Finance and the Real Economy: The Global Conjuncture

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Two aspects of global economic performance have come up for scrutiny in recent months. One is the slowdown in global economic growth, which persists despite upbeat assessments that a recovery is underway. Aggregate growth in OECD countries as a group was held up during the 1990s by the strong performance of the US and the creditable performance of the UK. But since 1999, even these economies, especially the US, have turned sluggish and are on the verge of entering what is conventionally considered a recession. This has occurred despite repeated efforts by the US Federal Reserve to drive down interest rates and the more recent tendency for the US government to revert to a period of deficit budgets. This has encouraged analysts to turn to the effects that the collapse of the stock market boom has had on consumption spending, suggesting a strong and link between financial sector performance and the real economy.

The other feature of global economic performance during the 1990s was the lack of synchrony in the economic cycle across countries, including the developed countries as a group. Here again, once a link was established between US economic performance and US growth, the facts that slow growth in Japan was attributed to the weakness of its banking system and that growth in a number of better performing developing countries collapsed after the East Asian currency and financial crises and the contagion that followed, suggested that finance played a major role in determining the contours of real economic development.

This 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 major historical landmarks in the process of the rise to dominance of finance are worth recalling. Till the early 1970s the private international financial system played only a limited role in recycling financial surpluses to the developing countries. The period immediately after the first oil shock saw a dramatic change in this scenario. Since oil surpluses were held in the main as deposits with the international banking system controlled in the developed world, the private financial system there became the powerful agent for recycling surpluses. This power was indeed immense. Expenditure fuelled by credit in the developed and developing world generated surpluses with the oil producers, who then deposited these surpluses with the transnational banks, who, in turn, could offer further doses of credit. 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. 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. 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.

Two other developments contributed to the increase in international liquidity during the 1970s and 1980s. First, the United States had 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. The explosion of the Eurocurrency market in the 1970s reflected this. This was sustained by the confidence in the dollar stemming from the immediate post-War hegemony of the US, which made it as good as gold. Such international confidence in its currency allowed the US to ignore national budget constraints on its international spending and resulted in the emergence of strong banking and financial interests with an international agenda. The influence of these interests was reflected in policies that affected domestic manufacturing interests adversely, as suggested by the widening and persistent US trade deficit after the mid-1970s.

Second, the loss of manufacturing competitiveness in the US meant that during different periods since the 1970s the dollar 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, is sensitive to both interest rate differentials and 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. In the early 1980s the volume of transactions of bonds and securities between domestic and foreign residents accounted for about 10 per cent of GDP in the US, Germany and Japan. By 1993 the figure had risen to 135 per cent for the US, 170 per cent for Germany and 80 per cent for Japan. Much of these transactions were of bonds of relatively short maturities.

There were also other real factors that created pressures for the expansion of finance. These included the changing demographic structure in most of the advanced countries, with baby boomers reaching the age when they would emphasise personal savings for retirement. This was accentuated by changes in the institutional structures relating to pensions, whereby in most industrial countries, public and private employers tended to fund less of the planned income after retirement, requiring more savings input from employees themselves. All this meant growing demands for more variety in savings instruments as well as higher returns, leading to the greater significance of pensions funds, mutual funds and the like.

Financial liberalisation in the developed countries, which was closely related to these developments, further increased funds available in the system. First, it increased the flexibility of banking and financial institutions when creating credit and making investments, as well as permitted the proliferation of institutions like the 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 virtually autonomously created by the financial system. These instruments allowed players to trade “all the risk of an underlying asset without trading the asset itself.” Finally, it increased competition and whetted the appetite of banks to earn higher returns, thus causing them to search out new recipients of loans and investments in economic regions hitherto considered risky.

Consequences of financial dominance

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. Principal among these is the growing importance of unregulated financial agents, such as the so-called hedge funds, in the system. Many years back the Group of 30 had cautioned governments that these funds were a source of concern because they were prone to "undercapitalisation, faulty systems, inadequate supervision and human error".[1] Though hedge funds first originated immediately after the second world war, they are estimated to manage close to $500 billion of investors' money. These investors include major international banks, which are themselves forced by rules and regulations to avoid risky transactions promising high returns, but use the hedge funds as a front to undertake such transactions. The operations of the now infamous Long Term Capital Management illustrate this. LTCM operated out of the US, as most hedge funds do, and was well known not only because of the two Nobel prize-winning economists who had helped to found it, but because its list of investors read like a virtual "Who's Who" of international capitalism, with almost every large bank and important individual wealth-holder being represented. The fund's principal trading activity was based on exploiting the differentials in interest rates between different securities. It was to the credit of LTCM, it was argued, that it indulged in such trades by investing primarily in sovereign debts in emerging markets which were more secure, and yet garnered returns as high as 40 per cent on capital. What was less praiseworthy was the extent to which its operations were based on borrowed capital. On an equity base of a little less than $5 billion, LTCM had borrowed enough to undertake investments valued at $200 billion or more. This was possible because there was nothing in the regulatory mechanism that limited the exposure of these institutions relative to their capital base. Yet when several of its own investments came unstuck in 1998 and LTCM therefore faced major repayment problems of its own, it had to be rescued by the US Federal Reserve, because the costs of its collapse were seen to be too major.

Such flows of credit to a few institutions are significant because in a world of globalized and liberalised finance, when countries are at different phases of the business cycle and characterised by differential interest rates, capital will tend to flow in the direction of higher returns in the short term. Nothing illustrates this better than the "yen-carry trades" of the period 1995 to 1997, which

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[1] A think-tank originally sponsored by the Rockefeller Foundation consisting of 30 important individuals from central banks, commercial banks, government and the economics profession.

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)."[2]

There are a number of points to note from these examples. To start with, the global financial system is obviously characterised by a high degree of centralisation. 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 making huge profits on highly speculative investments are at the core of that 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 to clear 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.

Financial consolidation and its consequences

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 is concentrating financial activity and financial decision making in a few economic organizations and integrating hitherto demarcated areas of financial activity that had been dissociated from each other to ensure transparency and discourage unsound financial practices..

Concerned with the consequences and implications of this process Finance ministers and Central Bank Governors of the Group of 10 commissioned a study of financial consolidation, the recently

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

released results of which are quite revealing.[3] The study covered besides the 11 G-10 countries (US, Canada, Japan, Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland and UK), Spain and Australia. It found, as expected, that there has been a high level of merger and acquisition (M&A) activity in the study countries during the 1990s, with an acceleration of such activity especially in the last three years of the decade.

