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Hedge Funds As A Weapon of State?: Financial and Monetary Power in an Era of Liberalized Finance

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Global Investors and National Interests:
Financial and Monetary Power in an Era of Liberalized Finance

On occasions throughout history, states have attempted to exercise financial and monetary forms of power as mechanisms for pursuing their national interests. Financial power refers, primarily, to the ability of a state to influence the direction of private international capital flows (i.e., toward friends and away from enemies) and has generally been viewed as requiring a national financial system characterized by centralization and government intervention. Monetary power, in part, refers to the ability of a state to manipulate the value of a target state's currency and has been perceived as being based upon large foreign exchange (forex) holdings in relation to the size of the broader forex market. However, given that the recent trend toward financial liberalization has brought with it a growth in disintermediated (and, thus, decentralized) capital markets, a decline in government intervention and a massive expansion in the size of the forex market relative to the size of national forex holdings, states would appear to be less able to exercise financial and monetary forms of power within the contemporary international financial system. In fact, much of the current research on the relationship between states and the financial markets has tended to emphasize the limits which financial liberalization has imposed upon the sovereign powers of states.[1]

Reflecting these developments, the purpose of this paper is to determine whether states retain the capacity to engage in financial and monetary forms of diplomacy within the present context of liberalized international capital markets. In doing so, it argues that what has been ignored in much of the current international relations literature is the historically unique characteristics of certain non-state financial actors and the opportunities which they may afford for the use of state power. Specifically, by demonstrating the increasing authority which is being exercised by hedge funds and how this authority is serving to re-centralize investment decision-making, this paper argues that these funds may provide a renewed site through which states might exercise financial and monetary forms of power.

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[1]For a review of this literature, see Cohen, 1996.

Financial and Monetary Power in Historical Perspective

Financial Power and its Preconditions

As Jonathan Kirshner notes, "[i]n general, in the practice of economic statecraft, large states are home states and small states are the targets" (1995: 21). In the case of financial power, size would also seem to be a precondition in that large states are generally the most important sources of finance and, thus, most capable of mustering a large pool of capital for foreign investment. However, while this precondition leads to the expectation that financial diplomacy will be engaged in most frequently by the dominant financial power, this has not been the case historically. In the nineteenth century, for example, financial power was used primarily by France and Germany to the extent that "[f]or both countries . . . private international finance was regarded simply as an extension of diplomacy by other means" (Cohen, 1986: 105). In contrast, as both Jacob Viner (1928) and Herbert Feis (1930) have demonstrated, Britain — despite its status as the world's financial hegemon — rarely made use of private international capital flows to achieve its foreign policy goals. In a similar fashion, the use of financial power in the twentieth century has been dominated by Germany and Japan and not, as we might expect, by the dominant financial power, the United States. As Andrew Spindler has observed, "U.S. government agencies rarely, if ever, appear to convey outright instructions to American banks on how to behave internationally" (1984: 200). Therefore, while economic size may be a necessary precondition for financial power, it is not a sufficient determinant of a state's ability to influence the direction of private international capital flows. In light of these findings, what conditions — other than economic size — might affect the ability of a state to engage in financial diplomacy?

For Spindler, differing state capacities to exercise financial power reflect the different types of national financial structures identified by John Zysman (1983). In Zysman's taxonomy, there exist three ideal types or models of national financial systems, each of which has implications for the ability of governments to influence the allocation of private capital. The first, which he describes as the credit-based, government-dominated model, refers to a financial system where firms are dependent on commercial bank loans for financing and where prices are

determined by the government. It is in this type of national financial system, of which France and Japan are examples, that governments are most able to exercise political influence. This is the case in that commercial banks, by acting as intermediaries between lenders and borrowers, serve to centralize the investment process and thus provide governments with a specific site through which they can exercise political influence. Also, because governments intervene to set key prices, this type of financial system is more likely to be characterized by a tradition of government intervention and less resistance to political influence on the part of financial institutions.

Zysman's second type of national financial system, summarized as the credit-based, financial institution-dominated model, refers to a financial system where firms are dependent on bank loans but where prices are determined by the market power of financial institutions. In this model, of which Germany is the key example, the capital allocation process is more centralized than in the credit-based, government-dominated model and, while this does provide governments with a site for exercising influence, it has led to a tradition of laissez-faire and to a degree of power for the financial institutions which is sufficient to enable them to resist government intervention. As a result, in this model, governments can influence private investment flows but they must generally do so through negotiation with the large banks.

In the third type of national financial system, which Zysman describes as the capital markets model, firms have access to developed stock and bond markets and prices are determined competitively by markets forces. In this type of financial system, of which Britain and the United States are examples, the government is less able to influence private capital flows due to the decentralized nature of stock and bond markets and due to the more entrenched traditions of laissez-faire. Stock and bond markets tend to be decentralized in that they are disintermediated; that is, lenders and borrowers interact directly without the involvement of a centralizing intermediary such as a bank. As a result, when financing occurs primarily through the vehicle of disintermediated stock and bond markets, rather than through the more centralized mechanism of commercial bank loans, there is no site through which governments might attempt to exercise political influence.

While Zysman's taxonomy is focused primarily on domestic capital allocation, Spindler notes that "the same differences in national financial structure also wield enormous influence on bank-government relations in the international sphere" (1984: 9). In other words, the more a state's national financial system is characterized by centralization and government intervention, the greater will be its capacity to exercise financial power. In terms of financial diplomacy in the twentieth century, the differences between Zysman's two credit-based models would seem to account for Spindler's findings that "[a]lthough both the German and Japanese governments have employed signals and incentives to influence the allocation of financial resources abroad by their countries' private sectors, the Japanese authorities have clearly done so more systematically and more vigorously" (1984: 182). In a similar fashion, the differences between Zysman's credit-based models and the capital markets model would also seem to explain the fact that "the essential features of today's dialogue between America's international bankers and foreign policy officials continue to reflect the arms-length nature of U.S. bank-government relations" (Spindler, 1984: 194).

