The Era of Crisis and that International Political Economy of the 2008 Financial Crisis

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Abstract

The literature on the 2008 financial crisis often focuses on the proximate causes of the crisis. However, there were many underlying factors that appeared to contribute to the crisis. One of them was the high levels of foreign capital that entered the US economy in increasing amounts before the 2008 crisis erupted. This has even famously been addressed by former Federal Reserve chairmen Ben Bernanke as the "global savings glut" that he believes helps to explain why foreign creditors share some of the responsibility for the crisis. While this paper does not take that position, it does see the need to explore the factors that help to explain these large influxes of capital into the US economy from 2000 to 2007. Thus, this paper shall explore how the role of the dollar and the strength of US financial markets helped to contribute to the large inflows of capital that were invested in the American economy during this time. This is a phenomenon that has continued since the 2008 crisis and therefore has important and ongoing implications for the state of the international political economy.

Introduction

What is unique to this era is a global economy that depended on the United States (US) to recycle the surpluses generated by the rest of the world's economic actors. These surpluses were increasingly recycled through the US financial sector, which was able to provide greater returns as long as one could tolerate the risk of occasional financial crises. Furthermore, the surpluses increasingly became funded by debt-financed consumption that saw the levels of US household debt increase to astronomical proportions. US households were living well beyond their means because of the ability to the recycled surpluses from abroad that sustained the flow of credit from the financial sector to US households, which saw their consumption become 70 percent of the US economy before the crisis. This tremendous imbalance in the US balance of payments with the rest of the world was pointed out by former US policymakers such as Paul Volcker. It is worth quoting at length what he said before the crisis in 2005:

> What holds all together is a massive and growing flow of capital from abroad, running to more than 2 billion every working day and growing...As a nation, we don't consciously borrow or beg. We aren't even offering attractive interest rates, nor do we have to offer our creditors protection against the risk of a declining dollar...We fill our shops and garages with goods from abroad, and the competition has been a powerful restraint on our internal prices. It’s surely helped keep interest rates exceptionally low despite our vanishing savings and rapid growth. And it’s comfortable for our trading partners and for those supplying the capital. Some, such as China, depend heavily on our expanding domestic markets. And for the most part, the central banks of the merging world have been willing to hold more and more dollars, which are, after all, the closest thing the world has to a truly international currency. The difficulty is that this seemingly comfortable pattern can't go on indefinitely, I don't know of any country that has managed to consume and invest 6 percent more than it produces for long. The United States is absorbing about 80 percent of the net flow of international capital" (Varoufakis 2011: 144-145).

The process that Volcker describes is actually something he himself helped to put into place when, as the Federal Reserve Chairman, he raised interest rates to over 21 percent from 1979 to 1981. It created a huge influx of capital from abroad that has remained the norm today. Some have estimated this net inflow to be between $3 to $5 billion a day (Varoufakis 2011: 114). This is astounding and it is worth exploring further the basis of this incredible influx of capital into the US political economy before the crisis.

Literature Review

The international political economy literature on the 2008 crisis has attempted to explain in several ways why there were increasing capital flows into the US from public and private actors that occurred before the crisis occurred. International political economy scholars have attributed it to a range of different reasons: from exchange rate policies and export interests of surplus countries to recycling petrodollar surpluses to "self-insurance" purposes. The first reason is based on the dependence many export countries such as China, Brazil, Japan, India and others have on the US market to consume their goods. This has been deemed Bretton Woods II by economists such as Dooley et al. 2003; Schwartz 2009; and Hung 2008 who see the necessity of recycling surpluses by investing in US securities as a logical arrangement whereby the US can continue consuming and its trade partners can continue exporting, leading all involved to maintain their respective growth regimes. The second explanation is based on "self-insurance" interests that have grown out of the volatile and speculative capital movements that have victimized countries such as Thailand, Mexico and others who have opened up their financial system to foreign investments but experienced currencies crises from sudden capital flight. The idea behind self-insurance is to build up foreign exchange reserve in currencies such as the dollar and have them in case of sudden capital outflows that put stress on a countries' exchange rate and jeopardize its economic growth. Studies by Cohen 2008; Setser 2008; Wolf 2008; Rajan 2010; and Obstfeld et al. 2010 have provided evidence supporting this explanation around the idea of "self-insurance." The last explanation based on the recycling of petrodollars is one that has a historical base in the oil shocks of the 1970s when the large surpluses generated by Organization of Petroleum Exporting Countries (OPEC) countries were recycled through the large New York City banks (Harvey 2005; Helleiner 2009). Momani contends that many Gulf oil producing countries have tacitly traded the investment of their petrodollars into US securities for US protection in the Middle East (Momani 2008). This arrangement of capital investments for internal and external stability is not new according to Helleiner and has its roots in the Cold War with countries such as West Germany and Japan (Helleiner 2011: 79).