As Table 1 shows, 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 each of these acquisitions has increased substantially since the mid-1990s. The total value of financial sector M&A initiated by firms in these countries, which stood at $39 billion in 1990 and $53 billion in 1994, rose three-fold to $154 billion in 1995 and $299 billion, $499 billion and $369 billion respectively in 1997, 1998 and 1999 respectively. This was because the average value of the M&A instances covered rose from just $224 million and $111 million in 1990 and 1994, to touch $504 million, $793 million and $649 million respectively during the last three years of the 1990s (Table 2). 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.

Table 1: Number of Financial Mergers and Acquisitions by Firms from Sample Countries

	Number	Value ($ mn.)
1990	337	38679.7
1991	565	38361.7
1992	630	40260.3
1993	692	65742
1994	792	53056.7
1995	901	153601.8
1996	878	99377.5
1997	936	298972.5
1998	933	498988.4
1999	970	369000.4

Table 2: Average Value of M&A

[3] Group of 10, **Report on Consolidation in the Financial Sector**, January 2001 available at www.bis.org; www.imf.org; and www.oecd.org.

Transactions in Sample Countries (US $ mn.)

1990	224.9
1991	153.4
1992	138.4
1993	163.9
1994	110.8
1995	309.1
1996	203.6
1997	504.2
1998	793.3
1999	648.5

The banking sector tended to dominate the M&A process in the financial sector, accounting for as much as 58 per cent of the value of M&A during the 1990s as a whole, as compared with 27 per cent in the case of 'securities and other' firms and 15 per cent in the case of the insurance industry. However, a closer look at the evolution of M&A activity through the 1990s suggests that while the instances of M&A in the banking industry were rising rapidly during the first half of the 1990s, they have tended to stagnate subsequently, while instances of M&A among securities and insurance firms have been on the rise. As a result, by the end of the 1990s, the number of instances of M&A among non-banking financial firms was almost as large as those among banking firms. The process of concentration is clearly sweeping through the financial sector as a whole (Table 3).

Over the 1990s as a whole the evidence seems to be that M&A activity was largely industry-specific, with banking firms tending to merge dominantly with other banks. However, matters seem to be changing here as well. While in 1994 there was one instance of cross-industry M&A for every five instances of intra-industry mergers, the ratio had come down to one in every three by 1999. The merger and acquisition drive within the financial sector is not merely creating large and excessively powerful organizations, but firms that straddle the financial sector. Exploiting the process of financial liberalization these firms were breaking down the Chinese Walls that had been built between different segments of the financial sector.

Table 3: Industry-distribution of number of M&A Transactions

	Banking	Insurance	Securities/Other
1990	180	69	88

1991	297	98	170
1992	366	97	167
1993	454	94	144
1994	503	100	189
1995	552	142	207
1996	504	147	227
1997	533	148	255
1998	528	163	242
1999	506	124	340

Needless to say, in terms of region North America, especially the US, which has become the apex of financial dominance, accounted for a overwhelming share of M&A activity in the study countries in terms of both numbers and value. Europe was a close second. And given the much larger and more dispersed financial sector in the US, as well the compulsions generated by monetary union in Europe, M&A activity in North America was dominated by intra-country, 'within-border' transactions, whereas cross-border M&A played a much more important role in Europe. But as the report notes, through strategic alliances the American financial industry has also spread its tentacles across the globe. In the net, the 1990s have seen an acceleration of the concentration of financial power and financial decision-making in fewer hands worldwide. There has been a reduction in the number of operators, a huge increase in the size of operators at the top end of the pyramid, and a growing integration of financial activity across sectors and globally.

The significance of these developments for the observed financial instability and recurrence of financial crises during the years of globalization should be obvious. 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:

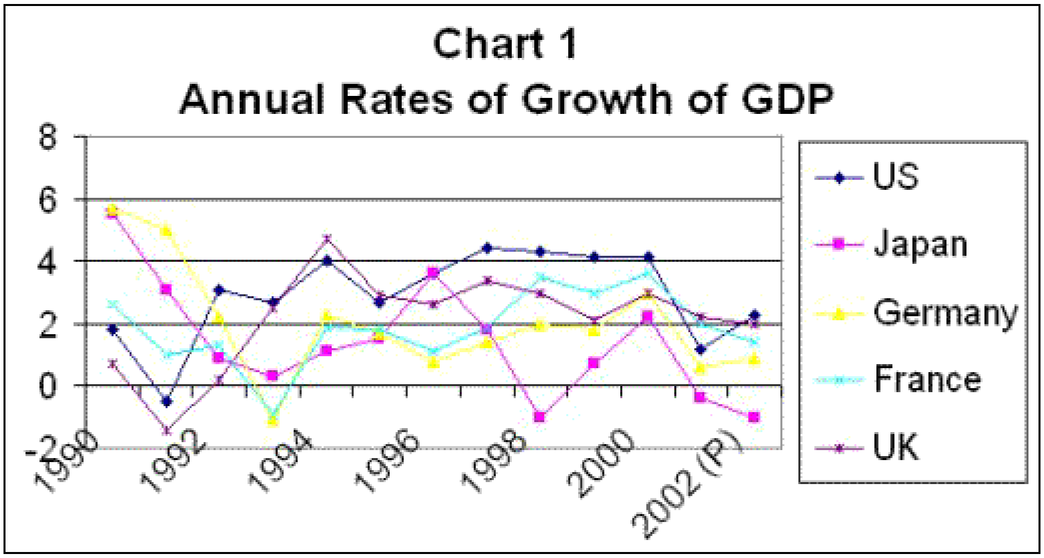
"It seems likely that if a large and complex banking organisation became impaired, then consolidation and any attendant complexity may have, other things being equal, increased the probability that the work-out or wind-down of such an organisation would be difficult and could be disorderly. Because such firms are the ones most likely to be associated with systemic risk, this aspect of consolidation has most likely increased the probability that a wind-down could have broad implications.

Important reasons for this effect include disparate supervisory and bankruptcy policies and procedures both within and across national borders, complex corporate structures and risk management practices that cut across different legal entities within the same organization, and the increased importance of market-sensitive activities such as OTC derivatives and foreign exchange transactions. In addition, 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 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.”

