Globalization and the U.S. Financial System

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Speed-of-light technology makes international investing effortless.

Globalization helped fuel the current financial crisis, and it will undoubtedly be employed to help resolve it.

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In the decades following World War II, the idea of globalization became more and more popular when describing the future of the world economy. Some day, markets for all sorts of goods and services would become integrated and the benefits would be clear. The standard of living would be raised everywhere as barriers to trade, production, and capital fell. The goal was noteworthy and has been partially realized. But recently it hit a major bump in the road.

Globalization has many connotations. Originally, it meant international ease of access. Barriers to trade and investment eventually would disappear, and the international flow of goods and services would increase. Free trade and common markets were created to facilitate the idea. A world without barriers would help distribute wealth more evenly from the wealthy to the poor.

To date, only financial services have succeeded in becoming truly global. Fast-moving financial markets, aided by speed-of-light technology, have swept away national boundaries in many cases, making international investing effortless. Government restrictions have been removed in most of the major financial centers, and foreigners have been encouraged to invest. This has opened a wide panorama of investment possibilities.

This phenomenon is not new. Since World War II, many governments have loosened restrictions on their currencies, and today the foreign exchange market is the world's largest, most liquid financial market, trading around the clock. And there is no distinction made in it because of those national peculiarities or restrictions for

the major currencies. If governments allow their currencies to trade freely, as most in developed countries, then a dollar or a euro can trade in Hong Kong or Tokyo as easily as it does in Dubai or New York.

Cross-Border Trading

Other financial markets quickly followed this precedent. The government bond markets, corporate bond markets, and the equities markets all started to develop links based on new and faster technology. Forty years ago, Gordon Moore, one of the founders of software giant Intel, made his famous prediction (Moore's Law) that microchip capacity would double every two years. New, faster chips were able to accommodate an increasing number of financial transactions, and before long that capacity spawned even more transactions. Soon, traders were able to cross markets and national boundaries with an ease that made the supporters of globalization in other sections of the economy jealous. During the same time period, manufacturers had been promoting the idea of the universal car, without the same level of success.

Wall Street and the other major financial centers prospered. Customers were able to obtain executions for their stock trades with a speed unimaginable in the mid-1990s. The NYSE (New York Stock Exchange) and the NASDAQ (National Association of Securities Dealers Automated Quotations) abandoned their old method of quoting stock prices in fractions and adopted the decimal system. Computers did not like fractions, nor did the old method encourage trading at the speed of light. Customers were now able to trade via computer in many major markets as quickly as in their own home markets. True cross-border trading was born, making financial services the envy of other industries that long had dreamed of globalization.

The results were astonishing. Volume on the NYSE increased from a record 2 billion shares in 2001 to a record 8 billion in 2008. Volume on the foreign exchange markets was in the trillion-dollar equivalents on a daily basis. The various bond markets were issuing more than a trillion worth of new issues annually rather than the billions recorded in previous record years. The value of mergers and acquisitions equally ran into the trillions annually. The volumes and the appetite for transactions appeared endless.

A Traditional Cycle

The U.S. economy traditionally had witnessed long periods of prosperity before slowing down substantially, usually brought to a temporary halt by an asset bubble that finally ran out of hot air. The situation had been replayed many times since 1793, when the first major economic downturn was recorded in New York. Similar problems were recorded at least eight times until 1929. Each boom was followed by a bust, some more severe than others. The post-1929 depression finally ushered in far-reaching reforms of the banking system and securities markets.

Until 1929, these recessions were called "panics." The term "depression" was used once or twice in the early 20th century, but during the 1930s the term became associated exclusively with that decade. The traditional cycle is still in evidence. The recession of 2001 followed the dot-com bust, and many of the day traders who had employed the new computer technology retreated to the sidelines much as their forebears had done in the 19th century. A recession followed, temporarily slowing down the appetite for speculative gains.

The 19th and the 21st centuries had more in common than might have been imagined. After gaining its independence from Britain, the United States had been dependent on foreign capital for the first 120 years of its existence. Until World War I, much of the American infrastructure and industry had been financed with foreign money, mostly in the form of bonds. Americans produced most of the goods and services they needed, but capital was always in short supply until the war changed the face of geopolitics.

