# Finance and Power

By JAMES G. LACEY and DAVID L. ASHER

A critical challenge for the new administration will be to reassert American leadership in the international economy and rebuild America's financial health. Economic strength has underpinned the national power and influence of every state in history. Economic strength, in turn, is driven by a strong financial system capable of raising large amounts of capital and efficiently deploying it. No nation has long maintained its strategic or military dominance after it has ceased to be the world's foremost financial center. If a nation allows its financial system to weaken, it undermines its economic strength, and by extension its ability to project its power and influence into the larger world.[1]

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Wars put heavy stress on financial markets and fiscal resources and also put national prestige at risk. Great Britain learned this lesson going into World War II: when combined with economic depression, systemic fiscal and financial frailty, and a decline in the global power of one's currency, war can become a mile marker for hegemonic decline even in victory.

To some extent, the costs of the conflicts in Iraq and Afghanistan also weigh down U.S. prospects for a quick economic recovery. Although the upfront costs of those wars and related military responses following 9/11 are far less than those of World War I, World War II, or the Vietnam War, they are still considerable, amounting to $859 billion thus far (or roughly 6 percent of GDP).[2] The price tag for rebuilding America's military forces in the wake of this conflict will add greatly to this figure.

In 1992, Clinton administration advisor James Carville said that in his next life, he wanted to come back as the bond market so he could scare everyone. His comment, although framed as a joke, was a stark admission that finance was already driving U.S. policy and that no major decision could be made without taking the reaction of the bond market into account. When Carville made his comment, global financial assets, including the market for U.S. Government debt, totaled about $42 trillion, and the combined GDP of the world was $21 trillion. If these huge numbers worried Carville in 1992, he would likely be panic-stricken to face a world where financial assets are now over $167 trillion with a global GDP of $48 trillion. These numbers represent not only huge growth in a short time, but also a divergence of the financial market from the underlying real economy.

When Ronald Reagan assumed the Presidency, global GDP and financial assets were relatively equal. By the time Bill Clinton became President, the ratio of financial assets to GDP was 2:1, and by 2008 it was closing in on 4:1. How the United States adjusts to this rapidly changing and little understood world of global finance will determine its strategic influence in the 21st century.

Unfortunately, for at least the past decade, the United States has set itself squarely on the path of wrecking the financial system that has maintained its global prominence for the past seven decades or more. Drastic action is now required to change course in time, for once economic rot sets in, it is historically very difficult to reverse. If the United States is to have any chance of doing so, policymakers must first understand how the global financial system works and how much it has changed since Carville first voiced his trepidation about the bond market.

A number of measures reveal that America's leadership position in the international economy has gone through a remarkable period of decline over the last decade. This is best reflected by the value of the dollar, which since 2001 has depreciated by 56 percent against the euro, 30 percent against the Canadian dollar, 24 percent against the British pound, and 4 percent against the Japanese yen. Remarkably, although the trade-weighted value of the dollar against all currencies declined by over 23 percent since 2001—which should have given U.S. exporters a large competitive boost—the U.S. trade deficit nearly doubled before exports began to rise in 2008.

Likewise, the cheapening dollar is becoming progressively less attractive as a store of value for other central banks. Markets are already adjusting to the fact that a weakening dollar is being increasingly replaced as a reserve currency by a strengthening euro (see figure 1). Since the turn of the decade, reserve holdings of the dollar have fallen approximately 8 percent, while euro holdings have risen in rough proportion. Although the dollar remains the chief currency for global trade finance, this leading status has come under stress (see figure 2). Presently, the United States accounts for only 26 percent of world trade, while 56 percent of global commerce is dollar-based. This strategic advantage could dissipate if confidence in the dollar's reliability as a storehouse of value slips further. As economist Barry Eichengreen notes, "Never before have we seen the extraordinary situation where the country issuing the international currency is running a current account deficit of 6 percent of GDP. Never before have we seen the reserve currency country so deeply in debt to the rest of the world."[3] By 2008, that ratio had fallen to 5 percent, but unless these trends are more

