New Financial Structures, Transmission Mechanisms and Deflation in the Global Economy

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The last two decades have witnessed a transformation of the world's financial system. The period has been characterised by an increase in the mobility of financial capital and agents across borders, an unprecedented build-up of liquidity in the world economy, substantially enhanced flexibility of financial firms to undertake diverse operations across financial activities, and the emergence of new avenues for speculative investment in areas such as foreign exchange and derivatives markets.

This transformation, resulting in large part from the accumulation of huge volumes of liquidity, has been facilitated by a process of financial liberalisation or deregulation in developed and developing countries. The process of liberalisation has (i) reduced the control and supervision exercised by governments and central banks over the financial system; (ii) consolidated and 'globalised' the world's financial system so that national financial agents no more dominate the financial structures of many, if not most, economies; and (iii) transformed financial systems outside the US and the UK in ways in which they increasingly resemble the 'American model'. Thus the ascendancy of finance in the global system has been accompanied by a two-fold process of financial globalisation involving the presence of common players across nation states and a growing lack of 'difference' in the nature of financial systems in the world economy.

This transformation of the financial structures of the world system, about which we will have more to say later, has been accompanied by three rather remarkable tendencies in the 'real' economy at the international level. First, even though the decade of the 1990s, the decade of accelerated 'globalisation', was one in which there was an increasing degree of international economic integration through larger and quicker cross-border flows of commodities and capital, that was the decade in which during most years there was an extreme lack of synchrony in real economic performance across the globe and even within the OECD group of rich countries. This lack of synchrony in the economic cycle was however not symmetric. Periods in which the world's leading economy, the US, was performing well, were the years in which most other economies, including those which registered the highest rates of growth of investment and output in the preceding three decades, were doing badly. But more recently, when growth in the US has slowed as well, the disease appears more uniformly spread, threatening a deflationary slump in the world system as a whole.

Second, US growth tended to peak during the 1990s precisely during the years when the deficit on the US budget was falling and transforming itself into a surplus, providing one of the pillars on which 'new economy' theorists built their case for a transformation of the nature of US capitalism. This development appears to have a two-fold implication. It

suggests that the 1990s were years in which private investment and consumption spending rose to more than just neutralise the deflationary consequences of reduced deficits and even budget surpluses. It also means that the principal mechanism through which the world's leading economy stimulated world economic growth during the preceding decades, was no more functional.

Third, even though during the American boom of the 1990s the US economy was notching up large, rising and record levels of deficits on its trade and current accounts, the stimulus this was offering the rest of the world system was obviously inadequate to ensure high growth in much of the world economy.

These features are quite clearly visible even in aggregate data. As Chart 1 shows, between 1991 and 1994, while the US and UK recorded sharp recoveries in annual rates of GDP growth, Germany, France and Japan witnessed a downturn. In the subsequent five years, only the US managed to maintain remarkably high rates of growth; performance in Germany, France and the UK ranged from moderate to good and that in Japan was dismal in almost all these years excepting 1996. It was only when the US economy lost steam early in 2001 and found itself on a downturn that there seemed to be a semblance of synchrony. The downturn that afflicted the US now appeared to be a more generalized phenomenon, making its implications more ominous. And today, even as the post-September 11 spending spurt seems to be halting the downturn in the US, the effects are less impressive in other major OECD nations.

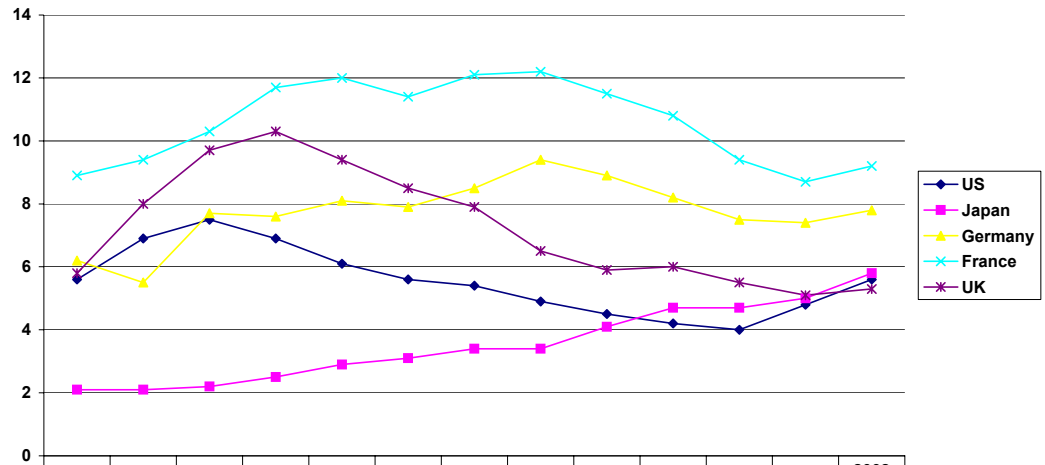
Chart 1: Annual Rate of Growth of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (P)
US	1.8	-0.5	3.1	2.7	4	2.7	3.6	4.4	4.3	4.1	4.1	1.2	2.3
Japan	5.5	3.1	0.9	0.3	1.1	1.5	3.6	1.8	-1	0.7	2.2	-0.4	-1
Germany	5.7	5	2.2	-1.1	2.3	1.7	0.8	1.4	2	1.8	3	0.6	0.9
France	2.6	1	1.3	-0.9	1.9	1.8	1.1	1.9	3.5	3	3.6	2	1.4
UK	0.7	-1.4	0.2	2.5	4.7	2.9	2.6	3.4	3	2.1	3	2.2	2

Per cent

This lack of correspondence in economic performance is even starker when assessed in terms of developments in the labour market. Unemployment rates in Germany and France rose significantly between 1990 and 1997, to touch 9.4 and 12.2 per cent respectively. Though they declined subsequently, unemployment levels in these countries are still above the 1990 mark. Unemployment in Japan rose continuously through the 1990s, though the low initial level of 2.1 per cent has meant that it still records rates close to the US and the UK. Only in these latter countries, the US and the UK, have unemployment rates fallen sharply since 1992-93, though that trend has been reversed in 2002 in the US (Chart 2).

Chart 2: Unemployment Rates



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (P)
US	5.6	6.9	7.5	6.9	6.1	5.6	5.4	4.9	4.5	4.2	4	4.8	5.6
Japan	2.1	2.1	2.2	2.5	2.9	3.1	3.4	3.4	4.1	4.7	4.7	5	5.8
Germany	6.2	5.5	7.7	7.6	8.1	7.9	8.5	9.4	8.9	8.2	7.5	7.4	7.8
France	8.9	9.4	10.3	11.7	12	11.4	12.1	12.2	11.5	10.8	9.4	8.7	9.2
UK	5.8	8	9.7	10.3	9.4	8.5	7.9	6.5	5.9	6	5.5	5.1	5.3

Per cent

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Thus, clearly, unlike in the four decades following World War II, when the world economy was ostensibly less integrated, the 1990s have seen a process of de-synchronization of the economic cycle in individual nations, which is visible even in the relative performance of the developed industrial nations. In what follows, this paper seeks to argue that these unusual features of the world economy during the 1990s were quite closely related to and in part the consequence of financial developments and the changes in financial structures in the international system during and in the years preceding the 1990s. The paper is concerned with investigating the nature of the role that finance has come to play, examining the links between finance and the real economy and assessing the implications for economic performance in the current global conjuncture dominated by finance capital.

The rise to dominance of finance

The developments in the world economy that created the conditions for the rise to dominance of finance capital relative to manufacturing capital need to be delineated. After the oil shocks, there was a substantial increase in liquidity in the international financial system, since oil surpluses were held in the main as deposits with the international banking system. Since the main financial players were located in the developed world, the private financial system there became the powerful agent for recycling surpluses. This power was indeed immense. By 1981, OPEC countries are estimated to have accumulated surpluses to the tune of $475 billion, $400 billion of which was parked in the developed industrial nations. The explosion of the Eurocurrency market in the 1970s partly reflected this. This power to the finance elbow was all the more significant because a slow down in productivity growth in metropolitan industry had already been bringing the post-War industrial boom to a close - a process that was hastened by the contractionary response to the oil shocks. [1]

This increase in liquidity was associated with a build up of dollar assets in the international system during the 1970s and 1980s. That occurred because the United States, which was home to the reserve currency of the world, faced no budget constraints even when spending abroad. As a result it built up large international liabilities during the Bretton Woods years, including those resulting from expenditures on the Vietnam War and its policing efforts elsewhere in the world. However, the loss of manufacturing competitiveness in the US meant that during different periods from the 1970s onwards, the dollar temporarily lost its position as the only acceptable reserve currency, fuelling speculative demand for other currencies on the part of those holding them. Such speculative demand, needless to say, was sensitive to both interest rate differentials and expectations of exchange rate variations, resulting in volatile flows of capital across currencies and borders. The results of these developments were obvious. The daily volume of foreign exchange transactions in international financial markets rose to $1.2 trillion per day by the mid-1990s, which was equal to the value of world trade in every quarter of a full year. Total cross-border transactions of bonds and securities increased from about 10 per cent of GDP in the US, Germany and Japan in the early 1980s to an average or more than 100 per cent by the mid-1990s. Most of these transactions were of bonds of relatively short maturities.

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[1] As a proportion of world output, net international bank loans rose from 0.7 per cent in 1964 to 8.0 per cent in 1980 and 16.3 per cent in 1991. Relative to world trade, net international bank loans rose from 7.5 per cent in 1964 to 42.6 per cent in 1980 and 104.6 per cent in 1991.

The impact on process of financial liberalisation

These initial developments in the world of finance which enormously increased the economic influence of finance capital set the stage for the financial liberalisation that has now occurred to differing degrees in virtually every country of the world. The nature of such liberalisation has been defined in part by the past and recent history of the US financial system. It is common to perceive the US financial system as being one in which a combination of a greater role for markets and a well developed system of monitoring, supervision and regulation, has allowed for greater flexibility, transparency and "efficiency" (whatever that may be taken to mean). In particular there is the perception that the US is a market-based system in which signals sent out by those acquiring and divesting shares in the stock market are an important means of disciplining firms and corporations. With the role of capital markets being identified as that of allocating scarce capital between alternative uses and that of guiding firm managers in making their investment decisions, this is seen as the best form of organisation of the financial system.

However, the evidence makes clear that neither is this an adequate conception of the nature and role of evolving financial structures in the US, nor has a financial system of this kind been the norm in the past in other developed countries or in the developing countries during much of the 20th century. After the crash of 1929, there were two major interventions in US markets aimed at protecting bank depositors from the adverse effects of stock market volatility. The first was the Glass-Steagall Act of 1933, that required deposit taking and lending institutions to be separate from those involved in underwriting or dealing in securities. The second was the constitution of the Securities and Exchange Commission, with substantial support for monitoring and research and significant powers of investigation and adjudication. It is only as a result of financial liberalisation in the US that there has been a gradual erosion of the Chinese Walls that were built between banking, insurance and stock market activity, as well as the dilution of the investigative and supervisiory role of the SEC. Since this occurred at a time when there was a substantial increase in the range of financial activities and instruments, the trend has been towards the creation of institutions that serve as financial supermarkets that provide various banking, investment banking, insurance, financial advisory and consulting services. Institutionally, therefore, the structure has evolved in the direction of allowing for varied situations of conflict of interest in a far less supervised and regulated environment.

It also needs to be noted that the capital market in the US did not really serve as a mechanism for allocating scarce finances between alternative investments at least as far as capital for investment is concerned. In fact, internal resources account for an overwhelming share of investment funds for US corporations. According to one estimate[2], during 1970-94, internal sources of finance accounted for 96.1 and 93.3 per cent respectively of net sources of finance for corporates in the USA and UK respectively, as compared with 78.9 and 69.9 in Germany and Japan.

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[2] Corbett and Jenkinson, Manchester School 1997.

Thus the notion that the US capital market has always been relatively free ignores the stringent regulatory regime that existed in the past. And the idea that the market there provides resources to finance the best or most "efficient" investment is not necessarily true.

