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1

The Rise of Fragile Finance

Not so long ago, finance and credit were considered to be a 'service' economy, supporting what many still consider to be the 'real' economy – manufacturing, labour, trade, tourism and so on. However, from the late 1960s onwards, perceptions about the role and functions of credit and finance have begun to change dramatically. To begin with, it appeared that on its own, financial system was able to generate massive, and relatively easy, profits, and that a growing proportion of the GDP of many advanced capitalist countries was generated by the financial sector alone. In the UK for instance, by the 1990s, the share of the financial sector in the economy as a whole surpassed 20% of the country's GDP. More importantly, the financial sector has acquired a far more prominent role in the political economy as a whole, especially when compared to the 'golden age' of capitalism – the economy of the Bretton Woods regime. Increasingly, the success or failure of an economy was related to the success or failure of the financial system. What were the causes of such a dramatic shift?

This chapter provides an introductory overview of the major changes that have driven the transformation of finance and facilitated its ascendance to the leading role in the global economic organisation it has assumed today. Specifically, as it is argued below, the rise of today's finance has been shaped by three interrelated processes: deregulation (liberalisation), privatisation, and financial innovation.

The post-World War II international financial regime

Finance is one of the perennial candidates for the title of the 'second oldest profession in history'. The origins of money and financial instruments go back thousands of years and are as old as history itself. The modern system of finance, however, has its roots in the re-emergence of market economy in Western Europe, from around the 11th century onwards.

Various instruments of credit evolved gradually over the centuries, but are strongly linked to the rise of the modern state system (Braudel 1982). By the late 19th century, many of the modern instruments of monetary policy and financial control had been developed (Germain 1997; Helleiner 1994; Knafo 2006). That period also saw the rise of immensely powerful financial houses such as J.P. Morgan and the Rockefellers in the USA joining the powerful European financial houses such as Barings or Rothschild which have been established earlier. These large financial houses were truly dominating the core capitalist economies. The early 20th century will be remembered by many as the rise of finance capital (Hilferding 1981) or banker's capitalism (Commons 2003). This period was the heyday of largely unregulated, highly mobile, politically powerful financial empires. It also witnessed one of the most famous financial booms in modern history: the 1920s stock market rise in the USA, driven by the euphoria associated with the new technological advances, new financial instruments and post-war recovery. The boom of the 1920s ended up with an infamous 'big bang': the Wall Street crash of October 1929, followed by the Great Depression of the 1930s.

What emerged in the wake of the Great Depression was an entirely new regime of financial regulation: a system characterised by tight governmental control over capital flows within and between nations, supported by a regime of fixed exchange rates. The immediate post-war structure of financial regulation is often described in financial literature as the period of *financial repression* – a regime of government policies and controls over the process of private financial intermediation (McKinnon 1973; Shaw 1973). Domestically, controls included interest rate ceilings, requirements for banks to hold government bonds to finance government budget deficits, targeted credit schemes to support 'selective' industries, high reserve requirements, and gold-anchored foreign exchange

rates. Internationally, the regime of financial repression was accompanied by capital control restrictions on access to foreign financial markets (Korosteleva and Lawson 2005). Formally guided by the Bretton Woods international agreements, the system functioned for a quarter of a century (1944–1971), remarkably, without a major outbreak of financial volatility or crisis.¹

The Bretton Woods era also saw the emergence of today's key international economic institutions such as the IMF, the World Bank and the WTO (formerly GATT). Although their role was not especially prominent during the years of the Bretton Woods regime itself, these bodies came to the forefront of world economic and financial integration in the post-Bretton Woods period. The tranquillity of the Bretton Woods era, associated primarily with financial stability, high post-war growth rates in major capitalist countries, as well as socio-economic balance, is conventionally attributed to the implementation of Keynesian economic policies. This period is often nostalgically referred to as 'the golden age' of capitalism. This age of financial and economic tranquillity, however, was about to be shaken by the breakdown of the Bretton Woods system in 1971–1973.