Monetary Power and its Preconditions

In contrast to financial power, monetary power would seem to be more exclusively dependent upon economic size and, in particular, upon the size of a state's foreign exchange holdings in relation to the size of the market for the target currency (measured in terms of the volume of transactions). While there exists a variety of methods for manipulating the value of a target state's currency, the most simple is that of dumping or purchasing the currency on international markets. Therefore, when the home country's forex holdings are large in relation to the size of the market for the target currency, the sale or purchase of the currency will constitute a larger percentage of total transactions and will, thus, have a greater impact on its value. Alternatively, if the ratio of home state forex holdings to target market size is smaller, the manipulation attempt will be less likely to have a unilateral impact on the target currency's value.

Size also becomes an important factor in determining how the market will react to an attempt at manipulation. As Kirshner notes, the success or failure of an attempt to exercise

monetary power — especially in larger markets — often depends on "whether the market will balance against or bandwagon with the currency manipulation" (1995: 37). Given that the source of the manipulation can be unknown[2], the reaction of the market will depend on whether the manipulation attempt is perceived as a short-term trend to be arbitraged against (balancing) or as a signal of things to come and, thus, to be followed (bandwagoning). Two key considerations will affect market perceptions; the size of the manipulation and the credibility of the target state. In both cases, the economic size of the home state will be important. In the former case, as noted above, the larger the ratio of home forex holdings to target market size, the greater will be the unilateral impact of a manipulation attempt on the value of the target currency. This is important for market perceptions for two reasons. First, as Kirshner notes, "the stronger the pressure, the more likely it will be recognized as a significant trend" and, thus, bandwagoned with the market (1995: 37-8). Second, because a large manipulation in a smaller market will constitute a larger percentage of total transactions, "the manipulation would represent a particularly overwhelming share of the information available to those holders of the target currency that did exist, making them more likely to bandwagon than to balance" (Kirshner, 1995: 273 in note 5).

In addition to being more likely to possess the material resources (i.e., forex holdings) necessary for currency manipulation, large states are also more likely to possess the normative authority necessary for influencing market perceptions of the credibility of a target state. States can influence market perceptions through passive signaling (i.e., simply revealing its intervention to the market) and/or through active signaling (i.e., mounting a rhetorical campaign against, or in support of, the credibility of the target state). Passive signaling is apt to be more successful when conducted by large states in that market actors will be more likely to assume that the monetary authority has access to better information about economic fundamentals (Dominguez and Frankel, 1993: 58). Large states will also have an advantage in active signaling because the opinions of their officials are more likely to be widely disseminated amongst, and heeded by, market operators. Overall, the precondition of economic size would seem to conform

[2]As Dominguez and Frankel note, "[m]ost foreign exchange transactions are anonymous; there is no central trading floor, and brokers are not obliged to reveal the identity of counterparties" (1993: 59-60).

to Kirshner's findings that, in historical instances of the use of monetary power, "a relatively small number of regionally or globally dominant states had a hand in almost every case" (1995: 263).

The Challenge of Financial Liberalization

The origins of the recent trend toward financial liberalization can be traced, initially, to the post-Second World War growth of offshore (Euro)markets and to the deliberate regulatory support afforded to them by governments.[3] As a more liberal and disintermediated form of capital allocation, the Euromarket emerged in response to investors' demands for higher yields and to the needs of borrowers to control the costs of capital. Over time, the competitive pressures generated by these markets were sufficiently strong so as to prompt a wave of deregulation and liberalization among traditional onshore markets. Deregulation, which involved the dismantling of the Bretton Woods system of capital controls, led to an increasing level of mobility for financial capital. At the same time, many states began to liberalize their domestic capital markets (with regulations supporting the development of disintermediated securities markets) in order re-attract mobile capital lost to the offshore centres. Taken as a whole, the liberalization of international capital flows and domestic financial markets has led to a number of trends which appear to challenge the ability of states to exercise financial and monetary forms of power.

Implications for Financial Power

In terms of financial power, the most significant trend has been the expansion of disintermediated stock and bond markets and the way that "this process has led to the disempowerment of traditional intermediating institutions, notably banks" (Sinclair, 1994b: 136). In the United States, for example, bank loans as a percentage of total corporate liabilities have dropped from 33 per cent in 1980 to 25.4 per cent in 1990 (IMF, 1992: 3). Also, while moving

[3]For a more detailed study of the causes of financial liberalization, see Helleiner, 1994.

more slowly in traditionally credit-based financial systems — such as those of Germany and Japan — the International Monetary Fund (IMF) notes that "the evidence indicates that the trend is toward a disintermediated, liquid, securitized structure" (1992: 3). Disintermediation is also evident at the international level in that commercial bank lending as a percentage of total capital movements has declined from 37% in the 1977-81 period to only 14% during the 1982-1986 period (Sinclair, 1994b: 136). Therefore, as Timothy Sinclair argues, "[c]apital allocation in its traditional form was centralized . . . [but the] pattern that is emerging would appear to destroy the idea that allocation is anything other than the disparate decisions of unconnected market players" (1994a: 451). In other words, with financing now occurring primarily through the vehicle of disintermediated securities markets, rather than through the more centralized mechanism of commercial bank loans, it would appear that banks no longer provide governments with as viable a site through which they can exercise financial forms of power.