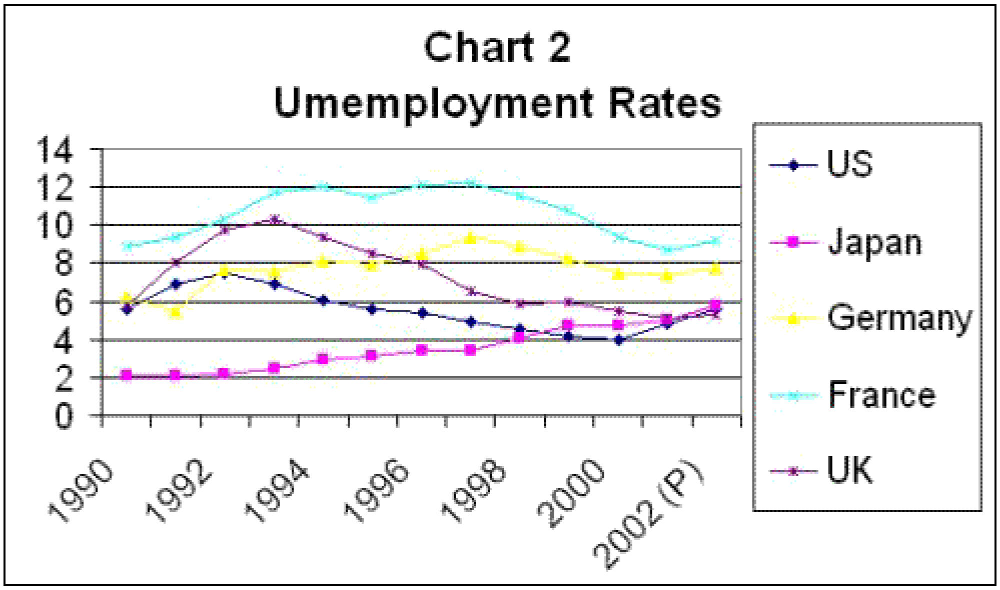
Implications for the real economy

It is now clear that the rise to dominance of this fragile structure of finance had major implications for the real economy in the developed and developing countries. Globally, there are three aspects of economic growth during the last decade that give cause for concern. First, 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. Second, these were the years during which a series of financial crises affected a range of countries from the eastern to the western hemisphere which in most cases either brought to an end a period of creditable growth of the real economy or worsened already adverse real economic conditions. Finally, a striking feature of the 1990s has been the unevenness of economic advance under capitalism. This unevenness is reflected in both the significant variations in economic performance between the advanced industrial economies, and in the widening of economic differentials between the advanced and underdeveloped regions of the world.



Of these the most disconcerting to many observers was the lack of any degree of synchronization of the economic cycle across the major economies. 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 quickly halting the downturn in the US, the effects are less impressive in other major OECD nations.

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 have fallen sharply since 1992-93, though that trend has been reversed in 2002 in the US (Chart 2).



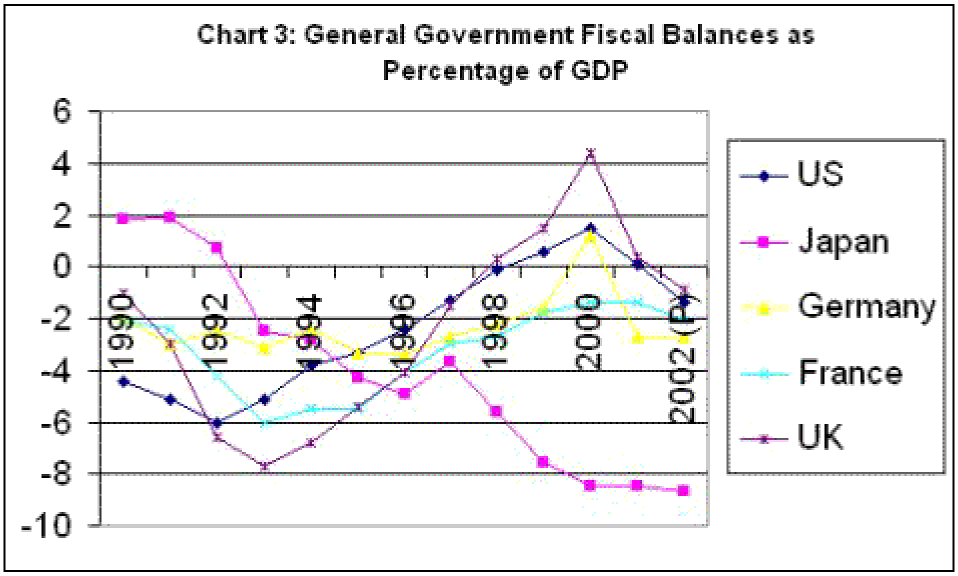
Thus, clearly, unlike in the four decades following World War II, when the world economy was ostensibly less integrated, the 1990s have seen a process of de-synchronization of the economic cycle in individual nations, which is visible even in the relative performance of the developed industrial nations. Not coincidentally, perhaps, the 1990s were also the years of globalization, years in which inter-country relationships were substantially mediated through financial flows. By that decade, as elaborated earlier, financial liberalization had ensured a build-up of liquidity at national and international levels, enhanced the flexibility of financial firms to undertake diverse operations across financial activities, provided new avenues for speculative investment in areas such as foreign exchange and derivatives markets, and rendered finance globally mobile.

Transmission mechanisms

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.

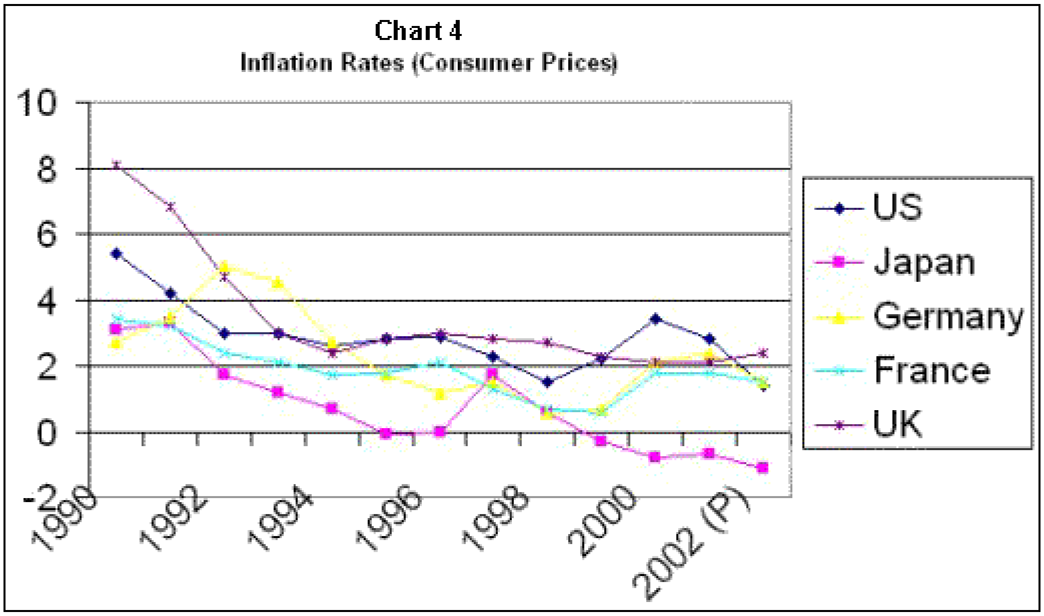
The rise of finance capital affects the ability of governments to undertake deficit spending even directly. Finance capital is wary of the possible inflationary consequences of deficit-financed expenditure, since such inflation affects the real value of financial assets and the real rate of return on 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 characterized 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.



