

Meltdown: Indigenous Jamaican Finance 1996; Wall Street or the Globe 2008, Halting Steps at Recovery and Caribbean Policy response

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1. Introduction

When Nicolas Kaldor introduced the idea of ‘stylized facts’ in his 1957 growth theory paper he perhaps was unaware he had created an enduring shorthand in approaches to methodology in referring to the remarkable historical constancies he identified in the process of long run economic growth. Considering financial innovation in capitalism we apparently confront an unending capacity to create ‘meltdowns’—such that use of the stylized facts concept appears perfect in two senses. First, the phenomenon embodies the uncanny habit of recurrence. Let’s take a quick look at bubbles and crashes in history: Wall Street and immediate Global Meltdown 2008; dot.com crash 2000; Long Term Capital Management 1998; Jamaica indigenous financial services meltdown 1996 [‘Storm in a Teacup’]; US Stock market crash 1987; US Savings and Loan bubble, 1985; Wall Street Crash 1929—worldwide depression; Overend and Guerney London 1866; Barings London 1890; South Sea Bubble London 1720. Should we retrace the steps a few more years? Unnecessary overkill! Crashes appear to recur once historical and institutional memory of economic actors and institutional regulators recede.

In our second sense, the ‘stylized facts’ is closer to Kaldor’s concept:

1. Financial innovation proceeds as entrepreneurs seek capital to pursue ventures too big or too new to be bankrolled by extant arrangements, or simply to find avenues for profitable deployment of finance capital
2. Players in search of return on capital and profits buy into these new arrangements generally allowed or made possible either by lacunae in the extant regulatory framework, or deregulation of an old restrictive regime
3. Large profits, spectacular returns lead to rising prices, if not values, and a period of euphoria ensues
4. There is an underlying instability as with all bubbles, increased risk emerges, at first imperceptibly
5. The inevitable crash comes suddenly, if not to the financial innovators normally using other people’s money, certainly to unsuspecting investors
6. Institutional change and regulatory mechanisms catch up, the state steps in to rescue capitalism from itself—this process is always controversial, usually involving powerful and connected vested interests

In keeping with our attempt to infuse some historical context to this complex and awkward phenomenon of human decision making [and greed in unregulated markets] in capitalism we include two little pieces of history as backdrop, one almost ancient, the other alarmingly present: Asked about Sir Isaac Newton most people recall the famous

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falling apple story. He ‘discovered’ gravity and other things Scientific. Yet Newton’s Knighthood conferred by Queen Anne, was in recognition of his service to Britain in the field of monetary regulation. He was made Master of the Mint in 1699, holding the position until his death in 1717. He moved the Pound Sterling from silver to the gold standard. Extant commodity money, money made of precious metal, was subject to ‘clippers’ and counterfeiters who debased the currency. Counterfeiting was high treason punishable by being hanged, drawn and quartered, yet its practice was considerable when Newton took office.

Newton achieved conviction of counterfeiters even in case of one highly placed in British society, punishing folk who would clip little pieces off the edges of coins, reducing the currency’s value—an early form of inflation. Governments also debased the currency by deliberately reducing its precious metal content. The practice of an inflation tax is not new. Nor is the practice, even prior to Newton, of monetary and financial regulation.

As distinct from Newton’s day, when monetary and financial regulation was collapsed into one operation, today it is not, it can no longer be. Monetary regulation is the province of central banks. They safeguard currency value, act as governments’ bankers and banker of last resort to commercial banks, influence either interest rates or money supply by various control instruments via open market operations through treasury bills and foreign exchange purchases. They also determine which, or what entities are allowed to operate in the financial services sector they oversee.

On the other hand financial services involving insurance, capital markets covering purchase and sale of stock, investment vehicles of all sorts, derivatives, collateralized securities and the like, require a different kind of skill set for their effective control. This is the domain in which financial innovation generally takes place. This is the domain that arguably, is more organically linked to the ‘real economy’ and that periodically, encourages euphoria by delivering vast returns prior to the crash.

The more recent historical situation is one with which you are all too familiar. It is a description of the most recent financial innovation at penultimate root of the Wall Street meltdown. I take it from a third edition in the Wiley Finance textbooks, some of what we currently teach our students in finance and economics classes:

“Financial Derivatives introduces the broad range of markets for financial derivatives. *A financial derivative is a financial instrument based on another more elementary financial instrument. The value of the financial derivative depends on, or derives from, the more basic instrument. Usually, the base instrument is a cash market financial instrument, such as a bond or a share of stock. ...* The text has two principal goals. First, the book offers a broad overview of the different types of financial derivatives (futures, options, options on futures, and swaps), while focusing on the principles that determine market prices. These instruments are the basic building blocks of all more complicated risk management positions. Second, **the text presents financial derivatives as tools for risk management, not as instruments of speculation. While financial derivatives are unsurpassed as tools for speculation,**

the book emphasizes the application of financial derivatives as risk management tools in a corporate setting. This approach is consistent with **today's emergence of financial institutions and corporations as dominant forces in markets for financial derivatives**. ... [The] Chapter (Financial Engineering and Structured Products) shows how forwards, futures, options, and swaps are building blocks that can be combined by the financial engineer to create new instruments that have highly specialized and desirable risk and return characteristics. While the **financial engineer cannot create instruments that violate the well-established trade-offs between risk and return, it is possible to develop positions with risk and return profiles that fit a specific situation almost exactly.**”

I hope to present in what follows first, a description of how the financial meltdown happened in Jamaica in mid 1996, the controversy generated in interpreting its causes and regulatory changes that followed after the fix of the problem. This is followed by a look at the Wall Street meltdown and the halting efforts at creating a funding and regulatory fix amidst the presence of deeply entrenched vested interests, amazing inequity in proposals still being implemented amidst an ideological struggle that may well prolong the length and depth of the current recession. I conclude with some thoughts on how Caribbean Monetary and Financial Regulators may respond to fallout from these potential outcomes.