Marshall Plan and the World Bank made possible the reconstruction and modernisation of Europe and Japan after 1945.

- With the eclipse of the system and the liberalisation of the capital markets began the modern age of debt and financial and real estate crises. As a reserve currency country the USA retained its dominant position and was able to run up debts in its own currency with impunity. In addition, from the 1980s onwards the »financial capital faction« was able to assert itself against the »real capital faction«, both politically and ideologically.

- It is especially countries on the periphery that suffer from the crisis-proneness of the new world economic order and the ideologically and power-politically laden roles of the IMF and the World Bank. Economic and societal modernisation in order to catch up with the advanced industrialised countries has become more difficult. This also applies, although under somewhat different circumstances, to the European periphery.

- Countries such as China, which chose not to fall in with the so-called Washington Consensus, have proved to be less crisis-prone and more dynamic economically. Countries such as Argentina or Korea succeeded with their heterodox crisis management and, as a result, are now praised by the IMF.

- A look back at the causes of and courses taken by previous crises provides clues for management of the current crisis at the global and European levels. A renewed rapprochement with a regime oriented towards the real economy seems indispensable.

Content

1. Introduction

Two phases can be distinguished in the development of the global economy after the Second World War: with and without the Bretton Woods system. In both phases the USA dominated with regard to both economics and economic policy and politics. The Bretton Woods system ended in August 1971 with the so-called »Nixon shock«, the USA's unilateral abandonment of the gold convertibility of the US dollar.

With the end of the Bretton Woods system which, among other things, rested on restrictions on the movement of capital, the modern age of debt and of financial and real estate crises began. The USA retained its dominant role as the largest economy and reserve currency country, but also prevailed politically and ideologically. The asymmetric position of the USA in the global economic and financial system which emerged in this way, as well as the political power and influence of the Anglo-American »financial capital faction«, formed not only the background of all future financial crises, but also exerted a considerable influence on their development.

In this article we shall try, taking a kind of historical-genetic approach, to reconstruct the causes of and courses taken by a number of crises, and on that basis, so far as it is at all possible given the uniqueness of all historical events, illuminate the background of the current financial and economic crisis and draw lessons for the management of crises at the global and internal European levels. This essay can also be seen as a plea for the revivification of the »real capital faction« and for a move closer to a regime oriented towards the real economy, both institutionally and politically.

2. Bretton Woods

The Bretton Woods system provided the stable institutional framework which made possible the economic reconstruction and catch-up of Western Europe and Japan after the Second World War. The USA supported this process through the Marshall Plan and the World Bank. Through direct investments by US firms the requisite capital and know-how was made available to Europe and the rest of the world. The demand of the much wealthier American consumers made the USA also in this respect the Western world's motor of economic development. Western Europe and Japan experienced a full-blown economic boom. Living standards increased extraordinarily rapidly and among a much wider segment of the population than ever before.

The Bretton Woods system fell because the inflation induced by the Vietnam War and the rapid growth in the US trade deficit linked to it undermined the status of the US dollar as global reserve currency. Countries such as Germany and Switzerland, which depended heavily on the American market, were no longer prepared to further increase their dollar reserves which were being devalued by inflation. Germany therefore unilaterally revalued the Deutschmark as early as July 1970 and thereby ushered in the end of the Bretton Woods system. In place of the system of fixed exchange rates and capital controls came flexible exchange rates and free movement of capital.

The advantages of a system of flexible exchange rates had been expounded convincingly ten years previously (Sohmen 1969). What was not known at that time was the dynamism that free capital movement would bring; in particular, largely as a result of the new permissiveness the interests of »financial capital« gained the upper hand over »real capital« in the US political system. Due to this political and ideological turn, under President Reagan deregulation and liberalisation of the financial markets were put on the political agenda, not only in the USA but internationally. In the following years, besides many other freedoms and forms of alleviation, new areas of business were opened up to financial capital.

International financial crises can occur only on the basis of largely free international capital movements. That is a rather obvious statement, but none the less true for all that. In the Bretton Woods system foreign exchange dealing had to be licensed. Private international capital movements were largely limited to direct investment. The fact that this system finally had to be given up is connected to the USA's abuse of its role as reserve currency country. Another defect was the asymmetry of the system, which imposed painful adjustment measures on countries with current account deficits, while surplus countries were not affected. The Euro system was furnished with a similar asymmetry at its origins and now risks being torn apart.

In the Bretton Woods system the financing of private and public investments was possible only through savings accumulated in individual nation-states by private households, companies and the state. On top of that might come foreign direct investment and foreign capital assistance (for example, the Marshall Plan and the World Bank). Since it was scarcely possible to import foreign capital, even if one wanted, all countries set great store by promoting the accumulation of savings, especially by private households. These savings were used primarily to finance state and enterprise investments. Private households in most countries scarcely had access to bank loans or mortgages.

3. Debt Crises

With the abandonment of capital controls within the framework of the Bretton Woods system in 1970 began the age of modern debt and financial crises. Admittedly, first of all an international capital market had to develop. This development was set in motion by the founding of OPEC. This occurred as a consequence of the downfall of the Bretton Woods system and dollar devaluations. OPEC among other things implemented drastic oil price increases.

Since the production costs of oil bear no relation to oil prices the sale of oil represents economic rent (Ricardo's differential rent). Previously, this had been appropriated largely by American and British oil companies. As a result of the price increases instigated by OPEC enormous rental income flowed into the oil producing countries. As a result, they became exporters of savings, in other words, of capital. With these so-called petrodollars they purchased companies in Germany and elsewhere in the world or entrusted them to American and European banks to lend out in their turn. The latter was known as petrodollar recycling.

But now the ability of the OECD countries to take up these petrodollars was curtailed, in particular because their economies had been weakened by successive oil crises. Where, then, should the banks turn with these petrodollars?

3.1 Mexico I

In the end primarily Latin American countries were to absorb these petrodollars. At that time they already had more than 50 years of predominantly successful economic development behind them. They had been able to protect themselves from superior foreign competition with customs duties within the framework of so-called import substitution policies. By that means, and with the help of the strong arm of the state, the larger countries in particular had managed to develop impressively from agrarian into industrial societies. Between 1940 and 1968 industrial production in Mexico grew on average by almost eight per cent a year (Hansen 1971). A significant middle class had formed which at that time made up the bulk of the urban population, at least in the larger cities.

This development strategy, despite all the prophecies of doom from both conservative and progressive voices, was spared any serious crisis until the debt crisis at the beginning of the 1980s. In the 1970s, Mexico had even begun to wean itself away from dependence on foreign technology and know-how and to produce capital goods not only for the domestic market, but also for export. Under President Luis Echeverría (1970–76), who had pinned his colours to the mast of economic and welfare state modernisation, the country experienced a considerable development boost: many factories were built, labour was in short supply and wages rose rapidly.

In this situation, companies and the government were keen to take advantage of petrodollars to finance expansion, especially because in Mexico new oil deposits had been discovered and Echeverría wanted to create the most modern petrochemical industry in the world. So it came about that private and state-owned companies in Mexico and Brazil, with the help of American and European banks, as well as the World Bank, created ultramodern industrial complexes, whose construction required considerable quantities of foreign exchange. In parallel with this, on the part of the state, sometimes also with the help of these same banks, physical infrastructure was developed and modernised, and the education system expanded.

Since these loans were arranged with variable interest rates, a rude awakening was not long in coming. Flexible interest rates, in connection with the theory of flexible exchange rates, had just become fashionable (Sohmen 1969). For the banks this system was very convenient, but borrowers were burdened with the risks from both exchange and interest rates. It was Latin America's bad luck – together with other developing countries – that Paul Volcker, newly appointed Chairman of the Federal

Reserve, began in autumn 1979 to raise interest rates in order to curb high inflation in the US economy. As a result, interest rates for Latin American debtors rose within the space of a few months from around six to more than 20 per cent. To compound matters, the severe recession in the US and the world economy induced by Volcker's policies all of a sudden snatched away foreign demand from the newly created companies in Mexico and Brazil. In addition, oil prices fell further, which hit Mexico particularly hard, having just become an oil-exporting country (having previously been an oil importer).

Thus began the second chapter of the Latin American debt crisis. Mexico had borrowed the most and was hardest hit by the interest rate explosion and shortfalls in demand. Soon Mexican companies were unable to service their debts. In turn, this meant that most US creditor banks – the level of whose exposure in Latin America had already given cause for alarm – would have had to file for bankruptcy under the law as it stood. This, however, was avoided because the Mexican state assumed the debts of private companies. Finally, in autumn 1982 Mexico had to declare itself insolvent.

In the third chapter of this sorry tale the US banks and supervisory authorities first of all pursued a policy of muddling through, until the realisation finally dawned that considerable loan write-offs were inevitable. This haircut, as it would be called nowadays, was facilitated by the so-called Brady bonds created in 1989. Brady bonds came in several variants: they were granted to debtor countries, making considerable use of IMF and World Bank funds and subject to no less considerable conditions and adjustment programmes. The banks' waiver amounted to 32 per cent of their claims. Ultimately, the owners of the US banks had to take the hit. However, their losses were limited to only two years (see FDIC 1998).

For the indebted countries, however, the outcome was much more painful. Mexico, which had previously made up the gap between its investment needs and domestic savings with petrodollars, thereby registering a current account deficit, now had to produce, in order to service its foreign debts, a savings and current account surplus in the order of five per cent of GDP. This was simply not possible during those times of severe economic crisis and shrinking revenues. The payment crisis and the enormous pressure to implement adjustment policies led to a dramatic loss of confidence both at home and abroad, a drastic devaluation of the peso, capital flight, interest rates sometimes reaching 100 per cent, a rolling back of the state and of state employment (Mexico now has the smallest state and the lowest social expenditure as a proportion of GDP of all OECD countries), numerous bankruptcies, especially of smaller and medium-sized companies, further impoverishment and the contraction of the middle class, which in Mexico continues to this day. Real wages in Mexico have still not returned to the level they stood at in 1980.

In the fourth chapter of our tale the debt crisis paved the way for a wave of financial crises, albeit of a fundamentally different character.

