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Part I

The Institutionalization of Global Finance

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Introduction: Why Study Global Finance?

What is the Globalization of Finance?

Globalization can be defined as the intensification of interactions at a distance among people around the world such that humanity as a whole can be said to be aware of sharing a common experience to a significant degree. There are many previous periods in history in which people interacted across vast distances, including great empires, such as those of the Mongols, the Romans, and the European ones. The nineteenth century saw great inter-continental flows of people, trade, and capital, as for instance the flows linking the expanding American economies with the rest of the world. While some scholars refer to these earlier periods of integration as examples of globalization, this tends to obscure the distinctive meaning and utility of the term. Use of the word "globalization" began in the 1960s and exploded through the last quarter of the twentieth century, and this alone is an indication that there was a widespread perception that something new was afoot. Both the intensity of the interactions and the awareness of them are qualitatively different today than in previous historical periods of integration.[1]

It is useful to think of globalization as involving both extensive and intensive expansion. Extensive expansion refers to the incorporation of ever wider geographic areas into the process, while intensive expansion refers to the growth in the density and complexity of interactions in any given geographic area. In the case of financial globalization one might refer to the opening of foreign bank branches in a country that previously had none as *extensive* growth, while the expansion of the range of financial products offered by those bank branches could be seen as *intensive* growth.

Both the intensity of the current period of globalization and people's awareness of globalization, and of sharing a common experience, make the current period unlike previous historical periods of internationalization. In earlier periods trade routes often extended around the world, but these usually involved luxury goods and accounted for only a small share of any particular country's economy. Exceptions include, for instance, the European colonization of North America, where furs (in Canada) and cotton (in the Thirteen Colonies) were vital for the economy as a whole. However, even in these cases, this level of interdependence was restricted to particular colonies' relationships to their colonizing power, and the types of cross-border flows were not nearly as varied as is the case today. Moreover, in none of these earlier periods was the popular awareness of being subject to *global* forces as strong as is the case today.

Finance can be defined with reference to its constituent parts: namely, money, credit, investments, and banking. More abstractly, it is the process by which savings are transferred from one entity to another for a period of time in exchange for a payment. Money, while important in finance, is typically defined by three other functions: it is a means of payment, a store of value, and a unit of account. Thus money is defined more by its use in facilitating payments and measuring value than by its connection to savings.

Finance can involve both public-sector and private-sector entities. Public-sector finance can involve the raising of funds by asking citizens to buy government securities – contracts that promise to make a stream of payments over time. It can also involve the lending of money by a public-sector international organization such as the International Monetary Fund to a national government. There is an enormous variety of types of private-sector finance, or financial "instruments," but these tend to fall into three main types: loans, securities, and insurance. Loans involve *intermediation* – a process by which an institution, usually a bank, takes the responsibility to gather savings and to make these available to borrowers in exchange for interest. The bank plays a key role in assuming the risk and responsibility for assessing and monitoring the creditworthiness of borrowers. Securities, by contrast, involve the direct purchase by an investor of a security issued by a firm or government that wishes to borrow. Insurance involves the selling of a contract to cover a risk, and is a form of finance because it involves the transfer of savings to an insurer in exchange for a future payment, a payment that is conditional on specified conditions, such as the destruction of an insured object.