The point to note, however, is that despite the fact that the preexisting US financial system was by no means a close image of today's concentrated, deregulated and poorly monitored financial sector in the US, financial liberalization in the rest of the world was aimed at replicating the structure that the US was generating over time. The core belief underlying this trend, as in other parts of the liberalization agenda, was that competition between unregulated firms and minimal government interference were necessarily good. Thus in the discussion in the British House of Commons that led up to the Big Bang in 1986, Secretary of State for Trade and Industry, Norman Tebbit argued that the task was to create the environment that can meet the challenges set by "modern technology and intense international competition." This, in his view was "best done by allowing market forces to operate responsibly but without unnecessary constraints, in a way which promotes efficient business."[3] The consequences of such liberalization were disastrous for British finance. As one insider has reminisced about the period:

> "The old City was ordered and hierarchical. Every firm had a clearly defined set of relationships with its clients and with the other firms that provided services and competition. Firms were prevented from breaking out of these boundaries by rules and customs. Suddenly, most of these relationships were thrown up in the air by Big Bang and, when they landed again, were very different. The City's response to this new landscape was hindered by its lack of experience of institutional change. It needed either a period of protection while it adjusted or help in raising its standards."[4]

Finance and late industrialisation

Britain was after all a case of a country which had the City, which was once the financial centre of the world. If even it was damaged by the instituional change associated with financial liberalisation, the experience of other countries which were late industrialisers could not but have been even more difficult. This is because the financial structures in these countries were created to deal with the difficulties associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its premitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low capacity utilisation during which they could find themselves a fooothold in world markets. Not surprisingly, late industrialisers created strongly regulated

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[3] Quoted in Augar, Philip (2000), **The Death of Gentlemanly Capitalism**", London: Penguin Books.

[4] Ibid., p. 50.

and even predominantly state-controlled financial markets aimed at mobilising savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit, and low interest rates.

In fact, financial structures and financial institutions were seen by writers like Alexander Gerschenkron as important "institutional substitutions" that helped backward economies to compensate for and even benefit from their initial lack of capital stock and productive capacities.[5] For example, analyses of the rapid growth of the German economy before the First Wold War tend to attribute a special role to the banking system, and the *Kreditbank* institution in particular, for promoting such growth. Interestingly, unlike what was sought to be achieved with the Glass-Steagall Act, the *Kreditbank* was an institution that was closer to today's universal bank, combining the roles of a commercial bank, investment bank, development bank and investment trust. The role played by the *Kreditbanken* and the resulting financial structure is captured in this description:

> "Institutions like the *Bank fur Handel und Industrie* were major sources of investment capital for the railroad and metallurgical development. The scheme according to which this financing was arranged was simple but risky in terms of traditional banking practice. Very large amounts of both fixed and working capital were advanced to industrial firms that were either starting up or expanding their operations. After this capital had been put to work, the banks converted these loans to marketable debt or equity. … Contemporaries who analysed the role of the *Kreditbanken* were fascinated by their intimate relations with the major industrial firms. Such close relations were a natural otugrowth of the scheme according to which the banks arranged industrial financing. The policy of granting large credits for fixed capital against security of uncertain value was unusually risky so that measures to reduce that risk should have been a matter of special concern. One simple expedient was the requirement that the borrower conduct all business threough one bank (or in cases where a loan was made by a consortium, through the leading bank). If this rule was followed, a bank was guaranteed adequate knowledge of a firm's condition. A second measure was the requirement that bank officials be appointed to the supervisory boards of the firms to which credit was granted. The directorships ensured the banks a voice in policy making in the industries they financed. In view of the fact that by 1905 the representatives of the eight major *Kreditbanken* had

[5] Gerschenkron, A. (1962), **Economic Backwardness in Historical Perspective**, Cambridge, Mass.: Harvard University Press.

grown to 819 directors of industrial firms, this voice was clearly a strong one. "[6]

It hardly bears stating that this kind of financial structure has much in common with the lead bank system in Japan. The financial system that underlay Japan's post-war growth was one in which government regulation and control was at the core .[7] Interest rates on deposits and loans were controlled, with the government using differential interest rates as a mechanism to target the growth of specific industries. Similarly the design and pricing of insurance products were State guided, keeping larger objectives in mind. The net result of such control was that: either (i) the government had to ensure financial agents a portfolio of activity that guaranteed returns adequate for self-sufficiency and growth; or (ii) the government had to canalise resources garnered through taxation or other means to the financial system to ensure the viability of individual financial agents. The government's implicit or explicit guarantee of such viability implied that it guaranteed depositors' savings as well, making bank deposits and insurance products rather than stock market investments the preferred form in which household savings were held.

This system was permissive on some fronts and limiting on others. Thus, it required firms to approach banks that were flush with funds drawn from household savings for finance. In turn banks were in a position to use the resulting leverage to ensure that their funds were profitably employed and properly managed. Inasmuch as the government "permitted" the banks to play this role, Japan saw the emergence of the main bank system where "a bank not only provides loans to a firm, but also holds its stock. Typically, a firm develops a relationship with a particular bank and relies on its steady support in funding over the long term. In return, the firm uses the bank for major transactions from which the banks earns fees and profits." Thus unlike in the US, where the performance of individual stocks and the threat of take over when stock prices fell, or "the market for corporate control", was the means to ensure effective deployment and efficient utilisation of capital, in Japan, it was the link between direct and indirect ownership and management that was the means to realisation of these goals. And the State was expected to monitor the monitors, who were the main banks.

The limiting role of the system was that it limited the ability of banks to undertake investments in areas that were not in keeping with development goals. Thus investments in stocks or real estate purely with the intention of making capital gains were foreclosed by regulation. Banks, insurance firms and non-bank financial institutions had their areas of operations defined for them. Regulatory walls that prevented conflicts of interests and

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[6] See for example, Riesser, J., (1911), **The Great German Banks and their Concentration**, Washington: U.S.G.P.O. and Neuberger, Hugh and Houston H. Stokes, (1974), "German Banks and German Growth, 1883-1913: An Empirical View," **The Journal of Economic History**, Vol. 34, Issue 3, September.

[7] Refer for example, Edward J. Lincoln (1998), "Japan's Financial Problems", **Brookings Papers on Economic Activity**, Volume 1998 Issue 2 and Takatoshi Ito (1996), "Japan and the Asian Economies: A Miracle in Transition", **Brookings Papers on Economic Activity**, Volume 1996 Issue 2.

speculative forays that could result in financial crises and hamper the growth of the real economy clearly separated these areas.

During the years of high growth this system served the Japanese economy well. It allowed banks and firms to take a long-term perspective in determining their borrowing and lending strategies; it offered entrepreneurs the advantage of deep pockets to compete with much larger and more established firms in world markets; and it allowed the government to "intervene" in firm level decision-making without having to establish a plethora of generalised controls, which are more difficult to both design and implement. Above all, when the rate of expansion of world markets slowed after the first oil shock, and Japan, which was highly dependent on exports for its growth, was affected adversely both by this and by the loss of competitiveness that an appreciating currency involved, the system allowed firms to restructure their operations and enter new areas so that profits in emerging areas could neutralise losses in sunset industries.

Not surprisingly, Japan's economic system was bank debt-dependent for financing investment and highly over-geared. Bank debt accounted for 95 per cent of Japanese corporate borrowing in the mid-1970s, as compared with a much lower 67 per cent in the US. And while outstanding bank loans amounted to 50 per cent of GDP in the US in the 1970s, from which level it gradually declined, the debt GDP ratio in Japan had touched 143 per cent in 1980 and rose to 206 per cent by 1995. This feature was, however, not a problem because the government worked to stabilise the system. As one observer put it: "A combination of international capital controls, willingness to use monetary policy swiftly to defend the currency, and the absence of other countries simultaneously following the same development strategy shielded Japan from serious problems."

In the event, Japan's economic success between 1950 and 1970 resulted in its system of regulation, which was "unusual" from an Anglo-Saxon point of view, being looked upon with awe and respect. Even now, but for the fact that Japan fares so poorly, the overwhelming evidence of accounting fraud, conflict of interest and strategies to ensure stock price inflation emanating from leading US firms such as Enron, Andersen, Merrill Lynch, WorldComm and Xerox, makes the Japanese system appear far more robust.

Looking at these instances where financial structures were designed to manage the constraints on growth set by international inequality, it is clear that the similarity of the "institutional substitution" with today's universal bank ends with activity spread. The financial institutions created to spur late industrialisation and face up to the inequality characteristic of the international system were national in character, functioned to overcome the debilitating effects of market rules and market signals, and mobilised capital to create a local industrial complex. In time, in contrast to the supposedly "market-based" systems of the Anglo saxon world, these were characterised as "bank-based" systems. That chracterisation, however, while capturing one aspect of these structures, missed out the diversity in the financial structures created in Germnay and Japan, and South Korea, Brazil and India, for example, to use finance as a means to overcome international inequality.

One consequnce of the process of financial liberalisation that spread worldwide in the wake of the rise to dominance of finance is that it is dismantiling these diverse structures and creating new financial systems in these countries that resemble the Anglo-Saxon "model" independent of the specific features and level of development of the country concerned. This, as argued below has had major consequences for real economic performance in these countries.

Immediate effects of liberalisation at the core

The point to note, however, is that this process of "homogenisation" was made possible, by the changes brought about by financial liberalisation in the developed countries. In the first instance, such liberalisation accelerated the build up of liquidity in the international system. It increased the flexibility of banking and financial institutions when creating credit and making investments. It permitted the proliferation of institutions like hedge funds that, unlike the banks, were not subject to regulation. It also provided the space for "securitisation", or capital flows in the form of stocks and bonds rather than loans, and "financial innovation", or the creation of a range of new financial instruments or derivatives such as swaps, options and futures that were effectively autonomously created by the financial system. These instruments allowed players to trade the risks underlying an asset without trading the asset itself.

The massive increase in international liquidity that followed found banks and non-bank financial institutions desperately searching for means to keep their capital moving. At first, there were booms in consumer credit and housing finance in the developed industrial nations. But when those opportunities petered out, a number of developing countries were discovered as the "emerging markets" of the global financial order. Capital in the form of debt and equity investments began to flow into these countries, especially those that were quick to liberalize rules relating to cross-border capital flows and regulations governing the conversion of domestic into foreign currency. The result of these developments was that there was a host of new financial assets in the emerging markets, which were characterized by higher interest rates ostensibly because of the greater risks of investment in these areas. The greater 'perceived risk' associated with financial instruments originating in these countries, provided the basis for a whole range of new derivatives that bundled these risks and offered a hedge against risk in different individual markets, each of which promised high returns.

There are a number of features characteristic of the global financial system which evolved in this manner. To start with, the global financial system is obviously characterised by a high degree of centralisation. Nothing illustrates this better than the "yen-carry trades" of the period 1995 to 1997, which emerged from the wide interest differentials between the United States and Japan, in conjunction with the belief that the Bank of Japan did not want the yen to strengthen in 1996–97. These trades involved borrowing in yen, selling the yen for dollars, and investing the proceeds in relatively high-yielding US fixed-income

securities. In hindsight, these trades turned out to be considerably more profitable than simply the interest differential, for the yen depreciated continuously over the two years from May 1995 through May 1997, which reduced the yen liability relative to the dollar investment that it financed. The implications of these and other flows to the US was that international liquidity "was intermediated in US financial markets and invested abroad through purchases of foreign securities by US investors ($108 billion) and by net lending abroad by US banks ($98 billion)."[8] With US financial institutions intermediating global capital flows, the investment decisions of a few individuals in a few institutions virtually determines the nature of the "exposure" of the global financial system. Unfortunately, unregulated entities, such as the “hedge funds”, making huge profits on highly speculative investments are at the core of this system.