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 4), which point to a significant and continuous decline in inflation rates across the major industrialized nations throughout the 1990s.



These circumstances render the picture of de-synchronized economic performance during the 1990s even more puzzling. To start with, we have the counter-intuitive trend wherein 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. Next, barring Japan, growth in many of the 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, 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 4) 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.

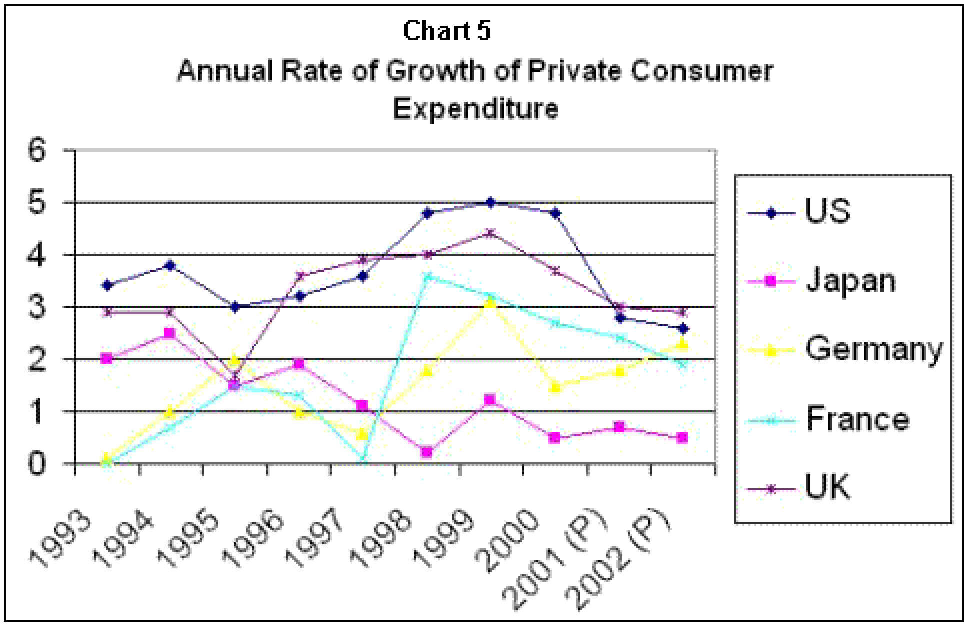


Table 4: Contributions to Changes in Real GDP in Selected OECD Countries
(As a percentage of real GDP in the previous period)

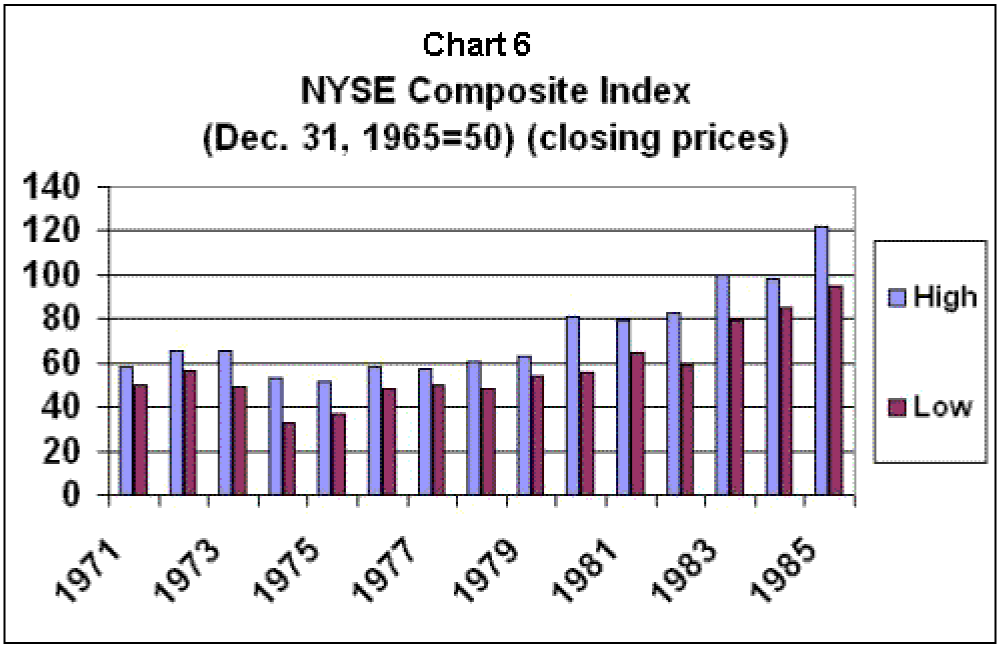
	2000	2001
United States		
Final Domestic Demand	5.1	2.4
Stockholding	-0.1	-0.2
Net Exports	-0.7	-0.8
GDP	3	2.2
Japan		
Final Domestic Demand	1.9	0.3
Stockholding	0	0
Net Exports	0.5	-0.7
GDP	2.4	-0.4
Germany		
Final Domestic Demand	1.6	-0.1
Stockholding	0.4	-0.9
Net Exports	1.1	1.6
GDP	3	0.6
France	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