Financial linkages have extended across large expanses of the globe in many previous historical periods (Germaine, 1997; Langley, 2002). The *bezant* gold coin introduced by Emperor Constantine in the fourth century AD was used as a remarkably stable international currency in the Mediterranean and Europe until the Middle Ages (Lothian, 2002). Beginning in the eleventh century AD the Italian city-states of Florence and Venice had well-developed international banking systems: the Bardi Bank of Florence had more than 30 offices in Italy, France, London, Bruges, Spain, North Africa, and the Greek, Latin, and Moslem Levant (Bautier, 1971), and in the fourteenth century the repudiation by the English crown of its debts to Italian banks, equivalent at one point to its annual war budget, triggered a financial crisis in Italy (Postan, 1973). A well-developed system for financing long-distance overland trade was created with the circulation of "bills of exchange" in the Champagne fairs. In the sixteenth century the German-based Fugger bank lent money, especially for financing wars, to kings around Europe. In the seventeenth century, when the Netherlands was the center of a vast system of global trade, much of this trade, including the sale of stock in the Dutch East Indies Company, was financed through the Amsterdam stock markets, which included futures contracts, margins, and short sales (Neal, 1990). In the nineteenth century London financial markets financed project after project around the world, including mining operations in Latin America, railroad construction across Russia and North America, the international cotton trade, and the operations of large international trading companies. In the early part of the twentieth century US banks were heavily involved in lending to Latin America.

This long history of international finance has been regularly punctuated by financial crises as well. The refusal of the British king to repay bank loans owed to Italian banks in the fourteenth century led to a crisis in the Italian markets. In the 1630s, when Amsterdam financial markets were at the center of the world economy, the tulip mania saw the prices of some rare tulip bulbs increase 60-fold, to the equivalent of five years' pay, and then cause havoc when they collapsed. In 1719 and 1720 stock market speculation in international investments, including the South Sea Bubble and the Mississippi Bubble, resulted in such severe crises across Europe that in the ensuing century joint stock corporations were banned in England and banking was discredited in France (Chancellor, 1999; Kindleberger, 1989; Neal, 1990; Porter, 1995).

The most recent period of international financial expansion – the period we call "the globalization of finance" – began in the 1960s. However, this occurred after a period in the middle of the twentieth century in which states had greatly increased restrictions on global financial flows. An early example was the Soviet Union's cutting all relations with international financial markets after the 1917 revolution that created it. After World War II the governments of most countries created strong controls over their financial systems in an attempt to make finance serve the priority of the time, which was rapid industrial growth and post-war reconstruction. These controls were also designed to try to prevent some of the serious financial problems of the earlier part of the twentieth century, that were seen as having contributed to the Great Depression of the 1930s and the war (Ruggie, 1982). Financial speculation and the stock market crash of 1929 had contributed to the Depression, and this in turn, along with the strict constraints imposed on governments by the gold standard, a powerful set of international monetary rules in force in the nineteenth and early twentieth centuries, had led to the excessive exposure of citizens to risks associated with the international economy. The post-World War II controls that governments used were designed both to insulate the domestic economy from the risks associated with cross-border financial flows and to reduce the negative effects of excessive financial speculation in domestic markets. A variety of measures, such as putting ceilings on interest rates or having governments own banks, were also designed to channel flows of cheap finance to the building of industry and infrastructure.

International monetary stability was further enhanced by the Bretton Woods monetary system, whereby countries pegged their exchange rates and the US dollar became the main international currency, backed by a commitment by the US government to exchange dollars for gold at $35 per ounce. At the meetings in Bretton Woods, New Hampshire, at which these arrangements were negotiated, the delegates also established the International Monetary Fund and the International Bank for Reconstruction and Development, now better known as the World Bank (Pauly, 1997). The former was designed to assist countries in maintaining their pegged exchange rates by providing short-term financing to governments facing downward pressure on their exchange rates (due to a shortfall in exports and the resulting decline in demand for the currency) and by approving periodic adjustments to the value at which the currencies were pegged. The latter was designed to facilitate the international mobilization of financial resources for national reconstruction and development, but these were envisioned as being channeled through and controlled by governments.

During the 1960s these controls over international finance that governments had created began to be eroded, and this launched the period of the globalization of finance that we continue to experience today. Firms and individual investors from different countries began depositing US dollars in accounts in London in order to escape various government regulations, and by the end of the decade these *Euromarkets* had become huge, appearing to many observers as if they were beyond the control of states. These international financial markets continued to grow rapidly in volume and complexity through the remainder of the twentieth century. From simple bank deposits, they grew to include international bonds, stocks, and a bewildering number of complex *derivatives* – contracts based on an underlying asset, such as a promise to make payments based on the future movement of an interest rate.

