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INSURING RISK: SYSTEMS OF GLOBAL FINANCE¹

Ann Capling and Michael Crozier

ABSTRACT Critical analyses of international financial markets tend to explain changes over recent decades in terms of a resurgent liberalism. This paper employs a systems theoretical approach to argue that there has been a far more fundamental transformation in the operations of these financial markets than simply a shift towards more liberalized regimes of regulation. The use of risk as resource and the systematic randomness of these new operational trends have perverse implications not only for the integrity of political systems but also for the neoliberal promoters and players inside the new complex system of global finance.

KEYWORDS financial markets • globalization • neoliberalism • risk • systems theory

In a recent address to the Federation of Bankers Associations of Japan, the chairman of the US Federal Reserve, Alan Greenspan, highlighted a fundamental dilemma faced by regulators of contemporary financial markets: 'How do we preserve an innovative and flexible banking system without either exposing the taxpayer to excessive potential cost or the financial system to excessive systemic risk?' (Greenspan, 1996). In one sentence Greenspan not only captures the nature of the central conundrum for contemporary financial regulators but also highlights two quite different potential effects of the current system, one external and one internal to the system. Of particular note is the caveat that neither potential cost to the taxpayer nor systemic risk are seen as problematic *per se*; rather problems arise, for the regulator at least, if either or both of these effects becomes 'excessive'. This appears to stand in stark contrast to past regulatory regimes which took a somewhat more conservative approach to banking and financial governance: entrepreneurs (and private corporations) supposedly engaged in risk behaviour, not (mainstream) financial institutions. But this type of contrast does not

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really grasp the transformations in international finance that have occurred in recent decades. A systems theoretical treatment suggests something *more* than the ascendancy of a neoliberal approach in global regimes of finance and banking. Indeed, we wish to argue that there has been a fundamental systemic shift in the overall system of international finance. A shift in which 'risk' becomes less of a *problem* and more of a *resource* for the 'normal' operations of the system.

CONDITIONS OF EQUILIBRIUM

As one of the principal architects of the post-World War Two reconstruction, John Maynard Keynes believed that the possibility for peace and prosperity was contingent upon the creation of a new international economic order in which the banking and finance sector served national economic and political objectives, not private interests. This belief was shared by American and Canadian planners of the reconstruction who, together with Keynes and a group of British planners, hammered out a plan for this new economic order. At an international meeting in Bretton Woods, New Hampshire in 1944, this plan was assented to by the representatives of 44 governments. In essence, the Bretton Woods agreement was designed to create a new international political economy which struck a balance between the domestic responsibilities of nation states (especially with regard to their welfare and employment goals) and the need for a liberal international trade system that would promote economic growth and efficiency. The key institutions of the Bretton Woods agreement were to be the International Trade Organization (ITO), the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD or World Bank). The Bretton Woods arrangements were premised on the notion that international trade would become the engine for economic growth, to the benefit of all nations. However, international trade needed to be underpinned by a stable framework for monetary and financial relations among nations. In particular, there needed to be a monetary system of *stable fixed exchange rates* and *currency convertibility* so that all nations could trade with each other, thus preventing a retreat into the fragmented and competing monetary blocs which exacerbated the Great Depression, and eventually led to war. In addition, there needed to be a stable financial system in which capital flows between nations would be highly regulated in order to prevent tax evasion and flights of financial capital, either of which could undermine the new tools of Keynesian macroeconomic management, especially taxation and interest rate policy (Stubbs and Underhill, 1994).

For a 25-year period, from the end of the war until the early 1970s, the Bretton Woods system worked – not exactly as the Bretton Woods planners had expected, but it worked nonetheless. Although the International Trade Organization had been aborted by protectionist interests in the US Congress

in 1947, a temporary arrangement, the General Agreement on Tariffs and Trade (GATT), provided a framework for multilateral trade liberalization. And although the trade liberalization process was uneven and halting until the 1960s, world trade boomed in the post war period. The massive expansion of world trade went hand in hand with the economic recovery, continuous economic growth, full employment and a period of unprecedented prosperity for the industrial capitalist nations.