Further, once there are institutions that are free of the now-diluted regulatory system, even those that are more regulated are entangled in risky operations. They are entangled, because they themselves have lent large sums in order to benefit from the promise of larger returns from the risky investments undertaken by the unregulated institutions. They are also entangled because the securities on which these institutions bet in a speculative manner are also securities that these banks hold as "safe investments". If changes in the environment force these funds to dump some of their holdings in order to clear the claims that are made on them, the prices of securities the banks directly hold tend to fall, affecting their assets position adversely. This means that there are two consequences of the new financial scenario: it is difficult to judge the actual volume and risk of the exposure of individual financial institutions; and within the financial world there is a complex web of entanglement with all firms mutually exposed, but each individual firm exposed to differing degrees to any particular financial entity.

But that is not all. On this base of entanglement, there has occurred a process of financial consolidation that increases the risks associated with the system substantially. During the 1990s, the three-decade long process of proliferation and rise to dominance of finance in the global economy reached a new phase. The international financial system was being transformed in directions that were substantially increasing systemic risk, and rendering the system more crisis-prone. Central to this transformation was a growing process of financial consolidation that concentrated financial activity and financial decision making in a few economic organizations and integrated hitherto separated areas of financial activity that had been dissociated from each other to ensure transparency and discourage unsound financial practices..

There has been a high level of merger and acquisition (M&A) activity in financial sector of the major developed countries during the 1990s, with an acceleration of such activity especially in the last three years of the decade. The number of acquisitions by financial firms from these countries increased from around 337 in 1990 to over 900 by 1995, and has more or less remained between 900 and 1000 a year since then. What is more, the size of

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[8] IMF, World Economic Outlook, December 1997: page 100.

each of these acquisitions has increased substantially since the mid-1990s.[9] As a result the annual value of M&A transactions, which stood at less than 0.5 per cent of the GDP of these nations in the early 1990s, had risen to as much as 2.3 per cent of their GDP in 1998. Clearly, M&A in the financial sector is creating large and complex financial organizations in the international financial system.

The occurrence of this heightened M&A activity in a period when liberalisation was occurring in the financial sectors across the globe obviously means that foreign agents come to play an extremely important role in the financial sectors of countries liberalising their financial systems. Once present it is inevitable that these agents would demand that any intervention in or regulation of the financial sector by the government would serve to limit their flexibility and may also work to favour domestic financial firms, which in many cases can be state owned. Acceding to their demand for "equal treatment" would most often require, therefore, some transformation of the financial structure in these countries.

Further, the increase in the incidence of cross-industry mergers within the financial sector consolidates the tendency towards entanglement of agents involved in sectors of financial activity characterized by differential risk and substantially differential returns, thereby increasing the share of high-risk assets in the portfolio of large financial agents. The concentration of increasingly globalized financial activity would lead to higher share of speculative investments in the portfolio of financial agents and greater volatility in investments worldwide as well as, making it difficult if not impossible for national regulators to monitor the activity of these huge entities. The risk of financial failure is now being built into the structure of the system.

This has two kinds of consequences. First it increases systemic risk within the financial sector itself. If transactions of the kind that led upto the savings and loan crisis or the Barings debacle come to play a major role in any of these large behemoths, and go unnoticed for some period by national regulators, the risks to the system could be extreme, given the integration of the financial system and entanglement of financial firms. Second, once a crisis afflicts one of these agents, the process of bailing them out may be too costly and the burden too complex to distribute. The G-10 report is quite candid on this count. To quote the report:

> "The larger firms that result, in part, from consolidation have a tendency either to participate in or to otherwise rely more heavily on "market" instruments. Because market prices can sometimes change quite rapidly, the potential speed of such a firm's financial decline has risen. This increased speed, combined with the greater complexity of firms caused in substantial

[9] The data refer to the G-11 countries (that is USA, Canada, Japan, Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland and UK) along with Spain and Australia. In these countries, the total value of financial sector M&A initiated by firms in these countries, which stood at $39 billion in 1990 rose to $499 billion by 1998. This was because the average value of the M&A instances covered rose from just $224 million in 1990 to touch nearly $800 million in 1998.

degree by consolidation, could make timely detection of the nature of a financial problem more difficult, and could complicate distinguishing a liquidity problem from a solvency problem at individual institutions.

The importance of this concern is illustrated by the fact that probably the most complex large banking organization wound down in the United States was the Bank of New England Corp. Its USD 23.0 billion in total assets (USD 27.6 billion in 1999 dollars) in January 1991 when it was taken over by the government pale in comparison to the total assets of the largest contemporary US firms, which can be on the order of USD 700 billion."

Implications for the real economy

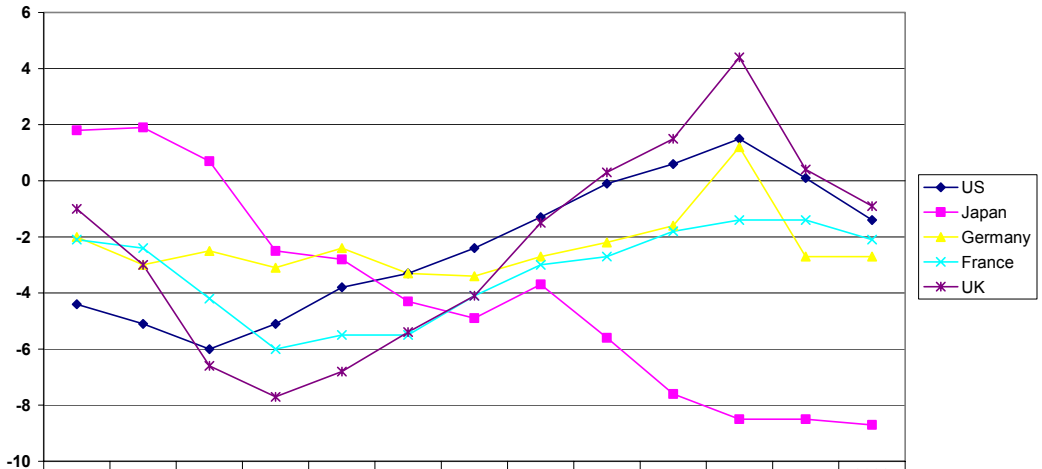
It is now clear that this rise to dominance of a globalised, centralised and fragile structure of finance had major implications for the real economy in the developed and developing countries. The very first impact was in the form of a shift to a deflationary stance across the global economy. At the most superficial level the de-synchronization of the economic cycle across developed countries may be attributed to the end of the era of Keynesian counter-cyclical policies, which the rise of finance capital implied. Greater integration through trade and financial flows meant that if any one country adopted counter-cyclical policies, it ran the risk of triggering domestic inflation, of undermining the ability of domestic firms to face up to foreign competition in local and foreign markets, of experiencing a worsening of its current account balance and a weakening of its currency, and of being threatened by a speculative attack on its currency that would be destabilizing. This is precisely what happened to France under Mitterand in the early 1980s. This loss of the ability to undertake counter-cyclical policies in isolation meant that when individual developed economies were faced with a downturn, they could not correct the imbalance by increased government spending.

The rise of finance capital affects the ability of governments to undertake deficit spending even directly. Finance capital is wary of the possible inflationary consequences of deficit-financed expenditure, since such inflation affects the real value of financial assets and the real rate of return on such assets. It is also wary of the possibility that governments resorting to deficit-financed expenditure may manage interest rates in a manner aimed at keeping down the cost of their borrowing requirements. Not surprisingly, financial agents constantly run down deficit-based spending and often respond by pulling out of economies characterised by high deficits on the governments' budgets. Fear of the destabilizing effects this would have puts direct pressure on governments to abjure deficit-financed spending.

The reality is that inasmuch as this fear of deficit spending afflicts each and every government, we should expect the adoption of a more deflationary stance across countries that could result in an overall slowing of global growth. The shift to a more deflationary stance did, in fact, occur. As Chart 3 shows, government fiscal balances in the 1990s reflect a sharp reduction in the level of deficit spending in the principal developed countries, with

the exception of Japan, where the level of deficit spending increased sharply. In fact, by 1998, the fiscal balance in the US and the UK had turned positive.

Chart 3: General Government Fiscal Balances as Percentage of GDP



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (P)
US	-4.4	-5.1	-6	-5.1	-3.8	-3.3	-2.4	-1.3	-0.1	0.6	1.5	0.1	-1.4
Japan	1.8	1.9	0.7	-2.5	-2.8	-4.3	-4.9	-3.7	-5.6	-7.6	-8.5	-8.5	-8.7
Germany	-2	-3	-2.5	-3.1	-2.4	-3.3	-3.4	-2.7	-2.2	-1.6	1.2	-2.7	-2.7
France	-2.1	-2.4	-4.2	-6	-5.5	-5.5	-4.1	-3	-2.7	-1.8	-1.4	-1.4	-2.1
UK	-1	-3	-6.6	-7.7	-6.8	-5.4	-4.1	-1.5	0.3	1.5	4.4	0.4	-0.9

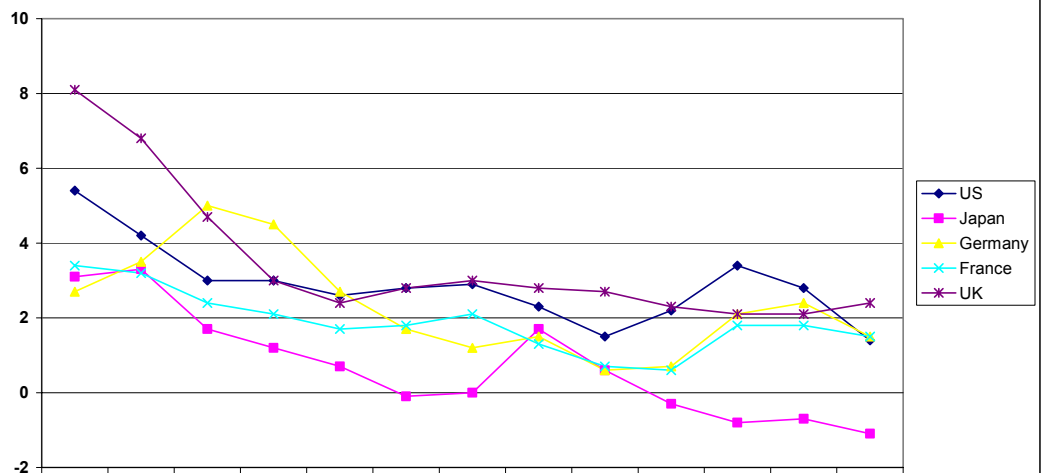
Per cent

It cannot be denied that this shift to a deflationary stance in fiscal policy across the major developed countries would have had an adverse impact on growth. To start with, in all these countries the stimulus to growth afforded by government expenditure would have been considerably dampened, since deficit spending relative to GDP fell in a period when tax rates were being substantially reduced to spur private initiative. This would have been aggravated by the global effects of reduced deficit spending in the world's leading economy, the US, whose currency serves as the world's reserve currency and is therefore considered 'as good as gold'. In the decades immediately after World War II, America used its hegemonic position and the fact that it was home to the world's reserve currency, to function as though it faced no national budget constraint. It could finance expenditures worldwide, including those on policing the world, independent of whether it had a surplus on its current account or not. It did not have to earn foreign exchange to sustain such expenditures, since the dollar was accepted in any quantity worldwide.

The willingness of the US to undertake such deficit-financed expenditures based on its strength as the world's leading power obviously meant that the United States served as an

engine for global growth. The post-War boom in the world economy is attributable in no small measure to this tendency. Conversely, the decision of the US government to move out of a regime in which it sustained a high and persistent deficit on its budget to one in which its budget showed a surplus must have substantially worsened the deflationary tendency in the world system. The consequent tendency towards deflation is reflected in price trends worldwide (Chart 2), which point to a significant and continuous decline in inflation rates across the major industrialized nations throughout the 1990s.

