Course 4

A Brief History of Financial Innovation, Deregulation and Crises: 1960 to 2000

Re-regulation but little structural change since the 2007-2008 financial crisis

- Complexity
- Capture
- Too many jurisdictions
- Too many products, markets and actors
- No alternative theory
- “Finance” is multidimensional, transnational

The result of a historical process

Shipping, Telecoms & Finance Leading Globalisation

IDEAL-X – 1955
operating on
the US East Coast

A 50-year
history… and
counting

Beginnings in the 1960s

- Bretton Woods: a stable, structured system
- Currencies pegged to the dollar and gold
- Regulations and credit controls
- Separate business entities
- 3 – 6 – 3 banking

No financial crises
Currency crises (Britain)

Changes

- Eurodollar markets (Moscow Narodny Bank in London, 1957)
- Eurobonds (Warburgs, in London, 1963) – the iconic “Belgian dentist” investing offshore to avoid tax.
- Securitisation of mortgages: Ginnie Mae (Housing Department – HUD) – mortgage backed securities 1970. Support homeownership for Afro-Americans.

End of Bretton Woods

- Fiat money

- Floating currencies
  - Friedman paper, 1971
  - Leo Melamed > International Monetary Market, May 1972 – Chicago Mercantile Exchange

London – hub for int’l finance

- US banks avoiding Regulation Q

- Re-cycling of petro-dollars after 73/74 oil shock

- Walter Wriston (Citicorp):

“countries don’t go bust”

Inflation and the “Volcker Shock”

- Fed funds rate peaked at 20% spring 1980
- Dollar surge
- August 1982 – Mexico Default

  Third World Debt Crisis

  “Washington Consensus”

- Savings & Loan crisis

Shareholder value

- Milton Friedman: 1971 "A Friedman doctrine"

companies social responsibility is to make profits

- Jack Welch – August 12, 1981, at The Pierre hotel:

"Growing fast in a slow-growth economy"

Stock-options for top management

Deepening of financial liberalisation in mid-1980s

- 1986 – London > “Big Bang”

- 1987 August: Alan Greenspan Chairman of Fed
  - Self-regulation
- October crash 1987
  - Liquidity support – interest rate cuts
  - “Clean not lean” and the “Greenspan put”

Liberalisation/deregulation of markets

- End of capital controls in Europe (1990)
- Erosion of Glass-Steagall Act and repeal 1999
- No regulation of derivative markets

Financial innovation and technology

Derivatives trading exploded in 1990s

- CDOs – collateralized debt obligations (1986): bonds restructured into “tranches” carrying more or less risk (with less or more returns)
  - Synthetic CDOs
- CDSs – credit default swaps (1994): insurance against risk

Risk became a tradeable commodity (John Kay)

The end to "home bias" in investment

- ICT – Internet mid-1990s onwards

- Convergence of accounting standards

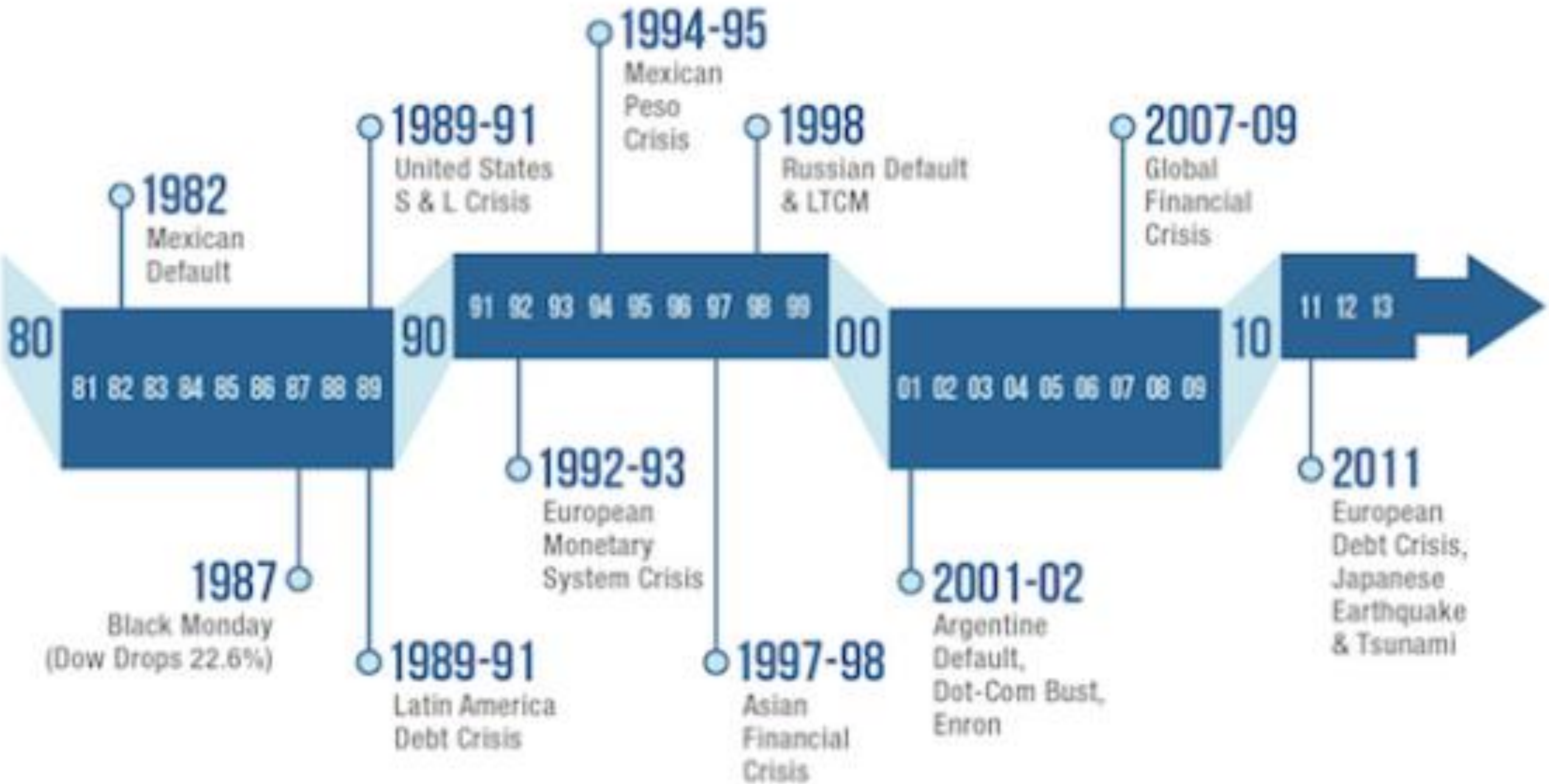
  International financial reporting standards
  IFRS – adopted in Europe in 2005

Ease of cross-border transactions and transparency

Repeated crises 1

- Japan 1989-1992 > two decades of stagnation
- Mexican crisis 1994
- Asian crisis 1997
- Russian and LTCM crisis August/Sept 1998
- Dotcom bubble – late 1990s (TMT stocks)
- General “irrational exuberance” in stocks

Repeated crises 2



Identifying some patterns

- Securitisation > rent extraction (Adair Turner)
- Risk > a tradable commodity (John Kay)
- Fraud (Martin Wolf)
- Complexity > yet simple ideas drive decisions
- Herd psychology > betting with the market
- In an asset boom, rising prices stimulate demand (André Orléan)
- Market failures > over-valuation of assets (When does a bull market become a bubble? Collapse?)
- Bubbles ultimately become Ponzi schemes
- Minsky: “stability leads to instability” > the “Minsky moment” of collapse