Chapter 1

Financial Globalization and Instability of the World Economy

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1. Introduction — Globalization

Since the mid-1980s the world has seen the development of globalization under the leadership of the US and the UK. Globalization can be summarized as "the tendency toward the market economy on the global scale". It has turned out to transform the political economy of the world dramatically, to an extent such as nobody could have expected, and it has defined the future course along which the world should proceed.

We might divide globalization into two types: "financial globalization" (FG), on the one hand, and "market system (or capitalistic) globalization" (MG) on the other. FG is the global unification or liberalization of the financial market, while MG is the multiplication of nations, on the global level, which would adopt the market system as the fundamental economic mechanism.

We may identify three upheavals which globalization has brought about to the world system over the last three decades: (i) recapture of leadership of the world economy through finance by the US and UK; (ii) collapse of the Cold War system and convergence toward the capitalistic system; (iii) rise of the emerging nations.

The first of these was caused by FG, the second and the third by MG. It was "Neo-Liberalism" (Thatcherism and Reaganomics) as a social philosophy that drew the world economy powerfully in that direction – 'leave all to the markets; government intervention in the economy will hamper its efficiency and development; the structure should be reformed in such a way that regulation be abolished as much as possible'. Promoted, backed and promulgated by the Neo-Liberalists, liberalization in the field of finance, labor and capital has been extended literally on the global scale – above all, the liberalization of finance (or FG).

In this paper, we will focus mainly on how FG has in the course of time been making the world economy increasingly unstable and volatile. In Section 2 we will explain how financial liberalization has proceeded in the US, while in Section 3 we will see how the world financial system has become unstable and vulnerable, leading up to a world economy characterized by instability. In Section 4 we will reflect upon what financial liberalization has implied in relation to the world economy. Finally, in Section 5 we will explain how the US administration has grappled with the meltdown caused by the Lehman Shock and barely managed to enact the Financial Regulatory Reform Act in July 2010.

2. U.S. Financial Liberalization —Attenuation of the Glass-Steagall Act and Enactment of the Gramm-Leach-Bliley Act

2.1 The Outline

The Glass-Steagall Act (the GS Act hereafter) enacted in 1933 had long been a dominant instrument for regulating and overseeing the US financial system. In the 1920s the USA saw financial fraudulence rampant, to the extent that President Roosevelt ascribed the Great Depression to it[4]. So it was that the GS Act was passed with the aim of imposing strict regulations on the financial institutions. It was composed of three pillars: (i) regulation of interest rates ("Regu-

[4] The Pecora Commission made a great contribution to revealing this fact.

lation Q"); (ii) separation of commercial banking from investment banking; (iii) regulation of interstate banking.

In the 1960s a movement calling for softer regulation was launched through the lobbying activities of banks eager to enter the municipal bond market. But the GS Act had worked well enough up until the 1970s, when the situation eventually changed.

In the 1970s the investment banks tried to edge into the sphere of commercial banking, providing customers with money accounts (with interest paid), including check and credit services. The role which the DTCC (Depository Trust and Clearing Corporation) played here was significant. Throughout the 1970s and 1980s computerization went ahead only in the mega investment banks, where individuals came to make transactions by means of the so-called "street names", which worked as a sort of reserve ratio in the case of the commercial banks. The investment banks were able to get new funds by exploiting them, which aggravated the commercial banks' growing impatience.

In the 1980s bills aiming at relaxing the GS Act had often been submitted to the Congress. Abolition of Regulation Q came first in 1986, followed by that of interstate banking regulation in 1995 (the Rigle-Neil Act). Lastly, the separation of commercial banking from investment banking was unlocked by the Gramm-Leach-Bliley Act (the GLB Act hereafter) in 1999.

2.2 Relaxing Separation between Commercial Banking and Investment Banking

Here we will see how the GS Act came to be alleviated and finally abolished, focusing on the separation of commercial banking from investment banking.

The movement toward relaxation might be said to have proceeded through a sequence of extended interpretations by the Federal Reserve Bank (FRB) of Section 20 of the GS Act. In December 1986 the FRB interpreted a clause in the Section which prohibits "in principle" a commercial bank from dealing in investment banking in such a way that it is allowed to do so for up to 5 percent of the total revenue, followed by the FRB's decision (spring of 1987) that a commercial bank can underwrite some securities.