In the meantime, the climate in the USA and Europe, despite the Reagan administration's reflation of the US economy by means of ever greater government borrowing, had already turned in the direction of neoliberalism. Even though neoliberal views were generally adhered to only when Wall Street could benefit from them the doctrine was preached to developing countries, which were subjected to the so-called Washington Consensus.

This applied especially to Mexico, which during those years was about to become a member of the free trade area NAFTA (with the USA and Canada). In place of the earlier industrialisation strategy now came the so-called Maquiladora industries along the Mexican–US border which functioned as »screwdriver factories« in the globalisation strategies of US companies. This went hand in hand with deindustrialisation processes in the interior of the country, while Mexico became a welcome sales market for North American consumer goods.

In the wake of the »resolution« of the debt crisis Mexican financial markets were also liberalised, deregulated and internationalised. Foreign and domestic »investors« alike could at any time bring their money into the country or just as quickly get it out again, worry-free. This was made even easier by the fact that not long after the debt crisis all Mexican banks came to have foreign, especially American owners.

4. Debt Crisis and Financial Crisis

The new quality of ensuing financial crises – they were no longer primarily debt crises – consists in the fact that they are closely interwoven with this new freedom on the part of actors in the international capital markets.

Seven features are of particular significance in this regard.

First, capital movements are barely connected to real investments any more. Overwhelmingly – and increasingly – this involves purely financial »investments«: a euphemism, since they rarely have anything to do with conventional investments. In fact, in most OECD countries the involvement of the financial markets in financing real investments (through the issue of shares and debentures, as well as loans) has progressively decreased over the past 30 years. This is connected, on the one hand, with the fact that net investment rates – in relation to GDP – in most, if not all industrialised countries over that period have fallen significantly, and on the other hand, with the fact that large companies in particular have been able to finance their investments easily from depreciation and profits.

Second, national and international financial markets are above all secondary markets: the vast bulk of traded securities no longer has anything to do with its original, usually medium- and long-term function (shares, debentures). They are, so to speak, old, used securities bought and sold by professional investors and funds, frequently at the expense of small investors, predominantly on the basis of short-term profit expectations and to spread the risk. Price movements are driven by these expectations and sentiments, with little relation to the reality underlying the securities. This applies a fortiori to all forms of debt securitisation.

Third, these markets are fundamentally based on the speculative expectations – in other words, expectations about expectations – of market participants.

Fourth, for these reasons the dominant feature of the behaviour of investors and the financial markets is their short-termism: investors' time-horizon is often only a matter of hours, sometimes only seconds.

Fifth, that leads to high volatility in the financial markets and, thanks to the by now all too well known inclination of investors to follow the herd, frequently to overreaction and underreaction in financial and foreign exchange markets, as well as violent and voluminous international and domestic capital movements. Volatility in the capital markets has increased enormously since their deregulation and liberalisation in the 1980s.

Sixth, it must also be noted in this connection that the volume of liquidity has increased on a scale inconceivable in the 1980s. The proportion of transactions that have anything to do with activities in the real economy has become tiny. This explosion of liquidity is the result of the ever higher debt pyramids that have emerged due to the deregulation and liberalisation of the financial markets, new financial »products«, low reserves and collaterals, and also correspondingly high credit creation multipliers.

Seventh, there is little the IMF, central banks and governments can do in response to these volumes either on an everyday basis or in the event of a crisis.

One consequence of liberalised international capital markets and flexible exchange rates is that exchange rates are determined primarily by capital movements – in other words, no longer by the trade or current account balance as under the Bretton Woods system. For example, in recent months Brazil has been exposed to a considerable influx of short-term money. This has driven up the exchange rate of the Brazilian real and so has impaired the competitiveness of Brazilian exports on the world market. When investors – for whatever reason (a fall in exports, a fall in interest rates, inflation, trade unions, change of government, popular unrest and so on) – withdraw their money again this brings about a more or less sudden and more or less drastic devaluation of the national currency. Obviously, in this way the volatility of the financial markets is transmitted to the real economy. Also obvious is the fact that these short-term capital movements are not connected to real investments or with imports and exports.

When expectations will change and a mad rush to get out ensue is by its very nature impossible to predict. In the cases of Greece, Ireland, Portugal and Spain this has gone on for some years. In these cases the financial markets have for years supported and expanded imbalances – supported or at least tolerated by the EU and its member states – which are unsustainable in the medium and long term. As regards the financing of budget and current account imbalances in the USA this has been going on for 30 years: it remains, as far as these macroeconomic imbalances are concerned, the severest and most sweeping crisis that has just not yet happened.

Other participants in these games of expectations and fear include rating agencies, governments and central banks. The operations of rating agencies in particular tend to trigger crises and their behaviour is procyclical. Once things start moving, they tend to do so very fast. The fact that, to date, there has been no flight out of US Treasury Bonds and other securities is ultimately an unsolved paradox (Obstfeld et al. 2000). The fear of central banks in the Asian countries with surplus savings that, by selling these securities, they would hit US demand and thus undermine their own economies, as well as lose a considerable part of their »stake« as a result of the expected foreign exchange losses must play an important role in this. Furthermore, the uncertainties with regard to the EU's ability to act and the future of the euro, even of the EU itself, cause them to hesitate to shift their reserves in the direction of the euro.

In the face of all this one can only say that the liberalisation of international payments and the international capital markets has done nothing to improve the allocation of capital either within or between economies. Instead, it has served only to ramp up its proneness to crisis.

It is for such reasons that, for example, Nobel Prize winner Jagdish Bhagwati, who among other things made his name as an unwavering advocate of the free trade of goods, is staunchly opposed to freedom for international capital markets – unless they are connected to the financing of trade and direct investments. Unlike in the case of foreign trade theory, no economist has been able to prove that free international capital movements go together with gains in prosperity (Bhagwati 2007). Bhagwati shares the opinion of Charles Kindleberger, another famous economist, that financial markets are »prone to cycles of manias, panics and crashes«.

Countries which have not abandoned themselves to this mania for hot money are as a result less susceptible to financial and economic crises. This is illustrated particularly clearly by the example of China which continues to maintain capital controls and thus has been able to avoid being dragged into the whirlpool of financial crises in recent decades, although at times it has suffered considerably as a result of the indirect effects on its exports. At the same time, China functioned as an anchor of stability for the crisis countries in the Asian Crisis in 1997/98. In the current crisis, it has done so again thanks to an economic stimulus programme worth around 15 per cent of GDP and a lending programme totalling double that amount which helped not only China itself but also neighbouring countries and, more specifically, also Germany to get back onto a growth course surprisingly quickly.

From an economic standpoint, there is another state of affairs, besides short-term capital movements, which ought to encourage caution. As already mentioned, in the Bretton Woods system investments had to be financed mainly from domestic savings. After the demise of this system and the lifting of controls on capital account transactions it was to be expected that investment and savings would become separated. Since investors in globalised capital markets can obtain funds anywhere it should no longer be possible to discern a correlation between national savings and national investments. However, savings and the investment needs of companies have scarcely diverged in most countries. This deviation of empirical evidence from theoretical expectations is known as the Feldstein-Horioka paradox (Obstfeld et al. 2000). It raises the question of what advantages there might be in free international capital movements if in a particular country there are barely any gaps between national savings and investment needs.

What the liberalisation of international capital markets has wrought instead is excessive state and private indebtedness in a few countries and their financing from the savings of other countries. The importation of foreign savings also tends to lead to currency revaluation, thereby impairing the competitiveness of the savings-importing country. As a result of this over the past 30 years the USA has largely lost its earlier industrial productivity. Conversely, the savings-exporting countries, such as Germany and China, by means of the tendency of their currencies towards devaluation, have obtained artificial competitive advantages and growth stimuli. However, this also means that they have been under less compulsion to engage in the complex business of stimulating growth domestically. To be sure, the export of surplus savings is always linked to lower consumption on the part of private households or the state. As a result, import or export of savings instigates a process of negative or positive cumulative causation in Myrdal's sense. This process can be observed not only at the global level, but also at the EU level.

5. Financial Crises

5.1 Mexico II

Mexico was the leading actor in both the first modern debt crisis and the first modern financial crisis, the so-called Tequila Crisis of 1994. As they say in Mexico, »Tan lejos de Dios, tan cerca de los EE.UU« (»So far from God, but so close to the USA«). The one crisis led to the next as the liberalisation of Mexico's foreign exchange and capital markets had been decreed after the first crisis.

Completely liberalised international capital movements do not go together with fixed exchange rates. If one wishes nevertheless to keep exchange rates stable one requires either large reserves or a strong and reliable partner in the background. Since reserves were low as a result of the previous debt crisis and both the government in Washington and Wall Street were pursuing other interests, in December 1994 the outgoing Mexican President Salinas de Gortari – otherwise an ardent advocate of neoliberalism – broke his promise not to alter the exchange rate.

Devaluation had become unavoidable, among other things, because of the reversal of short-term capital flows. The Mexican Central Bank had tried to halt the decline, but only accelerated the outflow of capital and soon found itself without reserves. The palpable need for security on the part of international, but also of Mexican »investors« was put under considerable strain by the impending change of government, the murder of one of the presidential candidates and Marcos, the enigmatic leader of a farmers' rebellion in Chiapas on whom the government had just declared war. Before the crisis these investors had »rewarded« Mexico with lavish purchases of Mexican securities – which in the end led to a capital account surplus of seven per cent of GDP – and now they tried to get their money to safety out of the country before the devaluation. Finally, Washington, the IMF and the Bank for International Settlements had to put together a package which was ultimately to cost the US taxpayer over 20 billion dollars because of a law pushed through by American investors. Ironically, Robert Rubin as new Secretary of the Treasury was able – in effect – to hand out 20 billion dollars to the owners of Mexican bonds, of which his former employer Goldman Sachs received the lion's share. Argentina and Brazil, which had been infected by the Mexican crisis, also had to participate in the rescue package for Mexico.