More important than the GATT in terms of the expansion of world trade was the system of international monetary management which provided a system of stable and fixed exchange rates, currency convertibility and short term loans so that nations could finance capital imports which were vital to rebuild the productive capacities of their war-torn economies. This system of monetary management was to be controlled by the IMF under the terms of the Bretton Woods Agreement. The Agreement provided for a system of fixed exchange rates where all members agreed to establish and fix the value of their currencies in terms of gold and maintain full currency convertibility with each other. The IMF, which was a multilateral organization with representation from all its members, was to act as the rule keeper and the main instrument for the international management of the exchange rate system. Moreover, the Fund itself, consisting of contributions in gold and national currencies from its members, would provide a source of short term loans for countries which faced a current account deficit.

Again, like the ITO, the IMF did not exactly function in the way the Bretton Woods planners had intended, largely because the magnitude of the wartime destruction was such that the IMF alone could not provide sufficient liquidity (loans) for the task of reconstruction. As a result, the Americans, whose already powerful economy had been further bolstered by the war, stepped in to shore up the monetary system. It did this by providing billions of dollars of aid to Europe and Japan, in effect, giving these nations the US dollars they needed to finance imports to feed and house their citizens and to rebuild their economies. In essence, the US Treasury and Federal Reserve Bank took on the role of the IMF – the US dollar became the world's currency and the US government the world's central bank. Nations pegged their currencies to the US dollar, which was backed by its huge gold reserves. Thus the international monetary system came to be based on the greenback, not gold. However, the system worked as long as the world had confidence in the stability and soundness of the US economy – and would continue to work while the US government was willing and able to put the interests of international monetary stability ahead of its own domestic interests.

Finally, the third key dimension of the Bretton Woods system was the tight control on the flow of financial capital which allowed governments to implement Keynesian policies aimed at promoting full employment and matching mass production with mass consumption. As Eric Helleiner (1994) explains, the Keynesian welfare state could only work as long as movements

of financial capital could be highly regulated. Macroeconomic management depended on governments being able to set their own interest rates *regardless* of interest rates elsewhere in the world. The growth of welfare expenditures meant that governments could not afford to allow business and individuals to evade tax by shifting their funds abroad. Funds for industry development and expansion would be threatened if domestic savers could invest abroad to take advantage of higher interest rates. And finally, the fixed exchange rate system could not be maintained against speculative moves of capital across borders. Thus movements of financial capital were highly controlled and regulated through controls put in place at both ends of all international financial transactions.

EQUILIBRIUM UNHINGED

But by the early 1970s, the Bretton Woods system of stable exchange rates and tightly regulated flows of capital began to break down – or rather, it was smashed by the US government which was overwhelmed by its own domestic problems including the declining competitiveness of its industrial sector and the crippling cost of the Vietnam war. In August 1971, the Nixon government suspended the convertibility of the greenback to gold and floated the US dollar. By 1973, most industrialized countries had been forced to follow suit, floating their exchange rates as well. This signalled the end of international monetary stability and the beginning of the global financial system, as we know it today.

One of the consequences of the move to floating exchange rates was the rapid emergence of speculative money markets and the rise of the forex cowboys. These markets grew so quickly that, by the late 1980s, the daily value of foreign exchange trade was *forty times* the value of international trade in goods. Perversely, these highly volatile money markets arose because of the need by multinational corporations to protect themselves against changes in currency prices. Under the Bretton Woods system of fixed exchange rates, corporate finance managers had not needed to protect their financial assets, profits and borrowings against changes in currency values. However, once exchange rates were floated, corporations had a great deal to worry about; for instance, fall in the exchange rate could send the cost of servicing overseas debts spiralling upwards.

As a result, large corporations had to adopt strategies which reduced their exposure to the risk of exchange rate fluctuations (Strange, 1986). One means of doing this is by *hedging*, that is, buying foreign currency *forward* and establishing a contract in which there is a *future* commitment to buy or sell currency at a specific price, regardless of the exchange rate on the day the contract is signed, or the day it takes effect. In itself, hedging is not speculative behaviour; in fact, it is aimed at overcoming risk by providing

certainty. However, hedging creates speculative opportunities in the money market, where *speculators* can buy or sell these forward contracts, hoping to benefit from a change in exchange rates. In turn, this speculative behaviour has an impact on exchange rates.

