Course 7

A Question of Money and a Brief History of Financial Innovation, Regulation and Renewed Crises – 1960 to 2000

Outline

- What is money?
- The inevitable trade-off between sound money and growth?
- Financial liberalization since the 1960s and repeated financial crises

1. What is Money?
Earthlings explain to Martians

Source: Kate Rowe

What is Money?

The standard tale… of money neutrality

- 1/ A medium of exchange
- 2/ A unit of account
- 3/ A store of value
- M0: cash and reserves at the central bank
- M1: M0 plus sight deposits
- M2: M1 plus time related deposits
- M3: M2 plus large time deposits, all money market funds, etc.

Common “views” of money

Roman coins
…survived

Today’s cash

Island of Yap: rai stone

Keynes: “these are people whose ideas on currency are more truly philosophical than any other that we have come across” (see exercise).

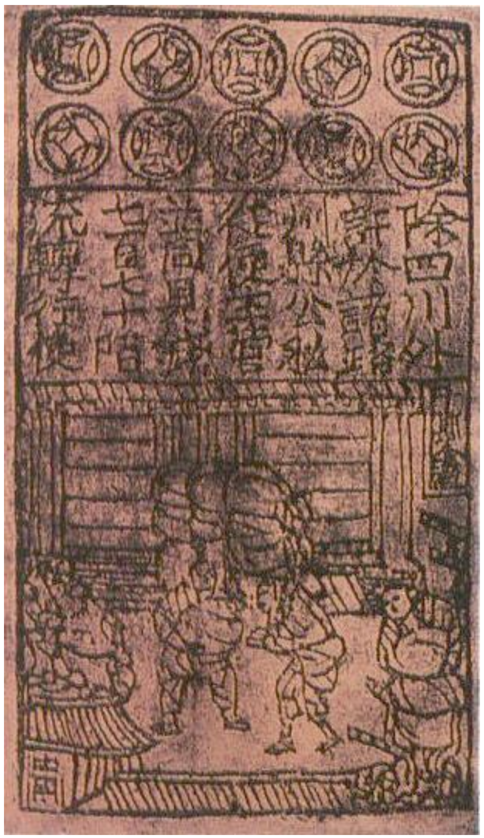
Cowrie shells: China, Africa

Tally sticks
UK (Middle Ages to 19^{th} century)

Early paper money

First banknote-type instrument, Tang dynasty (618-907).

True paper money "jiaozi", promissory notes during the Song dynasty in 11th century.



Bills of exchange in late Medieval Europe


Dublin 14th May 1713 Exa £28

At three days Sight pray pay to mr James [illegible] or Order the Sume of Twenty Eight pounds one Shilling & four pence Sterl. value received as p advice from

Your humble Serv[illegible]

To mr Henry Morse at the honble Sr Francis Childs House near Temple Barr Gate

London

"I promise to pay the bearer on demand"… £5

Money as a complex economic and social institution

- Requires notions of value, accounting and a legal framework
- The barter fallacy > suggests money is neutral
- The desire for money is unlimited
- Debt and money are the same thing
- (Felix Martin): money allows for social mobility and freedom
- Aglietta & Orléan (money mediates violence in society)

Legal tender

- The currency government takes taxes and makes payments
- The authorities protect legal tender > monopoly of issue > prevention of counterfeiting

- Regulation of banking system to control the creation of bank money

Many people want easy money > the temptation to "cheat" is inherent

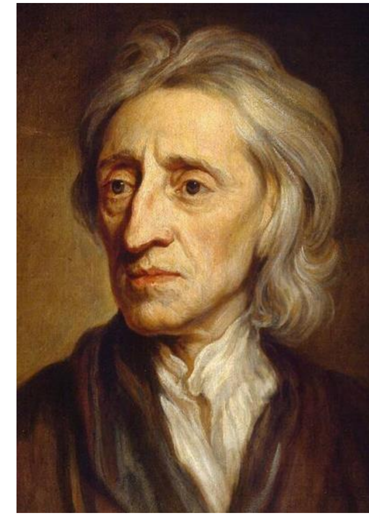
- Governments "dilute" real value (silver added to gold coins in ancient Rome, printing paper money, QE?)
- Financial system creates assets
- Bitcoin and crypto-currencies
- Fraud and corruption

[FT Film: "FTX: the legend of Sam Bankman-Fried]

[FT Film: "Credit Suisse: what next for the crisis-hit bank? 14 July 2022]

2. THE INEVITABLE TRADE-OFF

Guaranteeing stability & supporting growth



- Gold standard – money independent and absolute value, John Locke
- But supply of gold is irregular > … fluctuating growth

