

*Phil Gramm Speaks Out to Bob Novak
Is Everything Too Big to Fail?
How to Avoid a Global Recession*

PHIL GRAMM:
An Exclusive Interview

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**Is This The
Prime Culprit
For Today's
Global Financial
Chaos?**



Susan Dorothea White, "It Cuts Both Ways," carved huon pine & mixed media, 47 x 18 x 4 inches, courtesy of Monserrat Gallery, New York, NY.

conomic downturn which has gone on for years, with no sign of recovery even now.

In spite of such lessons, risk controls were overrun by greed once again in the 1990s. After the American slump of 1992, institutional investors plowed money into every conceivable financial instrument that looked likely to provide high returns. Equity markets throughout the world boomed. Then asset managers tried to beat the equity indexes through exotic alternatives. Emerging market debt became a hot investment, until the spreads over LIBOR almost disappeared. Capital flowed like a raging river into hedge funds, private equity funds, and other "alternative investments." The flood of capital reached a point where the best managed private equity funds publicly admitted that they could not absorb all of what was offered, because they could not find enough sound investment projects. Even the markets for collectibles like art bounded back.

In this global rush to raise investment performance, banks not only lent to hedge funds, but increased their own proprietary trading activities. Many banks would ask to see the transactions of the hedge funds to which they were lending, take a snapshot, and then engage in the same transactions on their own account — in effect doubling up their risk or exposure. "Prop trading" became a major source of profits, offsetting the diminishing returns from lending, currency transactions, and other traditional banking activities. For their part, hedge funds leveraged up their assets, loan upon loan, until there was

virtually not enough paper to absorb all the funds available, so the prices of paper assets rose higher and higher.

When the currencies and economies of East Asia began toppling in 1997, the bubble at first burst in Asia, but not in the rest of the world. Capital fled from Asia but continued to flow into other regions, and into even more exotic trading alternatives. A continuous wave of investors looked frantically to place more one-way bets, exploring virtually every nook and cranny of the global financial marketplace.

The strong dollar restrained the economy and provided an added anti-inflationary bias. Rubin's strong dollar was the enabler for the Fed's unwillingness to exercise monetary restraint in an election year.