However, this paper seeks to build on the literature in this area regarding these large capital investments into the US by exploring other factors that have contributed to world demand for dollars and dollar denominated securities, especially from 2000 to 2007 before the crisis. This paper contends that the need for countries that do not possess oil and need to borrow to invest in the US and earn dollars is a important factor in the capital flows into the US. While this was not specific to the period before the crisis, it is a factor that should not be overlooked. In fact, many emerging market and developed countries had to pay very high prices for commodities such as oil during the period before the crisis, and the countries who could not pay had to borrow the money. This condition has led authors such as financial analyst Henry Liu to call this arrangement dollar hegemony: "Dollar hegemony...is created by the geopolitically constructed peculiarity that critical commodities, most notably oil, are denominated in dollars. Everyone accepts dollars because dollars can buy oil" (Liu 2002) Furthermore, Liu explains how this hegemony manifests itself in countries around the world to who must earn, trade in and hold dollars (Liu 2002). Another factor that was also important was the safety and high returns that US financial markets could offer. This aspect is emphasized by writers such as Peter Gown and Eric Helleiner who contend that the US is unique in this regard because of the strength and attractiveness of its financial markets (Gowan 1999; Helleiner 2009). These are factors that should be included in any analyses put forth by writers in the international political economy literature that have attempted to explain the incentives or arrangements countries have in investing their capital into the US economy. Liu's characterization of the nature of such capital investments into the US economy as exploitative also stands in contrast to the mutually beneficial characterizations that Bretton Woods II, self-insurance and petrodollar-for-protection explanations represent. Is it the case that countries or firms that are forced to trade with the US purely to earn dollars to purchase oil or to pay their debts forces means we should see these investments as a necessity that is extracted from others in a tribute-like fashion for the right to have dollars? As a result, Liu is very opposed to this monetary system and he believes that it is the reason why the US is able to absorb capital surpluses to offset its chronic deficits (Liu 2002). This paper will expand on Momani, Helleiner and Gowan's formulations of the character of the monetary regime around the dollar and how it factored into the increasing capital investments that flowed into the US before the 2008 crisis.

Before exploring the other factors, it is worth recounting the petrodollar based explanation put forth by Momani. Her arguments form the basis for understanding why capital investments in the US in any period need to be understood in terms of the demand for petrodollars. According to her, the importance of petrodollars in supporting the role of the dollar as the pre-eminent currency in the world has been "underestimated" (Momani 2008). She argues that the significance of petroleum exporters in the Middle East conducting the oil trade in dollars, and investment of petrodollars in US securities has had important consequences for the dollar and the US economy. More importantly, the need for petroleum by the world's economies has translated into a large and continued need for the dollars to purchase oil. But how did oil exporters in the Middle East, specifically OPEC, come to trade their oil in dollars? Interestingly enough, the decision by OPEC to price their petroleum in dollars goes back to 1974 according to Momani. She pinpoints negotiations between the United States and Saudi Arabia in 1974 to price and trade oil in dollars through the creation of a US-Saudi Joint Commission on Economic Cooperation between the two nations that would schedule annual meetings for managing the oil and dollars coming out of Saudi Arabia. The reason for the focus on Saudi Arabia was because they were considered the "oil marker" or the largest and most important producer in the OPEC cartel says Momani (Momani 2008). By forging an agreement with Saudi Arabia, the US effectively ensured that OPEC would continue to trade its oil in dollars. Focusing on the effects for the dollar, she says that the status of the dollar has been intimately tied to the oil trade, especially by the countries in the Gulf Cooperation Council, which include Saudi Arabia, UAE, Qatar, Oman, Kuwait and Bahrain. Momani states:

