Predatory Finance: The New Mode of Global Warfare

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> "Coming events cast their shadows forward." – Goethe

What is to stop U.S. banks and their customers from creating $1 trillion, $10 trillion or even $50 trillion on their computer keyboards to buy up all the bonds and stocks in the world, along with all the land and other assets for sale, in the hope of making capital gains and pocketing the arbitrage spreads by debt leveraging at less than 1% interest cost? This is the game that is being played today. The outflow of dollar credit into foreign markets in pursuit of this strategy has bid up asset prices and foreign currencies, enabling speculators to pay off their U.S. positions in cheaper dollars, keeping for themselves the currency shift as well as the arbitrage interest-rate margin.

Finance has become the new mode of warfare – without the expense of military overhead and an occupation against unwilling hosts. It is a competition in credit creation to buy global real estate and natural resources, infrastructure, bonds and corporate stock ownership. Who needs an army when you can obtain monetary wealth and asset appropriation simply by financial means? Victory promises to go to the economy whose banking system can create the most credit, using an army of computer keyboards to appropriate the world's resources.

The main hurdle confronting this financial Lebensraum drive is that it requires the central banks of targeted economies to accept electronic dollar credit of depreciating international worth in payment for national assets. U.S. officials demonize countries suffering these dollar inflows as aggressive "currency manipulators" for what Treasury Secretary Tim Geithner calls "'competitive nonappreciation,' in which countries block their currencies from rising in value." Oscar Wilde would have struggled to find a more convoluted term for other countries protecting themselves from raiders trying to force up their currencies to make enormous predatory fortunes. "Competitive nonappreciation" sounds like "conspiratorial non-suicide." These countries simply are trying to protect their currencies from arbitrageurs and speculators flooding their financial markets with dollars, sweeping their currencies up and down to extract billions of dollars from their central banks.

Their central banks are being forced to choose between passively letting these inflows push up their exchange rates – thereby pricing their exports out of foreign markets – or recycling these inflows into U.S. Treasury bills yielding only 1% with declining exchange value. (Longer-term bonds risk a price decline if U.S interest rates should rise.)

The euphemism for flooding economies with credit is "quantitative easing." The Federal Reserve is pumping a tidal wave of liquidity and reserves into the financial system to reduce interest rates, ostensibly to enable banks to "earn their way" out of negative equity resulting from the bad loans made during the real estate bubble. This liquidity is spilling over to foreign economies, increasing their exchange rates. Joseph Stiglitz recently acknowledged that instead of helping the global recovery, the "flood of liquidity" from the Fed and the European Central Bank is causing "chaos" in foreign exchange markets. "The irony is that the Fed is creating all this liquidity with the hope that it will revive the American economy. … It's doing nothing for the American economy, but it's causing chaos over the rest of the world."

What U.S. quantitative easing is achieving is to drive the dollar down and other currencies up, much to the applause of currency speculators enjoying quick and easy gains. Yet it is to defend this system that U.S. diplomats and bank lobbyists are threatening to derail the international financial system and plunge world trade into anarchy if other countries do not agree to a replay of the 1985 Plaza Accord "as a possible framework for engineering an orderly decline in the dollar and avoiding potentially destabilizing trade fights."

The Plaza Accord derailed Japan's economy by raising its exchange rate while lowering interest rates, flooding its economy with enough credit to inflate a real estate bubble. IMF managing director Dominique Strauss-Kahn was more realistic. "I'm not sure the mood is to have a new Plaza or Louvre accord," he said at a press briefing on the eve of the IMF meetings in Washington. "We are in a different time today." Acknowledging the need for "some element of capital controls [to] be put in place," he added that in view of U.S. insistence on open, unprotected capital markets, "The idea that there is an absolute need in a globalised world to work together may lose some steam."

At issue is how long nations will succumb to the speculative dollar glut. The world is being forced to choose between subordination to U.S. economic nationalism or an interim of financial anarchy. Nations are responding by seeking to create an alternative international financial system, risking an anarchic transition period in order to create a fairer world economy.

Re-inflating the financial bubble rather than writing down debts

The global financial system already has seen one long and unsuccessful experiment in quantitative easing in Japan's carry trade. After its financial and property bubble burst in 1990, the Bank of Japan sought to enable its banks to "earn their way out of negative equity" by supplying them with low-interest credit for them to lend out. Japan's recession left little demand at home, so its banks developed the carry trade: lending at a low interest rate to arbitrageurs to buy higher-yielding securities. Iceland, for example, was paying 15%. So yen were borrowed to convert into dollars, euros, Icelandic kroner and Chinese renminbi to buy government bonds, private-sector bonds, stocks, currency options and other financial intermediation. Not much of this funding was used to finance new capital formation. It was purely financial in character – extractive, not productive.