Compared to the earlier debt crisis lessons had been learned regarding the rapidity of state intervention. Except that this time the Wall Street firms were able to let the taxpayer foot the bill. Naturally, for the Mexican economy there was no »feast« of the kind enjoyed by Wall Street. The package included the usual orthodox prescriptions, especially the reduction and strict control of government spending, the restructuring of enterprises and the economy, interest rate rises and monetary tightening by the Central Bank. As was only to be expected the economy stagnated over the next few years. Unemployment, underemployment and the informalisation of the economy increased and average incomes fell further.

5.2 Argentina

The extent to which politics and the economy are interwoven is clearly illustrated by the example of Argentina. The high national debt was a legacy of the military dictatorship, which President Alfonsín's government, democratically elected in 1983, could not evade. This was preceded by the hypothecation of state-owned enterprises under General Videla (1976–81) in order to obtain loans from US banks. Part of these loans was held with the commendatory approval of the IMF as low interest reserves by the Central Bank. On top of this came corruption and capital flight which contributed to the ruin of a country which only a few decades before had still been one of the most prosperous in the world. Last but not least, Argentina was sucked into the whirlpool of the debt crisis triggered by Paul Volcker and global recession.

The country was in the grip of an economic emergency when Raúl Alfonsín, of whom the voters had high hopes, took over the reins in 1983. However, in 1989 his government abruptly foundered on the country's insolvency, hyperinflation and popular unrest.

Carlos Menem and his minister for economic affairs Domingo Cavallo fixed the Argentinean austral to the US dollar within the framework of a currency board and became the star pupils of the IMF. Payments and capital movements remained completely unrestricted. The experiment was successful, although only in relation to the ending of hyperinflation. The austral, which was overvalued from the outset, drove company after company – whether export- or domestic market-oriented – into bankruptcy and the Argentinean economy as a whole into oblivion. Unemployment rose to levels not seen since the global economic crisis of the 1930s. On top of this the Brazilian real was devalued against the US dollar – a quarter of Argentinean exports at that time went to Brazil – which made Argentinean products even more expensive and bestowed an additional advantage on Brazilian exporters.

As was only to be expected in such circumstances Argentina was in no position to service its accumulated foreign debts or even to reduce them. Astonishingly, the IMF kept lending the country more money and extended the repayment periods, which ultimately only exacerbated the crisis. The new money vanished in the twinkling of an eye under conditions of free convertibility, not least to the tax havens which burgeoned during those years. Because of the strict link to the US dollar the shortage of money became ever tighter and a series of parallel currencies came into being. They were created by provincial governments – for example, the *Patacón* of Buenos Aires province – and even by the central government (the *Lecop*) since otherwise they would no longer have been able to pay the salaries of public employees. The situation in the country was intolerable and getting worse by the day. In Argentina a full-grown financial crisis had grown out of the original debt crisis caused by the dictatorship, which democratically elected governments now had to deal with and, one after another, came to grief.

Things got so bad in 2000 and 2001 that the population panicked, emptied their bank accounts and bought US dollars. There were mass demonstrations (including the vandalising of US firms and institutions) which President Rúa tried to check by proclaiming a state of emergency. Instead, he only fanned the flames. Ensuing police actions led to a number of deaths. Naturally, there were political changes as a result of this chaos and several changes in the country's political leadership. President A. Rodríguez Saá, who remained in office only a week, announced Argentina's insolvency at Christmas 2001. Foreign liabilities amounted to the gigantic – and not only by the standards of the day – sum of 132 billion US dollars.

With the declaration of insolvency it was possible to escape the conditions imposed by the IMF. Rodríguez's successor Eduardo Duhalde therefore abandoned the prevailing »orthodoxy« and the approach to combating the crisis which served only to exacerbate it and pursued the path of heterodoxy: he devalued the peso – a new peso which had succeeded the austral – let bank counters remain shut for a few days at a time, froze all bank accounts containing amounts over a certain threshold until 2010 (the so-called *Corralón*, a word meaning a large fenced-off meadow for cattle) and introduced an income support programme for families plunged into poverty. The dollar deposits which had benefited from devaluations were converted at the old exchange rate, debts at the new one. Since almost every Argentinean had a dollar account and had many other dollar-denominated debts people understandably felt cheated. Popular discontent remained at a dangerous level, in particular since the economy shrank even further (minus 11 per cent in 2002).

However, the heterodox policy was a resounding success. The drastic devaluation of the peso (by the end of 2002 by 300 per cent at 80 per cent inflation) brought about an upturn in the economy by the end of the year. In addition, inflation by the fourth quarter had fallen well below one per cent a month. In 2003 and 2004, the economy experienced real growth of nine per cent. Already by the beginning of 2003 the government began to relax the *Corralón*. In the course of the year a start was also made on repurchasing the parallel currencies and at rates which did not entail major losses for their holders. Even after that the Argentine economy grew at almost Chinese growth rates.

For the time being the problem of the country's defaulted foreign debt remained unsolved. It consisted in a ratio of 45 to 55 of liabilities to international institutions (such as the IMF and the World Bank) and to private creditors. With regard to the former, Argentina had occasionally fallen into arrears, but ultimately had kept up with its obligations. Given the significant economic improvement since 2003 it paid back these multilateral loans prematurely and from January 2006 was debt-free with regard to the IMF.

In contrast, private creditors – including German and Italian banks which had proven particularly intransigent in the debt negotiations – had to accept heavy losses. As with Brady bonds there were three kinds of bond with capital writedowns of between 30 and 70 per cent and a variant without a capital writedown but with a very long term at low interest. By mid-February 2005 more than 75 per cent of private debts had been restructured, with the creditors having to accept considerable haircuts.

In contrast to earlier agreements involving other countries one circumstance is particularly remarkable: creditors agreed that in future in the case of legal disputes Argentine law would apply and Argentina would be the place of jurisdiction. In this way Argentina would no longer be the victim of so-called vulture funds. Vulture funds are a kind of hedge fund which specialise in buying up Brady bonds and other securities which have incurred a capital writedown, at a corresponding discount, in order then to claim the full amount of the original debt and the accumulated interest, usually before US or British courts. Very often they are successful. Developing countries which found some relief for a few years by means of the Brady bonds were punished all the harder by vulture funds and the courts.

At the annual meeting of the IMF and the World Bank in October 2004 the European Union, too, called on Argentina to enter into negotiations with these vulture funds immediately, to increase its primary budget surplus to pay off its debts and to implement structural reforms (Wikipedia 2011). The heterodox methods for combating the crisis and their success rapidly consigned such demands to the »rubbish bin of history«.

6. Real Estate Bubbles

At this point we shall examine a component of a whole series of debt and financial crises, both old and new, namely real estate markets. For particular reasons which we shall look at in due course these markets, too, tend frequently to go into overdrive or languish in the doldrums. In addition, the securitisation of mortgages and other financial innovations that were responsible for a considerable part of the escalating liquidity glut in global financial markets.

6.1 USA 2007

Real estate markets have also played an extremely important role in the current financial and economic crisis, which broke out in 2007, since a considerable part of the credit pyramids which have stacked up over the past few years were based partly on the wondrous and manifold metamorphosis of mortgages into putatively secure mortgage backed securities (MBS). These credit derivatives were mostly divided up into likewise tradable collateralised debt obligations (CDO) and bundled into new tranches. These packages were frequently again securitised, divided and bundled (so-called CDO2). Then the whole lot were provided with top ratings by the rating agencies. These constructs which were nested and interlinked in particular by investment banks, which made 80 per cent of their profits from them, turned out to be the Achilles heel of the hypertrophied financial markets and later were to trigger the financial crisis.

As early as 2005 the US Federal Reserve had begun to pursue a more restrictive monetary policy. As a result, interest rates rose again to five per cent, for the time being putting a brake on the tumultuous upward trend in real estate prices. From 2006, prices began to fall, more and more rapidly. From mid-2007 to mid-2008 property values fell by 15 per cent. This, in turn, meant that more and more mortgages – especially subprime mortgages – could no longer be serviced. These involved 100 per cent mortgages – in other words, without a deposit – to borrowers with low creditworthiness. The idea was that such loans would, so to speak, finance themselves as house prices continued to skyrocket. In addition, mortgage debtors in the USA are legally liable only in relation to the property on which the loan was issued; in other words, not their other assets.

Such relationships are every bit as dangerous as they appear to be made in heaven: virtually no European bank would have touched them with a ten-foot pole. Nevertheless, even German banks – including the KfW development bank and some regional banks – felt a pressing need to get actively involved in the securitisation rounds which these doubtful loans underlay. They, too, set up so-called conduits and special investment vehicles (SIV) which were off-balancesheet so that they did not have to act as the issuer and so become liable. Naturally, the rating agencies could not be made responsible for their extravagant evaluations – either before or after the outbreak of the crisis – either. And as if these foolhardy constructs were not enough, these markets for credit derivatives, heaped on top of one another, were highly active, extremely short-term and frequently refinanced only via the interbank market.

With higher interest rates and the fall in real estate prices the holders of such multiple mortgage securitisations naturally got into difficulties. The rating agencies which had previously rated many of these securities AAA fell into a panic due to these developments and immediately lowered the valuation of some securities three grades, which had never happened before. The procyclical behaviour of the rating agencies inevitably served only to exacerbate the crisis. As a consequence, not only did various securities markets collapse in September 2007, but also interbank trading, which is of the utmost importance for payment transactions (overnight loans which banks grant one another for the purpose of short-term liquidity balance). The risks of the short-term over-running of longer-term liabilities had simply become too great. Hardest hit by this were hedge funds and the off-balancesheet special investment vehicles.

When the refinancing of these companies via the money market collapsed these securities had to be taken back onto the balance sheets of their parent company or sold. Only now did the sheer size of the shadow banking system come to light – even for experts and supervisory authorities this was one of the biggest surprises associated with the crisis. In July 2007, these special investment vehicles owned around 1,000 billion dollars worth of these risky securities that had to be refinanced in the short term. This corresponded almost to the entire stock of subprime mortgages and around 17 per cent of the value of all US mortgages. The depreciation in value amounted to between 30 and 70 per cent, far more than what the IMF had estimated as late as in April 2008 – its estimates turned out to be extraordinarily high for methodological reasons (see Hellwig 2008).