Chart 4: Inflation Rates (Consumer Prices)



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (P)
US	5.4	4.2	3	3	2.6	2.8	2.9	2.3	1.5	2.2	3.4	2.8	1.4
Japan	3.1	3.3	1.7	1.2	0.7	-0.1	0	1.7	0.6	-0.3	-0.8	-0.7	-1.1
Germany	2.7	3.5	5	4.5	2.7	1.7	1.2	1.5	0.6	0.7	2.1	2.4	1.5
France	3.4	3.2	2.4	2.1	1.7	1.8	2.1	1.3	0.7	0.6	1.8	1.8	1.5
UK	8.1	6.8	4.7	3	2.4	2.8	3	2.8	2.7	2.3	2.1	2.1	2.4

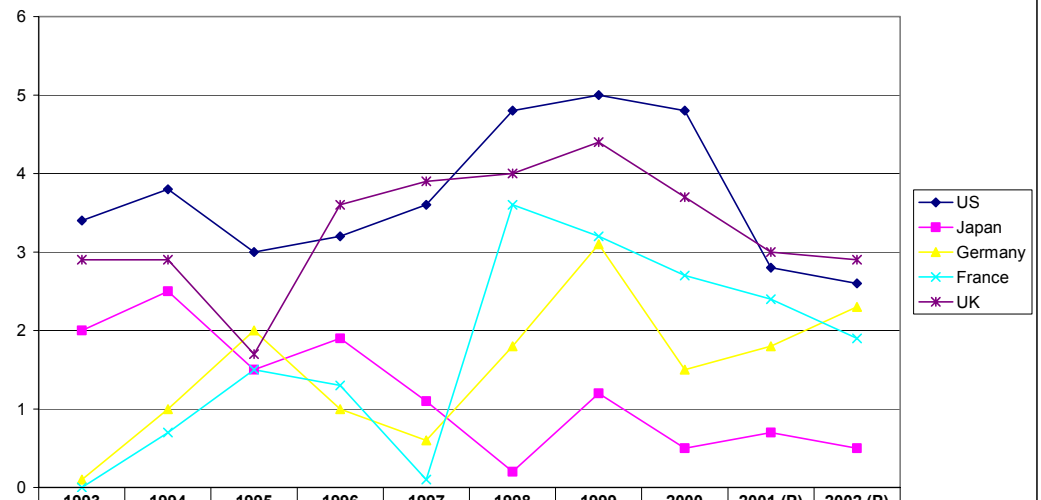
Per cent

It could be argued that it is because of this shift to a deflationary stance that, despite the remarkable performance of the US during the years after 1992, overall global growth has at best been on average just as good as the previous decade, and perhaps even worse. But what explains the performance of the US, which registered creditable rates of growth when it's government too was adopting a deflationary stance? The US, which saw a dramatic transition from deficit to surplus budgets, turned out to be a remarkable performer growth-wise precisely in those years in which that transition was occurring. Further, barring Japan, growth in some other developed countries, especially the UK, was not very much worse in the 1990s than it was in the previous decades, despite the dampening effects of their own deflationary fiscal stance and that of the US. Finally, we have the unusual fact that despite the consistent effort of the Japanese government to pump-prime its economy through a series of reflationary packages, the Japanese economy performed poorly right through the 1990s, except for a brief episode of growth around 1996.

The first step in unravelling this puzzling set of circumstances is to recognize that in the era of finance, when deficit spending is curtailed, the stimulus to growth has to come from the private sector. Since private investors need some inducement to invest, private sector-led growth in any economy must be stimulated by a rise in consumption expenditure either in the domestic economy or abroad, which translates into increased demand for domestic firms. There is reason to believe that the rise to dominance of finance does contribute to such an increase in private expenditure. Financial flows and financial liberalization can make a self-correcting contribution to neutralizing the deflationary bias resulting from reduced government expenditure in two possible ways: (a) they can permit a burgeoning of debt-financed consumption and housing expenditures that help sustain private and public spending so long as borrowers and lenders coexist; (b) they can trigger financial developments that increase the financial wealth of households, which in turn, through the 'wealth effect' encourages consumption and even dissaving.

The experience of the sample of developed countries being considered here captures the positive role that finance can play on both these counts. As Chart 5 illustrates, the annual rate of growth of private consumer expenditure has been well above average in both the US and the UK, moderately positive in France and Germany, and extremely poor in Japan. This explains in large part the relative performance of these countries, since computations made by the OECD Secretariat (Table 1) suggest that changes in final domestic demand, rather than increases in inventories or net exports, tend to explain almost all of GDP growth in the world's leading nations.

Chart 5: Annual Rate of Growth of Private Consumer Expenditure



	1993	1994	1995	1996	1997	1998	1999	2000	2001 (P)	2002 (P)
US	3.4	3.8	3	3.2	3.6	4.8	5	4.8	2.8	2.6
Japan	2	2.5	1.5	1.9	1.1	0.2	1.2	0.5	0.7	0.5
Germany	0.1	1	2	1	0.6	1.8	3.1	1.5	1.8	2.3
France	0	0.7	1.5	1.3	0.1	3.6	3.2	2.7	2.4	1.9
UK	2.9	2.9	1.7	3.6	3.9	4	4.4	3.7	3	2.9

Per cent

Table 1: Contributions to Changes in Real GDP in Selected OECD Countries (As a percentage of real GDP in the previous period)

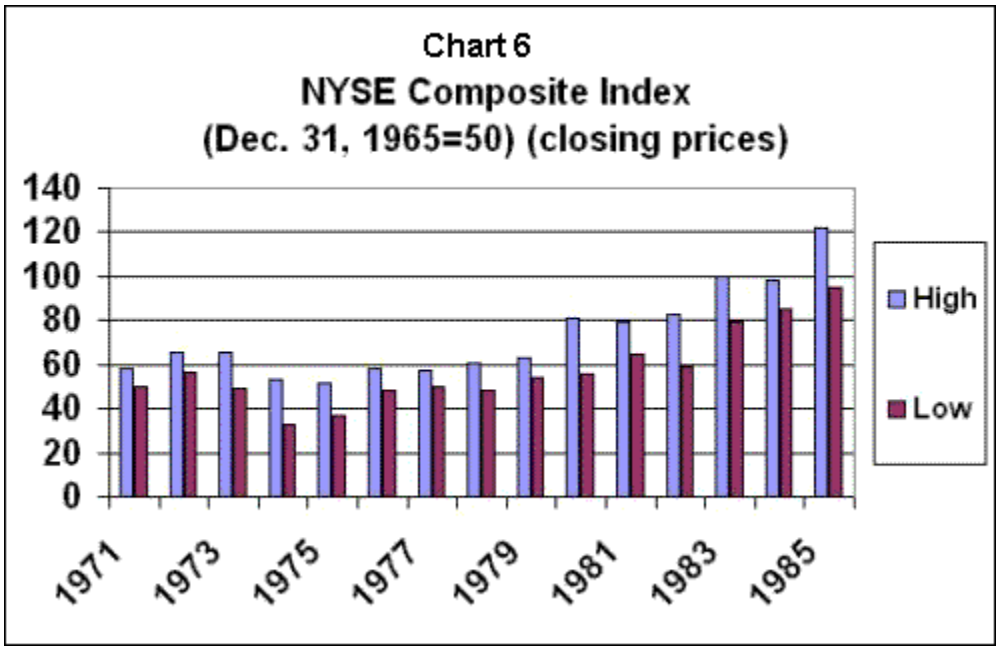
	2000	2001
United States		
Final Domestic Demand	5.1	2.4
Stockholding	-0.1	-0.2
Net Exports	-0.7	-0.8
GDP	3	2.2
Japan		
Final Domestic Demand	1.9	0.3
Stockholding	0	0
Net Exports	0.5	-0.7
GDP	2.4	-0.4
Germany		
Final Domestic Demand	1.6	-0.1
Stockholding	0.4	-0.9
Net Exports	1.1	1.6
GDP	3	0.6
France		
Final Domestic Demand	3.3	2.6
Stockholding	0.4	-1
Net Exports	-0.2	0.4
GDP	3.6	2
UK		
Final Domestic Demand	4.1	3.1
Stockholding	-0.3	-0.2
Net Exports	-0.7	-0.8
GDP	3	2.2

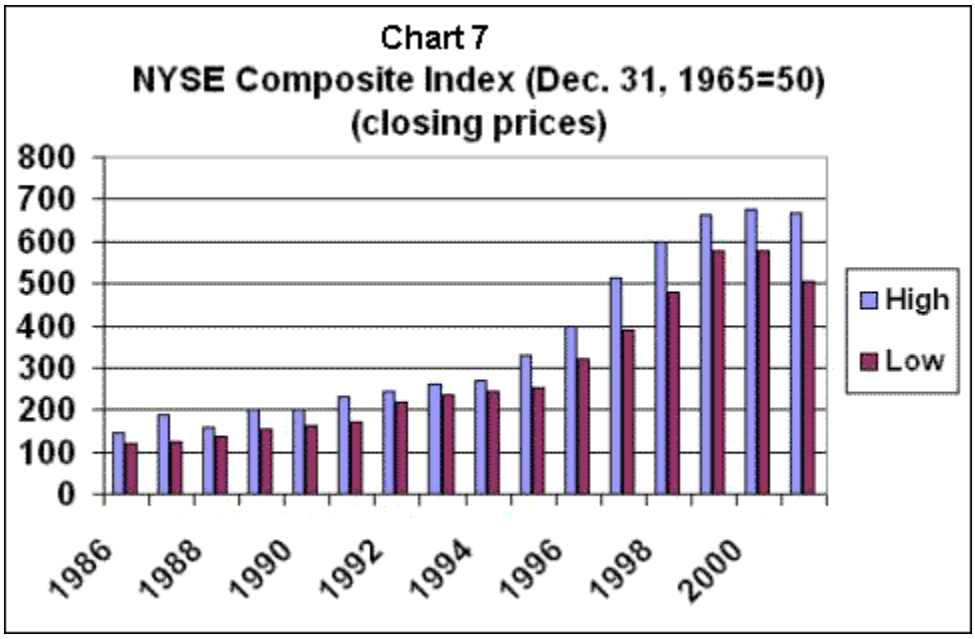
Being the hub of global finance, by virtue of being home to the world's reserve currency, the US epitomizes the impact that the rise of finance can have on private consumer expenditure and the real economy. Firstly, the US was the one country in which, through the 1980s and 1990s, credit helped fuel a consumption and housing expenditure boom. Secondly, a combination of higher interest rates and confidence in the dollar, due to the US being the leader and the dollar serving as the world's reserve currency, resulted in a preference for dollar-denominated assets among the world's wealth-holders.

The consequent flight to the dollar, in a world of mobile finance, was self-reinforcing. To start with, the flow of capital into the US strengthened the dollar, delinking its value from real factors such as the competitiveness of US manufacturing and the deficit on the current account of US balance of payments. But despite the strong US dollar, rising protectionist sentiments in the US encouraged international firms, particularly Japanese firms to invest in or acquire and modernise productive assets in the US as part of a strategy of defending markets. This reduced the degree to which increases in US demand leaked out of US markets. Further, the stronger the dollar became, the greater was the attractiveness of US financial assets as safe investments. And once a significant share of the world's financial wealth was invested in dollar-denominated assets, the greater was the pressure from wealth-

holders worldwide to prevent any downturn in US financial markets and any sharp fall in the value of the dollar. Even when evidence accumulated that US financial markets were witnessing an unsustainable speculative boom, the prime concern of international finance and international financial institutions was to ensure that the necessary correction took the form of a 'soft landing' rather than a crash.

The movement in the New York Stock Exchange's composite index during the periods 1971-85 and 1986-91 captures the impact of these developments on the performance of US financial markets (Charts 6 and 7). In the upward climb of the NYSE index which began in the early 1980s, the annual closing high and low values of the index rose by just 50 per cent between 1980 and 1985. Maintaining a similar growth path, between 1986 and 1994 these indices rose by a further 84 and 106 per cent respectively. However, during the speculative boom of the late 1990s, the high and low indices rose by 148 and 137 per cent respectively in a short span of five years, between 1994 and 1999. Subsequently, the boom tapered off, but there was no major corrective collapse in the NYSE indices during the slump years of 2000 and 2001. This partly helped prevent a collapse in the real economy, for the reasons detailed below.





It must be recognised that financial flows into and the ensuing stock market boom in the US do not directly translate into fixed investments in industry. This is because, in the US, the stockmarket plays a peculiar role. It does not help finance corporate investment, since internal resources account for an overwhelming share of investment finance in the case of US corporations. Thus in the US, if at all, greater liquidity could have at most helped sustain the venture capital boom, which was so crucial to triggering the tech and dotcom booms of the 1990s. Other than this, capital inflows impact on the real economy indirectly by spurring consumption demand. The liquidity created by capital inflows helps sustain a credit boom. And the "illusion of wealth" created by stock value appreciation, spurs consumption spending.