> The GCC has historically supported oil pricing in dollars and helped to reassert the strength of the dollar in the post-Bretton Woods era. Over many years, the Gulf states have accumulated large dollar-based foreign exchange reserves. They have also recycled

> their petrodollar wealth through purchasing US debt and securities, which kept the US dollar less vulnerable to fiscal and inflationary pressures (Momani 2008).

This geopolitical dimension of the dollar's role in the petroleum exports of the oil rich Persian Gulf countries is clearly emphasized by Momani as a key factor in maintaining the dollar as the top currency in the global economy. Not only has the use of oil been tied to payments in dollars but the funds generated from oil sales have also been held in dollar based investments in the United States. This not only creates demand for dollars but recycles dollars into US financial markets to be further used as loans for other needy borrowers, such as countries without oil or with large deficits. The role of dollar in the oil trade and subsequent borrowing needs in world financial markets was therefore an important part of preserving the dollar's importance along with reinforcing US financial markets where dollars can be obtained.

Why US Financial Markets?

However, Momani explanations do not assess another critical dimension of the factors that have induced countries to send large and increasing capital flows into the US before the crisis. It builds on Liu's notion of dollar hegemony by expanding it to include the role of the dollar and the role of Wall Street. This dimension that has helped to contribute to a majority of the world's capital flows being invested in the US before the crisis is what Peter Gowan calls the Dollar Wall Street Regime. He characterizes this regime as a chaotic exchange rate regime that grants enormous influence to US policymakers and Wall Street funds but generates volatile markets that force countries to depend on and invest in the US. He argues that it was this new monetary structure that arose to replace Bretton Woods during the 1970s. Gowan states that: "Under the previous system, private financial markets had been largely excluded -- banned by 'financial repression' -- from involvement in the international monetary system. Now they were to play a central role" (Gowan 1999: 23) In other words, a new monetary system based on markets determining the exchange rates of the world would bring Wall Street's dominance into the power equation. It is worth observing how Gowan goes on to explain this process:

> The strength of Wall Street as a financial centre re-enforced the dominance of the dollar. For anyone wanting to borrow or lend money, the size and strength of a financial system is a very important factor. The bigger a financial market's resources and reach, the safer it is likely to be and the more competitive its rates for borrowers are likely to be. And the same is true of securities markets (for bonds or shares). For those seeking royalties from securities a big market with very high rates of buying and selling is safer because you can easily withdraw at any time by finding a buyer for your bonds or shares. Furthermore, if you are a saver looking for high returns in more risky markets it is much better to place your funds in the hands of a big, diversified operator which can absorb losses in one area of trading and compensate the losses with gains elsewhere. Thus the size and depth of the US financial markets and the growing strength of US financial operators acts as an attraction for people to place their funds at the centre of the dollar area or to raise funds in that centre. In this way, the strength of Wall Street has reinforced the dominance of the dollar as an international currency. (Gowan 1999: 24)

As a result, this helps to better explain why the world can even send 80 percent of its capital investments into the US in the first place. It is because America's financial markets are large enough to absorb them. It is also because of the safety, liquidity and competitive rates it offers. He argues that by turning to the market to determine monetary relations, the US opened this door for its own financial markets to dominate in the global economy. The kinds of advantages in financial services that the US could offer put it at a clear advantage over other smaller and less developed financial markets. However this could only be fully tapped under a deregulated monetary system that provided a greater role for private finance such as the one that exist today. As a result, this helps to explain why the US introduced the volatile and chaotic "floating rate" monetary regime that exists today.