Since A. Greenspan, a former executive of J.P. Morgan, was appointed Chairman of the FRB in 1987, relaxation of the GS Act was expedited through the following stages:

(i) In 1989 the FRB permitted commercial banks to engage in underwriting securities for up to 10 percent of the total revenue (the first bank thus allowed was J.P. Morgan);
(ii) In December 1996 the FRB authorized bank holding companies to have investment banks as subsidiaries for up to 25 percent of the total revenue;
(iii) In February 1998 there emerged a merger deal between the Travelers Insurance Company (the CEO was S. Weil) and Citicorp (the president was J. Lead). This should have been impossible under the GS Act, but vigorous lobbying activities developed targeting top figures such as Clinton, Greenspan and Rubin, resulting in the FRB approval of the merger in September;
(iv) The final blow came with heated agitation calling for abolition of the GS Act, resulting in enactment of the GLB Act in November 1999.

2.3 Promulgators for the GLB Act

It was financiers such as Wile and Lead, and politicians and/or academics such as R. Rubin, L. Summers (whose protégé was Rubin), Greenspan and Phil Gramm (Republican Senator) who worked as the promulgators for the GLB Act.

Summers and Greenspan were responsible for drawing up the GLB Act, alias "the Citi-Group Approval Act". Rubin, who resigned as Secretary of the Treasury in July 2000, was welcomed as CEO of the Citi-Group. While he was there, he induced the Citi-Group to embark on risky investments such as the CDO (Collateralized Debt Obligation)[5].

Gramm was also involved with enactment of the Commodity Futures Modernization Act of 2000 (the CFM Act hereafter), which gave momentum to moves to legalize the future trade of energy and the credit default swaps (CDS hereafter).

Prior to this, B. Born, chairperson of the Commodity Futures Trading Committee (the CFTC), who was worried that the OTC (Over-The-Counter) Derivatives (esp. the CDS) had been transacted on an ever larger scale, evading supervision of the financial authorities, insisted on the need for supervision. Her move, however, came up against harsh opposition from Greenspan, Rubin (the then Secretary of the Treasury) and Summers, who had promoted relaxation of the GS Act. It was they who reversed the direction and succeeded in enacting the

CFM Act. Wendy, Gramm's wife and chairperson of the CFTC under the Reagan and the G.H. Bush Administrations, also worked hard for the CMF Act, thanks to which she was to be welcomed by Enron.

The salient feature of the CFM Act, known as the so-called "Enron Loophole" (the future trade's exemption from supervision), lies in "the single stock future" being allowed. This was to enable higher leverage and more speculative activities (the Act is held responsible for the California Electricity Crisis in 2000-2001).

Enron had been very much involved in derivative dealings in the 1990s. In 1999 it set up "Enron Online" and greatly extended derivative dealings. It was subsequently to be exposed for continued fraudulent accounting and was forced into bankruptcy, setting the scene for the so-called "Dotcom Bubble" to burst.

[5] Incidentally, Geithner, the Secretary of the Treasury (Summers was a protégé), was president of the FRB of New York. In September 2008 he forced the Lehman Brothers to go into bankruptcy, and yet bailed out the CitiGroup with the TARP fund.

Phil Gramm[6] was thereafter welcomed as executive by UBS[7], where he is reputed to have played a central role in its extensive involvement with the CDS.

3. The Instability of the World Financial System

How are we to evaluate the influences on the world economy resulting from financial liberalization or globalization? They can be approached from both affirmative and problematic viewpoints.

Enabling capital to move to the regions where it can obtain higher rates of profit, FG has contributed to generating vigorous economic growth such as would otherwise have been impossible in these areas.

Leaving further considerations from this affirmative viewpoint to a later date, we will focus here on the problematic aspect – the instability of the world financial system as cause of the collapse of the world economy. Firstly we will take the rise of the Shadow Banking System, followed by two examples of turbulence.