Much attention has been devoted to the latter of these effects. It is now widely accepted that, because of the direct (through investments) and indirect (through pension funds) involvement of US households in the stock market, the boom in those markets substantially increased their financial wealth. According to recent Surveys of Consumer Finances, a household survey conducted under the auspices of the Federal Reserve Board, using the broadest definition of share ownership there were an estimated 84.0 million shareowners in 1998. This represents an increase of 21 percent from 69.3 million in 1995, and a 61 percent increase from 52.3 million in 1989. The 1998 SCF suggests that there were 162.2 million household heads and spouses of household heads at the time of the survey. There were another 30.9 million unaffiliated adults, defined as persons over the age of 18 but who were neither heads of household nor spouses of heads of household. The results in Table 2 imply

that 51.8 percent of all individuals who are either household heads, or spouses of household heads, own stock.[11] By 1998, the probability that an individual between the age of 35 and 64 owned some shares stood at above 50 per cent, with the figure standing at 62.4 per cent in the 35 to 44 age group.

Table 2: Number of Individual Shareowners, by Method of Stock Ownership, 1989-1998 (in millions)

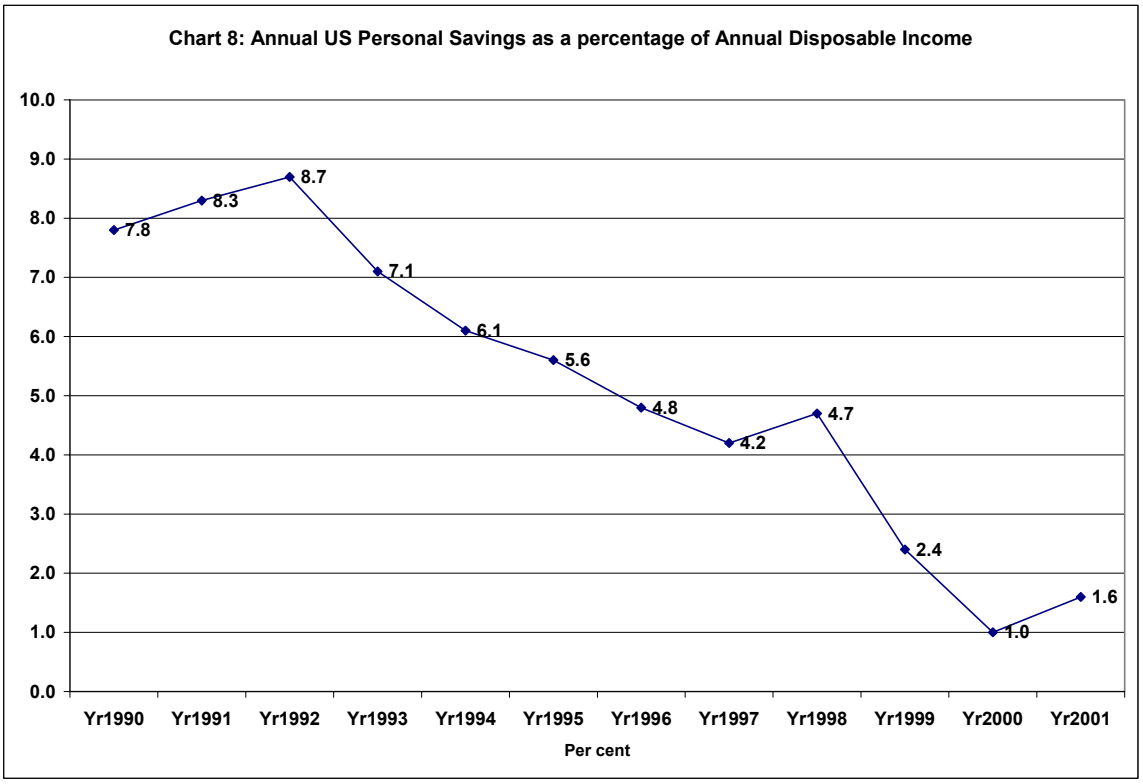
Method of Stock Ownership	1989	1992	1995	1998
Direct Stock Holding	27.0	29.2	27.4	33.8
Direct Holding or Holding Through Equity Mutual Fund (Excluding Retirement Plans)	31.5	35.3	38.6	48.5
Direct Holding, Equity Mutual Fund, or Self-Directed Retirement Account	42.1	51.5	59.6	75.8
Direct Holding, Equity Mutual Fund, Self-Directed Retirement Account, or Defined-Contribution Pension Plan	52.3	61.4	69.3	84.0

Notes: Tabulations are based on the 1989, 1992, 1995, and 1998 Surveys of Consumer Finances. All individuals who report holding mutual funds that invest in stocks and bonds are included as shareholders. If a married couple owns stock, both spouses are classified as shareowners. The Survey of Consumer Finances does not provide information on equity ownership by minor children, or by unaffiliated adults who are members of a household but are neither the household head nor the spouse of the household head..

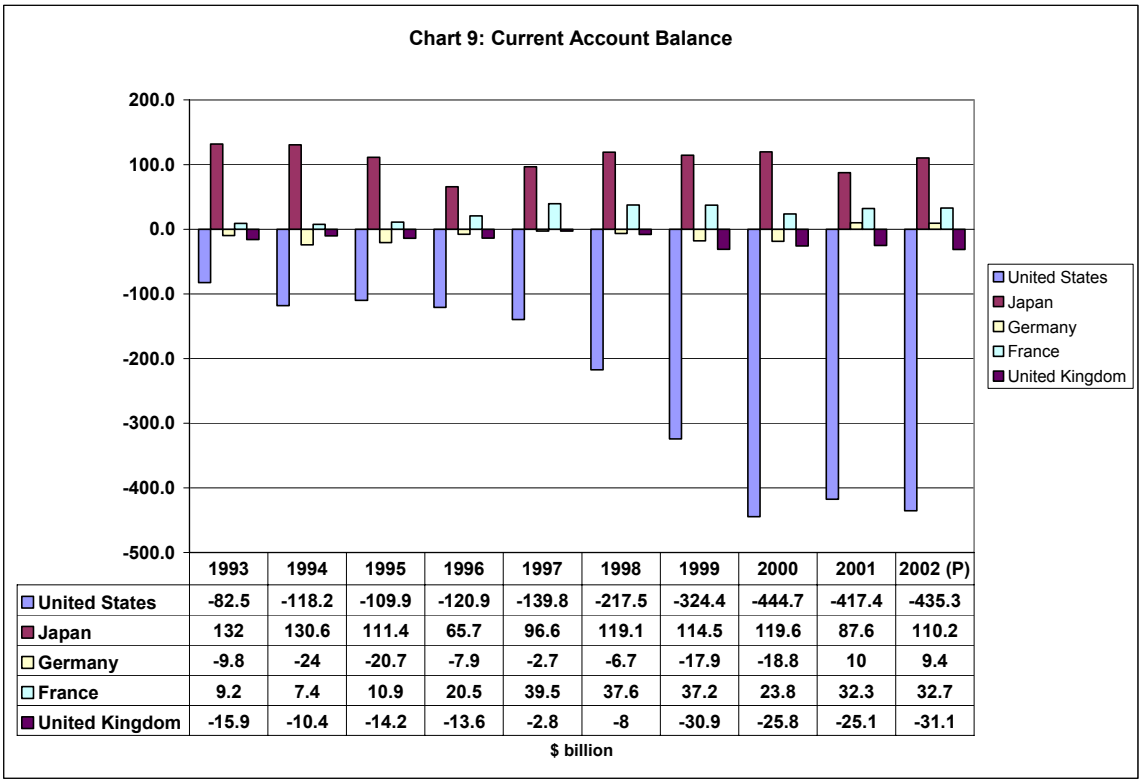
During the years of the stock market boom, which began at the end of 1994 and lasted till the end of 1990s (with one major glitch at the time of the financial crises of 1997-98), this wide prevalence of stock ownership resulted in a substantial increase in the wealth of American citizens. The consequent "wealth-effect", which encouraged individuals to spend because they saw their "accumulated" wealth as being adequate to finance their retirement plans, was seen as a major factor underlying the consumer boom and the fall in household savings to zero or negative levels.

Thus, in the US, the rise of finance spurred consumption directly by fuelling credit-financed spending, and indirectly through the wealth effect. As a result, the personal savings rate in the US collapsed from 8.7 per cent in 1992 to 1 per cent in 2000 (Chart 8), reflecting the growth in consumption expenditure that helped sustain the boom in the real economy. It was in this manner that the deflationary consequences of reduced government spending were more than neutralized in the US.

[11] Figures from New York Stock Exchange, **Shareownership 2000: Based on the 1988 Survey of Consumer Finances**, available at www.nyse.com.



If everything else had remained constant this private consumption expenditure-led boom in the US should have triggered growth in the rest of the world as well. Inasmuch as US demand is serviced through imports from abroad, this is what should be expected. And both relative competitiveness and the strength of the US dollar should result in some leakage of US demand abroad. That this did happen is suggested by the facts that the boom years were ones in which the deficit on the US current account widened substantially (Chart 9). In fact, there is reason to believe that the export success of individual countries like China depended on the benefits they derived from the booming consumer market in the US. But to the extent that the US remained a major player in frontline sectors like information and communication technologies and the new services, that US firms restructured themselves to improve their competitiveness and foreign firms chose to set up capacities in the US to cater to the local market, the consumption boom resulted in a real boom in the US as well. And to the extent that individual countries in Latin America, Europe and Asia were faced with domestic demand deflation, the share of benefit from a rising US current account deficit they obtained was partly or substantially eroded.



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (P)
United States	-82.5	-118.2	-109.9	-120.9	-139.8	-217.5	-324.4	-444.7	-417.4	-435.3
Japan	132	130.6	111.4	65.7	96.6	119.1	114.5	119.6	87.6	110.2
Germany	-9.8	-24	-20.7	-7.9	-2.7	-6.7	-17.9	-18.8	10	9.4
France	9.2	7.4	10.9	20.5	39.5	37.6	37.2	23.8	32.3	32.7
United Kingdom	-15.9	-10.4	-14.2	-13.6	-2.8	-8	-30.9	-25.8	-25.1	-31.1

Transmission mechanisms

What is noteworthy is that, despite greater global integration, the spill-over effect of the US boom was less visible during the 1990s than would have been expected based on past experience. Excepting for some success, however unstable, in Southeast Asia and China, growth was either moderate in the other industrial nations (barring the UK) or dismal, as in Japan and large parts of the developing world. The reasons are not hard to find. To start with, domestic deflation in many of these countries would have neutralised part of the benefit they derived from exports to the US market. Further, France, Germany and the UK were not major beneficiaries in terms of a net export boom. Whatever growth occurred there was based on an expansion of final domestic demand. Also, in these countries, the stimulating effect of financial flows on stock market values and the extent of involvement of households in the stock market were far less than in the US. Thus one of the principal ways in which a financial boom translates into a real boom, was far less effective in these countries.

But that is not all. In countries such as Japan and even in many developing countries like South Korea, which have predominantly bank-based rather than stock market-based financial systems, the financial liberalization that accompanied he rise to dominance of finance proved debilitating. In these countries, the high growth of the 1970s and 1980s was

fuelled by bank credit, which allowed firms to undertake huge investments in capacity and diversify into new areas where world trade was booming, in order to garner the export success that triggered growth. The consequent high levels of gearing of firms and high exposure of banks to risky assets could be 'managed' within a closed and regulated financial system, in which the state, through the central bank, played the role of guarantor of deposits and lender of last resort. Non-performing loans generated by failures in particular areas were implicitly seen as a social cost that had to be borne by the system in order to ensure economic success.