By 2006 the United States and Europe were experiencing a financial and real estate bubble of its own. And after it burst in 2008, they did what Japan's banks did after 1990. Seeking to help U.S. banks work their way out of negative equity, the Federal Reserve flooded the economy with credit. The aim was to provide more liquidity, in the hope that banks would lend more to domestic borrowers. The economy would "borrow its way out of debt," re-inflating asset prices for real estate, stocks and bonds so as to deter home foreclosures and the ensuing wipeout of collateral on bank balance sheets.

Quantitative easing subsidizes U.S. capital flight, pushing up non-dollar currency exchange rates

Quantitative easing may not have set out to disrupt the global trade and financial system or start a round of currency speculation, but that is the result of the Fed's decision in 2008 to keep unpayably high debts from defaulting by re-inflating U.S. real estate and financial markets. The aim is to pull home ownership out of negative equity, rescuing the banking system's balance sheets and thus saving the government from having to indulge in a TARP II, which looks politically impossible given the mood of most Americans.

The announced objective is not materializing. Instead of increasing their loans against U.S. real estate, consumers or businesses, banks are still reducing their exposure. This is why the U.S. savings rate is jumping. The "saving" that is reported (up from zero to 3% of GDP) is taking the form of paying down debts taken out in the past, not building up liquid funds. Just as hoarding diverts revenue away from being spent on goods and services, so debt repayment shrinks spendable income. Why then would banks lend more under conditions where a third of U.S. homes already are in negative equity and the economy is shrinking as a result of debt deflation?

Mr. Bernanke proposes to solve this problem by injecting another $1 trillion of liquidity over the coming year, on top of the $2 trillion in new Federal Reserve credit already created during 2009-10. This quantitative easing has been sent abroad, mainly to the BRIC countries: Brazil, Russia, India and China. "Recent research at the International Monetary Fund has shown conclusively that G4 monetary easing has in the past transferred itself almost completely to the emerging economies … since 1995, the stance of monetary policy in Asia has been almost entirely determined by the monetary stance of the G4 – the US, eurozone, Japan and China – led by the Fed." According to the IMF, "equity prices in Asia and Latin America generally rise when excess liquidity is transferred from the G4 to the emerging economies." This is what has led gold prices to surge and investors to move out of the dollar since early September, prompting other nations to protect their economies.

Speculative credit from U.S., Japanese and British banks to buy bonds, stocks and currencies in the BRIC and Third World countries is a self-feeding expansion, pushing up their currencies as well as their asset prices. Their central banks end up with these dollars, whose value falls as measured in their own local currencies. U.S. officials say that this is all part of the free market. "It is not good for the world for the burden of solving this broader problem … to rest on the shoulders of the United States," insisted Treasury Secretary Tim Geithner on Wednesday, as if the spillover from U.S. quantitative easing and deregulation was not promoting the speculative dollar glut.

So other countries are obliged to solve the problem on their own. Japan is holding down its exchange rate by selling yen and buying U.S. Treasury bonds in the face of its carry trade being unwound as arbitrageurs pay back the yen they earlier borrowed to buy higher-yielding but increasingly risky sovereign debt from countries such as Greece. These paybacks have pushed up the yen's exchange rate by 12% against the dollar so far during 2010, prompting Bank of Japan governor Masaaki Shirakawa to announce on Tuesday, October 5, that Japan had "no choice" but to "spend 5 trillion yen ($60 billion) to buy government bonds, corporate IOUs, real-estate investment trust funds and exchange-traded funds – the latter two a departure from past practice."

This "sterilization" of unwanted inflows is what the United States has criticized China for doing. China has tried more normal ways to recycle its trade surplus, by seeking out U.S. companies to buy. But Congress would not let CNOOC buy into U.S. oil refinery capacity a few years ago, and the Canadian government is now being urged to block China's attempt to purchase its potash resources. Such protectionism leaves little option for China and other countries except to hold their currencies stable by purchasing U.S. and European government bonds.

The problem for all countries today is that as presently structured, the global financial system rewards speculation and makes it difficult for central banks to maintain stability without recycling dollar inflows to the U.S. Government, which enjoys a near monopoly in providing the world's central bank reserves by running budget and balance-of-payments deficits. As noted earlier, arbitrageurs obtain a twofold gain: the margin between Brazil's nearly 12% yield on its long-term government bonds and the cost of U.S. credit (1%), plus the foreign-exchange gain resulting from the fact that the outflow from dollars into reals has pushed up the real's exchange rate some 30% – from R$2.50 at the start of 2009 to R$1.75 last week. Taking into account the ability to leverage $1 million of one's own equity investment to buy $100 million of foreign securities, the rate of return is 3000% since January 2009.