3.1 The Rise of the Shadow Banking System

Gaining momentum in the 1980s, FG ingenerated the “Shadow Banking System” (SBS hereafter). The US financial system, which had so far been supervised by the FRB under the GS Act of 1933 with the purpose of keeping the speculative activities of banking business under control, began to enjoy more relaxed conditions subsequent to the above-mentioned financial liberalization, spawn-

[6] Gramm ran for Republican nomination in the 1966 presidential election. In the 2008 campaign for the Presidency he was among McCain’s principal supporters. According to a certain source, he would have been the Secretary of the Treasury if McCain had been elected as President.

[7] In October 2008 the UBS, which suffered a huge loss, not only received public money (to the tune of 6 billion Swiss francs) from the Swiss government, but also handed over the bad assets (amounting to 72 billion Swiss francs) to it.

ing a whole series of new financial institutions such as hedge funds and private equity funds, which lend themselves freely to speculative dealings without supervision by the financial authorities. Working out various kinds of securitized papers such as the MBS, the CDO and the CDS and using leverage, these institutions came to be involved in risky speculative dealings in the global financial markets. Having witnessed their surprisingly high rates of return, the commercial banks, which had been kept under control by the FRB, found their way into the SBS by means of an off-balance technique, the product being “Special Investment Vehicles” (or SIV).

Thus, as the years went by the SBS grew bigger and bigger, to such a degree that the share of conventional banking shrank ever smaller, making the world financial system increasingly unstable and volatile.

Excessive FG had often precipitated the world economy into critical conditions, and yet the world had managed to avoid any great catastrophe. Eventually, however, FG led to the Lehman-shock in September 2008, which set the world financial system as well as the world economy plunging precipitously.

The resulting situation prompts the following questions: could the rise of the SBS really have been desirable, and indeed indispensable to the development of the world economy? What justification can there be for the layered securitized papers (see below) and the financial institutions’ speculative activities free from any supervision? To what extent can the financial engineering be justified in terms of improvement and/or growth of the capitalistic system?

Leaving these questions to Section 4.2 below, here we will take two examples of economic instability as caused by excessive FG: the Asian financial crisis in 1997-1998 and the subprime loan crisis of 2008, which see the US, the EU and Japan still in search of the way out[8]

[8] As examples of serious financial crises which occurred in the US (albeit having no influence abroad), we may mention the S&L crisis (around 1990 (and the burst of the Dotcom Bubble (around 2001; Enron is emblematic there).

3.2 Two Examples

The Asian Financial Crisis — The crisis of 1997, which started in Thailand, was caused by speculative activities in hedge funds. Thailand, which adopted the dollar-pegged system, began to suffer from a sharp drop in exports because of the appreciation of the dollar (and thus of the baht). Hedge funds, seeing the opportunity for speculation, continued to sell off the baht, which finally forced the Thai Government to devalue it. The Thai economy, which had so far gone on achieving a high rate of economic growth thanks to dollars borrowed in the short term, plunged into a serious depression which abruptly increased the debt in terms of the dollar. The depression rapidly propagated to Malaysia, Indonesia and so forth.

The hedge funds' speculative activities then turned to target Russia in 1998. In 1991 the Soviet Union had disintegrated into several nations, the largest being Russia. President Yeltsin went ahead with transformation of the Russian economy into a capitalistic system at a breakneck pace – the so-called "shock-therapy method". The result turned out to be devastating, causing high inflation and severe unemployment, as well as fiscal crisis in 1997. The Russian government was forced to collect the necessary revenues through the issue of national bonds. Thus it was Russia, sunk in a very fragile and chaotic situation, that the hedge funds targeted. Russia failed to maintain the ruble, and was forced to declare default for the national bonds.

Now came the turn of a hedge fund named "Long Term Capital Management" (LTCM hereafter), which continued to buy the Russian bonds. It gloried in its two Nobel Laureates for Economics (for the "Black-Scholes Equation" determining option prices) as cofounders. Although it had only 150 employees, it gained such a high reputation due to its initial startling success that major banks from all over the world were willing to hand out blank checks. Around 1998 LTCM, a neutral-type hedge fund, came to manipulate 100 billion dollars and to take a position of 1000 billion dollars.

Due to the Russian bond default, however, LTCM suffered heavy loss. Suddenly there emerged a very real possibility that, if the LTCM were left as it was, the world would plunge into a formidable financial crisis. It was in September 1998 that the Federal Reserve Bank of New York (the then president was T. Geithner) asked the Wall Street megabanks to bail out LTCM. Thanks to this prompt action the world economy managed to avoid an impending crisis.