But supporting growth may undermine money

Justin Yifu Lin: creation of paper gold (p-gold) as an international reserve currency

Banks & Credit

- Banks are a vital source of credit – small businesses and households
- Mortgage credit and consumer credit – late 19th century but really developed between the World Wars
- Essential function and weakness of banks is managing “maturity mismatch”
- “Know your customer” – business sense, and now a legal obligation

“Original sin” – US (western) domination of global finance

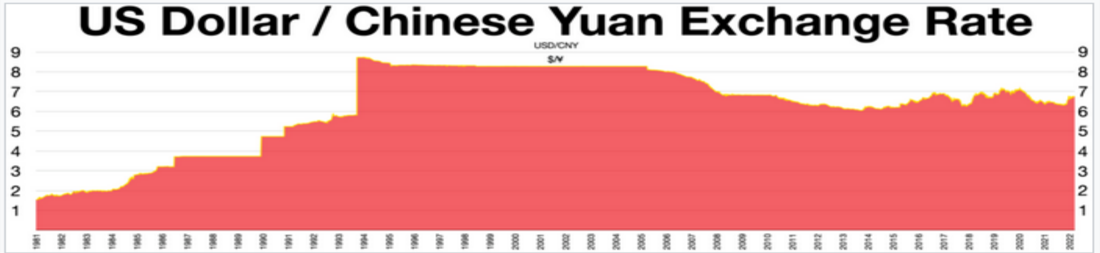
- Only a limited number of countries can borrow (internationally) in their own currency: US, Eurozone, Japan, UK, Switzerland, etc.

- Some governments cannot raise money, long term domestically.

What About China? 人民币 renminbi

The renminbi is not freely Convertible – at present.

Currency peg

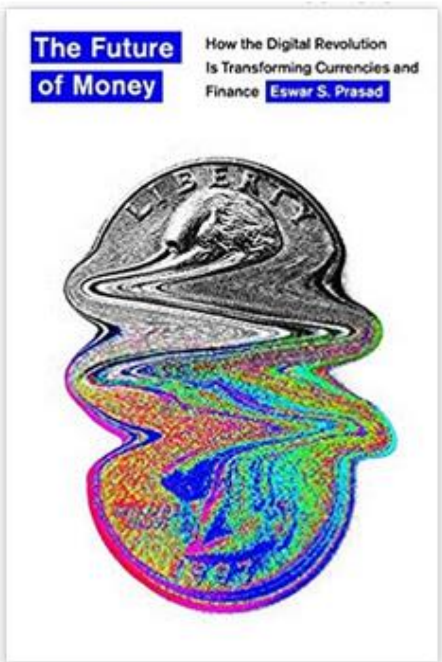


USD/CNY exchange rate 1981-2022

Caution (partly) due to the Asian crisis, GFC

But US sanctions or Iran and Russia > incentives for a parallel payment system

The Future of Money… Eswar S. Prasad (2021)



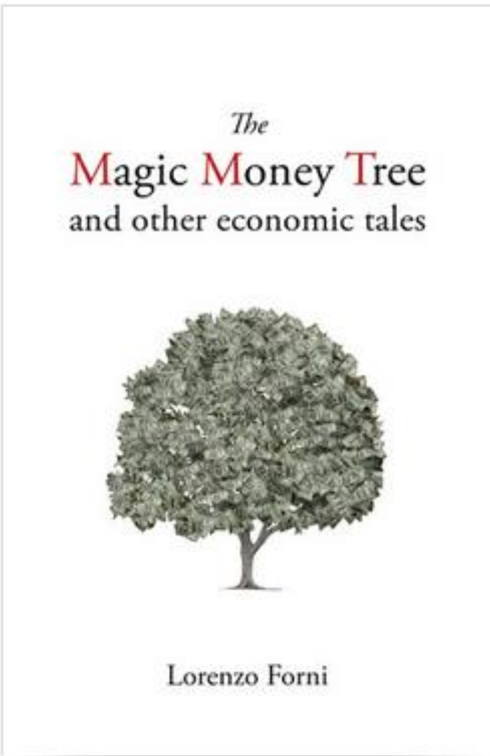
"Cryptocurrencies" are not really money, but assets – for the moment (payments in some emerging countries)

But: source of instability – hard to regulate

Stablecoins/crypto technology has potential in fintech for providing wider banking services/ cross-border settlements, etc.

CBDC – have potential too ("voluntary mode" money creation?)

There are always budget constraints



There are always budget constraints! (Forni, July 2021)

Ultimately growth is determined by constraints in the real economy.

Pushing these back involves education, R&D, infrastructure – microeconomic improvements

Does the creation of debt and money always outpace growth?
And so make financial crises inevitable?