In other words, a vicious circle has been created in which the very risk and volatility that the corporation is trying to protect itself against is actually exacerbated by these risk management strategies. Moreover, as the big corporations and financial institutions developed new instruments and products to manage risk, there was an increasing pressure from within the system to deregulate the international controls on capital movements. Not surprisingly, these deregulatory pressures came largely from the big American and British banks which stood to benefit the most from the deregulation of the international financial system.

It did not take long for the US government to respond to these pressures. The last plank of the Bretton Woods system was destroyed in 1974 when the Americans unilaterally abolished their capital controls. Japan and Western Europe pressed for the restoration of controls but were unsuccessful, largely due to the ascendancy of a new breed of anti-Keynesian economists who believed that government spending was out of control and needed to be brought to heel by financial markets. With the major player in the world economy abolishing capital controls, the rest of the industrial nations were eventually forced to follow suit, because the cost of divergence was too great due to the risk of capital flight. Since then we have seen the complete breakdown of the stable, predictable system of international economic management which underpinned the conditions for a period of unprecedented prosperity in the world. In its place is a globalized financial system which makes it almost impossible for governments to maintain any real autonomy or independence in domestic economic policy-making.

For the economic liberal, this turn of events is seen as the return of the financial system to its proper place – the market – where the fundamental principle of competition will ensure undistorted pricing processes and the most efficient outcomes. In this view, the stability gained through the Bretton Woods arrangement was bought at the cost of fettering market forces. At best governments were confused, mixing two alien principles: competition with bureaucratic administration. The new system of global finance by contrast enables the market to get on with what it does best without the distortions of non-market imperatives. However, something quite fundamental is missed in this account. It is too simple to attribute the establishment of the Bretton Woods arrangements to government muddleheadedness or, in the more sinister version, the ambitious encroachment of state power into the sphere of market ‘freedom’. To use the language of biology, while the Bretton Woods system may now be portrayed in pathological terms, that is as inimicable to international trade and finance, it is just a bit too convenient to forget that it was once a form of immunology for the market. Of help here is an

understanding of risk, especially in connection with the principle of competition in modern market economic activity.

Competition may very well stimulate innovation and motivate performance, but these are outcomes generated by the removal of security or, if you like, by *the inducement of insecurity*. In a competitive setting, risk must be taken in order to survive; on the other hand, in order to prosper there must be a calculation of risk, the management of future possibilities of gain and loss (the 'measurement' of risk-return ratios: credit/debit). When the calculation of risks overwhelms the readiness to engage in risk activity, competition reaches an internal limit: its medium of communication – the price setting mechanisms – jams in the face of unacceptable risk, thus curtailing innovation (economic growth if you like). As we have already indicated, the inter-war period witnessed just such limits of 'competition' in the realm of international trade. The pathology in this instance was the lack of a medium of communication to cope with the management of risk across competing monetary blocs. At the bottom line, 'price' remained volatile or insecure in the exchange between trading nations. It should be emphasized that 'risk' is hardly something new, especially in regard to the operations of modern market economic activity. As has been indicated, risk and its 'management' is an inherent element of the principle of market competition. It can never be overcome – this would undermine its productive role in competition – but different forms of risk 'immunization' have been attempted. What the Bretton Woods arrangements introduced was a particular type of immunology, a risk management strategy which employed the power of nation-states to do what the market at the time could not do: open up a medium of communication for international trade (cf. Luhmann, 1995: 461–2). The *overwhelming* insecurity of the international market – the inertia of risk overload – was thus gradually displaced by a set of state arrangements, including institutions that risk-managed international finance.

CREDIT AND RISK MANAGEMENT

Clearly, modern capitalistic economic activity is premised on the existence of a system which can raise and provide credit. At the most basic level, the financial system is composed of institutions which act as matchmakers between borrowers and lenders, where the cost of these transactions is determined by the market for financial products. Governments use financial markets as a means to finance budget deficits, usually through the issue of bonds, which are repayable with interest. Businesses use financial markets to raise money in order to fund investments. Individuals turn to financial markets to finance a house, a car, or even last night's dinner.

But all of these transactions entail an element of risk, especially for the lender: the bottom line is that there is no guarantee that a borrower will repay a loan. The market deals with risk in a number of ways, depending in large

part on the nature of the risk. Needless to say, risk aversion is not limited to individuals and small scale operators. In many respects, it is far easier for large corporations to manage their risk in the most basic of ways. For example, a large corporation can spread all of its risk amongst its shareholders, whose individual liability is limited to their equity in the business. The point to be made here is that a great deal of behaviour, indeed most behaviour, in financial markets is risk-averse. That is, most financial 'products' and transactions are designed to minimize risk. The profit for the sellers of financial products is generated by the price people are willing to pay to minimize their exposure to risk.

