THE PROFIT PARADOX: COMPETITION AND FINANCIAL MELTDOWN

“Only two things are infinite, the universe and human stupidity; and I’m not sure about the former.” - Albert Einstein

RAHIM MOHAMED

The global economic order is governed by the profit principle. All financial players operate with one common goal: to turn a profit. When the market functions properly, profit-seeking investors channel capital toward good ideas, spurring innovation and economic development. This is the essence of neo-liberalism.

Despite its merits, I hypothesize that the profit principle is at the core of periodic financial crises. Such meltdowns frequently occur when investors and larger financial interests are enticed into seeking gains through risky ventures. Though such risks are irrational, they are consistently taken by those who fear getting left behind during an economic boom. Going further, I argue that the competition characteristic of the profit-driven economic order has been the principle impediment to effective state-level and multinational financial
regulation. Here, my analysis centres on the moral hazard which stems from the ongoing interstate struggles for economic primacy. Thus arises the central paradox of this work: the principle which defines the neo-liberal order also threatens its existence.

The first section of this paper will be dedicated to constructing a narrative vis-à-vis the dynamics of financial crises. Building upon Kindelberger’s scholarship on market crashes (2008), as well as the related work of Wright (2000), I seek to connect the macroeconomic phenomenon of financial meltdown with the simple human desire to attain relative prosperity. After outlining this general pattern, my analysis will turn to problems inherent to the multilateral financial arrangement as I argue that existing arrangements cannot tame the externalities engendered by the pursuit of profit. Specifically, I will comment in detail on how lingering economic rivalries have thus far dashed the hopes of a prospective economic agreement which would lessen the likelihood of future crashes. Here, I will explain how the rivalry between the financial centres of London and New York undermined the Bretton Woods truce, and will identify prevailing power struggles which are likely to impede further global economic cooperation.

I. “KEEPING UP WITH THE JONESES”: THE BANAL ROOTS OF FINANCIAL CRISIS

With the benefit of hindsight, it is easy to identify the causes of a financial crisis. To this end, Kindelberger (2000) has constructed a general model of the market crash. In this framework, such phenomena follow a period of prosperity brought upon by robust speculative investment in an emerging area of the economy. As investments become more lucrative, more speculators are attracted to the marketplace, driving the price of holdings to levels which exceed their real value. This creates a bubble which inevitably bursts when opinion-leading expert investors sense the risk in the economic environment and begin to divest themselves of their financial assets. Crashes occur when this bubble burst elicits a frenzied reaction in less-sophisticated investors who follow suit, racing to dump underperforming assets. In essence, the model “crash” is a self-fulfilling prophecy. Driven by the fear of a meltdown, investors seal such a fate by withdrawing capital from the market in a destabilizing manner.

“In essence, the model ‘crash’ is a self-fulfilling prophecy. Driven by the fear of a meltdown, investors seal such a fate by withdrawing capital from the market in a destabilizing manner.”

Kindleberger’s narrative is convincing. History provides us with several examples of this very dynamic, most notably the Great Crash of 1929. The phenomenon stemmed from a wave of speculative investment emboldened by lax restrictions on loans. New investors came to Wall Street in droves throughout the 1920s, taking advantage of the profit-making opportunities afforded by the stock market. Bank credit was the primary instrument used to acquire financial holdings. The practice of buying stock “on the margin” and using the resulting profit to finance one’s loans was commonplace. Predictably, many investors were unable to cover their losses when inflated market prices fell. This had serious
consequences on macroeconomic financial stability and was ultimately a contributing factor to broader economic depression. Unfortunately, the Great Crash was not an isolated occurrence. Investors have conspired to make several similar mistakes over the past two decades. Seeing tremendous financial opportunity in the newly-industrialized economies of East Asia, profit-seeking devised new ways to package and trade existing mortgage debt. By using market forces to finance debt, financial institutions were in a stronger position to grant loans. This abundance of credit stimulated demand for real estate, leading a great number of consumers to buy property they could not afford, resulting in a vicious cycle in which both borrowers and lenders accumulated debt. This, coupled with declining housing prices, set in motion a financial crisis which spread from the banking sector to the stock market. While the final narrative on the present meltdown remains unwritten, it is clear that this story is one of various actors taking irrational risks in the hopes of profiting from a new economic opportunity.