The Subprime Loan Crisis— This crisis erupted in September 2008. Since 2005 high interest rate mortgage loans had been made, targeting the low income earners (the so-called "subprime loans"). The financial institutions bought them up, and issued MBSs (Mortgage-Backed Securities) with them as collateral. Then new types of securities were issued one after another, mingling other loans such as car loans, credit card loans and so forth as collateral. Thus the US economy came to be filled with multi-layered securities ("securitized papers"), which were duly certified by rating agencies, such as Moody's, as definitely safe securities (80 percent of the securitized papers based on the subprime mortgage loans were ranked as AAA), and sold all over the world. The financial institutions eventually went as far as issuing subprime mortgage loans without any assessment (the so-called "Ninja Loans"), and, based on them, set about structuring layered securitized papers. Thus the negative concatenation went on. It was on the occasion of the Lehman Shock that this fragile monetary and credit structure collapsed, plunging the world economy into deep depression.

4. "Financial Liberalization" Considered

As explained above, financial liberalization proceeded with the impulsion of financial capital toward liberalization as catalyst. It was a movement led by: (i) the US commercial banks, eager to break out of the conditions imposed by the GS Act; (ii) the competition of the above banks with the US investment banks which, free from regulation, saw rapid development; (iii) the US government, which again wanted to hold the world financial market as well as the world economy in the palm of its hands.

Motivated with this impulsion, the leading actors such as Rubin, Greenspan, Summers and politicians like Gramm made great efforts to attenuate the GS through extended interpretations of Section 20 and finally succeeded in getting through the GLB Act as well as the CMF Act.

4.1 The Geopolitical Significance

Financial liberalization accorded well with the US government's desire to regain world hegemony in the economic scene. The US Administrations which had suffered miserable economic performance throughout the 1980s came to think that finance could be a key to regain and extend US influence over the world economy. The "Washington Consensus", adopted by the IMF and the World Bank, as well as the "Shock Therapy" method, adopted by the former members of the Soviet Bloc, with US economists as advisers[9], also accorded with the financial liberalization movement.

These movements, moreover, derived strong support and credibility from the intellectual authority related to Neo-Liberalism, financial engineering, and the New Classical School as well as ideologies such as Neo-Conservatism and the Christian Fundamentalism. To say nothing of these ideologies, Neo-Liberalism also took on a very authoritarian stance, quite different from its ostensible one. As the progenitor of "freedom", the Neo-Liberalists did not hesitate to interfere with foreign countries where freedom, as they conceived it, was judged to be lacking, through either the "structural adjustment program" or military operations. In this sense, Neo-Liberalism contains a sort of "Power-ism".

In terms of political dynamics, furthermore, these movements can be said to have proceeded hand in hand with Cleptocracy – the "quid pro quo" ties between financiers and the financial authorities.

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[9] The most famous, and indeed, notorious was A. Schleifer, Professor at Harvard University (his protégé is L. Summers), in the case of Russia.

4.2 The Economic Significance

What kind of economic significance will financial liberalization be seen to have?

It constitutes an extension of the markets in which the financial institutions can raise funds to have at their own disposal (where securitized papers are structured, accompanying leverage), always pursuing speculative profits by means of the funds thus obtained. Indeed, in some cases the pursuit of profit has been practiced to such a degree as to incur moral hazard.

Hedge funds have targeted weak and fragile countries, mounting speculative attacks to make huge gains with no concern for the considerable damage to the countries concerned, ascribing the defects and failures to their economic systems. In recent years these attitudes have become blatantly evident. “Finance for finance’s sake”, or speculative activities without any regard for the real economy, can be characterized as “autotelism” on the part of financial capital, far from the original role which finance should play — the role of providing the financial activities required to make the real economy grow, and making the market economy run smoothly. Thus we see the phenomenon of real economy caught up in speculative waves.

The enlargement of the SBS was also a product of the activities of governments under the leadership of the US administration, which means some divergence from the original role which each government should play — the pursuit of its own economic growth. Any government should be independent of the financial community, implementing its own policies and placing top priority on the well-being of its people. In the movement aiming at financial liberalization, in fact, various governments including the US government have gone hand in glove with the financial community at the cost of a stampede of hedge funds, the emergence of multi-layered securitized papers and a catastrophic meltdown.