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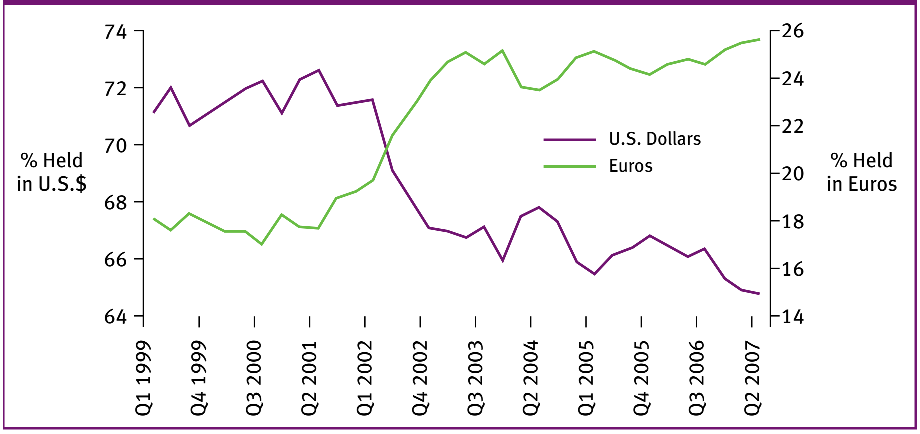
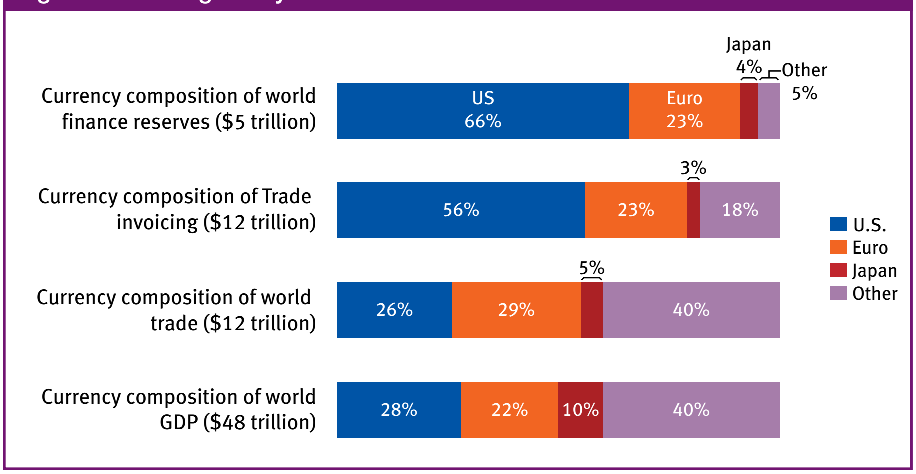
Figure 1. Currency Composition of Global Foreign Exchange Reserves (%)



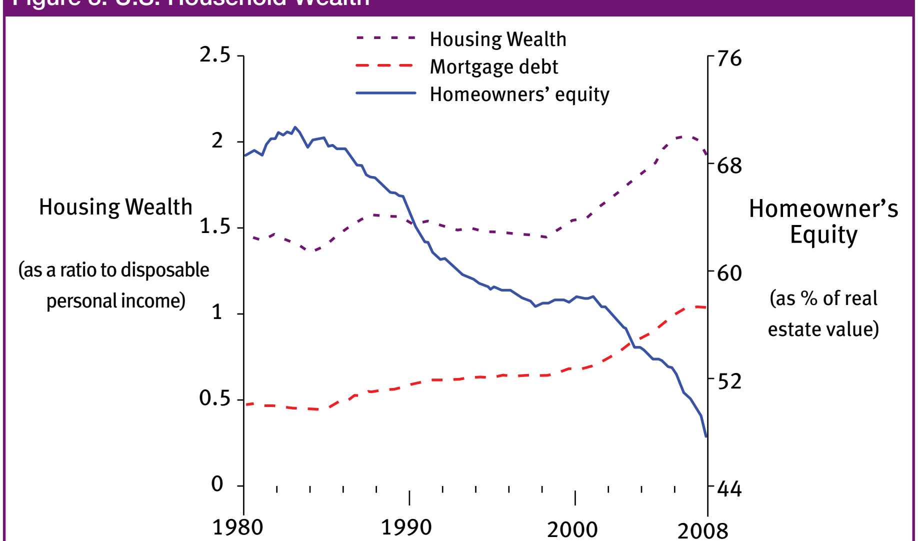

*Source:* London: Independent Strategy

Figure 2. The Hegemony of the Dollar




*Source:* London: Independent Strategy

Figure 3. U.S. Household Wealth




*Source:* International Monetary Fund/Haver Analytics

substantially reversed, the dollar's dominant position in global trade will rapidly erode.