Deregulation and privatisation

August 15, 1971 will be remembered by many as the day when 'money' died. On that day, as one brilliant study has put it, US president Nixon 'transformed it [the dollar as a symbol of real, tangible wealth] into something totally new, a currency without any underlying value whatsoever and without any limitations on the government's (or private sector's) ability to create it' (Kurtzman 1993: 60–1). The abolition of the fixed exchange rate regime anchored in gold parity entailed many far-reaching consequences for the world economy; in this book, it is the effect on the nature of finance and credit that interests us.

The gold-dollar parity that had served as the foundation for the financial system under the Bretton Woods effectively meant that exchange rate risks were assumed, and controlled, by the state. Once

1 The crisis of 1966 is a notable exception and according to many accounts, marks the beginning of the period of world financial volatility.

the gold standard was abolished and exchange rates were floated however, the risk of exchange rate fluctuations was transferred to the markets. Exchange rate risks were, in other words, privatised (Eatwell and Taylor 2000: 2).

The removal of the fixed dollar-gold anchor to world finance introduced an additional factor of risk which needed to be managed, a task that was taken up by the financial system itself. The early 1970s therefore, witnessed the rise of the financial risk-management industry. Not only did large trading platforms for trafficking in foreign exchange appeared in the world's key financial centres – New York, London, Frankfurt, Tokyo – but a whole new industry of managing various financial risks began to evolve (Germain 1997; Langley 2002).

Critically underpinning this process of privatisation of credit and financial risk was a concomitant process of financial deregulation, or liberalisation. According to Palan (2003), the term financial deregulation describes a medley of regulations that contributed to the reduction, and often, complete elimination of barriers in domestic and international financial markets. Again, in stark contrast to the nationalised, tightly monitored and controlled world of finance under the Bretton Woods, the post-1971 financial system has been shaped by the removal of capital controls, deregulation of interest and exchange rates, institutional reforms of the financial sector which allowed the formation of many new institutions and channels of financial intermediation to develop. Importantly, deregulation and liberalisation entailed not only institutional and structural transformations within the financial sector. Freed from state control, the financial system was able to stretch far beyond national boundaries of Western capitalisms and reach the terrain of developing countries.

Already in the 1960s, commercial banks and other financial companies, exploiting national regulatory loopholes in order to expand their business, introduced new credit instruments and channels that circumvented national financial controls (Guttman 1994: 157). The emergence of the Eurodollar market, the rise of offshore financial centres, as well as the deepening of private financial innovation generally, have been attributed to these developments (Burn 1999, 2006; Palan 1998, 2002, 2003). At the international level, if the decades of the 1950s and 1960s were the era of foreign aid and FDI;

the 1970s became the heyday of commercial bank lending. Western commercial banks, awash with petrodollars, were looking for new clients. Having identified the investment needs of industrialising countries, they advanced loans to many sovereign borrowers, particularly to Latin American economies. As a result, for most of the 1970s, the international investor euphoria was driven not only by the growth prospects offered by these industrialising economies, but also by the eagerness of Western commercial banks to lend overseas in search of higher profits (Rowbotham 2000; Frieden 1981). If in 1960, bank lending to developing world was close to zero, in 1973 syndicated bank loans totalled \$9.7 billion; in 1975 the figure rose to \$12 billion. Altogether, in 1978 commercial banks accounted for 30.4% of the total accumulated debt of the developing economies (Woodward 2001).