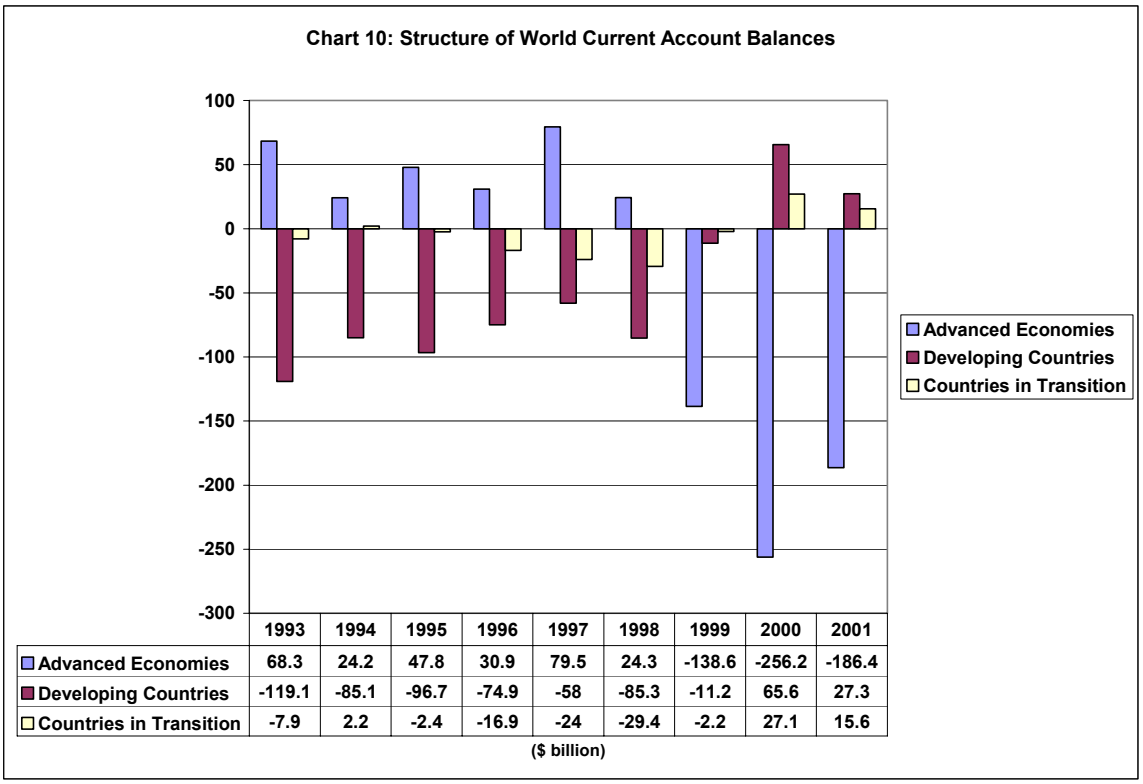
Such systems were rendered extremely vulnerable, however, once liberalization subjected banks to market rules. And when, in a post-liberalized financial world, vulnerability threatened the stability of individual banks, the easy access to liquidity, which was so crucial to financing the earlier boom, gave way to tight financial conditions that spelt bankruptcy for firms and worsened the conditions of the banks even further. At the beginning of 2002, the official estimate of non-performing loans of Japanese banks stood at Y43,000 billion, or 8 per cent of GDP. This, despite the fact that over nine years ending March 2001, Japanese banks had written off Y72,000 billion as bad loans. In the past this would not have been a problem, as it would have been met by infusion of government funds into the banking system in various ways. But under the new liberalized, market-based discipline, banks (i) are not getting additional money to finance new NPAs; (ii) are being required to pay back past loans provided by the government; and (iii) are faced with the prospect of a reduction in depositor guarantees, which could see the withdrawal of deposits from banks.

With banks unable to play their role as growth engines, the government has been forced to use the route of reduced interest rates to fuel growth. This has affected banks even further. With interest rates close to zero, lending is not just risky because of the recession, but downright unprofitable. As a result, despite government efforts to ease monetary conditions, credit is difficult to come by, adversely affecting investment and consumption. The net effect is that financial liberalization has triggered a recession that consecutive rounds of reflationary spending by the state have not been able to counteract.

In other situations, as in South Korea and Thailand, financial liberalization had permitted the financial system to borrow cheap abroad and lend costly at home, to finance speculative investments in the stock market and in real estate. When international lenders realized that they were overexposed in risky areas, lending froze, contributing to the downward spiral that culminated in the 1997 crises in Southeast Asia. In the event, deflation has meant that, a recovery in some countries notwithstanding, the current account of the balance of payments in developing countries reflects a deflationary surplus in recent years (Chart 10).

Thus, in countries which do not have the US advantage of being home to the reserve currency and have a financial system that is structurally different, the rise of finance has implied that that the underlying deflationary bias in the system induced by financial mobility has been worsened in more ways than one. If we add this tendency towards depression in parts of the world to the limited and countrywise-concentrated spill-over of the US boom into world markets, it becomes clear that the de-synchronization of the

economic cycle across countries during the 1990s is a fall-out of the rise to dominance of finance internationally.

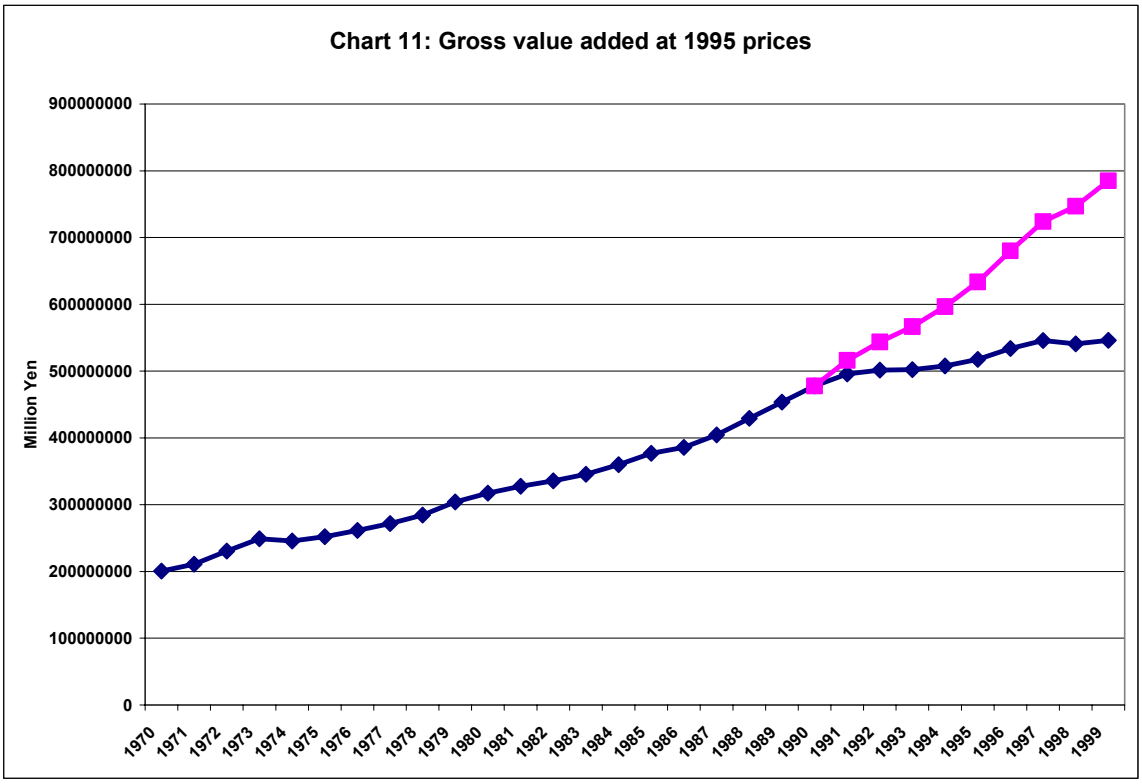


	1993	1994	1995	1996	1997	1998	1999	2000	2001
Advanced Economies	68.3	24.2	47.8	30.9	79.5	24.3	-138.6	-256.2	-186.4
Developing Countries	-119.1	-85.1	-96.7	-74.9	-58	-85.3	-11.2	65.6	27.3
Countries in Transition	-7.9	2.2	-2.4	-16.9	-24	-29.4	-2.2	27.1	15.6

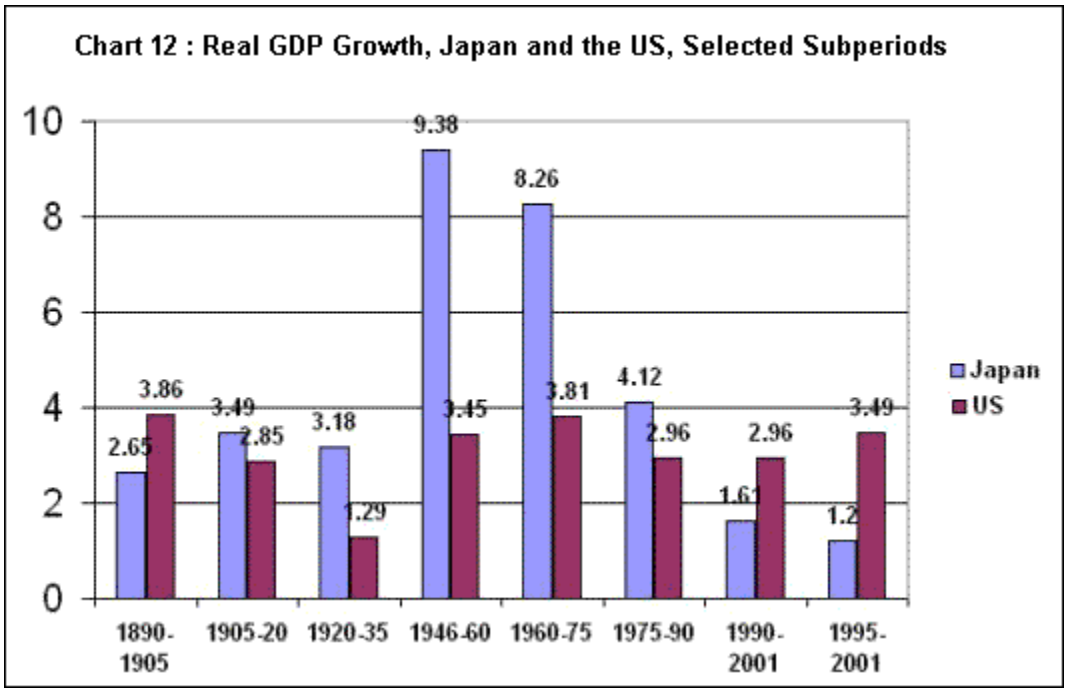
($ billion)

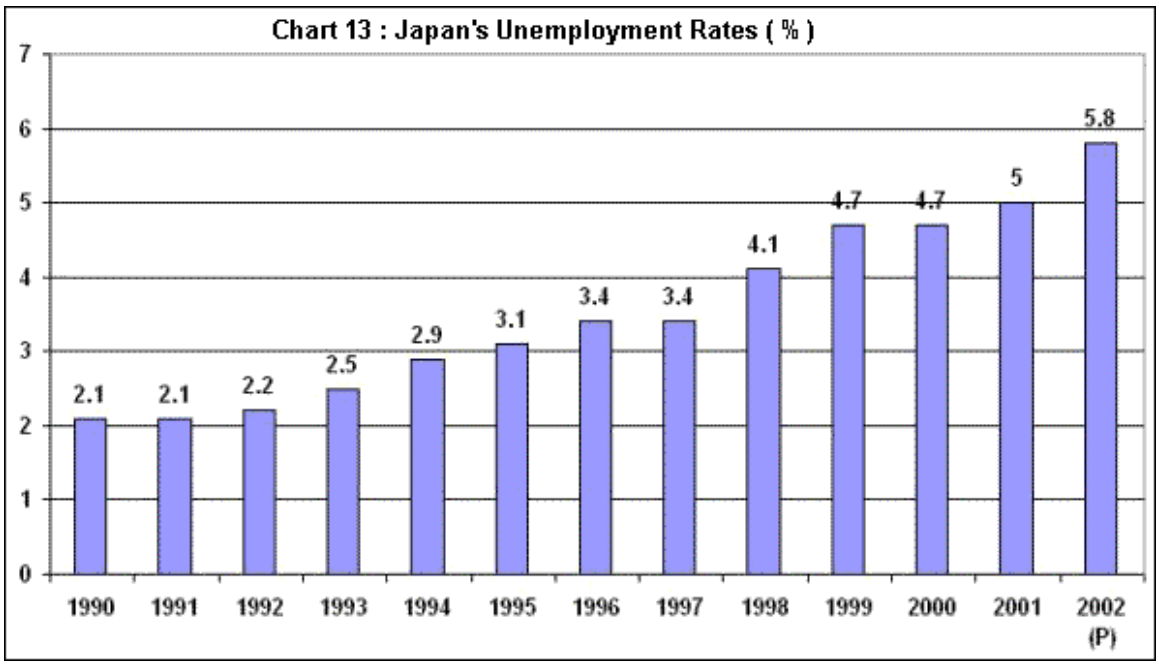
The curious case of Japan

The impact that financial liberalisation can have on a country where the financial sector plays a role completely different from that of the US is best illustrated with the Japanese experience. It is twelve years since the Japanese economy entered a phase of slow growth after decades of rapid expansion. During these years it has experienced four recessions, the last of which still afflicts the country's economy. Provisional GDP figures released in June 2002 suggest that the Japanese economy grew by 2 per cent during the first three months of the year. Coming after three consecutive quarters of contraction in 2001, this evidence has rekindled hope among some observers. They see Japan as being on the verge of a recovery from the fourth recession that has afflicted it in the twelve years since the asset bubble of the second half of the 1980s collapsed in 1990. Others are still pessimistic, based on recent experience in which similar cause for hope was quickly sunk by real developments.