Where disintermediation can reduce a state's capacity to exercise financial power, the trend towards greater transparency in banking and the broad acceptance of neoliberal ideas may reduce their willingness to engage in this form of diplomacy. Important here, for example, has been the 1988 Basle Accord which mandated banks to implement greater balance sheet transparency as well as the increase in transparency monitoring being conducted by central banks, the Bank for International Settlements, the International Monetary Fund and, to a lesser extent, private credit raters such as Moody's and Standard and Poor. Also important has been the adoption of freedom of information acts which allow for greater public oversight of banking activities. In terms of implications for a state's willingness to exercise financial power, Spindler notes that "[t]he forcing of bank-government relations into the light of day may complicate them for bankers and government officials alike, limiting the willingness of either side to become involved" (1984: 191-2). For the bankers, neoliberal views that political interference will lead to efficiency losses combined with notions of fiduciary duty[4] may make them unwilling to cooperate, especially if such actions were to be made public. For the government, political

[4]Fiduciary duty refers to the ethical responsibility of investment managers over their clients' investments. The traditional interpretation of fiduciary duty is to minimize risk, maximize returns and preserve capital.

considerations (both domestic and international) may reduce their willingness to exercise financial power if their actions could not remain covert. At home, such actions — especially within the current neoliberal context — could be perceived as putting domestic savings at risk. Internationally, publicity may "undermine sanctions by making compliance more difficult because of the potential for 'loss of face' [on the part of the target state] both nationally and internationally" (Kirshner, 1995: 28).

Implications for Monetary Power

In terms of monetary power, the most significant trend related to financial liberalization has been the massive expansion in the size of the forex market in relation to the size of national forex holdings. In the early 1970s, these holding were about eight times larger than average daily foreign exchange trading but, as *The Economist* reports, "[l]atest estimates suggest that foreign exchange trading is now more than twice the size of currency reserves" (Woodall, 1995: 30). In fact, the average daily turnover in the forex market has risen from the $10-20 billion range in 1973 to almost $1.2 trillion in 1995[5] (Porter, 1996: 669 and BIS, 1996). The implication of this trend is that any attempt at currency manipulation would now constitute a much smaller percentage of total transactions and, thus, be less likely to have a unilateral impact on the value of a target state's currency. This is not to say that central banks can no longer affect exchange rates or exercise monetary forms of power. Rather, as Kirshner argues, it means that "the success of currency manipulation will increasingly be dependent on the ability of actors to skillfully manipulate market forces. Specific tactics such as the mixture of public and private measures, and the timing of various acts will become decisive" (1995: 280).

In practical terms, this means that home states will have to supplement currency intervention in a way that provides the market with enough new information to induce bandwagoning; that is, they will either have to reveal themselves as the source of the intervention or mount a rhetorical campaign against the credibility of the target state. As one

[5]All figures in U.S. dollars.

recent study on the efficacy of foreign exchange intervention argued, "[i]f . . . intervention has an important effect on the exchange rate only when it influences expectations, this implies that the intervention must be publicly known in order to be effective" (Dominguez and Frankel, 1993: 136). At the same time, however, this need to go public may — for both political and economic reasons — serve to limit the willingness of a state to make use of monetary power. For political reasons similar to those which apply to the use of financial power, states may be less willing to engage in currency manipulation if it can only be accomplished with the target state and the broader public being aware that it is the source of the attempt. Governments, and especially their increasingly independent central banks, may also be unwilling to manipulate currencies if their intervention will be known to the market. On the one hand, if the market becomes aware that the intervention is politically motivated it may balance against the intervention and, thus, offset its effectiveness. On the other, central bankers may fear a loss of credibility if the market becomes aware that it is sending them false signals (i.e., those which are not based on economic fundamentals).

At a first glance then, the trends most directly associated with financial liberalization — disintermediation, transparency and the massive expansion in the volume of forex transactions — would appear to impose a number of constraints on the capacity and willingness of states to exercise traditional forms of financial and monetary power. However, as this paper will now demonstrate, recent trends within the securities markets and, in particular, the growing power of hedge funds may both renew, and actually increase, the opportunities for financial and monetary diplomacy.

The Power of Hedge Funds

While there is no legal or universally accepted definition of a hedge fund, they can be regarded most simply as an unregulated form of mutual fund (or unit trust) which caters exclusively to wealthy individuals and institutions and whose managers are compensated primarily on the basis of absolute rather than relative performance. Structured as unregistered private offerings, hedge funds are not required to file reports with any regulatory agencies and, thus, obtaining precise

information about the industry is difficult. However, according to an estimate by the American Association of Individual Investors (AAII), hedge fund assets rose from $21 billion in 1990 to over $70 billion in 1995 with the ten largest funds (known as 'macro' hedge funds[6]) controlling over 45 per cent of these assets. In fact, three of the largest macro hedge funds — Quantum Fund, Tiger Management and Steinhardt Partners — controlled $17 billion worth of assets representing almost 25 per cent of the 1995 industry total[7] (AAII, 1995). While impressive, the capitalization of these funds remains small in terms of the size of the securities markets as a whole and, alone, do not indicate any significant re-centralization of investment decision-making. Therefore, to understand how these funds are serving to re-centralize the capital allocation process, it is necessary to move our examination beyond the assets which they directly control and, instead, look to the increase in herd behaviour within the financial markets and to the ability of hedge funds to act as markets leaders.

Institutional Investors and Herd Behaviour

The growing power of hedge funds owes much to the rise of large institutional investors — such as mutual funds and pension funds — and to the way that they are serving to increase the collective or herd nature of the capital allocation process. As I have argued elsewhere (Harmes, 1998), institutional investors have contributed to herd behaviour through the way that they have served to centralize investment decision-making, through their tendency to observe and follow the behaviour of others and through their use of similar frameworks for evaluating economic fundamentals. In terms of the former, decisions relating to capital allocation have become

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[6]The term 'macro' refers to an investment strategy and not to the size of the funds. However, virtually all of the largest hedge funds employ a macro strategy. A 'macro' strategy seeks to profit from shifts in macroeconomic variables such as interests rates etc as opposed to profiting from individual stock movements and other more 'micro' shifts in fundamentals.