The 1970s boom in lending to developing countries ended with a 1982 Mexican default that became generalised as the Third world debt crisis. The 1980s saw a drop in the volume of foreign investment flows into the developing countries, or became what has also been termed a 'lost decade' for Latin America (Corbridge 1993; Griffith-Jones and Sunkel 1989; Congdon 1988). Yet following painful debt restructurings and the implementation of structural adjustment programmes (SAPs) in the crisis-hit countries, by the early 1990s, the global investment cycle had been restored. According to Krugman, the fall of the Berlin Wall in 1989 made investing outside the Western world seem less risky than before. The 1990s economic reforms in China also offered the financial sector new avenues for global expansion, and thus the former communist world supplemented the investment opportunities presented by the existing 'clients' – Asian 'tigers' and Latin American markets. International movements of capital became so immense that investment funds coined a new name for what previously was mostly called Third world: now they became 'emerging markets', the new promising frontier of finance (Krugman 2000: 84–5). Across the economies of Latin America and the former socialist bloc, privatisation programmes and economic restructuring implemented under the auspices of the paradigm of the Washington Consensus provided new opportunities for direct and portfolio investment, while the policies of financial deregulation, such as capital account liberalisation, the deregulation of the banking system and the opening of

national financial markets added to a sense of a new political and legal framework, accommodative to foreign capital (Kahler 1998: 4; Armijo 2001: 1; Eatwell and Taylor 2000, etc.).

Regional differences persisted, however, during the lending boom of the 1990s. In East Asia, despite the rapid growth in portfolio investment, FDI remained dominant. In the 'tiger' economies of East Asia, the success of state-led developmental models and export-led industrialisation contributed to the widely held vision of the 'Asian miracle', encouraging massive inflows of foreign investment (see World Bank 1993; Wade 1990). In contrast, portfolio flows were more significant in Latin America. There, a considerable portion of inward capital flows fuelling the rise of the emerging markets, was in reality indigenous capital previously held in offshore accounts. Together, East Asia and Latin America attracted the bulk of FDI and portfolio investment. South Asia, the Middle East, and sub-Saharan Africa lagged far behind (Kahler 1998: 4).

Although the volume and nature of foreign investment differed across the emerging markets, the 1990s financial boom was marked by one notable common feature. In contrast to the lending boom of the 1970s, when international capital flows were dominated by syndicated bank loans and the major recipients of money were Third world governments, in the 1990s, private capital flows have replaced multilateral and bilateral aid to developing countries. Between 1984–1989 and 1990–1996, net official flows fell by nearly 50%, while net private flows rose by approximately 700% (Armijo 2001; Woodward 2001).

According to Armijo (2001: 1), the change in the composition of capital flows entailed several political ramifications for the emerging markets. First, the greater share of private credit meant that borrowing countries were somewhat less subject to the political demands of creditor/donor states, but nonetheless were constrained to implement a package of neoliberal economic reforms. As this book will detail in Chapters 6–8, international financial institutions such as the IMF and the World Bank, global credit agencies and large institutional investors have assumed great influence over national political-economic programmes in emerging markets, and a good record on neoliberal economic restructuring was crucial to keep the country's favourable position in the global financial arena (Harmes 1998; Sinclair 2005). Second, the shift from public to private invest-

ment flows implies that while the governments in the emerging markets may now be less able to attain the political benefits from capital inflows, the political and economic influence of domestic big business increases (Haley 2001). Third, the shift towards more flexible and fluid forms of international investment has sharply accentuated the risk of balance-of-payments (BoP) crises for the borrowing country:

As liquidity sloshes about the global financial system, seeking the highest returns, a nation may find itself inundated with 'hot money' from abroad that can ignite a giddy boom – or abruptly starved for credit when the foreign money decides, for whatever reason, to leave (Greider 1997: 263).

Despite differences in the composition, nature and geography of international capital flows, the investment cycles of the 1970s and the 1990s shared certain traits. For example, during the 1990s, like many smaller banks in the 1970s, many institutional investors were 'sucked' into markets they did not fully understand by the prospect of higher returns, as well as by the desire not to fall behind their shrewder competitors (Woodward 2001; Congdon 1988). Emerging markets in turn, keen to restore their economic growth but often lacking domestic investment funds, welcomed financial inflows in the 1990s, just as they did in the 1970s. Therefore, if in the 1970s, the 'recycling' of OPEC oil surpluses served as a means of easing the burden of adjustment to higher oil prices, in the 1990s, the increase of FDI and portfolio investment reflected emerging markets' access to the global pool of private credit. In this process, just like in the 1970s, data processing and accounting systems often remained underdeveloped and inadequate in measuring the build-up of liabilities accurately and on time; while efforts to improve them remained insufficient (Woodward 2001: 202).