5. The Financial Regulatory Reform Act

The instability of the world economy recently witnessed appears to be attributable to the enlargement of the SBS: if we are to stabilize the world economy, therefore, we need to bring it under the control of the financial authorities. This is a point recognized by the Obama Administration.

5.1 How the Story Went in the US

Obama's Financial Regulatory Reform Proposals — It was in June 2009 when President Obama made public the outline of his financial regulatory reform proposals, aiming at repeal of the GLB Act and modern-day resurrection of the GS Act.

The central pillars are: (i) enlargement of the FRB, which is to work not only as a central bank but also as an institution to oversee systemic risk; (ii) creation of the Consumer Financial Protection Agency (CFPA), to guard consumers from financial abuse and fraudulence.

Through these institutions dealings in securitized papers, financial derivatives, futures and so forth were to be on open and clear markets, while the activities of hedge funds, investment banks, rating agencies and so forth could be overseen. Thus the proposal aims at scaling down, if not abolishing, the SBS.

The Bailout and Early Recovery of the Megabanks —First and foremost, the Wall Street megabanks were rescued through bailout with huge sums of public money[10].

The story does not end here. They were soon able to make immense profits by investing gigantic volumes of money obtainable with both the FRB's zero interest rate and quantitative easing (QE) policy, in the emerging nations (such as China, Brazil and India)

[10] Funded by the TARP (the Troubled Asset Relief Program), which was hastily proposed, and was to be used in a very ambiguous way by the Bush Administration.

through the so-called “zero carry trade”. Having repaid the public money to the government, the megabanks were to start a fierce battle aiming at blocking Obama’s financial regulatory reform[11].

The Growing Perception of Unfairness— Contrastingly, in spite of the FRB’s easy-money policy, the US real economy cannot be said to have made much progress towards recovery. Major worries for the American people include, among other things, the continued high unemployment rate, the rapid increase in arrears and foreclosure due to the bust of the housing market, which has also driven many local banks into bankruptcy (the number reaching a record high since the S&L crisis in 1992). The credit crunch by the local banks, in turn, has aggravated the real economy.

The perception of unfairness has grown among the public, for the Wall Street was instantaneously bailed out (by the Bush Administration) while the Main Street has remained stagnant (in spite of the Obama Administration’s strenuous efforts).

5.2 The Dodd-Frank Act

The Process — After public announcement of Obama’s financial regulatory reform proposals in June 2009, deliberations in the two houses proceeded very slowly.

On December 11, 2009 the financial regulatory reform act (the Wall Street Reform and Consumer Protection Act) got through in the House of Representatives. However, the Senate version, which was first laid out as a discussion draft in November 2009, was to proceed along a very difficult road thereafter. Leaving the details to my other paper[12], let us here summarize the process in the Senate:

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[11] As representative of the lobbyists criticizing financial regulation, we may mention the American Bankers Association, while in support of it we have an example in the U.S. Public Interest Research Group.
[12] See Hirai (2010).

(i) In May 2010 the Dodd Act (the Restoring American Financial Stability Act) was deliberated.
(ii) The deliberations continued for three weeks. On May 21 at long last the Dodd Act was passed with some slight modifications.
(iii) The Conference Committee was then set up to unify the House and Senate versions. After a few weeks' deliberations, the committee report was adopted.
(iv) On June 30 the Dodd-Frank Act was passed in the House, while on July 15 it finally got through in the Senate.
(v) On July 21 the Act was ratified with President Obama's signature.

The Gist of the Act — The Dodd-Frank Act covers the following.

(1) The Consumer Financial Protection Agency (CFPA).
This is to be set up within the FRB, but should remain independent. The director is to be nominated by the President (this reflects some compromise between the House version and the President's view).

During the subprime boom many financial institutions made mortgage loans to people on low incomes without any serious screening. In consequence, when the bubble burst a great many people were rapidly driven into default and foreclosure. It is in order to prevent this state of affairs from recurring (that is, to prevent consumers from being cheated and forced to conclude unfair contracts) that the CFPA is to be set up.