[7]Figures on the hedge fund industry vary depending on whether 'futures funds' and 'funds of funds' are included in the estimate. The estimates above do not include these types of funds. Counting hedge funds only, the fund-tracking firm Managed Account Reports Inc. (1996) estimated 1996 hedge fund industry assets at $96 billion. Counting all funds, the Magnum Group of Funds estimated that, in 1997, the total assets of the hedge fund industry were between $200 and $300 billion (Friedland, 1997).

increasingly centralized as more and more individuals delegate control over their savings to professional fund managers. In the OECD countries, for example, institutional assets rose from $13.8 trillion in 1990 to over $23 trillion in 1995 with over half being controlled by U.S. fund managers (OECD, 1997: 20). Therefore, rather than being composed of millions of unconnected individuals, "the investor base in securities markets in industrialized countries, and increasingly in developing countries, is [now] dominated by a relatively small number of large institutional investors" (IMF, 1995: 165).

Serving to reinforce this trend towards centralization has been the rapid growth of American mutual funds, the high level of concentration within this industry and the delegation of control over assets to them by other institutional investors. In October of 1996, the total assets of U.S. mutual funds stood at $3.39 trillion up from $2.162 trillion in 1994 and up from only $241 billion in 1980 (Useem, 1996: 256). Moreover, one example of concentration within this industry is Fidelity Research and Management — the largest of all mutual fund companies — whose assets grew by a factor of 100 between 1972 and 1995 to over $390 billion (Useem, 1996: 255). In terms of control over other institutional assets, pension funds have increasingly delegated control over their assets to mutual funds to the extent that, in 1993, they retained direct control over only 12 per cent of all institutional assets. At the same time, money and mutual fund managers oversaw 51 per cent of all institutional assets making them the largest single group of active investors (Useem, 1996: 255). In this way then, the delegation of control over assets by both individuals and some institutional investors to mutual funds has led to a centralization of investment decision-making within the (seemingly) disintermediated capital markets. As a result, capital is now being allocated collectively in an extremely direct fashion.

The second way that institutional investors have contributed to herd behaviour is by increasing the tendency of investors to ignore economic fundamentals and, instead, to observe and follow the behaviour of others. Important here is the fact that most fund managers are evaluated primarily on the basis of relative performance; that is, they are penalized for underperformance in relation to the median fund and, at the same time, they are not proportionately rewarded for overperformance. Consequently, "fund managers will follow the investment decisions of other fund managers in order to show clients that they know what they

are doing. If they follow other fund managers' decisions and the investment turns out to be unprofitable, they are more likely to be thought of as unlucky than as unskilled, since other fund managers will have made the same mistake" (World Bank, 1997: 126).

Also important to the tendency of fund managers to ignore fundamentals are the costs and difficulties associated with the collection and analysis of fundamental information. As a result, "observing the choices of others is often a cheap and helpful alternative" to analysing economic fundamentals (Hirshleifer and Welch cited in *The Economist*, 1994b: 91). Given this fact, many fund managers will often allocate capital in response to, what Shleifer and Summers (1990) term, 'pseudo-signals.' Pseudo-signals are any source of information, other than fundamentals, that investors believe will convey information about future returns. Prominent here is the tendency of some managers to either follow markets gurus (who are perceived as having better information about relevant fundamentals) or to buy and sell assets on the basis of price movements. In terms of the latter, one investment strategy which reinforces collective behaviour is the use of technical analysis. Simply put, "[t]echnical analysis typically calls for buying more stocks when stocks have risen (broke through a barrier) and selling stocks when they fall through a floor" (Shleifer and Summers, 1990: 24). In other words, fund managers will buy and sell securities on the basis of aggregate demand shifts without assessing whether or not they are in response to fundamentals.

In addition to promoting centralization and a tendency to follow others, institutional investors have also contributed to herd behaviour through their use of similar frameworks for evaluating economic fundamentals. Where this use of similar frameworks is most evident is in the tendency of institutional investors to employ extremely short-term investment criteria. As the IMF notes, "[i]nstitutional investors have certain characteristics that lead to a different pattern of behaviour from individual investors" (1990: 7). Chief among these characteristics, especially for mutual funds, is the growing competition within the fund industry and the ability of individuals to redeem their shares at a moments notice. Accordingly, "U.S. mutual funds need to meet performance standards over a very short time horizon, and open-ended funds face the risk of sizeable net redemptions if their quarterly performance lags behind the competition" (IMF, 1994: 18).

Also, within the funds themselves, these competitive concerns have become formalized in institutional structures which, in turn, serve to reinforce a short-term mentality among managers. Important here is the fact that "the performance of most money managers is evaluated at least once a year, and usually every few months" (Shleifer and Summers, 1990: 21). Also important is the extensive use of leveraging (speculating with borrowed capital) within the industry. Leveraging can impose a short-term horizon upon institutional investors by increasing the amount of risk to which the funds can be exposed. In other words, because they are taking highly speculative positions with borrowed money, fund managers may be forced to dump an asset in response to even a small movement in the asset's price. As *The Economist* observes, "the leverage that helps institutions build up large positions works against them once [asset] prices begin to slide, multiplying their losses and increasing the pressure to sell" (Woodall, 1995: 18). Employed broadly throughout the industry, the use of short-term investment criteria contributes to herd behaviour because fund managers will evaluate, and react to, economic fundamentals in a similar fashion. As the IMF argues, "when fund managers share homogeneous perceptions about both the evolution of financial variables and the impact of news, the potential exists for new information to produce massive purchases/sales and sharp movements in prices" (1993: 2).