Among the many reasons why, despite the advance of financial and IT technologies, these and other problems within the structure of global financial flows persisted, in the context of this book, one issue stands out in particular. Not only did the breakdown of the Bretton Woods regime in 1971–1973 see the rise of private finance and credit, but the end of national control over the exchange rate, interest rates and other monetary instruments provided

the momentum to another defining feature of global finance: the spiral of financial innovation.

Financial innovation

Financial innovation is as old as credit and money itself. In fact, the different forms that money had taken throughout history – from barley in ancient Babylon to gold, silver, plastic cards and mobile phones today – are examples of innovation in credit instruments. Although it is difficult to agree on a precise definition of financial innovation, it is clear that it differs from invention and innovation in other markets and industries in several important ways. First, due to the very nature of finance (unlike in product markets, in financial markets, money is exchanged for a future promise), innovations in finance do not normally require large capital inflows and can be introduced relatively quickly (Guttman 1994: 157). Second, financial innovation involves finding new ways of borrowing, lending and investing. As such, it not only leads to the invention of various new financial instruments, but also to the emergence of new financial practices and institutions. Third, the invention and establishment of new credit instruments fundamentally relies on investors' expectations, confidence and credibility, and much less on 'underlying' economic variables, or what is often called 'fundamentals' (Eatwell and Taylor 2000). This makes finance and credit particularly sensitive to fluctuations in moods and other subjective factors.

And although, as mentioned above, financial innovation has existed for centuries, it was the breakdown of the Bretton Woods regime that spurred the acceleration of its most recent wave. According to Guttman (1994) the first wave of innovation in finance took place in the 1960s, when rising inflation levels made low-yielding savings deposits less attractive for investors. Experiencing erosion of their traditional deposit base, the banks faced growing demand for loans. To bridge this gap between sources and use of funds, US commercial banks began to rely on a variety of borrowed funds. This shift in the industry in the 1960s, from asset management to liability management, marks an important point in the evolution of the credit-based economy (Guttmann 1994: 157–8; Henwood 1997). Or what is also often called, the debt economy.

An additional structural factor that underpinned the current rise of financial innovation has been the privatisation of foreign exchange risk mentioned earlier in this chapter. Freed from state control, fluctuations of currency rates became a risk that investors across the world have to take into account when conducting their operations. Thus exchange rate became a variable, and hence a risk and a product, tradable in financial markets. Monitoring, managing and controlling the risk quickly became a highly profitable industry in itself. Profits are attractive, and easy profits especially so. From its inception therefore, the financial risk management industry has attracted not only the traditional financial institutions like banks, but provided the market niche for younger companies, more flexible and willing to engage in risk trading. Thus, the deregulation of financial markets and the privatisation of exchange rate risk in particular, gave rise to a variety of institutional innovations within the financial sector itself.

The political, economic, financial and technological changes of the post-Bretton Woods period have facilitated the emergence of many new participants in financial markets, whose functions stretch far beyond the traditional realm of activity of commercial banks, insurance companies or building societies. Rather than simply serving as means for intermediation – connecting savers and borrowers (like a typical commercial bank) – new financial players target risk generally, and more specifically, changes in macroeconomic fundamentals, prices of underlying commodities (like corn or oil), market indices (exchange rates, prices of shares or bonds), financial indicators (e.g., interest rates) or aggregate indicators (e.g., stock market indices). The instruments designed to quantify, manage and trade in these risks are known as derivatives, or secondary financial instruments. Importantly, these secondary instruments can be based on underlying commodity markets, as well as financial markets themselves. As a result, the financial industry today is a complex, tightly interconnected, plethora of participants, including, among others, financial branches of transnational corporations, banks (commercial and investment), non-bank financial intermediaries, such as hedge funds, insurance funds, mutual funds, investment and pension funds, private equity funds, as well as individual retail investors.