To the extent the markets still functioned after the previous overshooting now massive downward swings took place. This directly affected the financial institutions which now, in contrast to how things had been previously, had to calculate their assets at market prices (so-called fair value accounting or mark-to-market accounting). In this way, systemic risk – in other words the transmission of the momentum of the crisis to other financial submarkets – was increased. The fact was that the correlation of market risks in the banks' risk models, on which they were supposed to rely within the framework of Basel II, was not allowed for and therefore hit them all the harder (Hellwig 2008, 2010).

The collapse of the credit pyramids and the fall in value of the underlying real estate plunged not only the US and international financial systems into crisis, but also companies and employees in the real economy – not to mention various governments which, for good or ill, felt compelled to bail out these financial institutions with hundreds of billions of euros in the face of certain ruin.

Unfortunately, these problems will be with us for a long time yet. For example, according to the Institute of International Finance in the commercial real estate sector alone in 2014 mortgages in the value of 1,400 billion dollars will mature, almost half of which have insufficient cover (the value of the mortgage is higher than the value of the underlying property). With regard to residential property the lack of cover in the USA alone amounts to another 700 billion dollars. There is a high probability that the financial sector will experience considerable difficulties due to the insolvency of many debtors (see Plender 2011).

6.2 Germany

Primarily the USA, the UK, Ireland, Spain and some central and east European countries are affected by the boom and bust of the real estate markets. Fortunately, Germany – apart from ill-fated private investors and special investment vehicles which were unable to resist the temptation of the supposedly certain profits of these constructs – was largely spared such a bubble in the real estate markets. That self-reinforcing excessive expectations did not develop could be explained by the fact that in western Germany the need for new housing has been low for years, while the building boom experienced by eastern Germany in the 1990s did not last long due to the shrinking of the population. It was the latter experience in particular that encouraged potential investors to be cautious. Although at the latest by 2000 it was clear that there would be considerable losses in value because many offices and rental property stood empty investors' losses were limited since they had financed their investments mainly on the basis of tax relief schemes subject to special depreciation allowances. The state and the taxpayers had, so to speak, bailed out investors and the banks financing them beforehand.

6.3 Real Estate Markets, the Construction Sector and the Economy

Considered in terms of the real economy the construction sector is extremely labour-intensive and uses a multitude of raw materials and industrial products in large quantities. For that reason, it is better suited than virtually any other branch to being an engine of economic recovery. That also applied to the eastern German economy which during the first year after the Fall of the Berlin Wall lost 80 per cent of its industry. The construction industry – infrastructure, commercial construction, residential – was one of the few sectors which at least for a while was able to a significant degree to create new jobs and income. Eastern Germany's need for capital was so great after *die Wende* (the economic and political transformation after the Berlin Wall came down) that the German savings did not suffice and the Federal Republic, contrary to its long-standing habit of financing the deficits of other countries, now for a few years soaked up foreign savings, becoming a net importer of capital.

China presents a dramatic example of such an economic stimulus programme with regard to its actions after the outbreak of the current crisis. It launched a public investment programme in the amount of 13 per cent of GDP. Furthermore, in 2009 almost three per cent of GDP was devoted to expansion of social security systems and further credits amounting to 30 per cent of GDP were pumped into the economy (as a result of which a burst of inflation is expected). By this means the country was able once more to achieve its habitual growth rates of between eight and 10 per cent within a very short period.

Thus China became the economic motor of the world economy. Without exports to China the German economy would not have been able to get back on the growth path so quickly, either. Such state financed economic stimulus programmes were also launched successfully in other Asian countries after the crisis (five per cent of GDP in Japan and Korea; in Germany only two per cent). All were classic New Deal programmes. The Korean government was clever enough to present its economic stimulus programme both domestically and on the international stage as a Green New Deal (although it is not particularly green) and thus to enhance its acceptance.

As one knows, little by little such economic stimulus programmes finance themselves since all economic activity also generates sales tax and income tax revenues for the state. This applies a fortiori in boom periods. In Ireland and Spain the construction and real estate boom and the favourable – precisely because of that – economic situation, as well as inflation, brought so much money into the coffers of the state that both countries were able to meet the Maastricht Criteria effortlessly and display considerable generosity to their citizens.

As we have witnessed, every boom has to come to an end sometime and then it costs the economy and the public finances all the more dearly, in particular if beforehand, as in Ireland, the tax system was increasingly oriented towards cyclically sensitive tax sources. It is even worse if in the crisis not only a real estate boom but also a complex and incalculable credit pyramid collapses and plunges the whole financial and real economy into a downward spiral.

6.4 Reasons for the Crisis-Proneness of Real Estate Markets

Real estate markets can undoubtedly spur on a country's economy. However, real estate markets – on the grounds of exaggerated expectations but also disappointments – can much more easily get into periods of boom and bust than other sectors of the economy. Are there plausible explanations for that?

The first striking thing is that since the 1970s – in other words, since the abandonment of the Bretton Woods system and the deregulation of the banking system and capital movements – financial crises have multiplied, with real estate crises at their centre.

At the same time, it is striking that the share of net investment in GDP of OECD economies has fallen dramatically. If investment rates had remained constant, according to an estimate in the *McKinsey Global Institute Report*, between 1980 and 2008 a total of 20,000 billion dollars more would have been invested. This dramatic decline in the demand for investment capital contributed to low interest rates and thus provided nourishment to credit bubbles (Plender 2011). Since the development of labour markets, naturally, is closely correlated with investment activity it is obvious that most unemployed and their dependents would have been spared their deplorable fate if investment had been maintained at its earlier level.

The question which immediately arises is why companies in the real economy have invested less than during the previous period over the past 30 years, Does it have something to do with the fact that with the end of the Bretton Woods system uncertainty became greater and time horizons for investors became shorter? Or does it stem from the fact that »real« companies also found it all too easy to make money in the financial markets? Or, under pressure from the financial markets, did companies concentrate so much on mergers, restructuring, unbundling and so on that they were unable to pay sufficient attention to new investment? Or did the short-term yield expectations of the owners or managers of big investment funds lead to the neglect of long-term investments? Or perhaps, as Lord Desai of the London School of Economics thinks, the innovative power of our economies has simply dried up? Only during the dotcom bubble a good ten years ago did technological optimism become so great that surplus credit did not have to be taken up by the real estate markets (Plender 2011). But as its name suggests, that too was only an aberration driven by exaggerated expectations.

Furthermore, it is striking that the monetary and financial assets of companies in the real economy (non-financial corporations) have grown enormously. As the Federal Reserve Board showed in a recently published study these US firms are sitting on monetary and financial assets worth 1,930 billion dollars (Reynolds 2011). This tendency is most striking with regard to large companies and conglomerates. In the course of time they have become financial institutions with production operations attached (as Siemens has long been) and are important investors in the financial markets. In 1980, General Electric still had 93 per cent of its profits in real production and marketing; in the first quarter of 2008, 56 per cent of its profits came from financial business (Lahart 2008). In 1986/87, Toyota made a profit of around 1.5 billion deutschmarks from financial transactions; this was half the year's pre-tax profits (Kamppeter 1990: 231f). If it is possible to earn a lot of money in a very short time in the financial markets without much outlay – at Toyota a handful of employees contributed more to company profits than several hundred thousand employees in its actual operating divisions – why should anyone go to the trouble of producing and marketing goods and services? As a result, the financial markets themselves probably contributed considerably to the decline in real investment rates.

The most important function of the financial markets, besides the maintenance of payment transactions, is the allocation of capital in the real economy. In reality, however, they reduce the capital available for real investments and »solipsistically« allocate it primarily to themselves. At the same time, the financial economy produces income and profits which no longer stand in any comprehensible relationship to the real economy. In the USA, depending on where one draws the boundary line – if one, for example, takes into account the financial transactions of non-financial corporations – up to 30 per cent of GDP goes back to the financial economy. On the basis of »rent«, employees in the financial economy receive incomes between 30 and 50 per cent higher than those of other employees (Philippon et al. 2008). In the USA, 27 per cent of profits earned in 2007 went back to the financial economy in the narrow sense (Lahart 2008). In total, the profits earned in the real economy are probably lower than profits in the financial economy. This means that a large part of the profits of the financial economy do not correspond to a real, consumable product. What we are dealing with are virtual profits which, in turn, are usable only virtually, in other words to invest in the financial markets – that is, until in the crisis the losses of financial institutions' virtual money were turned into hard cash by finance ministers using real tax money.

To the extent that companies do not get involved on their own account in the financial markets, thereby circumventing the banks, their growing monetary and financial assets will lead to higher deposits and investments also with financial institutions. On top of that, of course, come the savings of private households which are continuing to save, albeit in many countries less than in earlier years. The banks, correspondingly, must seek investment opportunities for the money they are entrusted with. It is for this reason they had to open up new areas of business in the face of the decline in the financing needs of the real economy.

These new areas of business include, *first*, credit cards, hire purchase and mortgages. While in the past private households in many countries had only limited access to bank loans, for some time now they have been inundated with them. The availability of mortgage finance undoubtedly contributed to the real estate boom.

A further basis for business was found, *secondly*, in the preparation and financing of corporate mergers – mergers and acquisitions or M&A – corporate restructuring and asset-stripping (leveraged buyouts or LBO; management buyouts or MBO) and, finally, in investment banking, hedge funds and a veritable flood of financial innovations, on which some impressive-looking credit pyramids were constructed. Splendid commissions could be earned on such activities if the banks directly or via their special vehicles were not themselves active on their own account in these business areas. What all this achieved for the competitiveness and efficiency of real companies is dubious, to say the least, if one examines the studies on M&As and LBOs. In any case, it is certain that these activities have led to considerable job losses and that many firms have subsequently foundered on the debt burden imposed on them in the process.