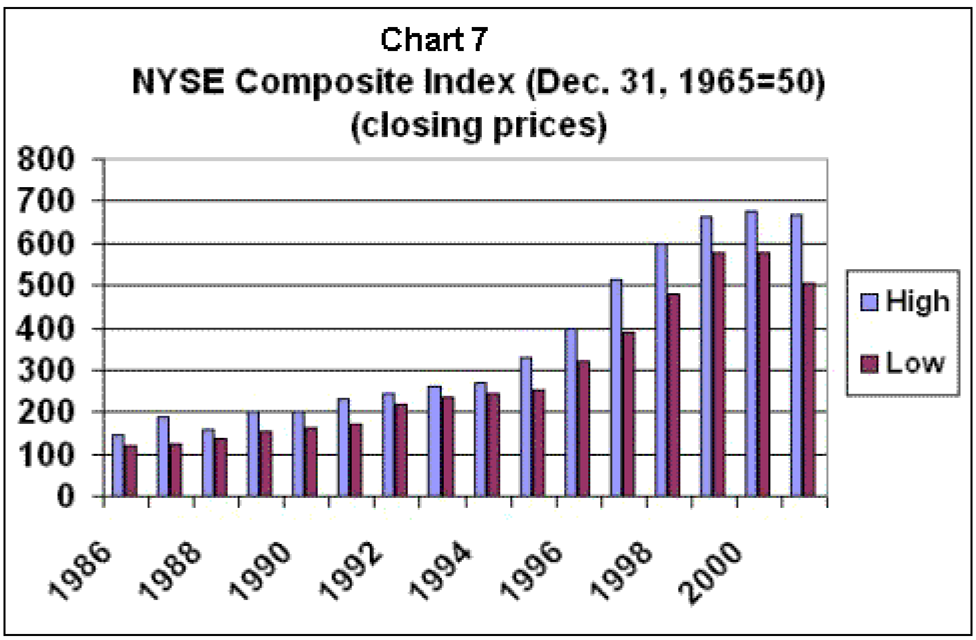
UK		
Final Domestic Demand	4.1	3.1
Stockholding	-0.3	-0.2
Net Exports	-0.7	-0.8
GDP	3	2.2

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. According to one estimate[4], 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

[4] Corbett and Jenkinson, Manchester School 1997.

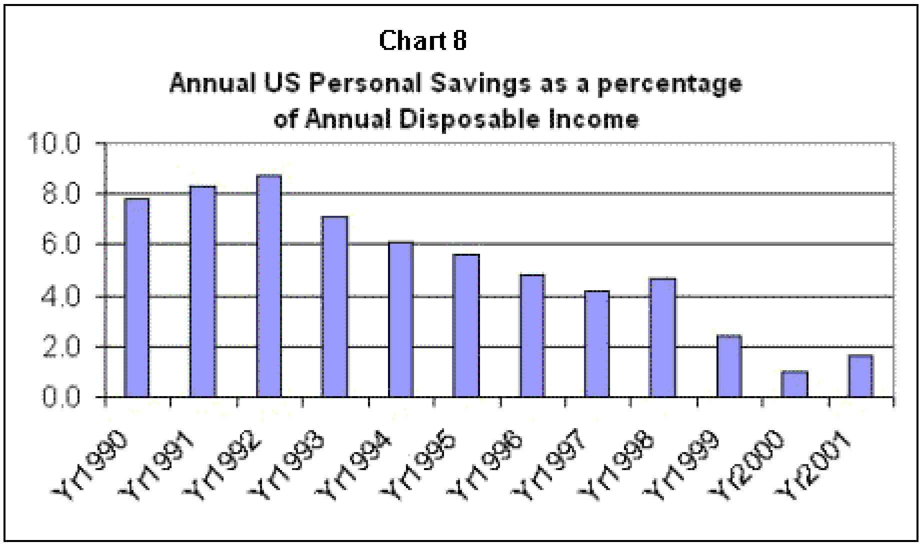
UK respectively, as compared with 78.9 and 69.9 in Germany and Japan. Thus in the US, if at all, greater liquidity could have at most helped sustain the venture capital boom, which was so crucial to triggering the tech and dotcom booms of the 1990s. Oher than this, capital inflows impact on the real 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, the number of share owners in the US increased by approximately 32 million between 1989 and 1998 and 15 million since 1995 to touch 84 million in 1998. While stock ownership through self-directed retirement accounts and through equity mutual funds were the two largest contributors to the growth in share ownership, between 1995 and 1998 even direct share ownership increased.[5] 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.

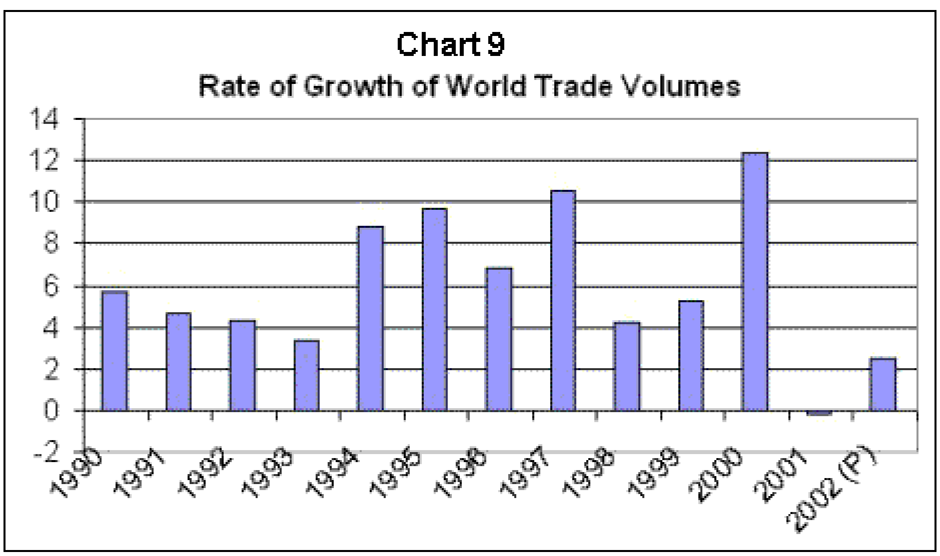
During the years of the stock market boom, which began at the end of 1994 and lasted till the end of 1990s (with one major glitch at the time of the financial crises of 1997-98), this wide prevalence of stock ownership resulted in a substantial increase in the wealth of American citizens. The consequent "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.

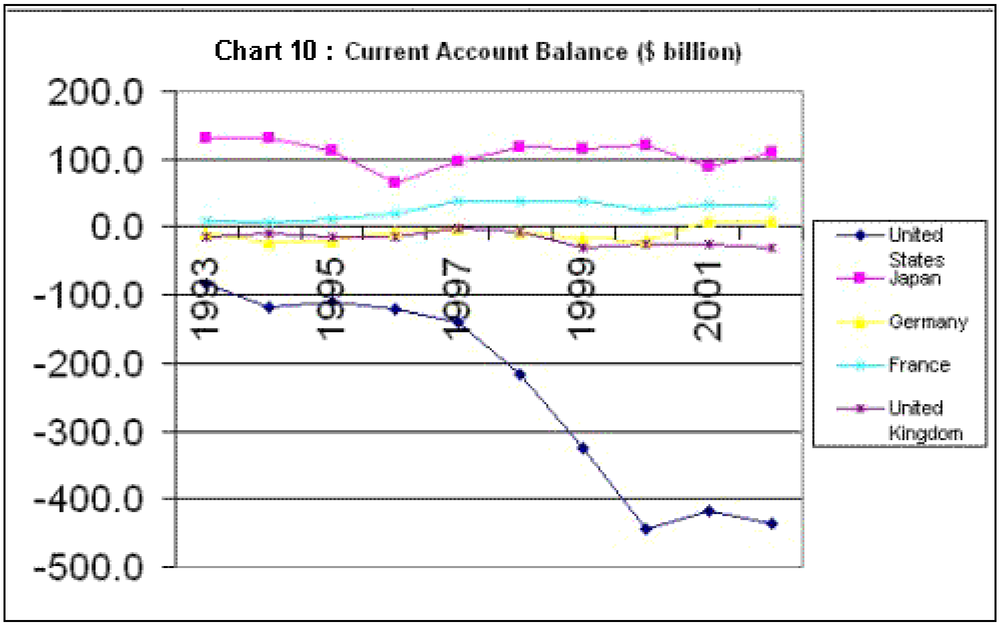
Thus, in the US, the rise of finance spurred consumption directly by fuelling credit-financed spending, and indirectly through the wealth effect. As a result, the personal savings rate in the US collapsed from 8.7 per cent in 1992 to 1 per cent in 2000 (Chart 8), reflecting the growth in consumption 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.