The variety of instruments and techniques that financial investors and traders adopt and develop is changing rapidly, and any attempt to summarise the products of innovation is likely to become obsolete

very quickly (see Finnerty 1992, in Henwood 1997: 51; also Miller 1986; Mishkin and Strahan 1999). At the same time, it is notable that along with the institutionalisation of financial innovation – i.e., the emergence and establishment of large institutional funds – some financial practices have become quite standardised and centralised. For example, futures, options and swaps have become standard and widely used derivative contracts, while some of the newer instruments, like synthetic and structured derivative contracts² – are customised products, which are tailored to the needs of a particular client or a transaction.

The participants of the global financial market trade on organised platforms, such as stock or currency exchanges; they can also conduct their operations face-to-face, or over the counter (OTC); or *via* the offshore financial centres. The worldwide deregulation of financial markets and the continuing advance of financial innovation makes today's finance incredibly complex, sophisticated and often, simply murky. For instance, in parallel to the rise of new trading techniques and products, financial innovation has been closely paralleled by the process of securitisation. Securitisation is a technique of converging assets that would serve as collateral for a bank loan into securities which are more liquid and can be traded at a lower cost than the underlying assets (Steinherr 2000: 291).³

Across many financial markets, securitisation has united many previously unconnected participants into a tightly interwoven chain of global credit. Yet along with making credit networks more fluid and interconnected, the securitisation and sophistication of today's financial techniques often make it particularly difficult to identify the 'ends' of a financial transaction. Specifically, while securitisation makes assets highly tradable, the 'bundling together' of such assets makes the task of evaluating price exposures, the nature of risks involved, as well as the very identity of borrower and lender, extremely difficult. This complexity, or obscurity, of finance, is one of the main outcomes of the post-Bretton Woods spiral of financial revolution (see Best 2005).

2 Structured finance – the creation of debt instruments by securitisation or the addition of derivatives to existing instruments.

3 As Steinherr notes, the largest category of securitised assets is real estate mortgage loans which serve as collateral for mortgage-backed securities. Car loans and credit card obligations are also securitised.

What drives financial innovation? As noted above, it is the privatisation of foreign exchange risk in 1971–1973 and the rise of the post-Fordist mode of economic organisation that account for the rise of the latest spiral of financial innovation (Eatwell and Taylor 2000, 2002; Strange 1997, 1998; Germain 1997), yet at least two other factors have facilitated the revolutionary transformations in the post-Bretton Woods finance. Both of these factors originate in science and scientific progress: one is related to the implementation of technological progress and its popularisation; another stems from the advances in fundamental science. Perhaps the most crucial of these factors has been the advance of information and communication technology (ICT). In a market economy, the ultimate effect of technological advances is to intensify competition and make the economic system more efficient. Yet it is common for a new idea and technology to take some time to be tested, adopted and find its customers. As Shiller (2003: 101–2) notes, the device as banal as a wheeled suitcase has taken more than 20 years to be invented, patented, produced and perfected to its today's version.

Similarly, the productivity benefits from the introduction of new IT techniques for the industrial economy were relatively slow to establish and measure. A 2002 OECD study reported that in the first half of the 1990s, IT contributed to a mere 0.2–0.5 percentage points per year of economic growth in the OECD economies. During the second half of the 1990s, the figure rose to 0.3–0.9 percentage points per year, with the US economy being the main beneficiary (Colecchia and Schreyer 2002). In contrast to this somewhat disappointing record of IT innovation in raising productivity, the financial sector adopted and implemented new technological instruments with great appetite and speed.