Making matters considerably more challenging, America's financial system and private finances have entered their darkest period in decades. In the last decade, Americans became more financially leveraged than at any time since World War II. Before the housing bubble burst in 2007, consumer and business debt had jumped by nearly 50 percent—twice the run-up experienced in the 1980s (see figure 3). Household mortgage debt accounted for the largest percentage of total private debt by far (see figure 4). In turn, the ready availability of subprime and adjustable rate mortgage financing drove a major increase in home ownership and sent property values skyrocketing. Consumers substituted these rising home values for savings, which at both the national and household levels are at 75-year lows. The ability to cash out home equity also drove a personal consumption binge of historical proportions (see figure 5). Even as the national savings rate turned negative, consumption accounted for ever greater amounts of GDP (over 71 percent in 2008). Consumption as a percentage of GDP is now 4 percent over its 25-year average, far higher than at any other point in American history.

In June 2007, the housing bubble burst. In the next 15 months, home prices fell by 7 percent nationally—the first sustained decline since the Great Depression. The housing crisis, in turn, triggered a string of bank failures. The first casualties were the large regional bank Indy Mac and the famed investment bank Bear Stearns. Unfortunately, in succeeding months, the Treasury and Federal Reserve still failed to get ahead of a crisis they hardly understood. Two U.S. Government–sanctioned institutions, Freddie Mac and Fannie Mae, saw their capital wiped out and had to be nationalized at a cost to the taxpayer initially estimated at over $200 billion.

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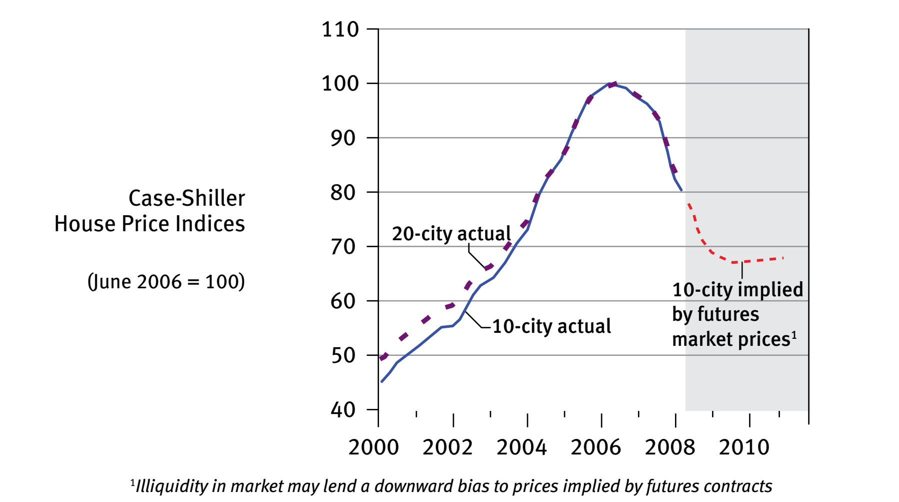
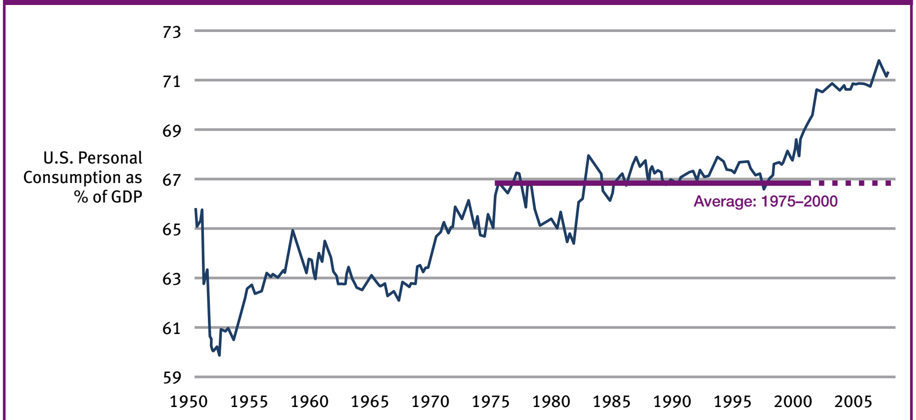
Even those steps did not stem the tide. In September 2008, two more large investment banks vanished, and the world's largest insurance company was taken over by the Government. The details of the largest government-led market intervention in history were recently hammered out with Congress. As a

Figure 4. U.S. Housing Prices




*Source*: International Monetary Fund/Haver Analytics

Figure 5. The U.S. Consumption Binge




*Source*: Morgan Stanley Research

result of these negotiations, the U.S. Government initially announced that it would begin recapitalizing the banking system through a combination of direct capital injections ($250 billion) and purchase of certain financial instruments ($450 billion) currently sitting in banks' books in order to set a price floor under the debt market.