Taken as a whole, the rise of institutional investors is significant for the potential of financial and monetary power for a number of reasons. First, by increasing herd behaviour and short-term price sensitivity, institutional investors may serve to amplify the impact of market bandwagoning. In practical terms, this is the case as the collective allocation of large blocks of capital on a short-term basis means that "the markets habitually take on a momentum of their own, and prices end up 'overshooting,' or reaching extreme highs and lows before settling back" (Pennar, 1995: 84). Therefore, because even a small change in new information can lead to a massive swing in prices, the impact of a successful attempt at financial or monetary diplomacy is likely to be felt much more deeply than before.

Second, because of their short-term horizons and markets clout, the rise of institutional investors has created a large demand for more liquid assets and, as a result, has contributed to the trend towards securitization. Securitization is when individual liabilities and assets are

converted into liquid financial instruments (such as stocks and bonds) that can be bundled together and easily traded in the marketplace. By expanding the number of assets that can be traded on a short-term basis, the trend towards securitization may alter the nature of financial power, its relationship to monetary power and the potential impact of both. In the former case, securitization means that financial power (in a similar fashion to monetary power) can now be exercised in the manner of an attack, rather than as a more long-term displacement or interference with private international capital flows. At the same time, this means that the interrelationship between financial and monetary diplomacy will be greater. As demonstrated by the recent currency/financial crises in Mexico and South-East Asia, a speculative attack against a currency can provoke a selloff of financial assets denominated in the currency and vice versa. Moreover, because financial and monetary attacks can become virtually one in the same, their impact in terms of breadth may increase proportionately. Pointing to the transmission role played by securitization, John Edmunds argues that the "market's displeasure is [no longer] felt first by export or import companies: It is felt everywhere at once, immediately and painfully" (1996: 133).

Finally, the herd behaviour associated with the rise of institutional investors is significant in that it would seem to have increased the potential for market manipulation even within the context of disintermediated securities markets. This is the case because, instead of having to manipulate millions of autonomous and unconnected individuals, a state would now only have to manipulate one large herd. However, to understand how this manipulation might best be achieved, we may now examine how macro hedge funds have served to re-centralize investment decision-making through their ability to act as market leaders.

The Market Leadership Role of Hedge Funds

One way that macro hedge funds act as market leaders stems from their ability to unilaterally move asset prices. Unlike other institutional investors, hedge funds are set up as either limited partnerships of less than 100 'partners' or they are chartered offshore. In either case, they are not subject to the (U.S.) Investment Company Act of 1940 which imposes leveraging restrictions

on investment companies. As a result, macro hedge funds are able to borrow up to twenty times their capital from commercial banks in order to take highly leveraged positions. They are also able achieve leveraging through the use of derivatives (such as options, futures and swaps) which allows these funds to purchase an asset without paying its full cost up front. In either case, macro hedge funds are able to take much larger positions than would be warranted by their capitalization and, therefore, can often single-handedly influence the movement of an asset's price.[8] Combined with the extensive use of technical analysis among institutional investors, these price movements can lead to a similar response by other investors in a manner that invokes significant market bandwagoning. As the manager of ECU Fund Management, Michael Petley, notes, "[i]f a market is rammed hard enough by hedge funds at strategic technical levels, a 'domino' effect may occur in which a predetermined series of stop-loss orders[9] will carry the market further and further down quickly precipitating those fund managers who are [leveraged] up in a market moving quickly against them, to run for cover, irrespective of any arguments about 'fundamentals'" (cited in Kelly, 1995: 221).

Possibly the most notable example of this process occurred in the summer of 1992 during the European Exchange Rate Mechanism (ERM) crisis. Prior to the crisis, George Soros — the now famous manager of one of the largest macro hedge funds, Quantum Fund — held the view that the British pound was unsustainably overvalued. Backing this view to a leveraged tune of $10 billion, Soros began to sell sterling short[10] in massive quantities. Combined with similar

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[8]Reinforcing the use of leverage is the fact that many macro hedge funds employ 'directional,' rather than diversified, investment strategies. As noted earlier, mutual and pension fund managers are compensated on the basis of relative performance and, generally, seek to limit their risk exposures through greater diversification. Hedge fund managers, in contrast, are compensated on the basis of absolute performance and, thus, often take greater risks by committing a larger percentage of their capital to a specific asset.

[9]A 'stop-loss' order is essentially is a computerized version of technical analysis which automatically sells an asset if its price drops below a predetermined floor.

[10]Selling a currency 'short' allows an investor to profit from a fall in the currency's value. Through the use of derivatives (such as futures and forward contracts) an investor is able to, in a slight reversal of the famous dictum, sell high and buy low. Specifically, the investor sells forward contracts in the currency (i.e., a promise to deliver the currency at the present price at some time in the future) and when the price of the currency falls, the investors buys the currency at the cheaper price and delivers the currency (as required by the forward contract) at the past, higher price.

actions by other hedge funds, "Soros's sales of sterling provided the momentum that put the pound into an uncontrollable spin" (Lycett, 1993: 36). Significant here was the way that Soros' move served as a signal for institutional investors to also begin dumping sterling. In response, the Bank of England spent over $15 billion in forex reserves and hiked interest rates from 10 to 15 per cent in an attempt to defend the currency. While significant, these efforts were overwhelmed by institutional investors unwinding their positions in sterling and sterling-denominated assets. Echoing this point, the IMF noted that, "[w]hile hedge funds acted as market leaders, the real financial muscle was provided by institutional investors" (1993: 11). At the end of the day (16 September, now dubbed 'black Wednesday'), Britain was forced to leave the ERM and George Soros became a household name for reportedly making over $1 billion on his leveraged bets.