In the financial sphere, the rise of mobile telecommunication networks, the development of Internet and satellite technology, along with many other inventions which facilitate the flow of information and money have been employed and advanced with astonishing ease and speed. In a fascinating story of the rise of megabyte money, Kurtzman (1993: 169) observes: 'the volume of information travelling on Internet is growing by 25% a month. Most parts in the system can send 2 million bits of information a second; some parts can move 1 billion bits a second...The average speed of transmission is half the speed of light.' Supported by

economic and political globalisation, the IT sector has raised the efficiency of financial institutions tremendously. The capitalisation of the new financial companies has far outreached the value of the 'old' economy-manufacturing giants. A powerful combination of financial and virtual technologies has created a colossal pool of funds that were central to the new economy's advance. This pronounced disparity of dynamism between industrial and financial accumulation is believed to mark a new epoch in the trajectory of capitalism (Fine *et al.* 1999: 71–2).

Finally, the rise of the new financial risk industry would not have been possible without advances in science, and in particular, discoveries in financial mathematics and physics. Managing financial risk – a process known as financial engineering – involves building sophisticated financial portfolios, in which price and risk exposures of various assets needs to be carefully weighted and projected into the future. The evolution of financial derivatives markets is thus intimately linked to developments in finance theory, financial mathematics and physics (Saber 1999). As a result, theoretical approaches to finance based in mathematics, such as the capital asset pricing theory (CAPT) or Black-Scholes option pricing model, became a powerful engine of financial innovation and engineering, facilitating the spread of portfolio selection and diversification models, arbitrage trading and leverage techniques at the global level.

Finance as a global system

The combination of the processes outlined above – the deregulation of financial markets, the privatisation of financial risk, the advance of financial innovation and sophistication – have contributed to the complexity of contemporary finance. Global financial ascendance does not only rest on rapid internationalisation of capital markets and a growing pool of financial capital. Today's financial capitalism came about through disintermediation, increased securitisation, arbitrage activities and 'over the counter' trading, critically endorsed by the policies of deregulation and liberalisation (Bello *et al.* 2000: 2–5). The complexity of credit that is the result of such transformations makes it difficult for an outside observer to penetrate into the internal workings of the financial market, for several reasons.

At a conceptual level, one of the difficulties in analysing the transformations within finance today stems from the fact that the dominant mode of thinking about economic and financial processes remains grounded in neoclassical economics and methodological individualism. Mainstream economic theory, despite being challenged from various angles, continues to hold that the trade in goods and services determines international capital flows and foreign exchange rates. Already in the 1980s, Peter Drucker (1986: 787) observed that while the economic theory teaches that exchange rates are determined by the comparative-advantage factors (such as comparative labour costs and labour productivity, raw materials costs, energy costs, transportation costs and the like), in reality it is the exchange rates that determine how labour costs in country A compare to labour costs in country B. With financial deregulation and privatisation advancing further, it became clear that today, financial variables and dynamics are determined not by economic 'fundamentals' (e.g., Eatwell and Taylor 2000; Best 2005) but by arbitrage opportunities and investor confidence. Another consequence of financial liberalisation and privatisation is that in the post-Bretton Woods world, capital account dominates the current account *via* the exchange rate. Thus, often the country's trade balance and general macroeconomic stability are influenced by the inflows and outflows of capital, adding to a risk of exposure to external shocks and a sense of fragility in the national economy.

The obscurity of modern finance aggravates this risk of fragility further (see Best 2005). Following the breakdown of barriers between financial markets, the consolidation of financial conglomerates and the spread of securities markets worldwide, all segments of the credit system are now tightly interdependent. At the global level, the continuous emergence and growth of new and largely secretive financial products means that regulatory authorities have not yet found a way to get companies to account for derivatives in their balance sheets (Allen 1999: 3). As the spiral of financial innovation evolves,

... its use, which was initially seen as a way of economising on money, becomes more and more difficult to distinguish from 'real' monetary use. The perspective then switches round, and

the instrument is soon recognised as money. The hierarchy of money forms is thus evolutionary and the limits of money somewhat blurred; some instruments may be analysed both as means of accelerating the circulation of money and as fully-pledged monetary forms (Levy-Garboua and Weumuller 1979, in Lipietz 1983: 90).