Thirdly, the savings surplus served to finance the budget deficits that had grown rapidly in almost every OECD country since the 1970s. Government bonds and their high creditworthiness furnished banks, pension funds and so on with solid reserves, providing them with backing for risky transactions. From this perspective a financial world without government debt would be a less risk-fraught and more stable one.

In terms of the global allocation of capital the US national debt, which has been growing uninterruptedly for the past 30 years now, in conjunction with current account deficits (double deficit problem), can only be regarded as a serious instance of the failure of international capital markets. The US economy, as one of the most prosperous in the world, copiously absorbs the savings of other, sometimes much poorer countries, such as China.

As quantitatively significant as these three areas of business may be, in most years they were apparently not big enough to absorb the surplus savings and the annual double-digit growth of liquidity in the financial markets. As a result, it thronged, *fourthly* – and this has been going on for a long time – into the share and real estate markets, generating inflationary pressure there. This can be easily grasped on the basis of the development of share prices.

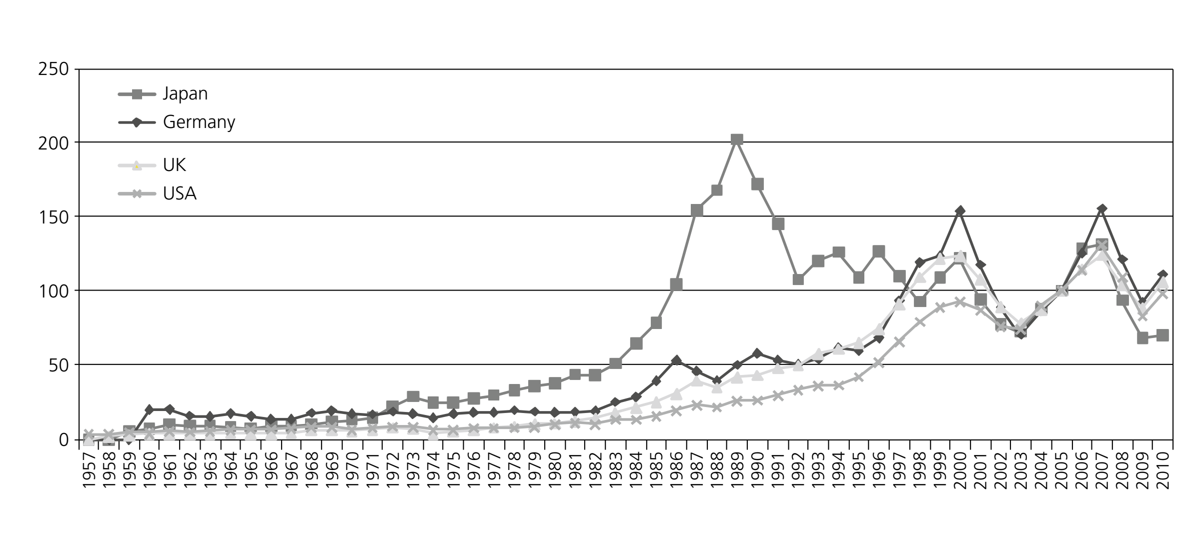
Figure 1 depicts share prices for the period from 1950 to 2010 for Japan, Germany, the UK and the USA. Until the early 1980s price increases remained extremely moderate – although that was a time of high growth rates due to the reconstruction and modernisation boom. In the early 1980s Ronald Reagan and Margaret Thatcher unleashed deregulation and liberalisation in the capital markets. Although growth rates have been much lower since then share prices have virtually exploded. Between 1982 and 2007, the year in which the current crisis set in, while in the USA share prices increased thirteen-fold and in the UK and Germany eightfold, in Japan they rose only threefold. However, in Japan, in connection with the bubble economy about which we will have more to say in due course, there were major price increases in the 1980s and 1990s.

One could also put it like this: while growth rates and so asset investments and the real value of invested capital (accumulated net investments) tended to stagnate or even fall, the valuation of companies exploded via the stock market. This connection is presented in Figure 2 with regard to Korea. The discrepancy is astonishing. Even if part of this discrepancy may be explained by an increase in companies' organisational capital one cannot avoid seeing it primarily as the expression of partial inflation in share prices. However, this inflating and so devaluing of assets is not included in the calculation of normal inflation indices. Central banks do not consider themselves responsible for inflation in securities markets. A great deal of liquidity is tied up by this inflation and the value of the assets of financial institutions and insurance companies distended, enabling them to get even more deeply involved in the financial markets.

Returning to the real estate markets there are institutional and political reasons to explain why they tend to be more unstable than other markets. Land in urban areas is scarce. Urban population and income growth therefore lead to rising real estate prices. It is enough if the incomes of a relatively small stratum of inhabitants increase for prices in the areas which they favour to skyrocket. We have seen that dramatically illustrated in recent years in relation to residential and commercial property in both Dublin and London. And the broader the income growth and/or the availability of building loans the more extensive and the higher the price increases.

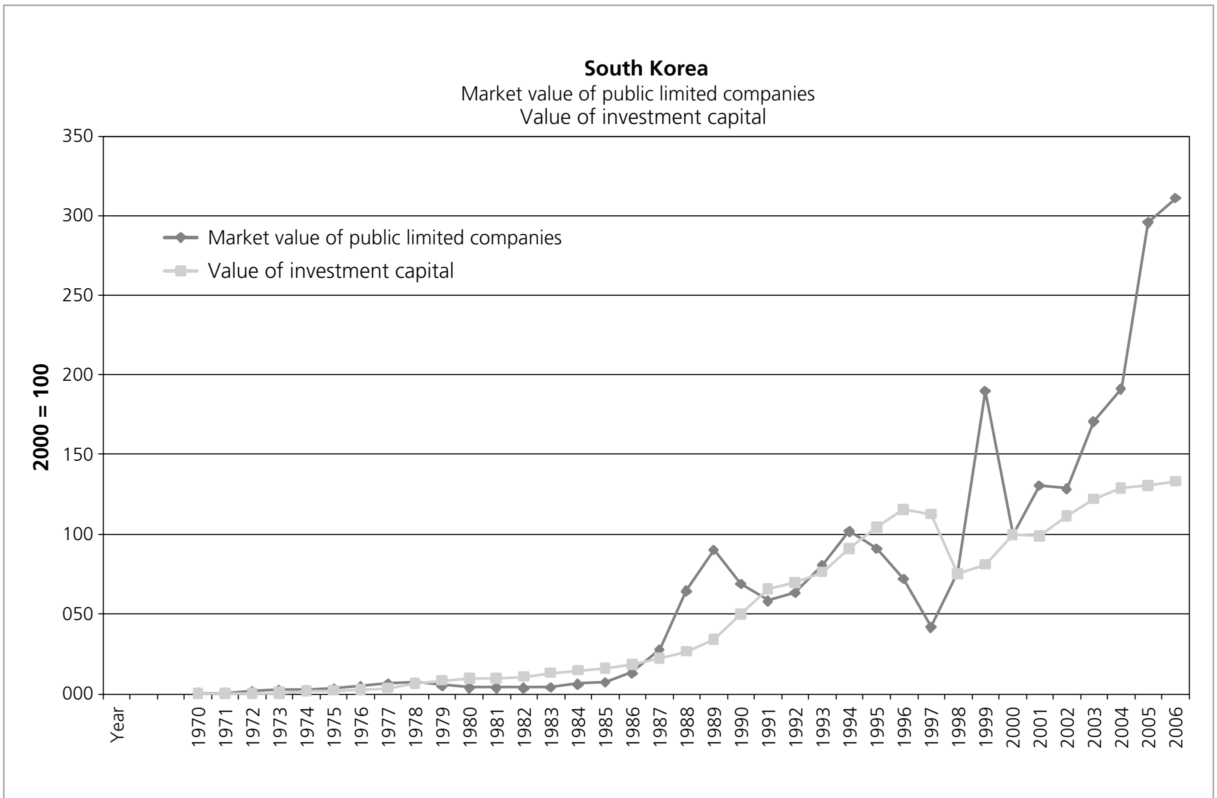
If price growth gets going properties are no longer built only according to need, but also in expectation of quick and profitable sales. This can tempt the banks, also as a result of competitive pressures, to scrutinise the income position of the borrower less closely (pre-eminently in the case of US subprime mortgages). If, on top of all that, the

Figure 1: Development of share prices in Japan, Germany, the UK and the USA, 1950–2010 (2005 = 100)



Source: OECD Datenbank

Figure 2: Market value of public limited companies and the value of company investment capital in South Korea (at constant prices), 1972–2006



Source: Bank of Korea, Economic Statistics System; author's calculations.

rating agencies reassure market participants by furnishing packaged mortgage securitisations with top ratings – making one-third of their profits in this way (Otte 2009: 11) – and governments, against their better judgement, fail to take action to curb the popular speculative fever, then crisis cannot be far away. This is exactly what has happened in the USA in the past few years. In Korea, the government of President Roh Moo-Hyun five years ago came under considerable pressure because it introduced a speculation tax on dwellings in the most expensive market segment and for the owners of several dwellings. In this way populism or media-generated populism can have procyclical effects and contribute to the formation of bubbles.

At another level, other institutional weaknesses take effect. Very few real estate markets are transparent; many factors are involved in price formation. Information on transactions in the market is incomplete, while statistics are usually published very belatedly. Often, prices are assessed by the mortgage banks which have a material interest in optimistic estimates. At the same time, they naturally try to pass on the risk as far as possible to the borrowers (see Plender 2011).

This is accompanied by an astonishing circumstance. Since real estate and land are nevertheless particularly safe they represent, in one form or another, the lion's share of assets and claims of banks and insurance companies. As a result, during boom periods they can feel richer, and in terms of their balance sheets they are indeed richer, and thus they can extend their business while complying with the rules on reserves, especially since they have to maintain procyclical fair-value accounting. When the boom turns into bust, however, the situation is reversed. Real estate and land, in connection with fair-value accounting, form the core of the banks' procyclical and self-reinforcing and self-confirming activity. Since the bonuses for bank employees entrusted with real estate transactions are oriented to the development of market prices they also have a procyclical effect. The asymmetry of bonuses, which predominantly arise in boom periods, therefore creates an incentive to disseminate optimism and to depict the world in a rosy light for buyers.