In addition to their ability to unilaterally move asset prices, macro hedge funds are also able to lead markets because of the normative authority which they possess. As Rosemary Bennett and David Shirreff note, "[t]he attention paid by investors and traders to the activities of hedge funds does . . . magnify their impact on the markets" (1994: 30). For example, in 1993, Soros' Quantum Fund purchased between two and three million ounces of gold at $345 per ounce as well as ten million shares in Newmont Mining. When Soros' purchases became known, and with no change in underlying economic fundamentals, speculation increased markedly to the extent that the price of gold rose to over $350 an ounce. Pointing to this example of normative authority, *The Economist* noted that "[h]is reputation as the 'man who broke the Bank of England' has put Mr. Soros in the position that all gurus aspire to; his prophecies are now self-fulfilling" (1993c: 21).

Much like central banks,[11] macro hedge funds exercise normative authority because they are perceived as having stronger analytical capabilities and better access to information about relevant economic fundamentals. As one anonymous forex trader observed, "[h]edge fund managers undoubtably have good political sources" (cited in Bennett and Shirreff, 1994: 30) and

[11]Noting the similarity between the normative authority exercised by macro hedge funds and that exercised by central banks, *The Economist* remarked that George Soros' "views have attracted at least as much attention as the head of the Bundesbank" (1993a: 66).

these sources, in turn, may result from their superior access to networks of elite interaction. That many hedge fund managers have become elites is illustrated by *Fortune* magazine's 1994 listing of the richest people in the United States. Of the top ten listed, six were managers of hedge funds (cited in Bennett and Shirreff, 1994: 32). The normative authority of hedge funds also stems from their higher tolerance for risky investments. This is the case as these funds, due to their need to limit their numbers to under one hundred partners, have minimum investment requirements ranging from $350,000 to $10 million and are, thus, composed of wealthy and risk-tolerant individuals and institutions. Due to this higher tolerance for risk, "[h]edge funds, for example, were amongst the first to venture into emerging markets. Their success made these markets respectable for mutual funds and pension funds" (*The Economist*, 1994a: 18).

Hedge Funds and Market Manipulation

At least in terms of potential, macro hedge funds would appear to have the ability to deliberately manipulate markets for their own economic benefit. Noting this potential, the IMF argued that "[w]ith greater concentration of wealth in the hands of professional fund managers, financial markets must cope with the effects of the attendant increase in the market power of market participants. Chief among these effects is the increased likelihood of market manipulation and even less efficient markets" (1995: 167). Through a strategy known as 'pumping up the tulips' (Train, 1989), a hedge fund manager could benefit from market manipulation in the following manner. First, through a highly leveraged purchase of an asset, the manager could unilaterally push up the asset's price and, thus, attract institutional investors making use of technical analysis. As these investors purchase the asset, its price rises further still and attracts even more technical investors. Second, to reinforce the price movement with normative authority, the manager could signal the market, passively, by simply making their purchases known or, actively, by making a public pronouncement in support of the asset. Finally, when the asset

price has risen sufficiently, the fund manager simply sells the asset at the higher price and realizes the profit; all without any changes in the economic fundamentals.[12]

One prominent manager who is widely reported to make use of this strategy is Jeffrey Vinik; the former manager of Fidelity's largest mutual fund — the Magellan fund — and who now manages his own hedge fund, Vinik Asset Management LP. As *Business Week* magazine reported, "[a]t Magellan, Vinik had a reputation of building up a large position in a stock, which pushed up the price. When the action attracted other investors, he would quickly unload his position" (Sparks, 1997: 98). As a hedge fund manager, Vinik has apparently reinforced this strategy through the use of passive signaling; that is, he often takes a position of more than 5 per cent in a company's outstanding stock which requires him to publicly disclose the move through a 13D filing with the U.S. Securities and Exchange Commission. In July of 1997, for example, Vinik purchased a 7.2 per cent stake in a company called Vivus. On 15 September he disclosed his purchase when the stock was trading at $26 and "[i]n less than two weeks, with no other news, Vivus soared to [$]38" (Sparks, 1997: 98).

In a similar fashion to Vinik, Soros has also employed this strategy, but on a much larger scale. In April of 1993, when Soros publicly announced his positions in Newmont Mining and gold, *The Economist* remarked that his public announcement was "[n]ot a bad ploy: the price of gold began to soar . . . presumably increasing the value of his investment" (1993a: 66). However, of possibly greater significance — in terms of the power of hedge funds — is the reportedly real target of Soros' attempt at manipulating gold prices. As *The Economist* speculated at the time;

> [t]here is a persistent rumor that Mr. Soros' real interest in all this is not gold at all, but the bond markets. Suppose that he recently sold bonds short (i.e. promised to deliver in future bonds which he did not then own) when [bond] prices were at their peak. Now that [bond] prices have fallen, as gold prices rose,[13] he stands to make a pretty profit. The trillions of dollars in the bond

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[12]Through the use of short selling, this strategy can also work in reverse; that is by profiting from pushing an asset's price down.

[13]Gold prices are often seen as an indicator of inflation and tend to move, inversely, in conjunction with bond prices which also reflect expectations of inflation. By manipulating the price of gold, Soros was also able to push down bond prices.

> markets have been jostled by a few judiciously placed millions in gold (1993b: 83).

Important to note here, therefore, is the way that a single hedge fund manager — through his market leadership role and clever tactics — was able to manipulate the incredibly large international bond market. While difficult to prove empirically, Soros was also suspected of manipulating markets in his speculation against the British pound and other ERM currencies. In June of 1993, Henry Gonzales, the chair of the U. S. House Banking Committee, stated on the floor of the House that he intended to "ask the Federal Reserve and the SEC to review Mr. Soros' impact on the foreign exchange market to determine if it is possible for an individual actor such as Mr. Soros to manipulate the foreign exchange market" (cited in Slater, 1996: 206).