This period of rapid international financial expansion was accompanied by a series of severe financial crises, including collapses of international banks in the 1970s, the developing country debt crisis of the early 1980s, the Mexican peso crisis of 1994, and the East Asian crisis of 1997/8. At certain points in each of these crises it appeared to many officials as if the whole global financial system was at risk of collapsing. Financial globalization became one of the most prominent aspects of globalization more generally, with its images of frenzied international bond traders and enormous instantaneous movements of electronic money from one side of the world to the other.

Patterns of the international expansion of financial flows have corresponded closely to patterns involving other international flows, and thus the globalization of finance involves many of the same debates as over globalization more generally. Many people, noting the earlier historical periods of international financial expansion, have argued that today's international financial flows are nothing new. These skeptics have also pointed out that many measures of financial globalization begin with the mid-twentieth century, a temporary high point of state control of the economy, and if measures are extended further back in history, it becomes apparent that part of what appears to be rapid financial globalization in the post-World War II period is instead simply a return to the types of cross-border financial flows that characterized the period before this unusual mid-twentieth-century anomaly.

One way to address these types of debates is to try to measure cross-border financial flows and relationships. For instance, Lothian

(2002, p. 710) has measured international correlations of interest rates over the past three centuries, and his data demonstrate convergence – "more countries becoming more integrated as time has elapsed" – with a marked convergence from 1990 to 2000, even if earlier correlations, such as those between Dutch and British interest rates in the eighteenth century are surprisingly high.[2] While this book will provide some such measures, its primary focus is rather on analyzing the institutional linkages that constitute global finance. Data alone are inadequate for the analysis of the globalization of finance. For instance, foreign exchange trading is sometimes used as an indicator of the globalization of finance, but its volume declined following the creation of the Euro – a major instance of cross-border integration – since there was no longer any need to trade the European currencies that were replaced by the Euro. Similarly, a foreign investment by a multinational corporation can be taken either as a sign of increased financial integration or as an institutional arrangement to allow a firm to exploit ongoing gaps and barriers separating markets and jurisdictions. Such complications require us to pay careful attention to the significance of institutional arrangements. This book demonstrates that a complex set of institutions for facilitating and governing the globalization of finance have emerged over the past quarter-century, and this decisively distinguishes our current period of financial globalization from previous ones. Especially important is the inclusion in these institutional arrangements of decentralized sets of rules – social practices – that link the daily experiences of individuals of all types with the formal organizations and laws that we normally associate with political authority in the governance of financial markets.

In sum, the globalization of finance refers to the intensification of financial interactions at a distance among people around the world such that humanity as a whole can be said to be aware of sharing a common involvement with these cross-border financial flows to a significant degree.

Why Study Global Finance?

People have mixed feelings about finance. Finance may be needed to buy something we couldn't otherwise afford, to save for the future, to help the firm we work for avoid bankruptcy, or for our government to build a new road. We also know that finance does not just bring these good things, but can bring bad things as well: crushing debt, harrowing economic instability, massive fraud, the loss of one's life savings, and huge economic rewards for speculators that may seem very unjust. Our ambivalence about finance comes not just from this mixture of good and bad effects, but because, even though we know it is important, it often seems mind-numbingly boring or frighteningly complex – pages of fine print or mathematical formulas.

All of these feelings about finance have become magnified as finance has become more globalized. Every few years a major financial crisis breaks out somewhere in the world and washes across large expanses of the global economy, throwing people into sudden poverty as it goes. Now we have to worry not just about *local* con artists, but worldwide financial fraud carried out through the internet. Yet we know that the globalization of finance has brought new opportunities as well, including a wider range of financial products and new opportunities for mobilizing globally large amounts of investment for needed projects. Understanding global finance seems even more daunting than understanding finance closer to home: if the insurance policy we buy from a local broker seems complicated, then understanding the effects of derivatives sold in London on the volatility of our exchange rates and thus the insecurity of our jobs can seem impossible.