Adair Turner, *Between Debt and the Devil*, Princeton UP, 2016

- "There is no silver bullet: no single policy that will remove the risks created by debt contracts, private money creation, and price cycles in existing assets."
- The pre-GFC orthodoxy of one objective (low inflation) and one policy tool (interest rates) produced an economic disaster.
- "As Hayek, Minsky and Simons rightly argued, private credit creation is inherently unstable, and there is no set of rules that can be defined once and forever to fix that problem."
- A degree of monetisation of public deficits.

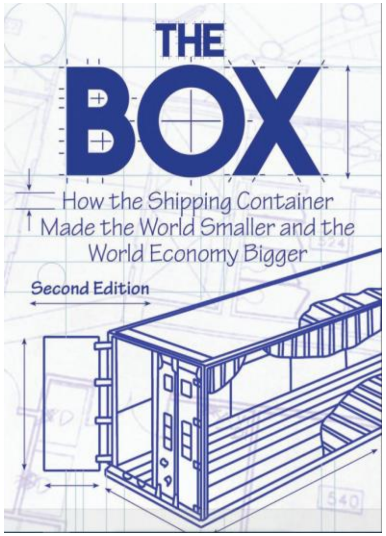
3. Financial liberalization since the 1960s and repeated financial crises

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

Beginnings in the 1960s



- A bit like container transport

  50 years to change global transport

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

Changes

- Eurodollar markets (as US dollars flowed out of the US: trade, defence and wars).

- Eurobonds (1963) – in London and "Belgian dentists"

- Securitisation:
- "Ginnie Mae" (1970) – mortgage backed securities

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 in 1970s

- 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 Volcker Shock

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

Third World Debt Crisis

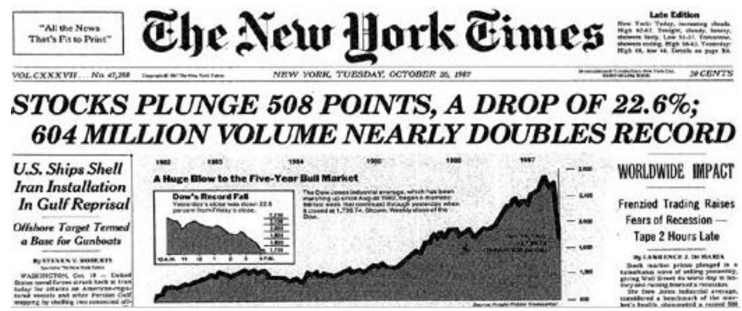
"Washington Consensus"

- Savings & Loan crisis

Financial liberalisation in mid-1980s

- 1986 – London > “Big Bang”

- 1987 August: Alan Greenspan Chairman of Fed
  - Self-regulation


"All the News That's Fit to Print"
The New York Times
Late Edition
NEW YORK, TUESDAY, OCTOBER 20, 1987
30 CENTS

STOCKS PLUNGE 508 POINTS, A DROP OF 22.6%;
604 MILLION VOLUME NEARLY DOUBLES RECORD

U.S. Ships Shell Iran Installation In Gulf Reprisal
Offshore Target Termed a Base for Gunboats

A Huge Blow to the Five-Year Bull Market
Dow's Record Fall

WORLDWIDE IMPACT
Frenzied Trading Raises Fears of Recession — Tape 2 Hours Late

- October crash
  - 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

- Collateralized debt obligations/CDOs (1986): bonds restructured into tranches
  - Synthetic CDOs
- Credit default swaps/CDSs (1994): insurance

- ICT – computing but especially Internet in mid-1990s
- Standardized accounting
- The end to “home bias”

Repeated crises

- Japan 1986-1992 > 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

Tax avoidance – evasion - fraud

- Large companies relocate profits to low-tax jurisdictions
- "Double Irish and Dutch sandwich"

"At least 55 of the largest corporations in America paid no federal corporate income taxes in their most recent fiscal year…"

[Mattew Gardner and Steve Wamhoff]

"For many decades now London has been rolling out the red carpet to corrupt and criminal individuals from around the world. "

FT Film: "[How London became the dirty money capital of the world]", 22 April 2022

Identifying some patterns

- Securitisation > has become a form of rent extraction
- Risk > a tradable commodity
- Fraud
- Complexity > yet simple ideas drive decisions
- Market failures (André Orléan: when credit is cheap, and asset prices are rising, the price mechanism goes into reverse).

Takeouts

- Money is always changing

- Paper money and assets have no real value, but are liquid; goods and services have real value but are illiquid

- Governments are essential to protecting its value – but they too undermine its value

- Credit has been essential to growth, but leads to periodic crises – with major consequences