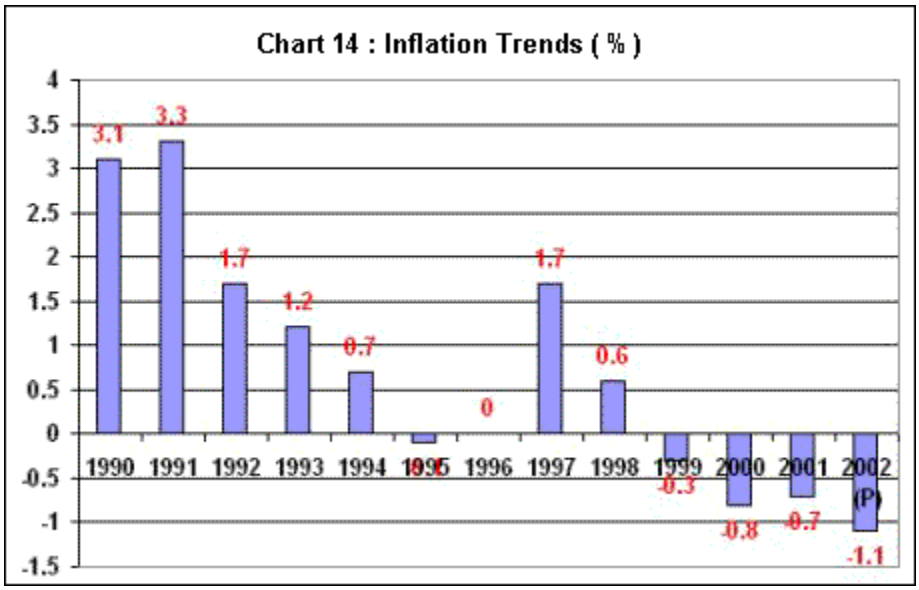
If the trend rate of growth of GDP experienced by it during the period 1970-90 had been maintained, Japan's GDP would have been close to 50 per cent higher by the turn of the last century (Chart 11). This is significant, since Japan's breakneck expansion since the Second World War had in fact slowed after the oil shock in 1973. As Chart 12 shows, as compared with annual rates of growth of 9.4 and 8.3 per cent recorded during 1946-60 and 1960-75, growth during 1970-90 was a much slower 4.1 per cent. It is from this slower rate, which was creditable when compared with that in the US for example, that Japanese growth has slumped to 1.6 per cent during 1990-2001 and 1.2 per cent during 1995-2001.

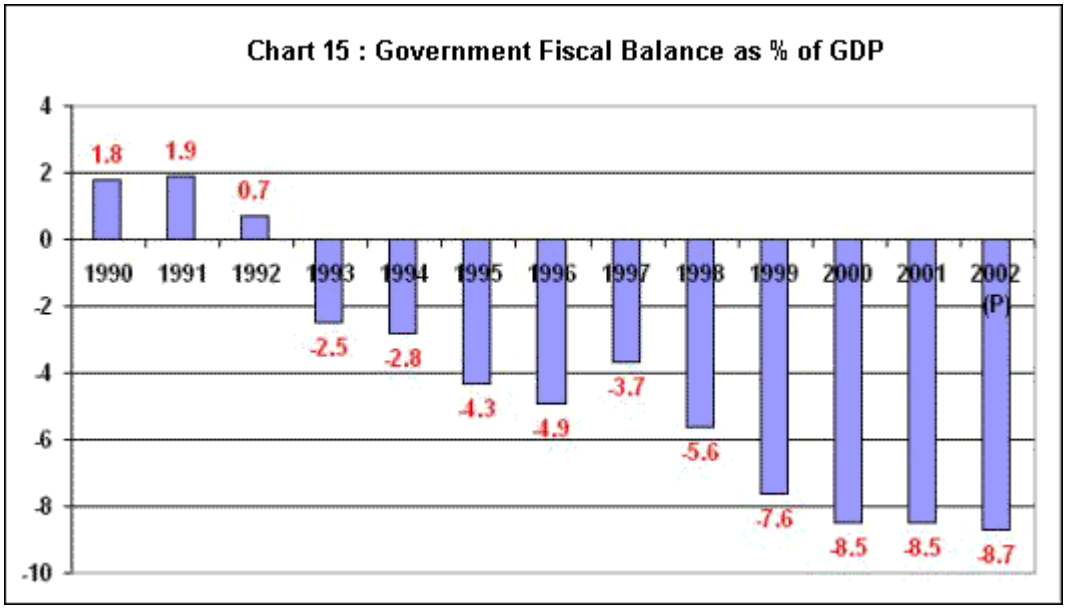




For a population that had almost forgotten the sufferings of war, because of rapid and prolonged post-war growth, the more than decade-long collapse of the economy has indeed been painful. Long accustomed to guaranteed and lifelong employment, the Japanese have had to contend with a rising unemployment rate, which nearly tripled from just above 2 per cent in 1990 to close to 6 per cent at present (Chart 13). Anecdotes about increasingly

insecure Japanese households cutting back on consumption are now legion. (Chart 16). Combined with a reduction in investment, which triggered the downturn in the first place, this has meant chronic deflation. Inflation rates that fell from 3 to zero percent over the first half of the 1990s, have been negative in most years since 1996 (Chart 14).





The principal puzzle emerging from the prolonged period of near-stagnation coupled with periodic recessions is the failure of conventional counter-cyclical policies to deliver a

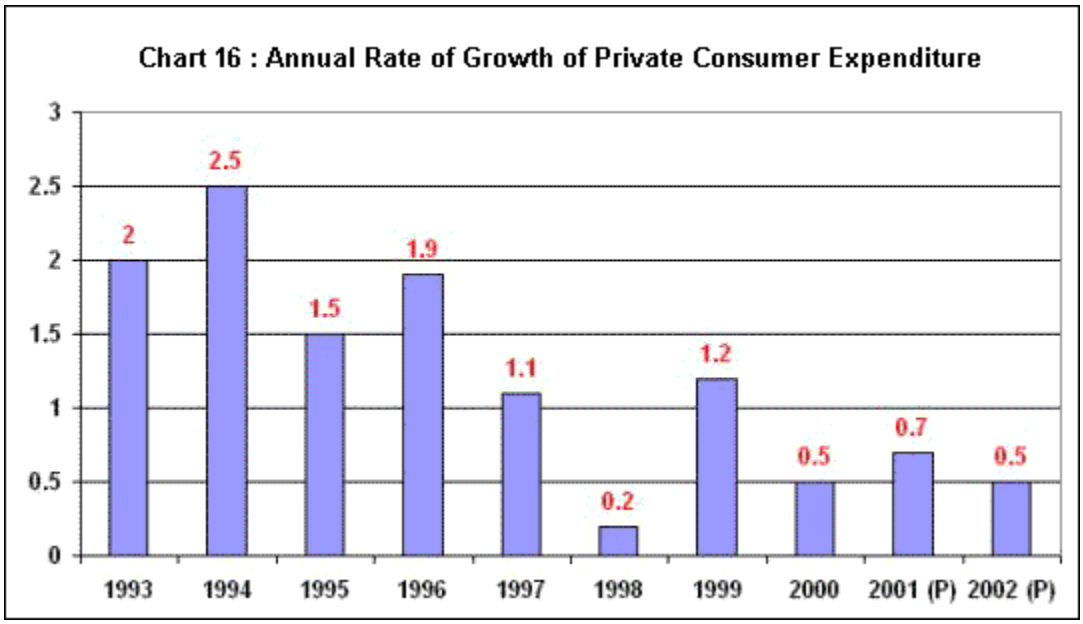
recovery. Over these dozen years, the Japanese government has launched almost as many reflationary initiatives, by increasing deficit spending and prodding the central bank to cut interest rates and maintain an easy money policy. The general government fiscal balance, which showed a surplus of close to 2 per cent of GDP in the early 1990s, has been in deficit since 1993. And the level of that fiscal deficit has risen from just 2.5 per cent of GDP in 1993 to 5 per cent in 1996 and 8.5 per cent in 2001 (Chart 15). Yet the Japanese economy has not been able to extricate itself from the recessionary bias that has characterised it through the 1990s.

Mainstream explanations for this predicament, now internalised by sections of Japan's government as well, revolve around its failure to reform what is considered to be a badly designed and unviable financial system propped up by the State. As has been noted by some observers, however, there are two problems associated with such explanations. First, they leave unanswered the question as to why during the years of rapid post-war growth the same Japanese financial system was considered to be have been the engine that triggered and sustained that growth, and therefore a "model" that was worth emulating. Second, it does not take account of the fact that the asset price bubble and its collapse, which preceded the period of deflationary bias, followed and in all probability was triggered, *inter alia*, by a process of financial liberalisation.

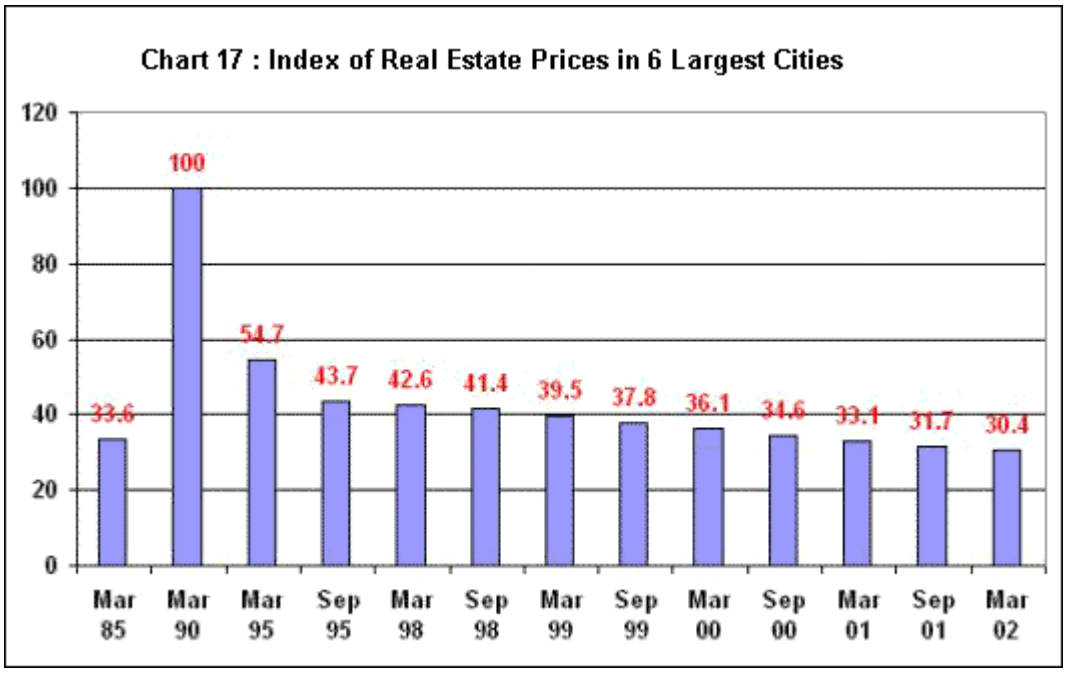
The question, however, is why the financial system that helped Japan sustain extremely high rates of growth for many decades prior to the 1990s, failed to serve it as well during the 1990s. The answer lies in the fact that the system was changed and considerably diluted as a result of American pressure during the 1980s. The pressure came from three sources. First, from international banks and financial institutions that wanted Japan to open up its financial sector and provide them space in its financial system. Second, once these external agents were permitted to enter the system, they wanted a dilution of the special relationship that existed between the government, the financial system and the corporate world, since that implied the existence of internal barriers to their entry and expansion. Third, these agents and even some Japanese financial institutions affected adversely by the deceleration of growth in the system, wanted greater flexibility in operations and the freedom to "innovate" both in terms of choice of investments and instruments with which they transact.