The complexity and risks associated with global finance are one reason why its management is left to experts. On the private-sector side, key financial decisions are often made by fabulously well-paid traders on the basis of complex transactions or mathematical models that even those who supposedly control the firm may not understand. On the public-sector side, regulators have difficulty keeping up with these transactions and models, and when they do, when they make plans to try to avoid a catastrophic collapse of the financial system, they seem to speak the same highly technical language as the private-sector traders – a language that the average citizen has trouble understanding. Fears that the global financial system is dangerously out of control come not just from the great sloshing global ocean of footloose money that can destroy whole economies in the space of days, but also from our nagging worry that no one really understands the destructive global forces that have been unleashed – or even worse, that those who understand these forces don't want us to know what they know.

As breakdowns in financial systems, such as the East Asian crisis of 1997–8 or the Enron collapse of 2001, begin to have increasingly severe consequences for the average citizen, this gap between those making financial decisions and those harmed by financial crisis, mismanagement, or fraud has become a more and more serious problem.

This gap between experts and non-experts is made worse because it can correspond to the gap between the wealthy and the poor, not just within countries but between countries as well. Traditionally, global finance has been managed by officials and firms from a small number of the most industrialized countries, such as the members of the Group of Seven or the Group of Ten, and it is only recently that officials from developing countries have been invited to participate in global policymaking. There is already widespread anxiety about the "democratic deficit" that accompanies globalization – the degree to which decisions are made in international institutions that appear remote and unaccountable to the average citizen. The large disparities in wealth and knowledge that are associated with this problem in global finance make the democratic deficit in this area especially troubling.

This book will argue that understanding global finance is not a task that should be left to the experts or to wealthy investors. Even if we just focus on financial transactions, global finance plays such a large role in the global economy and in the finances of the institutions on which we rely for our well-being, that it is valuable to learn about it. However, the book argues as well that understanding the evolution of global finance has many lessons that help us understand other important aspects of our contemporary world. These include lessons about how international institutions are formed in new areas of globalized activity, the contribution of knowledge to global governance, the role of risk technologies in controlling the future and in the unequal allocation across countries and social classes of the costs and benefits associated with contemporary risk, how confidence and trust are created when local traditions are incapable of doing so over the long distances that come with globalization.

This book does not just argue that knowledge about global finance should be more accessible, but aims as well to contribute to making it more accessible by avoiding overly technical language where possible, and by highlighting themes with relevance beyond the financial industry. At the same time it seeks to avoid excessive simplification. For those worried about the dangers of global finance, simple solutions that try to turn back the clock and shut down the global financial system are unlikely to work. This is not because there is something about the expansion of financial market forces that is natural and beyond human control, but rather that those who built the global financial system have constructed a huge, dangerous, and enormously complex machine that delivers, along with its often disastrous negative effects, enormous benefits for some powerful wealthy participants and smaller benefits for many smaller participants – and thus both the machine's momentum and the political configuration of forces associated with it make it more likely that change will come from altering the machine's functioning and direction rather than dismantling it.

This does not mean, however, that significant change in the governance of global finance is not on the horizon. Persistent global financial crises beginning in the 1990s put reform of the global financial architecture high on the agenda of policymakers and non-governmental organizations. While other issues such as terrorism or global warming may displace global finance from the top of this agenda, these debates over reform have already produced a willingness to consider serious changes in global financial governance, and some of these changes have begun to be implemented. For instance, it is now widely accepted that rapid liberalization of cross-border capital flows without ensuring a state's capacity for strong domestic prudential financial regulation is a serious mistake, and that capital controls can be a useful policy instrument under certain conditions. Initiating organizational change in a system as complex and knowledge-driven as global finance requires a strong understanding of how it works.