In addition, Gowan expands on the asymmetric power relations that existed between different world financial centers that helped to contribute to the growing influx of capital that made its way into the US before the crisis in 2008: "Talk of a global financial market rather than of the increasing influence of the American financial market over other national financial markets, obscures the power dimension of US financial dominance" (Gowan 1999: 27). Gowan goes on to argue that the financial integration that has occurred since the 1980s has been between New York and London to other financial centers around the world that has benefited Wall Street and Lombard Street the most (Gowan 1999: 27). Wall Street's size is "competitively decisive" in the competition between financial investors because it is larger and uses the dollar (Gowan 1999: 27). More importantly, countries that need to borrow to meet balance of payments deficits or to service their debts come to Wall Street:

> Wall Street offers the most competitive terms for governments wishing to borrow money for various purposes (including defending their currencies) and it offers new instruments so that governments and economic operators can tackle problems of exchange rate turbulence: not only a vastly expanding foreign exchange market but a whole new range of so called derivative markets such as forward foreign exchange derivatives, swaps of currencies, loans, etc" (Gowan 1999: 33-34).

What this means is that countries must operate in a chaotic and volatile monetary system where managing their currencies and maintaining fiscal solvency forces them to borrow and invest funds in Wall Street. But when countries borrow, it will likely be in dollars and they will likely have to come to Wall Street to do so, making them all the most dependent on US financial markets and US interest rates from the Federal Reserve (Gowan 1999: 34).

Furthermore, returning to the issue of "exchange rate turbulence", David McNally builds on Gowan's point and discusses how important addressing the currency risks for global corporations are, especially since their profits can be lost to unfavorable exchange rate movements (McNally 2011). However, on Wall Street, they can buy financial instruments that help them hedge or protect against this currency risk for a fee. This has led to tremendous growth in the currency markets, which stood at around $4 trillion during this period before the crisis. The fact that Wall Street is the best place for offering such hedging instruments makes it all the more attractive.

Having examined some of the factors in the international political economy regarding why the US is taking a majority of the world's capital flows, it is now important to look closer composition and motivation to maintain foreign holdings in dollar denominated investments that many public and privates investors had during this period before the crisis. A deeper look shows who the public and private investors were and their motivations. Among public investors, the countries with the largest reserves at the turn of the millennium included Japan and China. Japan's reserves went from just over $300 billion in 2000 to over $900 billion in 2008 (Goldberg et al. 2013: 4). Japan's investment in US assets like treasury securities went from $318 billion in 2000 to $587 billion in 2008 (Zandi 2009: 83). China's reserves went from $168.9 billion in 2000 to $1.5 trillion by 2007 (Lapavitsas 2009: 21). China's holdings of US assets such as treasury securities went from $60 billion in 2000 to $493 billion by 2008 (Zandi 2009: 83). Both countries had accumulated huge foreign exchange reserves and a very significant amount of both countries growing reserves during this period were being invested in US treasury securities: Japan had about two thirds and China had about half of their respective reserves invested in US treasuries alone. Furthermore, the total holdings of treasury securities by foreign central banks stood at $1.45 trillion in 2007, which meant that the combined holdings of Japan and China alone made up the majority of treasury investments by other central banks in 2007 (Painceira 2009: 209-10).

Aside from US treasury securities, both countries had also invested vigorously in agency debt that included but were not limited to the bonds of the government sponsored mortgage giants, Fannie Mae and Freddie Mac. In fact, foreign investment in agency debt had risen from $571 billion in 2003 to almost $1.4 trillion by 2007 (Bernanke et al. 2011: 20). Yet again, foreign central banks were a key part of the investors in this class of US debt: "a large and increasing fraction of agency debt is held by foreigners, often central banks...In fact, the largest holders of agency debt are China and Japan" (Acharya et al. 2011: 76). These countries were clearly heavily dependent on US consumption of their exports for growth. As a result, they were only interested in investing in the safest securities that the US could offer, which were treasury and agency debt. For these central banks, it was about ensuring their export-oriented growth models were maintained. But when it came to private investors, the motivations were based mainly on striving for returns.