In April 2008, the IMF estimated that the total cost of the U.S. subprime crisis could amount to over $1 trillion, but it is now clear that this was a lowball estimate. Worse still, the subprime blowout is buffeting other financial markets: the Standard & Poor 500 index fell to levels last seen in January 2001.

The U.S. Government can continue to backstop the market without imperiling its fiscal position, as a debt-to-GDP ratio of under 70 percent still gives financial officials some room to maneuver. It will become increasingly difficult, however, for the Government to absorb the costs of the largest financial bailout in history while dealing with slipping tax revenues, slower economic growth, and increasing public sector imbalances. It should be remembered that Japan went from having the best fiscal position in the Group of Seven (G–7) in 1990 to the worst in 2000, because, in response to its own financial and banking crisis, it mismanaged and delayed writeoffs and selloffs. Combined with the long-term funding challenges of entitlement programs such as Social Security and Medicare, the United States may be laying the groundwork for the emergence of an even worse financial crisis.

The implications of America's financial distress for the world economy are considerable, not simply because of the role that U.S. consumers play in driving global growth, but also because the entire global financial system has become leveraged to the U.S. household sector. This situation arose largely as a result of the explosive growth in financial instruments linked or leveraged to U.S. property markets, which were marketed heavily to foreign investors by U.S. investment banks. There were myriad strategies that offered apparently low risks and high returns (but in hindsight had high risk and potentially no positive return). These included "structured investment vehicles" that many banks used as a way to earn money off their balance sheet, arbitraging their ability to plow low-cost, short-term capital into longer dated and high-yielding asset-backed securities. These worked until the market for asset-backed securities imploded.

Another supposedly low-risk investment class was in collateralized debt obligations (CDOs), instruments issued by investment banks and backed by U.S. subprime loans, mortgage-backed securities, commercial mortgages, debt financing, and leveraged buyouts. Pools of CDOs were packaged into super-leveraged instruments called "CDO squared" or even "CDO cubed." Incredibly, these CDOs were given AAA ratings by the rating agencies, which implied almost no probability of default, because investors in CDOs had taken out insurance with bond insurers. Ironically, investors would learn, when it was too late to change anything, that these insurers had inadequate capital to cover a default and would head toward bankruptcy themselves. Chasing these Ponzi-like schemes were pension funds, banks, insurance companies, and other supposedly smart institutional investors that bought into the assumption that financial risk could be largely engineered away. Many of these investors came to realize gigantic losses. Investment banks such as Citigroup, Bear Stearns, and Merrill Lynch that were involved in selling CDOs also got clobbered. With the market for selling CDOs gone, Merrill Lynch decided in July 2008 to liquidate its mammoth unsold inventory of CDOs at 20 cents on the dollar.

The financial crisis of 2008 revealed that perhaps the fastest growing segment in the rapidly expanding derivatives universe was also its most dangerous: credit default swaps. In simple terms, they are a type of insurance policy contracted between two parties, whereby one guarantees a payment to the other in the event of a default, in exchange for an insurance premium paid along the way. The Bank for International Settlements estimated that, as of the end of 2007, there was over $57.8 trillion in credit default swaps outstanding—a fourfold increase over the level at the end of December 2005.[4] Large financial firms such as the now-defunct Lehman Brothers and Bear Stearns issued massive amounts of these swaps to cover their myriad risks. Among the biggest buyers of these default swaps were the banks and insurance companies, which also had snapped up the aforementioned CDOs. The net result was that when Lehman and Bear collapsed, already beleaguered banks and insurers were left holding the bag, with an expected payout on the failure of Lehman's credit default swaps alone of over $365 billion.[5]

*the U.S. housing finance bubble propelled asymmetric growth in the market value of derivatives contracts globally*

In summary, the U.S. housing finance bubble propelled asymmetric growth in the market value of derivatives contracts globally, which rose from $382 trillion in June 2004 to $684 trillion in June 2007—a jump of 135 percent.[6] Today, the notional value of the derivatives market adds up to 1,000 percent of world GDP—a tenfold increase since 1990.[7] In Berkshire Hathaway's annual report to shareholders in 2002, Warren Buffett pointedly described derivatives as "financial weapons of mass destruction." He further commented:

> *Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses—often huge in amount—in their current earnings statements without so much as a penny changing hands. The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen).*[8]

As a result of the derivatives boom, financial distress in the U.S. household and banking sectors has been magnified globally, adding to the stresses facing European and Asian economies. The potential unwinding of the globalization of financial leverage threatens the success of economic globalization itself.