There was one principal reason why Japan succumbed to these pressures: its dependence on world, especially US, markets to sustain growth. When faced with US opposition to protectionism against Japanese imports, Japanese investors sought to Americanise themselves by acquiring or establishing new production capacities in the US in areas like automobiles. In return for the "freedom" to export to and invest in the US, Japan had to make some concessions. But US demands were quite damaging. They began by requiring Japan to reverse the depreciation of its currency. Following the celebrated Plaza accord, arrived at in New York in September 1985, the yen, which had started to appreciate against the dollar in February 1985 from a 260 yen-to-the-dollar level, maintained its upward trend to touch yen 123-to-the-dollar in November 1988. Though the year following that saw movements that signalled a strengthening of the dollar relative to the yen, the downturn soon began again resulting in a collapse of the dollar from an end-1989 value of 143.45 yen

to its April1995 level of below 80. Any economy faced with such a huge appreciation of its currency was bound to stall, more so an export-dependent one like Japan's.



This trend, which resulted in the hollowing out of Japanese industry, undermined the principal area of business of the banks as well, which were faced with the prospect that some of their past lending could turn non-performing. It was in response to this that the Japanese banks joined the chorus against financial controls, demanding that they be permitted to diversify away from their traditional areas. Regulatory changes in the form of a revision of the Foreign Exchange Control Law in 1980 and permission for commercial banks to create non-bank subsidiaries (*jusen*) to lend against real estate investments was the government's response. Besides expanding overseas operations, the principal areas into which the banks diversified were lending against real estate and stock market investments. The rate of growth of real estate lending rose from 7 per cent in the second half of the 1970s, to 18 per cent in the first half of the 1980s and 20 per cent in the second half.

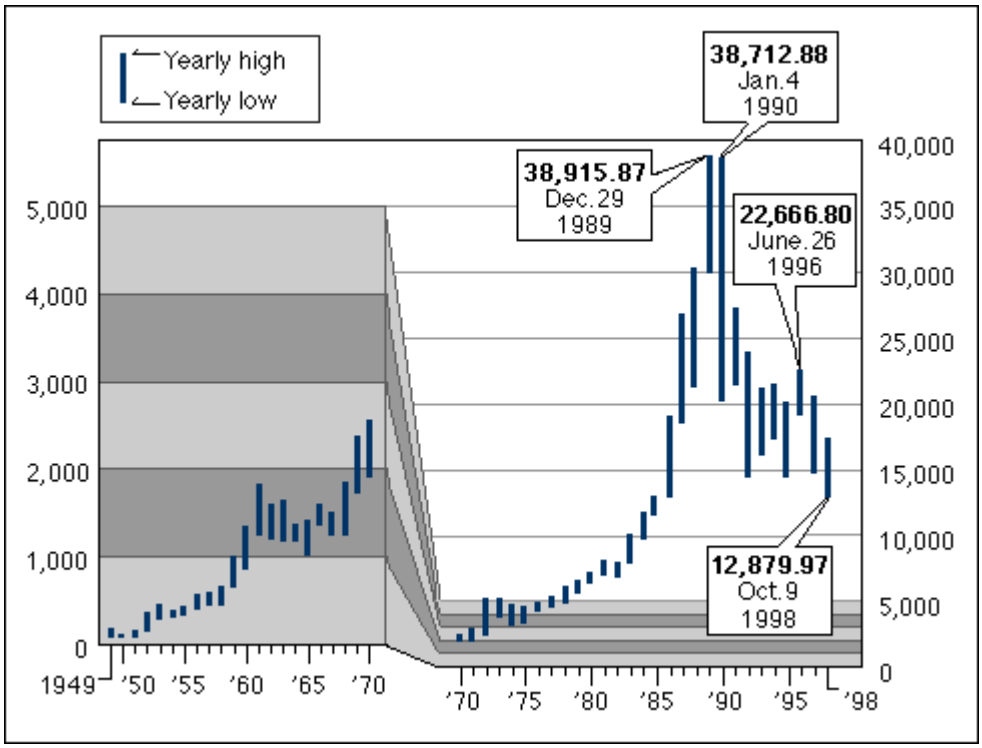


The result of this was a speculative boom triggered by a mad rush into the new areas. Even as GDP growth was slower in the 1980s than in the 1950s and 1960s, the six-largest-cities-index of real estate prices tripled between end-March 1985 and end-March 1990, from 33.6 to 100 (Chart 17). Similarly, as Chart 18 shows, there was a massive speculative boom in stock markets with the yearly high of the Nikkei stock market index rising from 12,500 in 1985 to 38,916 in 1989. By 1989 it was clear that the asset bubble was bound to burst, and in a belated effort to halt the frenzy and respond to householder complaints that acquiring housing was virtually impossible, the government stepped in by controlling credit and raising interest rates. The net result was a collapse in both real estate and stock markets. The real estate index fell to half its peak level by 1995 and to a third by 2001. And the Nikkei, which registered a high of 38,713 on January 4, 1990 fell soon after to an intra-year low of just above 20,000, and continued its downward slide thereafter right up to 1998. A slight recovery in 1999 was followed by a further fall in 2000.

The net result of this collapse and prolonged decline was a huge build up of bad debt with the banking system. At the beginning of 2002, the official estimate of the non-performing loans of Japanese banks stood at Yen 43 trillion or 8 per cent of GDP. This is despite the fact that over nine years ending March 2001, Japanese banks had written off Yen 72 trillion in bad loans. There is still much scepticism about official estimates of the extent of bad debts. In September 1997, the Ministry of Finance had announced that the banking sector held Yen 28 trillion in non-performing loans, but soon after that, using a "broader definition", arrived at a figure of Yen 77 trillion, which amounted to 11 per cent of outstanding private bank loans in Japan and 16 per cent of its GDP. And in 1998 the Financial Supervisory Agency placed problem debt at Yen 87.5 trillion and debt already declared bad at Yen 35.2 trillion, which added up to a total of Yen 123 million. Whatever, the figure, in the past this would not have been a problem, as it would have been met by

infusion of government funds into the banking system in various ways. But under the new liberalised, market-based discipline banks (i) are not getting additional money to finance new NPAs; (ii) are being required to pay back past loans provided by the government; and (iii) are faced with the prospect of a reduction in depositor guarantees, which could see the withdrawal of deposits from banks.

Chart 18: Post-War Trends in the Nikkei Index



Accumulation of such bad debt inevitably leads to a credit crunch, as banks are strapped for cash and turn wary in their lending practices. Overgeared corporations with outstanding loans on their books were no more favoured customers, resulting in a collapse of investment and a fall in utilisation for lack of long and short-term capital. Added to that, the insecure Japanese consumer has chosen to hold back on consumption. The rate of growth of private consumption expenditure had fallen by 2000 to a fourth/third of its 1993/1994 values (Chart 15). In the event, growth decelerated sharply, and periodic recessions were the norm.

The point to note is that with growth having slowed and firms finding it increasingly difficult to show a profit before interest and tax, they were unable to meet past commitments. As a result, the bad loans problem has only increased. This explains the fact that huge provisioning against past bad loans by the banking system has not adequately

reduced the ratio of non-performing loans. The government has over the last decade sought to resolve the problem by increasing its own expenditures in an effort to spur growth. With growth, it was argued firm performance would improve allowing them to clear at least a part of their debts. Unfortunately the depth of the slump was such that the government's effort to increase deficit spending, on a budget, which has always been small relative to the size of the Japanese economy, has not worked. Deceleration has persisted despite the fact, noted earlier, of a rising fiscal deficit on the government's budget.

But it is not only the higher deficit that has not worked. With the credit crunch created by the bad loans problem appearing as the most proximate explanation for Japan's decline, the argument that a badly designed and managed financial system was responsible for the crisis has gained currency. This amounts to saying that, rather than return to the regime that prevailed before the liberalisation of the 1980s, Japan must liberalise its financial sector further, allowing some banks and financial institutions to down shutters in the process, if necessary. This would only worsen the crisis in the short run, with depositors turning more nervous and the credit crunch intensifying. Yet, Japan is once again surrendering to external pressure and adopting precisely such an agenda. In fact, Prime Minister Koizumi rose to power in 2001 on the slogan that he would reform the Japanese system along these lines. But the immediate result of whatever he tried were such that he has been unable to proceed any further. Extended reform, to the extent that it has occurred, has not worked either. With the crisis persisting and the evidence that he is not pushing ahead with his reform agenda accumulating, even Koizumi's personal political ratings have taken a beating.

In practice, the real beneficiaries of further reform would be the international financial institutions who would be there to pick up the pieces as the system goes bust, so that they can come to play a dominant role in an economy into which they were unable to enter during Japan's miracle growth years. This is likely to be the denouement in this decade-long drama, unless policies change substantially in Japan. But to expect that of a country which based its earlier miracle growth primarily on an expansion into world markets may be to expect a little too much.

Other experiences

The point to note is that Japan was not the only country which liberalised its financial system, witnessed a restructuring of its financial structure, and paid a price in terms of growth. This was the case with many Latin American countries and Asian countries including the other Asian miracle, South Korea, during the 1990s. In all, these cases the build up of liquidity in the international system during the 1970s and 1980s was viewed as an opportunity. Some countries sought to use the easy access to such liquidity to pump prime their systems and raise the rate of growth, without dealing with major institutional and structural constraints that had earlier constrained their growth. Others, at a higher level of development, hoped to migrate out of areas of manufacturing in which they were losing their competitiveness into financial services by becoming regional financial hubs benefiting from the free flow of capital. To the extent that these strategies failed resulting in balance of payments difficulties, they were forced to turn to the World Bank and the IMF for financial support, in return for which they had to further liberalise their financial sectors. In the net

there has been a global process of financial restructuring, with financial systems losing their diversity and increasing approximating the American model. This obviously weakens the ability of these countries to "catch up", increases the unevenness of capitalist development and aggravates global inequality.

Conclusion

The comparative experience of Japan and the US suggests that the process of rise to dominance of finance impacts on the real economy in ways that have rather specific and far-reaching implications. That process, which had its origins in the US and UK, is one that reshapes financial structures in a way which (i) slows world growth; (ii) desynchronises the economic cycle across countries; (iii) strengthens economies like the US and UK with stock market-based financial systems; (v) weakens successful late industrialisers like Japan and countries in East Asia whose predominantly bank-based financial systems are substantially restructured; and (v) enhances volatility in the so-called emerging markets of developing countries and adversely affects their real economic growth. But in the process of doing so, the process encourages speculation, and fraudulent accounting and management practices aimed at sustaining the speculative boom. Recent experience suggests that these tendencies undermine the boom in the centres of finance capital, raising the danger of a return to a synchronised recession that can turn into a depression.