What drives such reckless behaviour? The answer may lie in psychology, as a growing body of literature links personal contentment to one’s relative economic well-being. Wright (2000) argues that people are driven to maximize income because they derive happiness from feeling more successful than those around them. This explains a mass of survey data which suggests that, while individuals become happier as they make more money, increases in GDP do little to enhance the aggregate-level of happiness within developed states. Moreover, it conforms to anthropological theory which indicates that humans are instinctively geared to seek high social status as a means of assuring reproductive success.
Applied to the economic realm, Wright’s hypothesis helps explain the “irrational exuberance” characteristic of financial manias. Indeed, it is likely the case that the fear of not sharing in the profits of a fertile market is the fundamental impetus which drives high-risk speculative investment. Individuals may be compelled to take irrational financial gambles in order to maintain or improve their relative social position. Kindleberger himself senses this broad dynamic as he writes: “There is nothing so disturbing to one’s well-being and judgement as to see a friend get rich.”

The problem of irrational exuberance is compounded when profits attract novice investors with a shallow awareness of economic fundamentals. Such actors may be more apt to finance unpromising ventures as they are less equipped to evaluate stock value. This narrative figures in Rajan and Zingales’ (2003) assessment of the late-1990s “dot.com” bubble. They argue that several high-tech holdings became overvalued when unsophisticated investors rushed to acquire internet-related assets. For their part, firms eager to exploit their ignorance began to re-brand themselves as e-businesses. What followed was a steep crash as “smart money” eventually bet against such gimmicks. In the framework of a free market, earning opportunities will always attract naive investors.

This sentiment is not restricted to the layperson, as even opinion-leading expert investors face incentives to gamble. Cool-headed, strategic vision may be cast aside as a financial executive is often only considered as good as his or her firm’s latest quarterly profits. The story of Jeffrey Vinik, the deposed manager of the Fidelity Magellan fund, epitomises this reality. Fearing that the high-tech bubble was about to burst in 1996, he significantly reduced his fund’s holding of technology stocks. Such assets, which had previously made up nearly 40% of the firm’s portfolio, took up less than 4% under Vinik’s tenure. Unfortunately, Vinik was forced to resign when Magellan showed weak annual figures in relation to its competitors. His conservative plan for stable, long-term growth failed to satisfy a clientele seeking to reap the spoils of the tech boom.

Ironically, a safer plan for self-interested expert investors may be to follow the insanity of the marketplace. This holds as the performance of such professionals is often measured against a general benchmark of market trends, such as the S&P 500. As such, a dominant strategy may be to acquire commonly-held stocks as an “insurance policy” and blame any resulting shortcomings in return on macroeconomic factors. At the very least, financial elites who follow investment trends will shield themselves from a Vinik-style underperformance. In other words, “smart” investors who fear for their jobs may be pushed into letting the less-sophisticated, marketplace lunatics run the asylum.

Can the spectre of crashes ever be vanquished under existing conditions? Some neo-liberals express hope in the idea that investors will gradually learn from history. For instance, Rajan and Zingales acknowledge the instructive effect of bubble bursts as they hypothesize that such events punish investors for irresponsible behaviour. The also note that capital is channelled away from the naive herd and towards more savvy, short selling financial elites as markets contract. This, they argue, helps the financial environment regain equilibrium. However, the long term viability of such market-imposed discipline is questionable. It is impossible to tell how future financial innovations will affect investor behaviours as
such advances often engender the widespread belief that innovation has “changed the rules” of financial interaction. This was certainly the case prior to the most recent meltdown. The credit crisis directly followed a period in which financial elites believed that advanced mechanisms designed to distribute credit risk had changed the rules of lending. As Tett (2007) observes, such attitudes can lead to irrational economic behaviour as actors “[throw] caution to wind,” amidst misplaced faith in the soundness of the existing system.11