The Renewed Potential for Financial and Monetary Power

As has been demonstrated above, hedge funds can and do manipulate markets for economic reasons. The question this gives rise to, however, is whether or not they could also do so for political reasons. In terms of capabilities, Anatole Kaletsky — economics editor for *The Times* — appears to think it is possible. In an open letter to Soros, in which he asked Soros to attack the French franc, Kaletsky wrote: "you alone can save Europe from the madness of premature monetary union. You can do this by breaking the link between the mark and the French franc . . . other investors are bound to follow wherever you lead" (1993: 27). Moving beyond the issue of mere potential, several prominent political leaders have accused Soros — who has sought to advance specific political goals through his philanthropic foundation, the Open Society Institute — of using the market power of his hedge fund to influence policy outcomes.

In September of 1993, following revelations about Soros' moves against the ERM currencies, Willy Claes — the Belgian foreign minister and president of the EC's Council of Ministers — indirectly accused Soros of political motivations in an interview with *Le Figaro*; he stated that "[t]here is a kind of plot. In the Anglo-Saxon world, there exists organizations and personalities who prefer a divided Europe . . ." (cited in Slater, 1996: 214). More recently, leaders of the Association of South-East Asian Nations (ASEAN), led by Malaysian prime

minister Dr. Mahathir, have accused Soros of a deliberate plot to undermine their currencies because he disapproves of their decision to admit Myanmar into the ASEAN fold. Even though such accusations smack of conspiracy theory and scapegoating, and have little basis in fact, they do indicate a growing recognition of the political potential to be found in the power of macro hedge funds. Therefore, while it is extremely unlikely that hedge funds have acted politically in the past, the point is that they could be made to do so in the future.

Hedge Funds as a Weapon of State

In a similar fashion to the way that states have influenced commercial banks in the past, a government wanting to harness the power of a 'domestic'[14] hedge fund could apply the traditional mixture of carrots, sticks and moral suasion. However, given that the power of hedge funds (in contrast to that of commercial banks) stems from their ability to lead markets and not from their direct control of assets, an additional opportunity presents itself. Specifically, it may be possible for a state to covertly establish its own macro hedge fund, build its credibility as a market leader and use it to manipulate the direction of private international capital flows. In terms of setting up the fund, hedge funds are not required to disclose information about investment decision-making to their shareholders and, as a result, a state-sponsored fund could be set up with a minimal amount of capital in that most of the capital could still be sourced from private investors. In terms of establishing the fund as a normative leader, a state could simply leak advance information (about monetary policy directions, etc.) to the fund manager and thus build their perceived ability to predict and profit from future events. Important to note here, therefore, is that this ability to set up a covert hedge fund would, due to the relatively small resources involved, not be limited solely to the larger powers. Accordingly, the growing power

[14]In this situation, a 'domestic' hedge fund may be regarded as any hedge fund — whether chartered in the home country or not — whose managers would be subject to influence by the home country government. For example, while George Soros' Quantum Fund is chartered offshore, Soros himself resides in the United States and, thus, might be subject to influence by the U.S. government.

of macro hedge funds may increase the opportunities for financial and monetary diplomacy by extending the capability to a greater number of states.

Macro hedge funds may also increase potential opportunities by overcoming many of the factors which serve to reduce a state's willingness to engage in financial and monetary forms of diplomacy. First, because hedge funds remain exempt from many of the transparency requirements that apply to other financial institutions, it would be very difficult to directly tie an instance of manipulation to the fund itself or to its sponsoring state. As a result, neither the target state nor the broader international community would be aware of the source of the manipulation or even that it was politically motivated. Second, in instances of currency manipulation, the use of a macro hedge fund would absolve the home state's central bank of the need to put its credibility at risk and would, thus, overcome this barrier to a state's willingness to engage in monetary diplomacy. Finally, given that these forms of diplomacy rely upon manipulating international investors, many of whom will not be those of the home state, governments would have to worry less about efficiency losses to domestic investors. At the very least, they would not have to worry about being held accountable for any losses which did occur.

Whether influenced or established, a state-sponsored hedge fund could be deployed either offensively, to initiate a run on a target state's currency and securities, or defensively, against the financial markets themselves, to support an ally facing a speculative attack. Also, because it would be difficult to tie an instance of manipulation to the sponsoring state, the action has the potential to be more effective than if conducted directly by the home state's central bank. In contrast to a central bank, a seemingly private hedge fund would be less likely to be suspected of having political motivations. As a result, market actors would be more likely to bandwagon even when the move ran counter to economic fundamentals. This advantage, in turn, would open up a further potential use for monetary power; that is, a state could use a hedge fund, defensively, to support a domestic macroeconomic expansion. At present, the increasing mobility of financial capital combined with the trend towards price overshooting has served to reduce a state's capacity for expansionary monetary and fiscal policies. Specifically, because even a small change in economic fundamentals can lead to a massive swing in prices, the costs of pursuing policies seen as unsuitable by investors have increased proportionately. As *The*

Economist notes, "[t]he risk of extreme price movements puts a greater premium on policies conducive to fiscal discipline and price stability" (Woodall, 1995: 25). In this way then, a state-sponsored hedge fund, which would be perceived as having greater credibility than an expansionary central bank, could be used to help counter a speculative overshooting of prices induced by a stimulative policy.

Hedge Funds and Non-State Actors

Just as the relatively small resources required to set up a hedge fund may extend the capability for financial and monetary power to a greater number of states, so too may it diffuse the capability to certain non-state actors. In the paragraphs below, this paper explores the willingness and capability of two non-state actors to harness the power of hedge funds as well as how they might deploy them to advance their political goals.