[5] 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 world trade volumes grew at above average or remarkably high rates (Chart 9) and the deficit on the US current account widened substantially (Chart 10). 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.





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. 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.

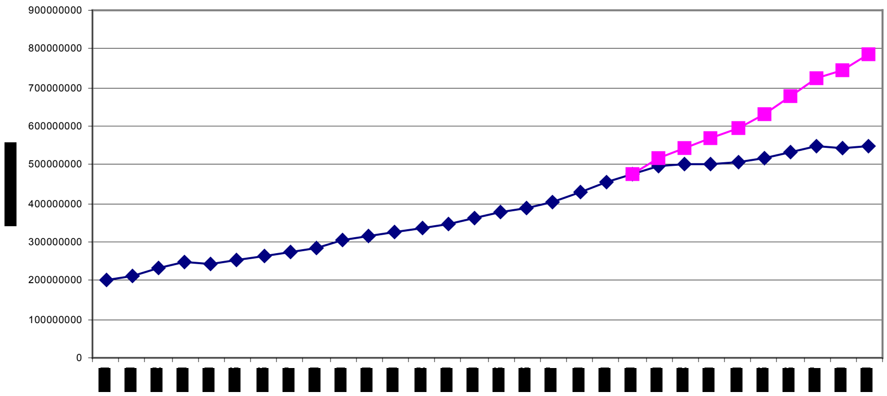
In other situations, as in South Korea and Thailand, financial liberalization had permitted the financial system to borrow cheap abroad and lend costly at home, to finance speculative investments in the stock market and in real estate. When international lenders realized that they were overexposed in 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 9).

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.

The curious case of Japan

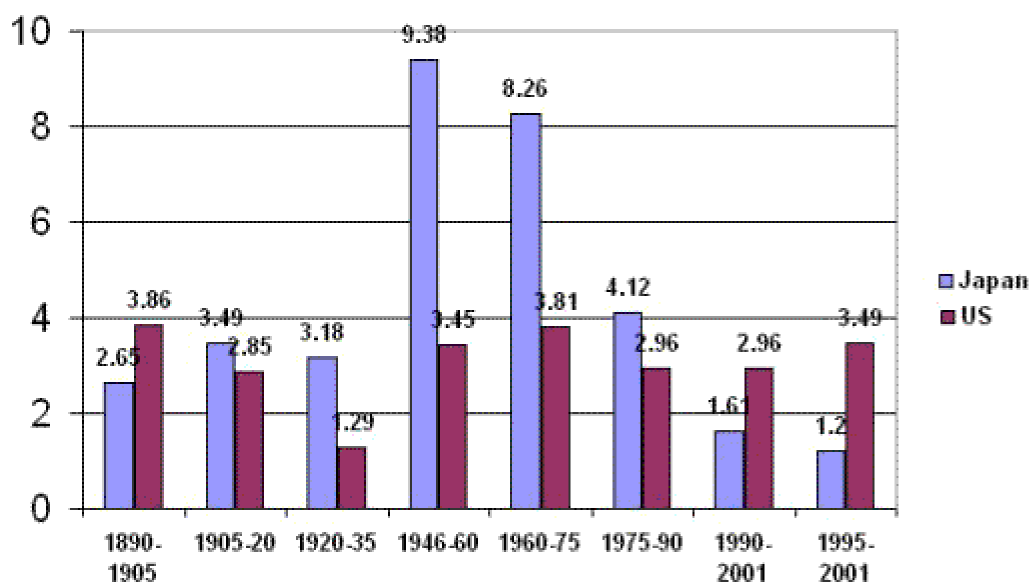
The impact that financial liberalisation can have on a country where the financial sector plays a role completely different from that of the US is best illustrated with the Japanese experience. It is twelve years since the Japanese economy entered a phase of slow growth after decades of rapid expansion. 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.

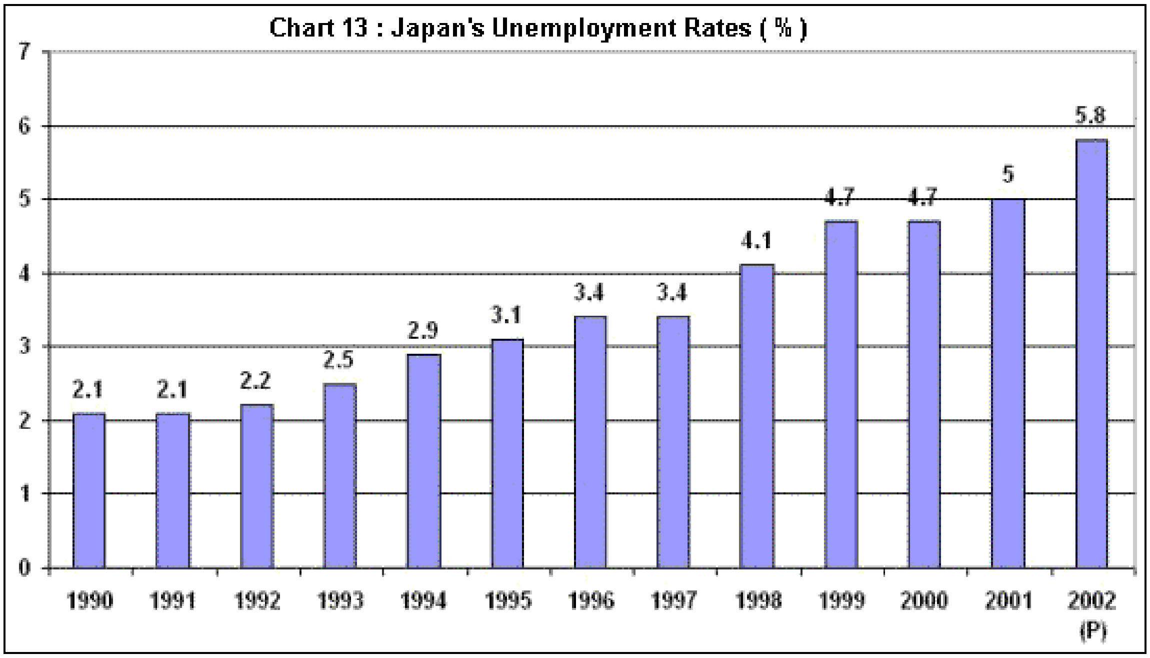
Chart 11: Gross value added at 1995 prices in the Japanese Economy