6.5 Spain in the Seventeenth Century

Comparable to the modern day credit glut was the gold and silver which flowed into Spain from Mexico, Bolivia and Peru in the sixteenth and seventeenth centuries. Although the state remained poor and in debt, certain segments of society, including the state's creditors, were suddenly very rich. This new wealth consisted of rents acquired by the Spanish state and certain segments under the aegis of state power and without giving anything in return (as was the case at a later date with petrodollars).

These rents could have been turned into capital if they had been invested in agriculture or industry. In fact, the Spanish economy was undergoing a period of early industrialisation which, similar to the Netherlands and England, could have been very successful. In the event, this development was ended by the influx of precious metals, however. This influx improved Spain's terms of trade: in other words, Dutch and English goods could be bought on favourable terms, naturally to the detriment of domestic producers, whose competitiveness was further weakened by the emerging inflation. The result was that Spain's economic development was terminated. People paid with gold, which was not something anyone could manufacture, and were swept up in real estate speculation. By the eighteenth century this was all a thing of the past and Spain, despite its colonies, became a country at Europe's periphery (see Bagú 1949).

The gold and silver which migrated on to England was ultimately used by English traders to buy Chinese tea and the Chinoiserie so coveted in Europe, and subsequently was used to decorate Chinese and South-East Asian palaces, temples and women. When the river of gold ran dry and China had still not developed a taste for European goods, the country was compelled via the Opium Wars (1839–42 and 1856–60) to permit the import of opium and its socially destructive consumption, which also undermined the state. Only in this way was it possible to close the trade and financial circle since Europe's lust for Chinese products was unabated.

What the Spanish example makes clear is that the unbridled and unabsorbable influx of rents or capital can weaken or even destroy a country's competitiveness and economic development: especially if the capital can clear out again without hindrance and overnight. The Tequila Crisis was one such calamity. Countries such as Brazil currently regard themselves as exposed to such capital inflows, detached from real domestic economic conditions, and implement, even with the agreement of the IMF, capital controls and the domestic neutralisation of such monetary flows via the central bank. In a report published in March 2011 the IMF praised the successful measures undertaken by the Korean Finance Ministry against speculative capital inflows, describing them explicitly as »legitimate macro-prudential measures«. Clearly, the IMF has undergone a Pauline conversion (KDB Bank 2011).

6.6 Japan's *bubble keizai* 1990

At the origin of the Japanese bubble economy and its decline since 1990 stood the Plaza Accord of 1985. Among its precursors is the interest rate rise implemented by Paul Volcker, then Chairman of the Federal Reserve, in 1979, which triggered the Mexican debt crisis (see above). The high interest rates and the restrictive monetary policy brought it about that the USA, under the aegis of recently liberalised capital markets, registered considerable capital inflows. This was how, in turn, President Reagan's budget deficit policy was financed, since US savings were insufficient.

US policy had no wish to have the blame for the savings-investment imbalance laid at its own door and so put the blame on, among others, Japan and Germany, whose companies were enjoying artificial and unjustified competitive advantages in the US market due to the strongly revalued dollar. Accordingly, surplus countries were obliged to drastically revalue their currencies at the meeting at New York's Plaza Hotel in September 1985.

As for the US trade balance, virtually nothing resulted from these revaluations in the medium term: on the contrary. How were absorption imbalances supposed to be eliminated by exchange rate changes?

The Japanese economy rapidly came under pressure as a result of these revaluations, at least in the perception of the government and the central bank. The latter reacted by easing monetary policy and reducing the discount rate from 5.5 to 2.5 per cent (and unfortunately left the interest rate at this level during the bubble). Japanese companies also allowed themselves to be influenced by the expectations of a crisis triggered by the Plaza Accord and increased the pace of the restructuring of the economy that had commenced some years previously in the direction of high-tech and knowhow. In particular, they accelerated the relocation of many simple production segments to China – which at that time also because of this was able to enter a phase of high growth which continues to this day – and concentrated in Japan on high value production, organisation and innovation segments. The results were breathtaking. For example, in electronics, automobile- and shipbuilding Japan rapidly became the leading industrialised nation. At the same time, factory and plant engineering enjoyed a boom due to the relocation of production works.

Although Japan's export rate at that time was still below 10 per cent of GDP – Japan remains, in contrast to what is commonly believed, primarily a domestically driven economy – it increased its current account surpluses in the wake of this dynamism to a level of five per cent of GDP, thereby continuing to contribute substantially to the financing of the US double deficit, whether directly through the purchase of US treasury bonds or indirectly through the large-scale purchasing of prestigious American real estate and companies. To US authors, too, it was clear that Japan had become »number one« (hence the title of a book by Ezra Vogel). Its economic success, its reputation abroad and the purchase of some of the most famous US firms and real estate inflated Japan's self-confidence into »un-Japanese« arrogance. The concept of *kokusaika* (internationalisation) was on everybody's lips at that time and embodied the international recognition that had at last been achieved, if not the conquest of the world.

Also part of the Plaza Accord were the liberalisation and deregulation of the economy, in particular the banking system. As early as the 1970s the comfortable position of Japanese banks as the »housebanks« of large companies – they financed whatever companies or the state deemed necessary and were under the strict paternal care of the Finance Ministry – was undermined by the first thrust of liberalisation. After decades acting as a kind of public financial service provider and in that form contributing significantly to Japan's economic success they now came under pressure of competition and had to offer new products and services (Nakaso 2001: 2). In addition, over the years the financial situation of their major clients had improved and their dependence on bank financing had decreased.

The banks therefore had to seek new areas of business. In the Japanese case they turned primarily to real estate markets. This was tempting because during those years these markets underwent an unprecedented boom. The central bank had provided the most important precondition for this with its low interest rates. The abovementioned expansion mechanisms led the way; soon enough, credit allocation was merely a matter of expected price increases for real estate. The banks' balance sheets looked wonderful and formed the basis for their increasing international involvement. The economy overall, also because of the construction boom, was visibly flourishing: the changes and the exuberant optimism were a source of constant amazement (the author was living in Japan at the time).

This optimism was also passed on to foreign investors. Since it was not easy for them to participate in the real estate boom they concentrated on the stock market and came to be among its most important players. This went together with the fact that at that time most shares were held by Japanese companies amongst one another as a sign of good partnership and were barely traded. The stock market boom was triggered by privatisation and the stock market flotation of the state telecommunications monopoly NTT. Its value alone exceeded the total value of German share capital. Large Japanese companies issued, within the framework of *zaiteku* (»financial technology«: direct fund raising by the issuance of new shares, convertibles and external bonds and also by utilising internally generated cash and new instruments developed by securities firms), new shares, among other things, in order to invest the proceeds at a fixed interest rate. This was a huge business because of course these shares cost them no more than the paper they were printed on.

Real estate and stock markets in this way reached intoxicating heights, based on low interest rates and driven by speculative expectations. Finally, it was halted by the central bank's repeated base rate rises which started in summer 1999 and by the following summer had reached six per cent. In the process, share prices fell 75 per cent. The real estate market experienced a similar fate, although the collapse of these markets meant that precise measures cannot really be provided.

The consequences for the banks were not as dramatic as one might suppose because at that time there was still no fair-value accounting. The banks kept mortgages on their books and the private households which had taken out these loans in most cases continued to service them without interruption. Their book losses became real losses only in the event of sale; and since mainly owner-occupied property was involved, after the outbreak of the crisis people had little interest in selling.

Office space and other commercially built and mortgaged property were another matter, however, and their value plummeted. Some time or other this inevitably affected the situation of the banks. To begin with, however, the crisis did not manifest itself in the real economy. Growth rates had halved, it's true, but until 1992 were still very much in positive territory. The crash on real estate markets was held to be a necessary correction which would soon make way for a revival. To be on the safe side, however, the government had already begun to take the economy under its wing by increasing government spending. This did not have as strong an effect as expected, primarily because the central bank at first did not wish to lower interest rates (only at the end of 1995 did it reduce interest rates to 0.5 per cent).

In any case, the situation of the banks became increasingly critical. The Finance Ministry began not only to stage rescues, but to allow banks to go bankrupt, to rehabilitate themselves or merge. These measures only really got off the ground in 1997, however, and were then accompanied by the collapse of some securities houses. Even the interbank market at times came to a standstill. This all happened, therefore, during the period in which the 1997 Asian Crisis got going in Thailand. Japan remained largely untouched by this crisis because its financial system was practically still under the control of the Finance Ministry. Foreign investors had still not completely ceased trying their luck in the stock exchange, but it was no longer systemically important.

If one considers the gravity of the crisis in the real estate and stock markets and in the financial economy one can only be astonished at how lightly the Japanese economy got off after the bursting of the bubble in 1989/90, especially in comparison to the current financial and economic crisis. After 1990 growth rates were negative only once, in 1998, and that was attributable mainly to the repercussions of the Asian Crisis in 1997/98 for Japanese exports. Also in 1998 the unemployment rate for the first time passed the four per cent threshold. The expansionary fiscal and later also monetary policy – with interest rates below one per cent – contributed much to this, from today's perspective, astonishingly stable development. Whereas up to 1992 the national budget had recorded surpluses, after that the budget deficit increased to around seven per cent of GDP. The state's gross debt in the meantime has grown to 200 per cent. Having said that, it should be noted that around 40 per cent of government bonds are held by the Japanese central bank. Besides that, the Japanese state has substantial assets at its disposal: the reserves of the state pension insurance system alone are worth around 50 per cent of Japanese GDP (Kamppeter 2004).

To sum up, the methodology of the Plaza Accord did not address the real problem of the international savings–investment imbalances, but rather aroused fears which, on the one hand, caused the central bank to abandon its restrictive course and, on the other, motivated companies to redouble their efforts to transform the Japanese economy into a high-tech and knowhow driven economy.