At risk is the almost century-long U.S. primacy as the world's foremost financial power. If that primacy declines, economic growth will slow as capital becomes more costly and harder to obtain. Furthermore, as Cicero pointed out 2,000 years ago, the key to success in war is "endless streams of money." That remains true today. If raising capital in vast amounts becomes harder, America's ability to finance the military forces it requires in the future will be more difficult.

The United States has always snapped back following times of economic doubt and apparent decline. The stagflation and stagnation of the 1970s produced in the wake of the Vietnam War, the 1973 oil shock, and the decisive break with the fixed exchange rate system were followed by the economic boom of the 1980s and victory in the Cold War. There is no reason to believe that recovery should be any different in the coming decade. But understanding the scope of the problems—and devising and implementing a strategy to solve them—will be imperative.

Noted economic historian Charles Kindleberger observed that nations that have turned back negative economic tides and emerged stronger from moments of seeming decline are those that possess flexibility and adaptability, rather than passivity and rigidity.[9] Americans are known for being flexible and adaptive. Unfortunately, however, the scale and scope of America's global economic and financial challenges are considerable, and they will defy any easy or rapid solution. **JFQ**

## NOTES

[1] An efficient financial system can make up for a number of other strategic deficiencies. For instance, France, during the Napoleonic era, was more populous and had a far larger economy than Great Britain. Throughout the Napoleonic Wars, however, Britain consistently raised more capital than France—cash that William Pitt used to fight a global war, while also subsidizing most of Britain's continental allies. It stands to reason that the opposite—that weak financial institutions undermine a nation's strengths—is also true.

[2] With enactment of the Fiscal Year (FY) 2008 Supplemental and FY2009 Bridge Fund (H.R.2642/P.L. 110–252) on June 30, 2008, Congress approved about $859 billion for military operations, base security, reconstruction, foreign aid, Embassy costs, and veterans' health care for the three operations initiated since the 9/11 attacks: Operation *Enduring Freedom* (OEF), for counterterror operations in Afghanistan and elsewhere; Operation *Noble Eagle*, to provide enhanced security at military bases; and Operation *Iraqi Freedom*. This $859 billion total covers all war-related appropriations from FY2001 through part of FY2009 in supplemental appropriations, regular appropriations, and continuing resolutions. Of that total, the Congressional Research Service (CRS) estimates that Iraq will receive about $653 billion (76 percent), OEF about $172 billion (20 percent), and enhanced base security about $28 billion (3 percent), with about $5 billion that CRS cannot allocate (1 percent). About 94 percent of the funds are for DOD, 6 percent for foreign aid programs and Embassy operations, and less than 1 percent for medical care for veterans. As of April 2008, DOD's monthly obligations for contracts and pay averaged about $12.1 billion, including $9.8 billion for Iraq and $2.3 billion for Afghanistan. See Amy Belasco, *The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11*, CRS Report RL33110 (Washington, DC: CRS, July 14, 2008).

[3] Barry Eichengreen, "Is the Dollar About to Lose its International Role?" April 14, 2005, available at <www.econ.berkeley.edu/~eichengr/reviews/handelsblatt5apr29-05.pdf>.

[4] See Statistical Annex to Bank for International Settlements Quarterly Review, September 2008, 103, available at <www.bis.org/publ/qtrpdf/r_qa0809.pdf>.

[5] Heather Landy, "Lehman Credit-Default Swap Payout Could Climb as High as $365 Billion," *The Washington Post*, October 11, 2008, D3.

[6] Bank for International Settlements, "Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007—Final Results," December 19, 2007, available at <www.bis.org/press/p071219.htm>.

[7] "The New Monetarism and the Credit Crunch," October 20, 2007, Independent Strategy, London.

[8] Berkshire Hathaway, Inc., 2002 Annual Report, available at <www.berkshirehathaway.com/2002ar/2002ar.pdf>.

[9] Charles Kindleberger, *World Economic Primacy, 1500–1900* (Oxford: Oxford University Press, 1996), 36.