(2) Volcker Rule
This was first advocated by P. Volcker in January 2010 and supported by Obama, and was incorporated into the Act. The rule aims at prohibiting commercial banks from dealing in so-called "proprietary trading", for it would expose the depositors' money to risk through speculative activities by the banks[13].

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[13] This September JP Morgan and Goldman Sachs decided to close the proprietary trading section, heeding the Volcker Rule.

(3) Lincoln Provision
This provision was first adopted by the Senate Agriculture Committee chaired by B. Lincoln in April 2010 and was incorporated into the Act. It aims at making derivative transactions fair and transparent by abolishing Over-the-Counter (OTC) derivatives and creating an open market[14].

(4) Establishment of a committee to prevent possible systemic risk
The committee is to be composed of nine members headed by the Secretary of the Treasury.

(5) The president of the FRB of New York is to be appointed by the US President.
The aim here is to block influences from the Wall Street.

(6) In the case of megabanks running into bankruptcy, clearing and dissolution should be carried out smoothly with the fund collected from the financial industry.

In short, the "TBTF" (Too Big To Fail) idea should be swept away. The megabanks have got used to assuming that because they are huge the government will never fail to rescue them in the event of their failure. Otherwise the economy as a whole, they think, would be exposed to serious crisis. Thus they are likely to venture upon impossible speculative activities – and all this adds up to serious moral hazard.

Challenging the TBTF, the provision aims at clearing financial institutions on the brink of failure through the self-responsibility of the financial industry rather than with taxes.

It is estimated that it will take a year and half for the Dodd-Frank Act to be implemented. Each section needs interpretation, so

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[14] Recently the yields gained by hedge funds have shown some decline. Wary of risks, investors are now tending to concentrate their resources in large funds rather than small ones.

there will be confrontation on it. Lobbying activities are very influential and might change the nature and the course of direction.

Moreover, should other countries – including the EU (with the UK) – fail to follow suit, the aim of the Dodd-Frank Act will be thwarted. For finance has been developed on the global scale, so any loopholes will remain gaping. If the US intensified regulation but other countries did not follow suit, the financial institutions would continue risky speculative activities, shifting their headquarters to the more easy-going countries.

And yet the Dodd-Frank Act should be welcomed, for this will be the only feasible and effective path which could lead to financial regulation on the global level.

Worrisome Present Situation — As of today we need to bear in mind the following facts of the US economy. Although the need to keep the activities of the financial institutions under the control of the financial authorities has been repeatedly urged since the Lehman Shock, it was not until July 21, 2010 that the Dodd-Frank Act was at long last enacted – just a few months ago. It will take another year and a half, moreover, for the Act to be effectively implemented. This means that so far virtually no regulation has been imposed on the SBS system.

The Wall Street megabanks were rescued by the government and made huge profits through the dollar carry trade: scandalously enough, these profits were then distributed among the executives who, by contrast, have shown no interest in helping get the Main Street back on its feet.

These states of affairs have infuriated the common people with the impression that all that the Administration and the FRB have done so far has been to rescue the Wall Street, while leaving them in the lurch. Such anger might appear all the more justifiable on recalling the barefaced personnel adhesion among the FRB, the Treasury and the megabanks.

The US society faces the potential risk of serious conflict between the two groups — the mega financial community and the masses.

In spite of the serious difficulties President Obama came up against, he finally succeeded in putting through the Dodd-Frank Act. This is a great achievement, although it amounts to only one step forward. The real test of its success hinges on the implementation from now on.

In this regard what is worrying is the fact that the approval rate for the Obama Administration has been sharply falling, mainly because it has not succeeded in reducing the high rate of unemployment. So at present the Republican Party is expected to win the midterm election in November. If so, the implementation of the Dodd-Frank Act will entail great difficulties. Even today the Administration has some difficulty in deciding the top-ranking posts of the new institutions to be set up by the Act. The difficulty will be much greater after the election.

6. Conclusion

We have examined financial liberalization or globalization, and the increased instability of the capitalistic system brought about by it, focusing on the USA as a center of the world economic system. We cannot imagine continuance of the capitalistic system without finance. And yet there is a danger that serious meltdowns will be repeated if the financial system is left as it is. The future of capitalism will hinge upon how the “right capitalism” can be maintained and developed, harnessing this restive horse.

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