Private investors included both foreign and US investors that were searching for better returns in the midst of the low yield environment at the time. A look at these inflows, though, shows how much capital was being wielded by these private investors. It is what author Jack Rasmus has called the "global money parade" due to how enormous it became before the crisis:

The global money parade consists of that segment of wealthy individual investors,

> institutions and corporations that commit their short-term liquid assets to speculative investing around the world, chasing and even creating financial bubbles in the process. At their disposal is perhaps as much as $20 trillion, a global pool of cash and liquid assets that shift back and forth and between various opportunities on a short-term basis, seeking projects where price escalation can deliver quick and above-historic-average investment returns...(they) may directly invest in the speculative opportunities but more often deposit their investible assets with hedge funds, Investment banks, private banks, etc., that carry out the investment on their behalf (Rasmus 2010: 216).

He estimates that the portion of this which resides outside the US is anywhere from $6 to $11 trillion and is the very epitome of "hot money" as it often resides in tax havens such as the Caymans islands, the Seychelles, Vanuatu, Bermuda, the Isle of Man, Lichtenstein, Cyprus. Luxembourg and Switzerland (Rasmus 2010: 213-214). Much of these funds made their way into the US shadow banking sector that was composed of unregulated investment entities such as hedge funds and structured investment vehicles (SIV) Apparently, many of these shadow banks that were armed with this hot money had purchased approximately $17 trillion in mortgages between 2000 and 2007 (Rasmus 2010: 232). What this means is that private capital investments in Wall Street's structured financial instruments and credit derivatives dwarfed the foreign securities holdings of governments abroad by several fold. Furthermore, they were clearly seeking returns by placing their funds in the US shadow banking sector which was not insured by the FDIC or backed by any US government guarantees. These investors were still assured greater safety by investing in US financial markets because of the size and liquidity that existed in case they need to find a buyer and exit quickly.

Conclusion

But what these capital flows also represented are a US dominated monetary regime that uses the strength of its financial markets and the dominant role of the dollar as the denominator in the oil trade to sustain the deficits, the consumption and the growth of the US political economy. This "structural privilege" has allowed the US to overcome repeated financial crises in ways that no other countries can claim to do. It has the global reserve currency and it can print it to bailout its financial system during a crises. In fact, not only do US policymakers have the ability to address financial crises at home, like in 2008, but they can frequently involve themselves in addressing crises abroad. This includes the debt crises in Latin American in the 1980s, the currency crises in Asia and Russia in the 1990s and the larger crisis that engulfed the US and Europe beginning in 2007. The US handled each crisis differently because of the political and economic dimensions differed. When US commercial banks had loans that were at risk of being defaulted on the debt crises in countries such as Mexico, the US intervened swiftly and was able to prevent, once in 1982 and again in 1995 (Panitch and Gindin 2012; Harvey

2005: 103). When capital flight and currency problems affected Thailand, Indonesia, and South Korea, the US was less swift to intervene because, according to journalist Naomi Klein, it allowed American business interests a political opportunity to force these countries to open up their economies for further investment (Klein 2007: 266). In 2008, when American and European financial institutions began to take huge losses and decline to the brink of collapse, the US took a number of massive spending measures to rescue the intertwined financial systems of the US and European political economies (Panitch and Gindin 2012; 312-316). The US ability to successfully address financial crises at home and abroad have allowed it to contain a number of catastrophic and serious crises without suffering the same consequences as other countries for it so far. As a result, the US has become the lender of last resort in a globalized economy that will continue to experience crises. As long as it can continue to bailout the world from these crashes, the era of crisis will continue.

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