Brazil has been more a victim than a beneficiary of what is euphemized as a "capital inflow." The inflow of foreign money has pushed up the real by 4% in just over a month (from September 1 through early October), and the past year's run-up has eroded the competitiveness of Brazilian exports. To deter the currency's rise, the government imposed a 4% tax on foreign purchases of its bonds on October 4. "It's not only a currency war," Finance Minister Guido Mantega explained. "It tends to become a trade war and this is our concern." Thailand's central bank director Wongwatoo Potirat warned that his country was considering similar taxes and currency trade restrictions to stem the baht's rise. Subir Gokarn, deputy governor of the Reserve Bank of India, announced that his country also was reviewing defenses against the "potential threat" of inward capital flows."

Such inflows do not provide capital for tangible investment. They are predatory, and cause currency fluctuation that disrupts trade patterns while creating enormous trading profits for large financial institutions and their customers. Yet most discussions treat the balance of payments and exchange rates as if they were determined purely by commodity trade and "purchasing power parity," not by the financial flows and military spending that actually dominate the balance of payments. The reality is that today's financial interregnum – anarchic "free" markets prior to countries hurriedly putting up their own monetary defenses – provides the arbitrage opportunity of the century. This is what bank lobbyists have been pressing for. It has little to do with the welfare of workers in their own country.

The potentially largest speculative prize promises to be an upward revaluation of China's renminbi. The House Ways and Means Committee is demanding that China raise its exchange rate by the 20 percent that the Treasury and Federal Reserve are suggesting. Revaluation of this magnitude would enable speculators to put down 1% equity – say, $1 million to borrow $99 million – and buy Chinese renminbi forward. The revaluation being demanded would produce a 2000% profit of $20 million by turning the $100 million bet (and just $1 million "serious money") into $120 million. Banks can trade on much larger, nearly infinitely leveraged margins, much like drawing up CDO swaps and other derivative plays.

This kind of money has been made by speculating on Brazilian, Indian and Chinese securities and those of other countries whose exchange rates have been forced up by credit-flight out of the dollar, which has fallen by 7% against a basket of currencies since early September when the Federal Reserve floated the prospect of quantitative easing. During the week leading up to the IMF meetings in Washington, the Thai baht and Indian rupee soared in anticipation that the United States and Britain would block any attempts by foreign countries to change the financial system and curb disruptive currency gambling.

This capital outflow from the United States has indeed helped domestic banks rebuild their balance sheets, as the Fed intended. But in the process the international financial system has been victimized as collateral damage. This prompted Chinese officials to counter U.S. attempts to blame it for running a trade surplus by retorting that U.S. financial aggression "risked bringing mutual destruction upon the great economic powers."

From the gold-exchange standard to the Treasury-bill standard to "free credit" anarchy

Indeed, the standoff between the United States and other countries at the IMF meetings in Washington this weekend threatens to cause the most serious rupture since the breakdown of the London Monetary Conference in 1933. The global financial system threatens once again to break apart, deranging the world's trade and investment relationships – or to take a new form that will leave the United States isolated in the face of its structural long-term balance-of-payments deficit.

This crisis provides an opportunity – indeed, a need – to step back and review the longue durée of international financial evolution to see where past trends are leading and what paths need to be re-tracked. For many centuries prior to 1971, nations settled their balance of payments in gold or silver. This "money of the world," as Sir James Steuart called gold in 1767, formed the basis of domestic currency as well. Until 1971 each U.S. Federal Reserve note was backed 25% by gold, valued at $35 an ounce. Countries had to obtain gold by running trade and payments surpluses in order to increase their money supply to facilitate general economic expansion. And when they ran trade deficits or undertook military campaigns, central banks restricted the supply of domestic credit to raise interest rates and attract foreign financial inflows.

As long as this behavioral condition remained in place, the international financial system operated fairly smoothly under checks and balances, albeit under "stop-go" policies when business expansions led to trade and payments deficits. Countries running such deficits raised their interest rates to attract foreign capital, while slashing government spending, raising taxes on consumers and slowing the domestic economy so as to reduce the purchase of imports.