Albert Einstein once said, “Only two things are infinite, the universe and human stupidity; and I’m not sure about the former.” The narrative of contemporary finance reaffirms Einstein’s wisdom as investors continue to find innovative ways to act irrationally in the pursuit of profit. Perhaps it is not their fault, for social research indicates that man is predisposed to defend his relative position in society at all costs, even if this means making a risky investment in a dot.com stock or financing a real estate acquisition with a subprime loan. Nonetheless, these misguided actors are only part of the story. History shows that competition can make states just as petty. Past and ongoing roadblocks to the effective multinational governance of finance will be discussed below.

II. Economic Turf Wars and the Failure of Multilateral Governance

Can effective multilateral cooperation curb the darker elements of multinational finance? Kindelberger suggests that the answer is “yes.” He notes that the period between 1945 and 1973 was a long economic peace, devoid of financial crisis.12 It is probably not a coincidence that this timeframe coincided with the post-World War II Bretton Woods economic system.

In essence, the Bretton Woods regime entailed the cartelization of global finance. The financial powers of the day agreed to put in place limits on the cross-border flow of capital in order to give states greater economic sovereignty. Specifically, the ability of investors to direct resources towards speculative ventures abroad was constrained. What resulted was an environment in which state-level financial institutions obtained a de-facto monopoly over domestic finance. With this authority, states had increased ability to moderate fluctuations in the market through intervention. They could temper “irrational exuberance” through tactics such as limiting entry into certain sectors of the economy and freezing capital flows.13 This system was by no means a panacea, and it reaped several well-documented economic consequences. However, it did contribute to the development of a stable financial order. Stricter rules on capital transfer meant the cessation of ungovernable manias driven by speculative investment. The events which hastened the downfall of Bretton Woods exemplify problems inherent to international economic cooperation.

It could be argued that the system was doomed from the start. American delegates to the Bretton Woods Conference ensured that capital controls were less than airtight. However, it was resurgent British banks who were the first to exploit these loopholes. By the end of the 1950s, London-based financial institutions began to accept foreign deposits valuated in dollars, sidestepping Bretton Woods-friendly controls on the trade of Pound Sterling levied by the British government. This newly-formed “Eurodollar” Market became an attractive site for investment as it was largely free from government intervention. Westminster ultimately turned a blind-eye to the Eurodollar Market as it stood to benefit from London’s
restoration as the capital of global finance.\textsuperscript{14}

The noise from London was not well-received in New York. Amidst uncertainty generated by the Vietnam War, dollar holdings drifted away from Wall Street and towards the more lucrative financial environment of its rival. Washington could do little to reverse this trend within the Bretton Woods framework as financial interests could simply sidestep domestic regulations by becoming more heavily-invested in the laissez-faire Eurodollar Market. As tensions between London and New York grew, the United States left the Bretton Woods system in 1971, adopting an open-border policy in an effort to reassert its threatened financial hegemony.\textsuperscript{15}

While the London-New York rivalry was not the sole agent of the demise of the Bretton Woods system, it underscores the difficulty of maintaining multilateral economic cooperation in an environment of interstate competition. Holistic economic agreements like Bretton Woods necessarily preserve a set of norms and hierarchies. In this case, states were compelled to accept limits on the transfer of capital, forsaking economic opportunities. The temptation to cheat was overwhelming for an ambitious London who seized an opportunity to regain financial primacy by exploiting the shortcomings of the existing regime. In the words of economist Susan Strange, “the laws and morals of the jungle took over” as the gentleman’s agreement on finance was compromised.\textsuperscript{16}

