Capital Wars: The Rise of Global Liquidity.

Michael J. Howell. Cham: Palgrave Macmillan, 2020. 304 pages. Cloth, $59.99. ISBN: 9783030392871

In response to criticisms of his *General Theory* published a year earlier, John Maynard Keynes published a rejoinder that explained his theorization of the relationship between money demand and uncertainty (Keynes 1937). Unlike risk, where the range of possible outcomes is treated as knowable and the associated probabilities therefore calculable, uncertainty relates to situations where agents are unable to imagine the outcomes and are consequently unable to insure themselves against adversity as they can when risk is calculable. The response, according to Keynes, can be conceptualized as the precautionary demand for money (see de Carvalho 2010). However, this is "hurriedly skipped over in the traditional textbooks, but … seems to better describe the growing systemic risks we face than the better-known speculative motive" (vii). These risks, and the world of which they are an increasingly significant bi-product, are portrayed by Michael Howell in *Capital Wars*, "a hybrid of economic and finance theory and real-World experience" (ix), and an unrivalled "description of the workings of the modern global financial system and the interrelationship of finance and the real economy" (Plender 2020). Using flow-of-funds analysis pioneered by Morris Copeland and popularized by Henry Kaufman and Raymond Goldsmith (38), Howell "links income and expenditure flows to their counterpart changes in stocks of assets and liabilities" unlike national income accounting, which ignores "the stock consequences of flows" (39). Whereas mainstream economics focuses "almost exclusively on the uses of funds," flow-of-funds analysis sheds light on "sectoral imbalances and balance sheet mismatches" (40), and therefore the sustainability of those uses: "Sustainability depends upon future access to liquidity which today largely reflects financial intermediation beyond the traditional banking system" (61). It also avoids a narrow focus on net imbalances that has fueled the misleading "savings glut" explanation of the U.S. trade deficit (Palley 2013).

At the root of Howell's book is the "key idea … that economic cycles are driven by financial flows, namely quantities of savings and credits, and not by high street inflation or the level of interest rates." These flows are the result of "Global Liquidity, a $130 trillion pool of footloose cash" that was 166% of world GDP at the end of 2019 (vii). The US dollar remains hegemonic, despite the effective sovereign default that brought an end to the Bretton-Woods dollar-gold standard in 1971. Soon after this the US ensured that "critical commodities, the most notable being oil, are denominated in fiat dollars" (Liu 2008). Howell refers to this as an "oil-based standard" that in the early 1990s was superseded by emerging markets' demand for the dollar. In his view this continues to underwrite its hegemony, but also constitutes "the roots of our current financial instability" (6). For this reason, Howell argues, policymakers should focus on financial stability, rather than consumer price inflation: "when the economic background is characterized by the need to refinance large outstanding debts, rather than to finance new capital projects, balance sheet capacity, i.e. liquidity, is crucial" (28).

Howell proceeds to develop his model of global liquidity by placing it in the context of greater volatility, deepened by "a battle for supremacy between national capitals, and specifically the intensifying tussle between America and China, with fast-moving financial flows the modern equivalent of shock troops" (43). China's entry to the World Trade Organization in 2001 accelerated the decline in U.S. capital expenditure "to levels that barely cover its wear and tear" (47), while financial markets benefited from an influx of cash that was increasingly concentrated in fewer giant corporations that regarded productive investment as unlikely to generate the kind of returns possible via financialization. Meanwhile the globalization of manufacturing industry drove down wages and prices, while entrenching structural unemployment in Western economies that became increasingly dependent on debt-fuelled consumer spending. "Unlike traditional capital investment, much of this spending is unproductive and, therefore, not so easily paid back. Hence these swollen debt burdens need to be refinanced" (49). This has increased the frequency of defaults due to illiquidity, rather than insolvency, and has transformed the

financial system into a refinancing system, rather than a source of funds for productive investment. Worse still, it is "more than ever dependent on the supply of potentially flaky safe assets to help rollover increasingly flaky debts creat[ing] a negative feedback that highlights the inherent dangers in credit markets" (49).

