Henry Wong

The Hedge Fund Mechanism and Global Financial Disasters

Creating a Safer Investment World

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Introduction

September 16, 1992 has come to be known in the Britain as the Black Wednesday. On that day, the British pound was forced into a significant devaluation, and the consequence of which was the withdrawal of the British currency from the European Exchange Rate Mechanism (ERM). As a condition to joining the ERM, the British government had agreed to maintain the currency fluctuation within the range of 6%, or else the government was obligated to intervene. The government did intervene at the beginning of the crisis; however, after draining $15 billions of its foreign reserves and a series of interest rates increases that began to cause inflation, the government eventually decided to stop the intervention by letting the pound float. George Soros, the hedge fund manager who committed $10 billions in selling the pound, turned out to be the major figure behind the currency attack. Soros, as a result of the attack, earned $1.1 billion for his Trillium Investment Fund as well as the title of "the man who broke the Bank of England."

The incident of Black Wednesday was the first time hedge funds flexed their muscle, revealing the enormous potential influence they had not only on the market but also the larger policy context. Although the incidence shocked the world, it did not yet inspire the awareness of hedge funds as an important source of instability within the financial system. It was in part because the consequences of the withdrawal were not disastrous and also because it was seen as a rare exception. Hedge fund managers were still widely acclaimed as astute investors, and Soros gladly acknowledged his role in devaluating the pound.

Since the Asian financial crisis, the perception toward hedge funds began to shift from astute investors to "highwaymen of the global financial system." There were accusations, mostly from the Asian region, that hedge funds were behind the collapse of the financial markets across the region. It was claimed that hedge fund managers, Soros in particular, were again actively pushing down market prices to their benefits. This time Soros did not accept the role of market manipulator like he did in the pound devaluation. The severity of the financial crisis of 1997, when a succession of national government across the region came under threat, was of a scale unprecedented: Exchanged rates across the region were thrown into disarray; unemployment rates skyrocketed; and national GDP of many countries substantially shrunk. Economic development in the once fastest growing region of the world was said to have pushed back for a decade. Shortly after the Asian financial crisis, in 1999 hedge funds once again appeared on the headline as LTCM, the then world's largest hedge fund, crumbled. The outcome of the LTCM demise would not be any less disastrous than the Asian financial crisis if not for the deliberate bailout by the US Federal Reserve Bank and the cooperative attempts of Wall Street financiers to save the firm.

The Asian financial crisis and the LTCM demise have alarmed some of the world's foremost financial regulators, national governments and academia. It was suggested that the two crises have clearly shown the destabilizing nature of hedge funds. Critics of hedge funds argued that the lack of regulations had given them unbounded power that goes beyond the control of any nation states. The influence of hedge funds was not only limited to the arena they participate in, but they also have the potential to seriously disrupt social, economic and political orders. Nor was their influence confined to the geographical areas where their activities are directed, their activities, though nationally directed, can produce global impacts. On the other hand, other proponents countered, typically based their arguments on the neoliberal tenets, that in fact hedge funds serve the stability of the global system. According to the proponents, the claim that hedge funds' activities are detrimental to national economies was based upon a misinterpretation of causality. Hedge funds typically look into troubling economies for profits, thus weaknesses that can lead to economic breakdowns already existed before the influx of hedge funds' attacks. In fact, by placing downward pressure on markets and economies that would inevitably fail, hedge funds facilitated the adjustment process. In other words, they have been performing painful yet necessary treatments on these ailing economies.

The academic and policy debate on hedge funds, which was initiated by the successive Asian and LTCM crises and which continues today as one subcontext of the current world's financial crisis began in 2007, has focused on the question of whether hedge fund per se is a threat to financial systems. Both advocates and opponents have been approaching the question from two rather narrow perspectives. First, there has been a strong tendency to focus on certain risk factors of hedge funds. There has often been in depth examination on how such specific factors by themselves may be destabilizing. This approach is adopted most likely because the tradition of the academic finance discipline has dictated risks to be the primary concern. Risks are widely studied in depth and in isolation from other variables for the purpose of generating clear-cut causal results. Another tendency is the understanding of hedge funds as a static and coherent concept. The concept of hedge fund is flexible with only a few features that form the core of the concept. These core features are usually used as the basis of discussion on the systematic impacts of hedge funds. This second tendency is perhaps due to the elusive nature of the concept where the only component that is shared by all hedge funds is their private and secretive character, and thus for the sake of consistency any secondary characteristics tend to be disregarded. The two approaches have largely framed the context in which the debate of hedge fund threat has taken place.