What destabilized this system was war spending. War-related transactions spanning World Wars I and II enabled the United States to accumulate some 80% of the world's monetary gold by 1950. This made the dollar a virtual proxy for gold. But after the Korean War broke out, U.S. overseas military spending accounted for the entire payments deficit during the 1950s and '60s and early '70s, while private-sector trade and investment were exactly in balance.

By August 1971, war spending in Vietnam and other foreign countries forced the United States to suspend gold convertibility of the dollar through sales via the London Gold Pool. But largely by inertia, central banks continued to settle their payments balances in U.S. Treasury securities. After all, there was no other asset in sufficient supply to form the basis for central bank monetary reserves. But replacing gold – a pure asset – with dollar-denominated U.S. Treasury debt transformed the global financial system. It became debt-based, not asset-based. And geopolitically, the Treasury-bill standard made the United

States immune from the traditional balance-of-payments and financial constraints, enabling its capital markets to become more highly debt-leveraged and "innovative." It also enabled the U.S. Government to wage foreign policy and military campaigns without much regard for the balance of payments.

The problem is that the supply of dollar credit has become potentially infinite. The "dollar glut" has grown in proportion to the U.S. payments deficit. Growth in central bank reserves and sovereign-country funds has taken the form of recycling of dollar inflows into new purchases of U.S. Treasury securities – thereby making foreign central banks (and taxpayers) responsible for financing most of the U.S. federal budget deficit. The fact that this deficit is largely military in nature – for purposes that many foreign voters oppose – makes this lock-in particularly galling. So it hardly is surprising that foreign countries are seeking an alternative.

Contrary to most public media posturing, the U.S. payments deficit – and hence, other countries' payments surpluses – is not primarily a trade deficit. Foreign military spending has accelerated despite the Cold War ending with dissolution of the Soviet Union in 1991. Even more important has been rising capital outflows from the United States. Banks lent to foreign governments from Third World countries to other deficit countries to cover their national payments deficits, to private borrowers to buy the foreign infrastructure being privatized or to buy foreign stocks and bonds, and to arbitrageurs to borrow at a low interest rate to buy higher-yielding securities abroad.

The corollary is that other countries' balance-of-payments surpluses do not stem primarily from trade relations, but from financial speculation and a spillover of U.S. global military spending. Under these conditions the maneuvering for quick returns by banks and their arbitrage customers is distorting exchange rates for international trade. U.S. "quantitative easing" is coming to be perceived as a euphemism for a predatory financial attack on the rest of the world. Trade and currency stability are part of the "collateral damage" caused by the Federal Reserve and Treasury flooding the economy with liquidity to re-inflate U.S. asset prices. Faced with this quantitative easing flooding the economy with reserves to "save the banks" from negative equity, all countries are obliged to act as "currency manipulators." So much money is made by purely financial speculation that "real" economies are being destroyed.

The coming capital controls

The global financial system is being broken up as U.S. monetary officials change the rules they laid down half a century ago. Prior to the United States going off gold in 1971, nobody dreamed that an economy could create unlimited credit on computer keyboards and not see its currency plunge. But that is what happens under the global Treasury-bill standard. Foreign countries can prevent their currencies from rising against the dollar (which prices their labor and exports out of foreign markets) only by (1) recycling dollar inflows into U.S. Treasury securities, (2) by imposing capital controls, or (3) by avoiding use of the dollar or other currencies used by financial speculators in economies promoting "quantitative easing."

Malaysia used capital controls during the 1997 Asian Crisis to prevent short-sellers from covering their bets. This confronted speculators with a short squeeze that George Soros says made him lose money on the attempted raid. Other countries are now reviewing how to impose capital controls to protect themselves from the tsunami of credit flowing into their currencies and buying up their assets – along with gold and other commodities that are turning into vehicles for speculation rather than actual use in production. Brazil took a modest step along this path by using tax policy rather than outright capital controls when it taxed foreign buyers of its bonds last week.

If other nations take this route, it will reverse the policy of open and unprotected capital markets adopted after World War II. This trend threatens to lead to the kind of international monetary practice found from the 1930s into the '50s: dual exchange rates, one for financial movements and another for trade. It probably would mean replacing the IMF, World Bank and WTO with a new set of institutions, isolating U.S., British and eurozone representation.

To defend itself, the IMF is proposing to act as a "central bank" creating what was called "paper gold" in the late 1960s – artificial credit in the form of Special Drawing Rights (SDRs). However, other countries already have complained that voting control remains dominated by the major promoters of arbitrage speculation – the United States, Britain and the eurozone. And the IMF's Articles of Agreement prevent countries from protecting themselves, characterizing this as "interfering" with "open capital markets." So the impasse reached this weekend appears to be permanent. As one report summarized matters: "'There is only one obstacle, which is the agreement of the members,' said a frustrated Mr Strauss Kahn." He added: "The language is ineffective."