The liberalisation and deregulation which had already begun in the 1970s forced the banks out of their previously passive role in support of the real economy and the state and with that the first, highly successful phase of the reconstruction of the Japanese economy was ended. The financial sector was rebuilt and detached itself from its close entanglements with the real economy and the state. Under pressure of competition and the temptations of easy money it assisted energetically in inflating the largest bubble to date – until it finally burst due to the actions of the central bank.

Subsequently, the central bank was often reproached, first with having reacted too laxly and then too harshly. That is probably correct, but even central banks have to make decisions and experience uncertainty and cannot jump over their own cognitive and ideological shadow. What the Japanese bubble economy also shows clearly is the great power of central banks with regard to economic life. It contributed enormously with its interest and monetary policy to the emergence of the bubble and in the end, albeit gradually, caused it to burst.

6.7 The Asian Crisis 1997/98 and South Korea

One peculiarity of the Asian Crisis was that it began in a small country – Thailand – with the bursting of a real estate bubble and then, like an aggressive and mutating flu virus, in no time at all and on a broad front spread to the so-called Tiger countries, old and new. The trigger of the Thai crisis was speculation against the baht which led rapidly to capital flight and, linked to that, the collapse of the stock market. The speculators won out because the central bank had hardly any reserves, certainly not in comparison to the »investors« who led the attacks.

For many observers and actors the crisis came as a surprise, despite the real estate and lending boom which the country had enjoyed in the years leading up to it. Thailand belonged to the second generation of Tiger economies. For some years it had been the target of extensive direct investments by foreign firms. The Thai economy had grown by nine per cent a year, on average, since 1986. The exchange rate fixed by the central bank was not considered to be in danger. On the contrary, based on the success of the economy rather a revaluation was expected. For this reason it was considered normal to take out loans in yen and US dollars, given the lower interest rates in Japan and the USA. The hike in US interest rates by 2.5 per cent in 1995 brought it about that people increasingly took out loans in yen (the so-called yen carry trade). Apparently, the Japanese central bank's announcement of an increase in Japanese interest rates – in the event not actually carried out – at the beginning of May 1997 was what caused international »investors« to stage their assault on the baht in mid-May and to withdraw their money from Thailand. As a consequence, the exchange rate halved, the stock market plummeted by 75 per cent and the economy contracted by almost 10 per cent on a 12-month basis. One indicator of the scale of the crisis is that 600,000 foreign workers had to leave the country.

The boom had a number of familiar features. The rising real estate and share prices gave Asian banks putative security against further lending. Even share purchases were financed with loans. The volume of credit grew in these countries twice as rapidly as their GDP (which was modest by comparison with what we experienced in the run up to the current crisis). In their optimistic myopia, their speculative mania and herd behaviour investors also in this instance refused to recognise that profits cannot be based ad infinitum on price rises which they themselves generated.

Another peculiarity of the Asian financial crisis was the deployment of heterodox economic policy measures. The best known of these were the capital controls introduced by Malaysia in defiance of the IMF, which wanted to commit all the affected countries to so-called structural adjustment packages (SAP). Endangered banks were nevertheless put back on their feet and companies granted bridging loans. In this way a spillover of the crisis could be prevented and Malaysia was able to overcome it more quickly than the other affected countries. Later on, even the IMF had words of praise for Malaysia's methods and indeed renounced the old neoliberal dogmatism – which cannot be said of the EU, as its approach to the current crisis shows. Countries such as Indonesia, which were unable to elude the diktats of the IMF, fared much worse than Malaysia. The domestic political weakness of the government in this instance bolstered the IMF.

Hong Kong, which had just achieved independence from the UK, came up with something special when its own »investors« followed their foreign counterparts in the wake of their flight from the island state by dumping shares on a massive scale. As a countermeasure, the Hong Kong Monetary Authority (HKMA) and Finance Minister Donald Tsang declared war on the speculators and in August 1997, without further ado, bought 75 per cent of the Hong Kong shares then in circulation! At the same time, they prohibited a number of types of financial transaction, including futures contracts on the Hang Seng index. In 1999, the HKMA sold its shares at a profit of 30 billion HK dollars – a pretty good yield on a »stake« of 120 billion HK dollars during a period of crisis.

Korea also constitutes an interesting example of heterodox policy, although due to domestic political weakness – the crisis broke a few months before the government of Kim Young Sam was succeeded by that of Kim Dae-Jung – initially it had to subordinate itself entirely to IMF diktats.

In the eyes of nervous investors every crisis also has internal causes. How and to what extent their perceptions correspond to reality is another question. In terms of the real economy no conspicuous crisis moments could be discerned in Korea. In the perceptions of the investors unsettled by the Thai crisis it must have been something else. In fact, the debts of some large Korean *chaebols* were extraordinarily high, at 400 per cent of equity. This indebtedness was predominantly a legacy of the not too distant past in which the still intact South Korean planned economy had enthusiastically pursued modernisation. During this period the state controlled companies' investments through the banks under its control within the framework of five-year plans. Their role was somewhere between that of Japanese and East German (GDR) banks.

After the massacre in Kwangju in 1980 the military saw itself compelled, after a brief interregnum, to allow more freedom and democracy. The planned economy model could no longer be sustained in its old form. In addition, the economy had reached a level at which companies needed more decision-making autonomy. At the same time, also playing a role here – ignoring questions of public welfare as a government aim in itself – was a certain conflation of political freedom and the economic freedom of certain actors. In any case, the Economic Planning Board and its spiritus rector the Korea Development Institute (KDI), had recognised the need for a paradigm change. After the largely shielded catch-up phase companies were to open themselves up more to international competition.

This paradigm change also included a drastic improvement in the ratio between debt and equity inherited from the planned economy. That alone was an enormous task for companies, in particular since, at the same time, they were supposed to achieve international competitiveness. Since the export economy and the domestic economy were still growing reasonably well the Korean Development Institute thought that companies would be able to get to grips with this restructuring process.

Then came the Asian Crisis. Foreign investors and investment companies saw the high debt but not the intended paradigm change. Korea then went the same way as Thailand. Its reserves were too meagre to defy the speculation against the won. The IMF turned up with a classic SAP. High interest rates – they climbed as high as 25 per cent! – would quickly separate the wheat from the chaff, while the economy, with the help of corresponding structural measures, would soon get going again. In practice, however, the opposite happened. The chaff was not separated: instead, virtually every company was turned into chaff – even the banks which previously, at the behest of the state, had had to liberally supply these companies with credit.

The experts at the KDI were horrified. An industrialised country, which Korea had become long ago, does not consist of companies which more or less monadically eke out an existence on the market, but rather of complex networks which regulate the exchange between and within companies and only in that way are able to form a productive whole. In addition, of course, there are the workforce with their company-specific skills acquired over the years which after companies go bust are practically useless and cannot easily be retrained.

Initially, the IMF stuck to its guns, making its financial support conditional on implementation of the adjustment package (to be more precise, ultimately at the expense of the emerging Korean economy and its taxpayers). The KDI experts argued, however, that the country's industrial fabric would be damaged irreparably by the structural adjustment programme and presented the IMF with calculations showing that the costs of all these bankruptcies would ultimately render the IMF itself insolvent. In early spring the IMF's self-confidence and resolution began to crumble. After unemployment rose considerably and social discontent threatened to boil over the focus shifted to the rescue and rehabilitation of companies. According to Korean bankruptcy law many of them were, to begin with, put under »work out«, which means that initially they were kept on their feet and restructured. When they were over the worst, they were reprivatised.

The banks, which had lost their historical function, were – at great expense (170 billion US dollars) – wound up, restructured and merged or, if you like, »normalised«. Apart from the still state-owned Woori Bank, today they are all foreign-owned and, while operating within a particular legal framework and regulations laid down by the supervisory authorities and the central bank, they obey their foreign owners, occasionally to the considerable frustration of the Korean side.

The Korean economy was the quickest of all the affected countries to recover from the crisis. Kim Dae-Jung, president from 1998 – although he had set policy since his election in December 1997 – staked everything on increasing the country's foreign exchange reserves so as to protect the country against such a crisis in the future. This is what led virtually all of the country's valuable resources – as already mentioned, including the banks – being sold at firesale prices to foreign owners. Large companies such as Samsung, LG and Hyundai are today in majority foreign ownership. In the meantime, their value has multiplied, in particular because the economy soon managed to get back on a growth and innovation course.

Foreign exchange reserves have for some years stood at around 300 billion US dollars, about 20 per cent of Korean GDP. The other East Asian crisis countries also set about building up a decent foreign exchange cushion after the crisis. The accumulation of such reserves clearly involves a waste of economic resources. They are one of the burdens which national economies in Asia and elsewhere have had to bear in the new financial order which emerged after the disintegration of Bretton Woods. One unintended consequence of this – but also due to uncertainty about the euro – is that the US dollar has been reinforced as a reserve currency and the USA's borrowing capacity has been boosted.

7. Conclusions

7.1 Renewal of a Capitalism Based on the Real Economy

■ In contrast to international trade, so far no one has been able to prove, either theoretically or empirically, that the liberalisation of international capital movements is associated with gains in public welfare (as distinct from private enrichment).

■ In particular, short-term capital movements are characterised by expectations about expectations, herd behaviour, moments of euphoria and panic, large volumes, high volatility and severe over- and under-shooting. Even Michel Camdessus, former head of the IMF, today blames speculative activities for the excessive exchange rate fluctuations that »have nothing to do with economic fundamentals« (*Die Zeit*, 27 January 2011: 22).

One can either prevent such short-term capital movements – as happened, for example, in Malaysia – impose restrictions on their freedom of movement or subdue them with transaction taxes, which could be varied in accordance with the level of speculative strain in the markets (Kamppeter 1990).

▪ The profusion of tax havens represents a particular problem. They are the most important, but at the same time most opaque and uncontrolled nodes in the international financial system. However, everyone knows that they are largely utilised and controlled by the City of London and Wall Street (Shaxson 2010). Since most transactions go through only a few central clearing houses in the USA and Europe, from a technical standpoint the establishment of full transparency and the implementation of transaction taxes would not represent a major problem.