Howell's model, derived from the flow-of-funds framework, equates liquidity with its sources (savings plus change in the monetary base plus change in bank and shadow bank credit), its uses (real investments plus financial investments plus change in cash holdings), and the overall change in wealth (57). Howell further subdivides the sources of liquidity into their public and private sector components, in order to demonstrate the importance of what he terms the quality mix of liquidity—the difference between private and public sector components—to foreign exchange markets. Liquidity shocks, whether resulting from net capital inflows or productivity growth's impact on domestic profits, are associated with the private sector "and thereby trigger changes to the real exchange rate" (65), causing an increase in the event of a favorable shock. Ultimately, liquidity is "a gross funding concept that represents the size of financial balance sheets" and which is both broad and deep in scope, as it encompasses cross-border effects and "extends beyond the traditional retail banking sector, to include corporate cash flows, and repo and wholesale money markets" (97). Since most credit takes the form of collateralized loans "that derive from wholesale money markets, not banks; ultimately sourced from corporate and institutional cash pools" and funds the "rollover of huge outstanding debts … liquidity is more important than the level of interest rates" (97).

What Howell calls the "shadow monetary base" comprises offshore wholesale markets and the available pool of private sector collateral. Together with central banks' balance sheets (the traditional monetary base), it supports expanding private sector liquidity (95) that can be accessed without recourse to traditional bank sources. For example, private equity group Thoma Bravo's $6.6bn acquisition in July 2021 of mailing and shipping business Stamps.com was part-financed by $2.6bn of private lenders' funds, including an unspecified amount

from Thoma Bravo's own lending arm. Private lenders' funds are estimated to control $364bn, "as low interest rates send investors hunting for higher yields in private markets." They are often "run by the same institutions that separately operate large [private equity] funds," which "might compete for an acquisition and then end up as partners in the debt financing … PE on one side, private credit on the other" (Rennison, Platt, and Indap 2021).

Howell proceeds to discuss the roles of the main central banks, the nature of cross-border capital flows, the rise of China and other emerging markets, the global liquidity cycle and its relationship with standard economic cycles, financial crises and safe assets, and the eastward trajectory of the world's economic center of gravity. He concludes by observing that the conduct of monetary policy fails to take account of an investment world that is already bigger and continuing to grow, with important consequences. The predominance of private sector credit and debt, combined with global supply chains denominated in US dollars, is increasing the procyclicality of the monetary system. Policy responses to this ignore the refinancing focus of credit markets, with "ultimately destabilizing" consequences (278). Howell notes the rise of China as an industrial powerhouse and its "remarkably immature" financial system (276), a mirror image of the present-day US. The threat posed to US dollar hegemony by the rise of the yuan may lead to "countervailing geopolitical forces and likely spur attempts to halt the free flows of capital" (277). For this reason, he envisages a regionalization of currency, trade and supply chains—a reversion to spheres of influence.

Austerity policies pose a threat to stability because they deprive the markets of the safest of assets (bonds), meaning that there is both a tendency to hoard those that are available, whilst attracting lower quality private sector "safe" assets whose values are procyclical. In this way the liquidity upon which the system depends "is built from the same safe asset pool that is being adulterated by flaky private sector debts. In this vicious spiral, more poor-quality debts are being funded by still more poor-quality private sector debts" (272). Nevertheless, in an aside, Howell casts doubt on modern monetary theory as a solution "because our

economic problems and low rate of new investment have little to do with the lack of money, per se" (274). Instead, it is a question of policy, based on an appropriate understanding of the financial structure (275).

Howell distinguishes between "funding liquidity" (ease of financing) and "market liquidity" (ease of trading). Whereas the latter refers to "the ability to buy and sell assets and commodities in size around current prices", funding liquidity refers to "the availability of cash to meet expected liabilities" (25). Although conceptually distinct, they are not separate, and can interact to create "dangerous downward liquidity spirals" in the event of crisis (25). As noted earlier, Howell defines global liquidity as the worldwide aggregated funding liquidity including cross-border capital movements. Considering the power of private sector capital movements and regulators' real but limited influence on these, Howell's justifications for the more inclusive concept appears to be appropriate. Given its innate procyclicality, "partly dependent on the buoyancy of capital asset prices and exchange rates" (26), global liquidity shocks "are typically bigger, longer-lasting and more pervasive than the calibre of shocks studied by economists and Central Banks when using their so-called DGSE models of the economy" (7). They are also more frequent, as more than 60 countries "have experienced asset booms followed by banking crises" since 1980 (7).