Paul Martin, the former Canadian prime minister who helped create the G20 after the 1997-1998 Asian financial crisis, noted that "the big powers were largely immune to being named and shamed." And in a Financial Times interview, Mohamed El-Erian, a former senior IMF official and now chief executive of Pimco, said: "You have a burst pipe behind the wall and the water is coming out. You have to fix the pipe, not just patch the wall."

The BRIC countries are simply creating their own parallel system. In September, China supported a Russian proposal to start direct trading between the yuan and the ruble. It has brokered a similar deal with Brazil. And on the eve of the IMF meetings in Washington on Friday, October 8, Premier Wen stopped off in Istanbul to reach agreement with Turkish Prime Minister Erdogan to use their own currencies in tripling Turkish-Chinese trade to $50 billion over the next five years, effectively excluding the U.S. dollar. "We are forming an economic strategic partnership … In all of our relations, we have agreed to use the lira and yuan," Mr. Erdogan said.

On the deepest economic plane today's global financial breakdown is part of the price to be paid for the Federal Reserve and U.S. Treasury refusing to accept a prime axiom of banking: Debts that cannot be paid, won't be. They tried to "save" the banking system from debt write-downs in 2008 by keeping the debt overhead in place while re-inflating asset prices. In the face of the repayment burden shrinking the U.S. economy, the Fed's idea of helping the banks "earn their way out of negative equity" is to provide opportunities for predatory finance, leading to a flood of financial speculation. Economies targeted by global speculators understandably are seeking alternative arrangements. It does not look like these can be achieved via the IMF or other international forums in ways that U.S. financial strategists will willingly accept.

Notes

[1] Sewell Chan, “Currency Rift With China Exposes Shifting Clout,” *The New York Times*, October 11, 2010.

[2] Walter Brandimarte, “Fed, ECB throwing world into chaos: Stiglitz,” Reuters, Oct. 5, 2010, reporting on a talk by Prof. Stiglitz at Columbia University, http://www.reuters.com/article/idUSTRE6944M920101005. Dirk Bezemer and Geoffrey Gardiner, “Quantitative Easing is Pushing on a String” (paper prepared for the Boeckler Conference, Berlin, October 29-30, 2010), make clear that “QE provides bank customers, not banks, with loanable funds. Central Banks can supply commercial banks with liquidity that facilitates interbank payments and payments by customers and banks to the government, but what banks lend is their own debt, not that of the central bank. Whether the funds are lent for useful purposes will depend, not on the adequacy of the supply of fund, but on whether the environment is encouraging to real investment.” (p.c., G. Gardiner)

[3] Tom Lauricella, “Dollar’s Fall Roils World: As Global Leaders Meet, Strains Rise Among Nations Competing to Save Exports,” *Wall Street Journal*, October 8, 2010, quoting Edwin Truman, a former U.S. Treasury official now a senior fellow at the Peterson Institute for International Economics.

[4] Alan Beattie, Chris Giles and Michiyo Nakamoto, “Currency war fears dominate IMF talks,” *Financial Times*, Oct. 9, 2010, and Alex Frangos, “Easy Money Churns Emerging Markets,” *Wall Street Journal*, Oct. 8, 2010.

[5] Gavyn Davies, “The global implications of QE2,” *Financial Times*, October 5, 2010.

[6] Alan Beattie, “Global economy: Going head to head,” *Financial Times*, October 8, 2010.

[7] Megumi Fujikawa and David Wessel, “Central Banks Open Spigot,” *Wall Street Journal*, October 6, 2010.

[8] Jonathan Wheatley, “Investors calm over Brazil tax rise,” *Financial Times*, October 6, 2010.

[9] Alan Beattie, Joshua Chaffin and Kevin Brown, “Wen warns against renminbi pressure,” *Financial Times*, October 7, 2010.

[10] Alan Beattie, “Global economy: Going head to head,” *Financial Times*, October 8, 2010.

[11] Chris Giles and Alan Beattie, “Leaders pledge cooperation on currencies,” *Financial Times*, October 9, 2010.

[12] Chris Giles and Alan Beattie, “Global clash over economy,” *Financial Times*, October 10, 2010.

[13] Alan Beattie and Chris Giles, “IMF meeting dashes hopes for co-operation,” *Financial Times*,

October 10, 2010.

[14] Joe Parkinson, “Turkey, China Shun the Dollar in Conducting Trade,” *Wall Street Journal*, October 8, 2010.

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