▪ The same applies to the introduction of transaction taxes in capital and foreign exchange markets. Since their aim is to lower speculative tension and volatility in these markets they would still be performing their function if those who paid them were reimbursed, for example, at the end of the year.

▪ The deregulation of national capital markets should also be examined in terms of market and system stability and their contributions to national prosperity. Normative issues have become unavoidable: are the financial markets and financial institutions fulfilling their obligations towards the real economy? Their most important tasks are undoubtedly the allocation of capital in the real economy and the organisation of payments. When it comes to financial activities beyond real investments and payments necessary to the real economy closer scrutiny is called for and perhaps even licensing.

▪ Since the main tasks of the financial system are, on the one hand, the accumulation of savings and their allocation as productive capital in the real economy and, on the other hand, the smooth management of payments, it would make sense to separate these tasks. A separated banking system could consist of four or more pillars: for example, investment banks, savings banks, commercial banks and clearing banks. Further specialised banks in private, cooperative or public trusteeship are also conceivable.

A separated banking system segments and reduces systemic risk: if an investment bank comes under threat this does not also jeopardise savings deposits and payments. In addition, conflicts of interest are avoided between different »arms« of the current universal banks.

▪ The volume of liquidity in the financial system has exploded due to the proliferation of financial innovations, low collateral and traditional credit creation. It represents a very large multiple of the volume of transactions in the real economy. The claims and commitments of individual financial institutions can exceed the GDP of the countries in which they are resident by several times.

During crisis periods, at least if one accepts the premise that banks represent a systemic risk and therefore have to be rescued by the state in which they are resident, they annul the rules of national sovereignty and burden the treasury and the taxpayers to an unforeseeable and potentially ruinous extent.

In a separated banking system, these risks are at least more transparent, separable and thus also calculable.

▪ Particular systemic risks are involved in the combination of a real estate boom and its hypothecation or the allocation of mortgages because during the boom the banks can fall victim to excessive exuberance and optimism. If mortgages are also securitised several times over and made more presentable with the help of the rating agencies it is important to be keenly aware of the incipient dangers, even if the state and the economy profit from the building boom temporarily. In most financial crises in recent decades the bursting of real estate bubbles has played a key role. Fair value accounting – or mark to market accounting – should be abandoned since it is distinctly procyclical.

7.2 Macroeconomic Imbalances

▪ Although the Bretton Woods system perished because of its structural defects (adjustment obligations and burdens only on deficit countries) and the selfish behaviour of the USA (which as reserve currency country in particular did not have to adhere to the deficit country rule), the USA continued to use its existing position as reserve currency country to the effect that it could use the savings of other countries to fund its overconsumption. That is possible only because international capital movements were liberalised after the demise of the Bretton Woods system. Like the financing of US deficits, the recycling of petrodollars also contributed to the emergence of an international capital market.

■ In a system with liberalised international capital flows exchange rates tend to be determined by capital movements; in other words, no longer by the trade or current account balance. On the back of that, short-term capital movements and foreign exchange trading in the wake of speculative surges or for technical reasons – interaction of programs which automatically generate buy and sell decisions – lead to high volatility and to constant major deviations from exchange rate trends.

■ Macroeconomic savings–investment imbalances between countries follow a path of negative or positive cumulative causation and get bigger and bigger over time. The savings-exporting countries obtain, as it were, artificial competitive advantages, while deficit countries suffer from corresponding disadvantages. This dynamic has contributed to the deindustrialisation of the US and British economies and to the »industrialisation« of the German economy. When the moment of truth arrives and the deficits can no longer be financed the countries producing surpluses are suddenly revealed as kings without any clothes because they are no longer able, as before, to keep their economies going through exports. Furthermore, when they want to claw back some of the money they have lent out over the years logically they themselves must begin a life as importers of savings with current account deficits.

■ International macroeconomic imbalances are regarded as a problem of over- or undervalued currencies, but this is merely wishful thinking since it gets cause and effect the wrong way round. The false methodology of the Plaza Accord of 1985 was based on this perception. Against much cherished expectations this agreement changed nothing with regard to macroeconomic imbalances. In addition, the Japanese economy experienced an innovation boom and soon became the most competitive OECD economy. However, the boom was hijacked by speculation and ended in a dramatic real estate and stock market crisis.

Today we understand better than at that time that it is futile to pay too much attention to trade and current account imbalances and public debt when there are global macroeconomic imbalances. Instead, what matters is the underlying absorption ratio with regard to investment and savings. Nonetheless, we are currently experiencing how China is under renewed fire from the other side of the Pacific in the same false spirit of the Plaza Accord.

■ The liberalisation of the financial markets entails that money, frequently in alarming quantities, is shunted back and forth across the globe and indeed without any reference to prevailing absorption ratios. Spain in the seventeenth century was an earlier instance of such a destructive inflow of money which could not be turned into capital. The Latin American financial crises and the Asian Crisis ten years ago are other examples. Even Chile tried in the wake of the Asian Crisis to protect itself against undesired capital inflows. Not least countries such as Brazil and Korea are currently seeking to protect themselves against this influx of unwanted short-term money by means of taxes and other »unconventional« measures. Certainly, the »investors« who are behind this appear to be losing interest in the BRICs (according to the financial press at the beginning of March 2011). It may be that soon they will have to defend themselves against galloping capital flight.

■ Experience shows that, despite the virtually unlimited international freedom of movement enjoyed by capital, even in the USA investment in the real economy is largely financed from national savings. That contradicts the hopes associated with the liberalisation of international capital movements by economists. The assumption was that the capital markets would channel part of the savings of rich countries to developing countries, thereby contributing to their development, naturally in the form of real investments.

Precisely that was what happened in the 1970s, at least, in Mexico. The interest rate hike by the US Federal Reserve and the speculation against the peso which that brought into play, together with capital flight, destroyed these pious hopes, however. Since then, the savings of richer countries have not flowed into the developing countries, but savings have flowed out of developing countries into the USA, thereby contributing to the constant magnification of global macroeconomic imbalances.

■ Short-term capital movements have since then wrought their destabilising and destructive mischief in all financial crises. They have contributed nothing to the allocation of capital in order to increase the productivity of our economies: quite the contrary. Even the IMF has come to take a critical view of their role.

7.3 Crisis Management

▪ What surplus countries such as Germany need, therefore, instead of the export of savings or capital is a higher absorption of domestic savings. The trick here is not to reduce the consumption of private households but their savings and to redistribute them to the state (Schulmeister 2010). China has pointed the way in this respect by expanding social security systems (households no longer have to make provision to the same extent and are saving less). In addition, via their economic stimulus and immense credit programme considerably more domestic savings are being absorbed at home. In China, naturally, there is still enormous development potential, in particular in the interior of the country, away from the coastal regions. But there is no lack of neglected tasks in Europe too: education systems, environmental protection, better opportunities for immigrants and young people and so on.

▪ Until such a redirection of income takes place it makes more sense, in any case, to lend surplus money to one's own state rather than to put it at the disposal of another one which in the past has already inflated its own debts out of existence. In surplus savings countries such as Germany it therefore makes sense for the state to incur debt.

▪ At the same time, deficit countries must also have the possibility to get out of their menacing – especially in terms of domestic policy – crisis situation. It should have become clear with regard to the crises examined here that continued adherence to neoliberal IMF packages only prolongs crises. It has been shown that heterodox methods of the kind Argentina was the first to implement are the best way forward.

▪ In the realm of heterodoxy the imagination virtually knows no bounds. For example, at the outset of the current crisis Korea allowed itself the luxury of implementing an employment programme which ultimately helped predominantly older people. It was not really their intention to give jobs to 200,000 older people. In fact, the aim was to support the incomes of families – in Korea three-generation households are the norm – whose main breadwinner had become unemployed in the crisis, the expectation being that this extra income would enable the continued servicing of mortgages, thereby protecting the banks against further deterioration.

▪ If the EU and some of its member states are unable to free themselves from earlier neoliberal IMF visions and packages – which the IMF itself has already managed – the situation of the countries hardest hit by the crisis will only be exacerbated. Without the solidarity and support of the countries less affected by the crisis the danger is that the crisis will degenerate into an infinite regress. As Korea demonstrated in the Asian Crisis the only way out that makes sense is the renovation and modernisation of old structures, not their destruction. Even Argentina after many years managed, by flouting the conditions imposed by the IMF, to carry out a breathtaking turnaround. We must not give in to despondency, although admittedly in Europe, with its established structures, more patience and also money will have to be summoned up.

The crisis countries should not be punished but supported in getting out of their own specific problems by way of growth. To that end, in particular, an expansionary economic climate has to be created by surplus countries such as Germany which enables both them and crisis-hit countries to free themselves from the fatal dynamic of current account imbalances and deficits as well as from the export of savings and from debt. Without such a turnaround the future looks bleak.

Since we have preferred to rescue the banks and to burden the crisis countries with additional public debts, and are now preparing to further undermine their credibility by threatening insolvency proceedings it has become more difficult for the crisis countries to escape this fatal dynamic. A haircut for private banks would have brought some relief. However, cutting the debt currently weighing down these states would not only set a dangerous precedent, but also threaten the financing of state deficits, without which the crisis countries will not be able to accomplish the requisite turnaround. It is obvious that guarantees or the temporary absorption of debts of crisis countries by the ECB would be a good way of supporting this turnaround and of taking the wind out of the sails of the speculators. Persistent economic crises cannot be overcome without decisive government action and a temporary increase in government expenditure.

▪ The political situation in North Africa and other Arab countries has changed dramatically in recent months. The EU and its member states had come to a comfortable arrangement with the authoritarian regimes in the region, hoping for some stability in the neighbourhood and support in stemming the flood of migration to Europe. Some of these countries are heavily indebted to foreign banks. New, hopefully more liberal and democratic governments will have to restructure the economy and embark on a course of modernisation if they are to meet the expectations of their citizens. Then, at the latest, will the question arise of how far Europe can and wishes to support them in this. A key issue in this respect is how to deal with the inherited debts of the previous authoritarian regime. Without some relief we run the risk, as happened in Argentina, of jeopardising the newly won democratic and political progress and economic restructuring.

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