The situation remained unchanged until the late 1970s, when the position again was reversed. The U.S. household savings ratio declined and foreign capital poured into the country. Bonds were the favorite again, but the equities markets also benefitted substantially. Consumers, accounting for about two-thirds of the U.S. gross domestic product since the 1920s, bought domestic and foreign goods, while foreigners supplied the capital necessary to finance the federal government and many American industries. The situation persists today, with about half the outstanding U.S. Treasury bonds in the hands of the Chinese government alone.

The housing boom in the Silicon Valley, California, before the dot-com asset bubble presaged the mortgage crisis of 2008.

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the idea that everyone should own his or her own home.

Demand for the securitized bonds proved strong, so strong that Wall Street securities houses began cranking them out at increasingly fast speed. Much of the demand came from foreign investors — central banks, banks, sovereign wealth funds, and insurance companies — all drawn by their attractive yields. Dollars were being recycled by these investors, especially central banks and the sovereign wealth funds, from the current account balances they were accumulating with the United States. The money left the United States as Americans purchased imports from foreign producers and found its way back as investments.

The Mortgage Boom

After the dot-com bust and the Enron and WorldCom scandals, it appeared that Wall Street was due to take a breather for lack of new ideas to fuel another bubble. But it was a combination of cyclical trends that reappeared and together fueled the greatest short-term boom yet. Globalization, an influx of foreign capital, and esoteric financial analytics combined with residential housing to produce the most explosive — and potentially destructive — boom/bust cycle ever witnessed in American history.

The recent market bubble was created by the boom in residential housing. Normally, housing follows stock market booms but has not caused them. In the wake of the dot-com bust and the post-September 11 trauma, the situation became reversed. The home became the center of many investors' attention. First-time buyers abounded, and many others clamored to refinance their existing mortgages. The new thing was really an older thing dressed up by modern finance.

This phenomenon was difficult to detect in its early stages. All of the factors that converged to produce it had been seen before. Many were well-known and time-proven methods in finance. Securitization had been used for several decades by the U.S.-related housing finance agencies to convert pools of residential mortgages into securities that were purchased by investors. This provided even more available funds for the housing market at a time that demand was very high after 2001. The new thing on Wall Street became financing the "American Dream" —

Victims of Their Own Success

The mortgage boom began after 2001, and within a couple of years it was in full stride. Demand remained strong for mortgage-backed securities, and soon subprime mortgages, credit default swaps, and other exotic collateral based on derivatives became part of the asset backing. By the late summer of 2007, as short-term interest rates rose from historically low levels, cracks began to appear in this collateral and asset values began to collapse, creating the banking and insurance crises within months. In the past, without the technology, the results would have taken years.

The boom was aided immeasurably by the deregulation of the U.S. financial markets in 1999, officially culminating over two decades of a gradual easing of once stringent rules. The new financial environment it created allowed banks and investment banks to cohabit, something that had not been allowed since 1933. When they began to share the benefits of deregulation under the same roof, older ideas of risk management began to crumble in a greater quest for profit.

The credit market and collateral crisis marks the end of the almost 40-year legacy of the federally related housing agencies and all of the benefits they provided since the social legislation passed during the 1960s. Wall Street, the credit markets, and the U.S. housing industry all were victims of their own success when the markets

collapsed in 2008. Greed, lack of regulatory oversight, and the sophistication of structured finance, which created many of these exotic financial instruments, all played a role in the most recent setback for the markets and the economy as a whole.

Most importantly, the crisis demonstrates the pitfalls of deregulation and globalization. Unfortunately, the appropriate skepticism that must accompany every boom has been missing. Globalization helped fuel the crisis and will undoubtedly be employed to help resolve it. Deregulation will be swept aside in favor of more stringent institutional controls on financial institutions designed to prevent fraud and deceit. It took almost four years after the market crash of 1929 to erect a regulatory structure to separate different types of banks and establish national securities laws. Moore's Law suggests that it will occur faster this time around. The forces that shaped globalization will demand it. ■

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BROOKLYN DAILY EAGLE

WALL ST. IN PANIC AS STOCKS CRASH

Attempt Made to Kill Italy's Crown Prince

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Newspaper headline from the stock market crash of 1929.