Our analysis seeks to contribute to the debate by adopting a different approach. We seek to look at the risks of hedge funds not merely as a single factor isolated from the influence of others but rather see the risks as a changing variable that can influence and be influenced by others. We will investigate how the outcome may be altered as the interaction among these risk factors shift. Risks are viewed within a web of risks, in other words. Hence, our analysis is not confined to the investigation of the core features of hedge funds but also those that are derived from these core features. As we will see, such an expansive conceptualization is highly significant, because it is mostly these secondary features that pose as the greatest cause of concern. Depending on the larger political and economic circumstances, the secondary features can pose a different form of threat to the global financial system. We have identified four structural conditions in the global financial arrangement, namely financial innovations, financial deregulation, investor perception and the hedge fund mechanism, that are responsible for transforming the form of hedge fund threat. Each one of these structural condition is a vulnerability factor, and the interactions among the vulnerabilities constitutes one of the cores in this analysis. Hence, our framework of analysis is most distinctive in that it places a heavy emphasis on both the interrelations among the features and risks factors within hedge funds and the interrelations among these features and changes in the global political economy. The risk model of hedge funds, in other words, is examined through the lens of the vulnerability model. An important argument of this analysis is that a proper understanding of hedge fund risks (such as how they are triggered) demand recognizing the context of vulnerability behind.

We have found no simple answer to the question of whether hedge funds are a threat to the global financial system. The answer is contingent on the presence (or absence) of certain risk factors and changes in the larger financial system. Our findings point out that size and the relative importance of the hedge fund mechanism is one key risk factor that determines whether a hedge fund threat or failure can disrupt financial systems. Only a few of the world's giants in the hedge fund industry possess this potential. Secondly, we have found that none of the national and international regulators to date have been capable of providing accurate diagnosis on problems associated with hedge funds because of their use of faulty methodologies that has lacked a proper vulnerability perspective and are biased toward the financial sector. Thirdly, it is shown that the belated and piecemeal responses of national and international regulators where attention are only given to an area of risks only after a disaster occurred have been completely ineffective in curbing hedge funds as a potential source of threat. Instead the threat the risks inherent in hedge funds and the hedge fund mechanism have been transformed into critical vulnerabilities of the evolving global financial system. These arguments will be illustrated through our analysis of the development of hedge funds and its policy context beginning with the Asian crisis and extending up to the world's financial crisis which began in 2007.

Prelude

Hedge Funds and the Global Political Economy

Hedge Funds in the International Political Economy

In the face of the continuing advance of globalization, the conflict on one hand between the compelling urge of national states to integrate global market forces, and the desire of the states to avoid too great of a reliance or even domination, on the other, has never been more acute. This question of dependence vs. independence has been a subject of continuing debate in the realm of International Political Economy (IPE), a field of study that examines questions related to the interaction of social and political affairs and the role of economic power in political affairs [Gilpin 2002]. Integration into the global economy offers the opportunity for nations to reap the fruits of free trade, foreign capital and new technologies. In theory, both developed and developing countries can both benefit from the full participation in economic globalization. While access to the vast capital and consumer markets in the developed world can be powerful impetus for the economic progress of developing countries, the developed countries can also gain from the vast labour market of their developing counterparts. Up to a certain point, the relationship between market forces and the state can be mutually beneficial, but the distinctively different nature of the two dictates that a clash is inevitable. The goal of governments is to harness market forces in the interest of their societies or the powerful interest groups within these societies [Gilpin 2002]. Governments want to see that market resources are properly channels to areas they consider important. It is also in the interest of the governments to maintain certain cultural values, institutions and, most importantly, the political autonomy of their nation state. These inherent duties of governments motivate authorities to restrict and thus to shape market forces in ways that strengthen the welfare of the nations. By way of contrast, market forces are by nature aversive to such restrictions. The goal of market individual market actors is to achieve the largest profit possible, and hence expansion is what they sought after [Gilpin 2002]. The logic of the market system is not only to expand horizontally from region to region, but also to infiltrate and integrate as many aspects of society as possible and to place these areas under the market-price mechanism. This goal of market actors toward increasing commoditization threatens to overrun the cultural, economic and political domains that the states have sought to protect [Gilpin 2002]. The conflict between the state and the market has constituted a major dilemma in today's international economy.