Hedge Fund Nationalism? In the run up to the October 1995 sovereignty referendum in Quebec, La Caisse de depot et placement du Quebec — Canada's most powerful pension fund — was used to covertly stabilize the Canadian dollar "to support separatist arguments that a Yes vote would not unsettle financial markets" (Simon, 1996: 11). Moreover, whereas the Caisse had to rely solely upon its purchasing power in supporting the Canadian dollar, a covertly established hedge fund (that would be seen as being politically neutral) could have reinforced such purchases with normative authority. It is in situations of great uncertainty that investors look most to market leaders who are perceived as having better analytical skills and access to information. Therefore, given the uncertainty surrounding the referendum's outcome, it seems reasonable to suggest that news of major Canadian dollar purchases by a leading hedge fund manager could have had a greater impact on the currency's value than the less than a quarter of a cent nudge achieved by the Caisse. Had the Quebec government been aware of such an opportunity, could and would they have sought to exploit it? In terms of the former, the amount of capital required to set up such a hedge fund would be well within the resources of the sovereigntist movement. In terms of willingness, the actions of the Caisse combined with statements by Premier Jacques Parizeau seem to confirm reports that "[a] strategy had been set

up to counter the speculators" and, in turn, that the sovereigntists would be willing to make use of any opportunity available to them (Tremblay, 1996: 259).

Hedge Fund Socialism? In a similar fashion to the Quebec sovereigntists, some U.S. trade unions have also sought to deploy institutional assets for political purposes. The AFL-CIO, for example, has recently established a Center for Working Capital "to coordinate the holdings of all unions and union members and turn billions of pension assets into a new weapon for labour" (Bernstein, 1997: 110). Dubbed 'pension fund socialism' by economist Peter Drucker (1976), trade unions have used the shareholder power of their members' pension funds to influence the decisions of corporate managers. Given their use of this strategy and the considerable resources wielded by their members' pension funds, U.S. trade unions would seem to have both the willingness and capability to also harness the power of hedge funds. In fact, many pension funds are already major hedge fund shareholders.

Once established, a labour-sponsored hedge fund could be used to counter a stock sell-off induced by the adoption of labour-friendly policies by a corporation's management. Applied on a larger scale, a labour-sponsored hedge fund could also be used to influence policy outcomes. Such a fund could have been used, for example, to assist U.S. trade unions in their efforts to prevent the signing of the North American Free Trade Agreement (NAFTA). Prior to the signing, the Mexican peso was unsustainably overvalued due to large capital inflows from institutional investors who anticipated large gains following the conclusion of the trade agreement (Krugman, 1995). At the time, a handful of prominent economists — such as MIT's Rudiger Dornbusch — called for a devaluation of the peso for economic reasons. For political reasons, however, the Mexican government put off devaluing the currency until months after the NAFTA had been implemented. The implicit reasoning behind this move was that an overvalued peso was necessary to assist the NAFTA in passing through the U.S. Congress by preventing the much-feared flood of Mexican imports following the implementation of the Agreement.

In December of 1994, when the devaluation finally did occur, "[w]hat began as an understandable sell-off picked up speed because scores of portfolio managers at mutual funds and pension funds had no choice. They had to worry about near-term performance and about

meeting investment criteria. And mutual fund managers had to worry about the prospects of massive redemptions" (Pennar, 1995: 85). Moreover, because the short-term and herd behaviour of institutional investors was so extensive, the resulting sell-off caused a decline in prices which far overshot what was justified by the devaluation itself. In fact, within two weeks of the devaluation, the peso dropped by over 30 per cent and the Bolsa (a Mexican stock market index) lost almost 50 per cent of its value in dollar terms. As *The Economist* argued, "on their own [Mexico's economic fundamentals] did not justify the scale of the capital outflow or of the depreciation of the peso; the markets simply lost their heads" (Woodall, 1995: 18). In response, the U.S. government, in conjunction with the International Monetary Fund, was forced to put together an unprecedented rescue loan for the Mexican government. In this situation then, as was the case with the British pound in 1992, the economic fundamentals pointed to a currency that was unsustainably overvalued. Therefore, just as George Soros was able to bring forward an inevitable sterling devaluation through massive short selling, so too might a labour-sponsored hedge fund have been able to provoke an earlier run on the Mexican peso and other securities. Had this occurred, the prospects of the NAFTA in the U.S. Congress would have been much bleaker.

Conclusion

Taken as a whole, this paper has sought to determine whether or not states retain the capacity to engage in financial and monetary forms of diplomacy in the present context of liberalized international capital markets. On the one hand, it has shown that the trends most directly associated with financial liberalization — disintermediation, transparency and the massive expansion in the volume of forex transactions — would appear to impose a number of constraints on the capacity and willingness of states to exercise traditional forms of financial and monetary power. On the other, this paper has also demonstrated how the increase in herd behaviour within the financial markets combined with the ability of hedge funds to act as markets leaders seems to have led to a significant re-centralization of investment decision-making and, in turn, to a renewed site through which states might exercise financial and

monetary forms of power. Furthermore, by outlining some of the political uses for which both state and non-state actors could deploy the power of a macro hedge fund, this paper has sought to bring a number of potential threats and opportunities to the attention of policymakers. Of course, which uses are regarded as threats and which are seen as opportunities depends entirely on one's political perspective.

Finally, while focusing specifically on the renewed potential for financial and monetary power, the broader purpose of this paper has been to contribute to both the emerging literature on the increasing power of non-state actors and to debates concerning the extent to which this trend is serving to undermine the sovereign powers of states. In terms of the former, it has sought to frame an argument about the ontological significance of hedge funds in a manner that might be more persuasive to realist scholars. In terms of the latter, it has sought to move beyond existing theorization which perceive the existence of a dichotomous and zero-sum relationship between the power of states and non-state actors. Specifically, by demonstrating how the increasing power of macro hedge funds could be harnessed by states, this paper hopes to make a case for a more nuanced understanding of the relationship between the power of state and non-state actors.

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