The technique and practice of managing financial risks allows new forms of risk to be generated and elevates volatility both in space and time; which is now both necessary in order to make money, and itself creates more risks (Leyshon and Thrift 1997: 294). In the words of Susan Strange, 'far from stabilising the system by damping its ups and downs the devices such as futures markets – developed to deal with uncertainty – have actually served to exaggerate and perpetuate it' (1997: 119). This apparent ability of financial markets to generate new forms of money is particularly alarming on a global scale. The opening of new credit lines and the 'bundling up' of assets into deeper and yet increasingly narrow pools of capital intensifies the debt structure of many financial institutions and countries. This, in turn, makes them more susceptible to herd-like behaviour of investors in times of financial strain or panic. Yet this new source of huge risks remains poorly understood and not fully captured by existing monitoring models (Eatwell and Taylor 2000: 45–7).

Another consequence of the ascendance of the tightly interconnected, privatised credit system has been the notably uneven pattern of growth in the financial sphere and in the industrial economy (Brenner 1998, 2000). The rise of the financial risk management industry has led to a long period of financial ascendance, which in turn, obscures the long-term growth rates in most OECD countries, which have remained lower than in the 'golden age' of the 1950s and 1960s. In the booming currency markets, more than 1.5 trillion dollars change hands daily; the creation of new types of financial derivatives stretches the global pool of credit further. For instance, the market for credit derivatives continues to grow at a fast rate; in 2004 it reached nearly \$3 trillion (BIS 2005a; Fitch Rating, 15 November 2004). Between 2002 and 2005, the rate of growth of global trade in financial derivatives averaged around 30% per year, while the growth of world gross product stayed at around 3.9% (IMF 2005b).

Risk, therefore, is far from being an incidental factor in the world of finance. Rather, the global financial system has come to manifest an 'institutionally structured risk environment' (Giddens 1991). In this system, access to new financing almost overwhelmingly depends not on existing equity, but on the commodification, or numerification, of past debt. As Strange and others argue, today, it is the ability to tap credit, more than profits earned in the last cycle of production that determines a firm's ability to expand (Aglietta and Breton 2001; Germain 1997: 126; Strange 1997).

The realities of this vast, complex and sophisticated web of credit and hence inevitably, debt, pose serious challenges to various participants of the global economy. One of the most significant of such challenges is the marked increase in financial volatility. Financial instability has many causes and can be quite indiscriminate, as this book shows further. Yet a major consequence of the institutional and structural changes in the nature and organisation of finance outlined above relates to knowledge and thus, power differential, that exists between private markets and public authorities. Nowhere is this discrepancy more evident than in the emerging markets.

The creators of novel financial instruments and techniques – institutional funds and financial companies – typically know much more about the behaviour of these products, and therefore, can benefit from their use. Firms, financial institutions and governments in the emerging economies, although now active players in the global capital market, are still constrained by their conditional access to credit, availability of hard currencies and previous historical records. They remain at a distinct disadvantage when having to discern the specific conditions of a market segment and critically, when trying to avert panic or a looming crisis. In this regard, despite the worldwide deregulation of financial markets and credit networks, financial institutions in the emerging markets who borrow through them tend to take higher risks than their counterparties in the advanced capitalism (Surin 1998; Haley 2001; Horowitz and Heo 2001; Armijo 2001: 3). And although, as I argue in this book, the global interconnectedness of credit also facilitates the spread of financial contagion across the world, it is the emerging markets, dependent on foreign capital inflows, export markets and the availability of foreign exchange, which are particularly prone to recurrent financial instability and crises. As illustrated by recurring

crises throughout the post-Bretton Woods period and in particular, during the last decade, the explosion in new financial instruments and markets, supported by highly sophisticated systems of financial coordination on a global scale entails alarming repercussions. Difficulties of individual institutions can quickly translate into large-scale collapses of industries, national economies and even regions. As this book will detail below, it is the hazards of financial expansions that typically contain crisis tendencies. Trouble is, the murky nature of the process of private credit expansion also makes it difficult to discern crisis potential in time.

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