It is tempting to place this story in context with the larger neorealist narrative of states fighting for economic security within an anarchic global environment. However, it would be inappropriate to cast a capital control rift between two “friendly” states in such stark terms. As the United States and United Kingdom had already demonstrated a measure of mutual trust through military integration under NATO, there is no indication that either country would seek to constrain the security of the other. Instead, the London-New York rivalry was probably born out of

\begin{quote}
Albert Einstein once said, “Only two things are infinite, the universe and human stupidity; and I’m not sure about the former.” The narrative of contemporary finance reaffirms Einstein’s wisdom as investors continue to find innovative ways to act irrationally in the pursuit of profit.
\end{quote}

a more nuanced struggle for prestige as both actors involved were willing to undermine the Bretton Woods compact in order to lay claim to the capital of global finance. Models dealing solely with state security cannot explain such status-seeking behaviour. There is little reason to believe that a future multinational financial agreement will succeed where Bretton Woods failed. If anything, major actors are currently in a worse position to build economic cooperation. The global order is more fragmented now than in the aftermath of World War II. The economically hamstrung and politically isolated United States presently faces legitimate challenges to its position of global primacy from a rising China and an increasingly-integrated Europe. Moreover, contemporary strains on commodities like oil have made resource-rich states, such as Russia and the OPEC
countries, major wildcards in the global economy. If history is any indication, the emerging prospect of a multi-polar system is more likely to lead to intensified competition between power-seeking states than further economic cooperation. Moreover, there exist deep divisions on how best to govern the international fiscal landscape. The model of economic liberalism, which was hailed as a world-unifying cornerstone of “the end of history” just over a decade ago, is undergoing a serious re-evaluation from even its most stalwart supporters in the shadow of the ongoing crisis on Wall Street. Without an undisputed hegemon or a clear paradigm for a new financial order, the prospect of any relative economic fortune. The dynamic at play in individual economic behaviour is mirrored in international political economy as competition inhibits the ability of states to build a consensus around rational activity.

**CONCLUSION AND FURTHER DISCUSSION**

The same principle of profit that structures marketplace interaction is the root of the periodic crashes which threaten the existence of global financial order. Such meltdowns are triggered when the investment of profit-seeking interests causes a certain economic property to become overvalued, and are exacerbated when an inevitable correction sends the same actors scrambling to cut their losses. Moral hazard invariably plays a role in these phenomena as market-savvy interests attempt to profit from the ignorance of the irrational, profit-seeking herd, often taking irrational action themselves in the process. Though all parties involved are simply acting out of self-interest, a negative macroeconomic outcome emerges. This narrative fits the Great Crash of 1929, as well as more recent crises in Asia (1997) and on Wall Street (2008). Moreover, the cycle’s repetition indicates that the prospect of the market ever “learning its lesson” and policing itself is bleak.

The problem of cyclical crashes has been compounded by the fact that the international community has thus far failed to develop a method of reconciling the imperative of financial stability with the benefits of profit-seeking. In fact, the
competitive nature of states themselves has been a major impediment to cooperation in this area. As states continue to jockey for economic primacy, it seems clear that they prefer the instability of the present financial environment to the ingrained hierarchies which would be inherent in any viable general agreement on marketplace conduct. Like investors, states would rather “gamble” in hopes of improving their relative prestige than accept a more stable permanent fate.

Perhaps there can be no purely economic solution for what is, essentially, a human problem. For all the complexity of the financial environment, crashes can often be traced to individuals who do not want to be left to watch as their peers exploit fertile markets. Perhaps this widespread culture of one-upmanship can be managed as more is learned about what makes humans apt to derive emotional well-being from relative economic prosperity. However, the facts indicate that crashes will continue to be a part of economic life as financial freedom entails the freedom to make bad decisions.

ENDNOTE

8. Ibid, 103.
9. Ibid, 103.
13. Rajan and Zingales, 243-246.
15. Ibid, 262, 263.