Deepening global integration has increased the fragility of national economies at the same time as they become more interdependent on one another. It is no doubt that enhanced economic ties among nations has immensely contributed to global economic growth in the last several decades. Classical economics has long established how increase in economic ties can augment specialization and thereby giving a relative advantage to all participants regardless of their level of development. In this case, nations are both consumers and producers, consuming products and services that others specialize in while selling those they themselves are best at producing. Of course, the economic system is disrupted when certain countries can no longer consume the same quantities of products and services as they used to or when other countries seek to dominate technological production processes. Depending on the severity of the issue, it may possibly trigger conflict among countries and a domino-like decline among other participants. Thus, the well-being of a national economy has become highly reliant on others under the new system of interdependence. The mismanagement of an economy by a national government, which naturally is beyond the control of other states, is no longer a problem limited to that nation but its negative impacts can be transmitted throughout the global system.

Increasing global integration in the financial realm is perhaps the most acute example of both the independence/dependence dilemma and the interdependence paradox. While it remains debatable whether global trade and investment has in fact become as global as it seems, few questions the globalized nature of today's international financial system. With rapid development in digital technologies over the past two decades and the pervasiveness of financial liberalization, billions of dollars can be transferred regularly and routinely from one national capital system to another almost instantaneously. The well-being of a nation's capital market holds tremendous social, economic and political implications for the nation's society as a whole [Summers 2000].

In contrast to the era prior to financial globalization where nation states could only rely on domestic aids or international aids with stringent conditions attached, countries in this era of globalization are able to secure massive financial resources from private and institutional investors around the globe to sustain societal advancement. Besides the traditional avenue of the banking system, a wide variety of sources, such as private equity capital, sovereign wealth funds, hedge funds and investment banks, also serve the function of transferring capital from one region to another through their participation in global investment. These non-traditional sources of capital constitute what some refer to as a "shadow banking system." The efficient allocation of even a small amount of capital can generate a disproportionately large amount of social benefits. Lawrence Summers [2000] has pointed out that a 2% increase in the efficiency of capital allocation can lead to an increase of national GDP by 6%. The boom in the financial activities across the world has brought in various financial innovations that has facilitated not only efficiency in capital allocations, but they have also allowed the global financial system to infiltrate deeper into societies [Summers 2000]. The innovation of securitization, for instance, has made it possible for a low-income household in the U.S to receive financing from the central bank of China through a complex chain of financial intermediaries. The bank of China, on the other hand, is able to obtain a due profit from the investment; and on the whole financial globalization benefits loaners with a wider range of investment options to choose from. Clearly, the gains of such mutual dependence are too tempting to be foregone by any national states.

Tempting for national governments as it seems, the down side of global financial integration seems to bring equally sufficient reasons for rejecting such policies. Susan Strange, in her two prominent publications Casino Capitalism [1989] and Mad Money [1998], has shown that the international financial system, due to changes in U.S policies and the larger global political environment, has been marked by increasing instability and volatility over the last decades of the 20th Century. Expansion in financial globalization has encouraged substantial short-term speculation. In fact, speculative activities are more resembling of gambling than investing. While they do play a role in financing societal development, they most often do not allocate to areas where the capital is most needed. The fact that capital is allowed to leave as fast it comes within the current global financial arrangement means that domestic businesses may lay in ruin as speculators retreat. The freedom of exit endowed to foreign investors may leave states vulnerable as their control over the investors is substantially weakened. The well-being of societies falls outside the hands of the government onto the hands of international profiteers.