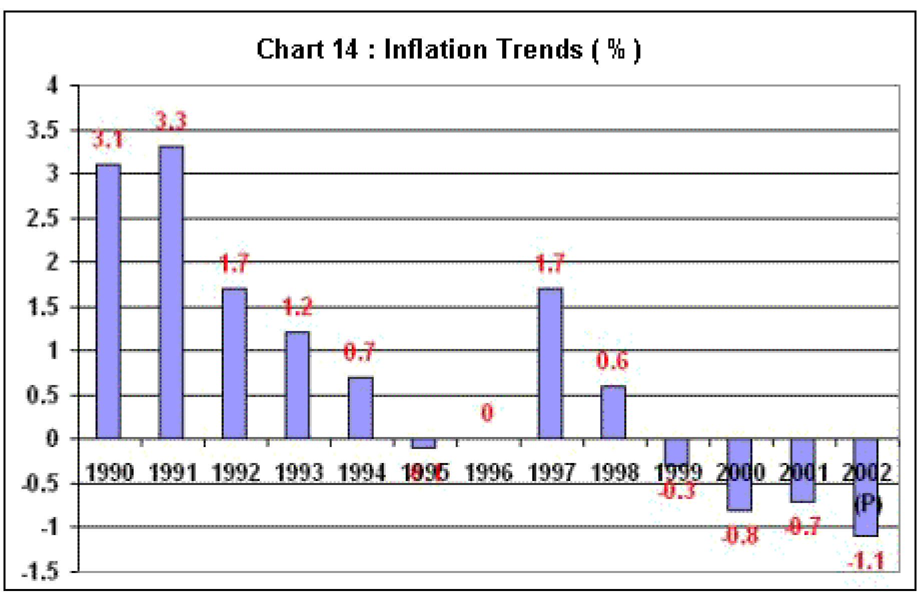
If the trend rate of growth of GDP experienced by it during the period 1970-90 had been maintained, Japan's GDP would have been close to 50 per cent higher by the turn of the last century (Chart 11). This is significant, since Japan's breakneck expansion since the Second World War had in fact slowed 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.

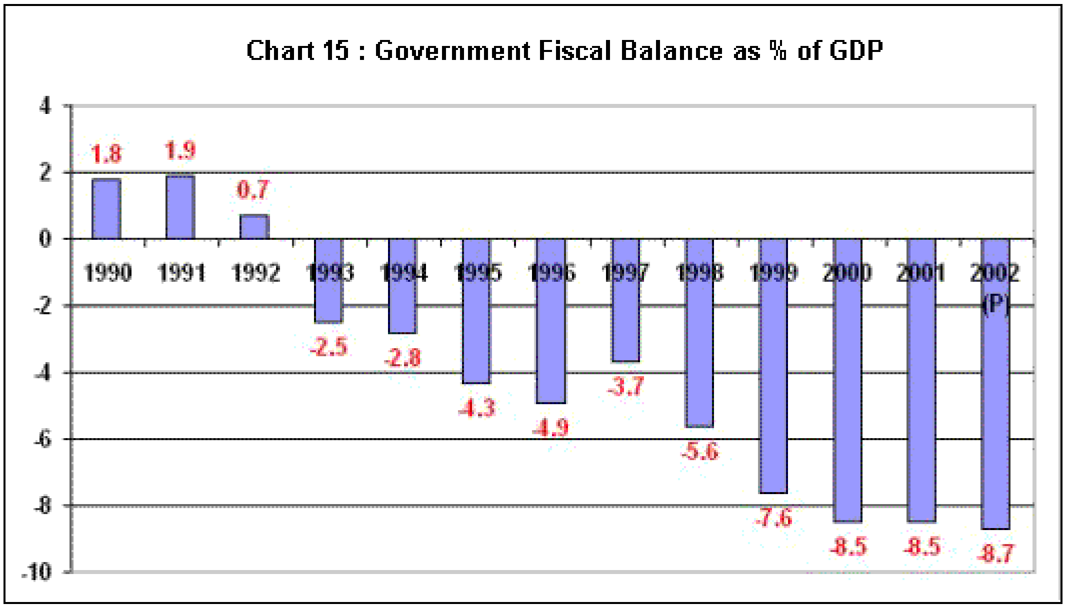
Chart 12 : Real GDP Growth, Japan and the US, Selected Subperiods





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 financial system that underlay Japan's post-war growth was one in which government regulation and control was the key.[6] 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

[6] 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.

ensure financial agents a portfolio of activity that ensured that they earned 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 speculative forays that could result in financial crises and hamper the growth of the real economy clearly separated these areas.

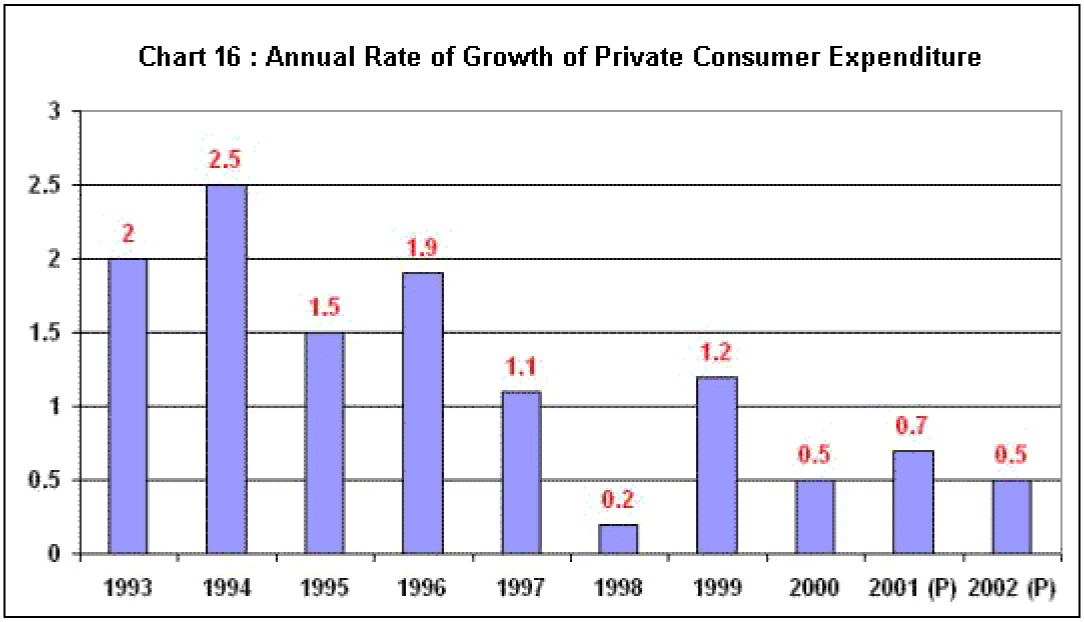
During the years of high growth this system served the Japanese economy well. It allowed banks and firms to take a long-term perspective in determining their borrowing and lending strategies; it offered entrepreneurs the advantage of deep pockets to compete with much larger and more established firms 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 overgeared. 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."