Howell is an alumnus of Salomon Brothers, where the predominant view was that "watching money and capital flows was the nearest thing to obtaining *insider information*" while staying on the right side of the law (11). Based on the pioneering and influential work of the firm's then Managing Director (Kaufman 1986), Howell and his colleagues developed the basis of what is here described as a liquidity theory of investment. The details and implications of Howell's subsequent work on this theory are elaborated throughout the book. Its relevance is seemingly vindicated by the disproportionate rise in asset values (as compared with profits) since 1980, and the forced, if often reluctant, transition of central bank policy away from anti-inflationary monetary targeting to liquidity provision via quantitative easing (12). In addition to its frequent divergence from standard economic

theory, Howell's argument is also much more geopolitically conscious, hence the book's title: "think of capital wars as a conflict between nations, fought out in investment markets, that parallels the more familiar concept of trade wars and which ultimately involves a battle for currency supremacy" (3).

This battle ultimately belongs to the United States and China. Whereas the US, "the main supplier of the global currency to World markets, is a large, low productivity growth economy, with highly developed financial system and a capital surplus," China "is a large, high productivity growth economy, with underdeveloped financial markets and a far greater need for 'intelligent' and risk-seeking capital" (12). This is unsustainable and therefore must change. However, the pathway to a world in which China's currency assumes reserve status is fraught with uncertainty, even as the US can no longer (nor wants to, apparently) "absorb the excess savings of others" (5), including China's "annual US$6 trillion nest-egg" (5). While China's "future challenge is to encourage a commensurate growth in the international use of the Yuan" (21), following its rapid industrialization, this will not be easy. Howell cites the IMF to the effect that "a switch from a World trading system centred on *American deficits* to one revolving around *Chinese surpluses* could ultimately dampen World GDP growth by as much as 2% per annum" (5).

The explanation for this lies in China's centrality to global production networks: "Global Value Chains (GVC) use US dollars extensively to finance their inventories and their US dollar needs grow disproportionately as these supply chains lengthen" (65). This gives further impetus to the build up of precautionary dollar reserves by Asian central banks that began in the wake of the Asian crisis of 1997. Given its centrality in these GVCs, China's dollar reserves are such that it accounted for 28.5% of global liquidity in 2019, compared to the US's 22.7% (22). This effective recycling of dollars Howell attributes at least in part to China's "relative financial immaturity" (23).

Howell's geopolitical awareness places him in a small group of writers including Henry C. K. Liu and Michael Hudson (both, like Howell, Wall Street veterans). Hudson's focus on debt as a means to extract rent might be seen as a useful counterpoint to Howell's emphasis on balance sheet capacity and global flows of savings and credit. Tellingly, both employ the war analogy (Hudson 2015).

In closing, Howell reflects that "while capitalism undoubtedly excels at aggregate wealth creation, it does by collapsing the industrial cost structure and erecting a towering financial superstructure" (272). The soundness of this structure becomes ever more fragile. The accumulation of risk in pursuit of outsized profits, in a world of "excess production and abundant savings" (5), can quickly threaten to cut off the supply of liquidity necessary to support the servicing of debts that now comprises the majority of global investments. The problem is less one of "too big to fail" (although that is also a legitimate concern) than "too interconnected to fail" (237). For providing such a comprehensive guide to this superstructure and its deleterious economic and political impact, Howell is to be congratulated.

References

de Carvalho, Fernando J. Cardim. 2010. Uncertainty and money: Keynes, Tobin and Kahn and the disappearance of the precautionary demand for money from liquidity preference theory. *Cambridge Journal of Economics* 34 (4): 709–725. DOI: 10.1093/cje/bep020

Hudson, Michael. 2015. *Finance as Warfare*. Rickmansworth: World Economics Association /College Publications.

Kaufman, Henry. 1986. *Interest Rates, the Markets, and the New Financial World*. New York: Times Books.

Keynes, John Maynard. 1937. The general theory of employment. *Quarterly Journal of Economics* 51 (2): 209–223.

Liu, Henry C. K. 2008. Shifting China's export towards the domestic market. *Asia Times Online*, 29 July. Accessed at: http://www.henryckliu.com/page165.html.

Palley, Thomas I. 2013. Gattopardo economics: The crisis and the mainstream response of change that keeps things the same. *European Journal of Economics and Economic Policies: Intervention* 10 (2): 193–206. DOI: 10.4337/ejeep.2013.02.04

Plender, John. 2020. The fractious interplay between China and the US. *Financial Times* July 13 (16).

Rennison, Joe, Eric Platt, and Sujeet Indap. 2021. Private credit joins PE group to freeze out the banks. *Financial Times* July 15 (10).