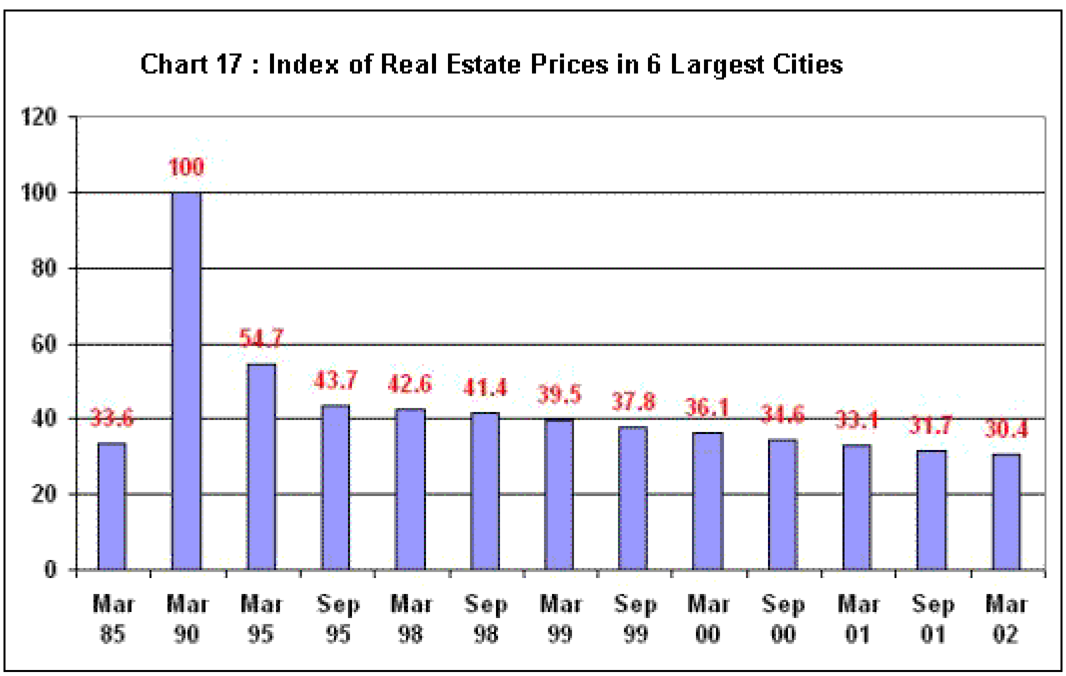
In the event, Japan's economic success between 1950 and 1970 resulted in its system of regulation, which was "unusual" from an Anglo-Saxon point of view, being looked upon with awe and respect. Even now, but for the fact that Japan fares so poorly, the overwhelming evidence of accounting fraud, conflict 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.

The question, however, is why the system failed to serve Japan 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.



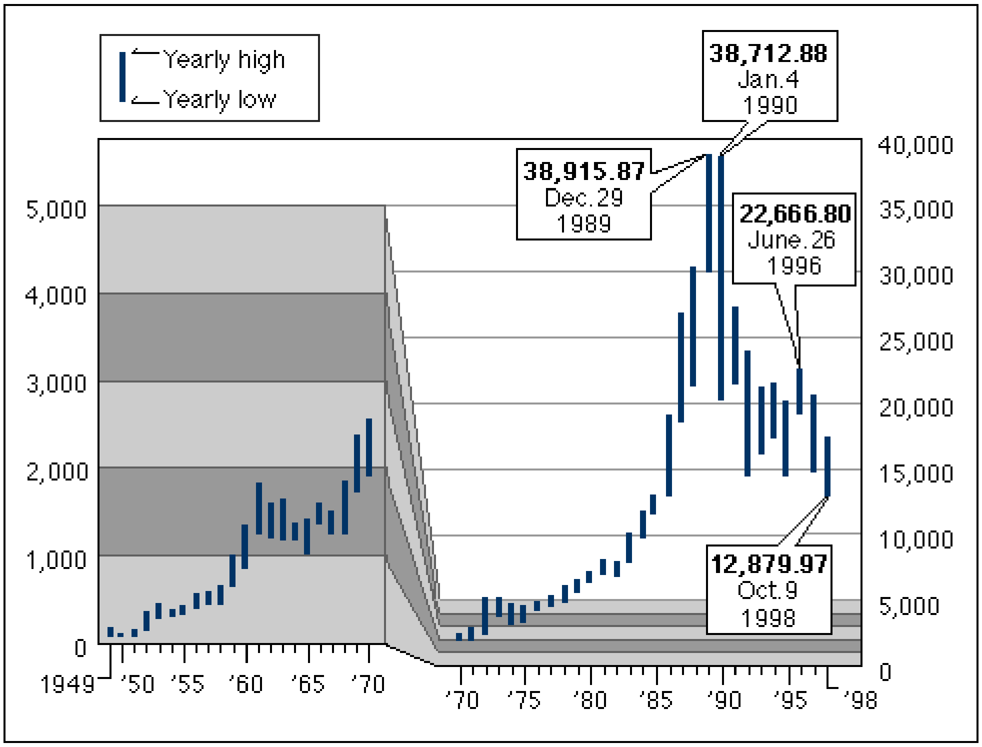
This trend, which resulted in the hollowing out of Japanese industry, undermined the principal area of business of the banks as well, which were faced with the prospect that some of their past lending could turn non-performing. It was in response to this that the Japanese banks joined the chorus against 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 corporation 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.

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 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.