RISK AS RESOURCE

Nonetheless, not all transactions fall into this category: the antithesis of risk-averse behaviour is speculation, in which individuals and institutions take on risk as a means to securing a quick profit. Economists differentiate between 'good' and 'bad' speculative behaviour, between 'normal' and 'excessive' speculation. Economics textbook accounts make the following distinction. Normal speculation is the sort of increased share trading activity that occurs when 'normal' good news is 'received' by the markets. By contrast, abnormal speculation is triggered by 'rumours' rather than the 'usual economic factors'. Such 'rumours' are usually associated with the 'there's gold in them thar hills' mentality, when hints of an impending mineral discovery spark the sort of mob behaviour that we have become accustomed to seeing in stock markets.

In the past few years, a new form of financial instrument has emerged, one which seems paradoxically to encourage speculative behaviour in the guise of risk management. These instruments are known as *derivatives*. There are basically two kinds of derivatives, simple and complex. Simple derivatives have been around for a long time and they include futures, forward contracts, options and swaps. Another more recent type of simple derivative is a swap contract which is used to allow a borrower to swap one type of loan (fixed interest rate) with another borrower who has another type of loan (floating interest rate) to the mutual advantage of both. No principal is exchanged, just the nature of the contract. The notion of a swap contract is further complicated by the fact that derivatives *can be traded* either on stock exchanges or privately in over-the-counter (OTC) transactions. In addition to simple derivatives, there are new complex derivatives which combine elements of simple derivatives: for instance, the *swaption* is a derivative which incorporates an option to swap.

The dynamism of these types of transactions lies in the capacity to draw *future-possibles back into the present* and work them for both profit and risk management. The complex version of this strategy is not simply the introduction of any number of variables (options), but the ability to draw the

increasing number of future-possibles into *an ever-expanding present*, thus opening up more and more opportunities for returns and risk management. In a manner, future-possibles become secondary to this internal dynamism, even though external stimuli – e.g. shifts in the projected status, market perceptions, or whatever, of a future-possible – offer yet more opportunities to rearrange the ‘risk’ and make a profit inside the dynamic. This indicates a highly self-referential system in which external stimuli are merely opportunities for further self-reproduction – the activity of measurement of risk-return ratios – rather than determinates or modifiers of the system itself. Needless to say, this particular system can have rather significant ramifications for other systems proximate and beyond. Indeed, in the ‘real world’ of global finance for instance, market participants believe, and observers have noted, that ‘prices in the cash market more often reflect trading in derivative markets – rather than the other way around’ (H. J. Blommestein/OECD, 1995). The business here is risk-return ratios, and not the pricing of money *per se* – a highly abstract and complex business in itself. Nonetheless, and as we will see, this self-referential system of risk management has a certain susceptibility (and ‘strength’) which has the potential to radically reshape the system itself: this is a hypersensitivity to changes in its own conditions.

Viewed from the ‘outside’, however, there have been some spectacular derivatives disasters in the past few years. The most notorious of these is the 1995 collapse of a 233-year-old British merchant bank, Barings, due to the activities of one Singapore trader who managed to lose nearly \$2 billion by betting that the stock exchange would rise. But if the spectre of Nick Leeson going to jail in his baseball cap is the most well-known disaster, there have been other more serious calamities. For instance, in 1993 the German metals and mining conglomerate Metallgesellschaft AG almost went broke when the head of its American marketing subsidiary lost almost \$2 billion trading oil futures contracts. And there have been several disasters in the copper industry as well, in 1994 when the Chilean state copper company lost more than \$2 million through the activities of one of its traders and in 1996 when the Japanese trading company Sumitomo, one of the world’s largest companies, revealed losses of more than \$2 billion through the activities of one rogue trader.

CONDITIONS OF UNCERTAINTY

The question arises as to whether these types of disasters are the exception or the extreme outer case of the derivatives system of risk management, generated by players acting in an overly speculative and avaricious manner. On a systems level, this question is quite meaningless and more generally uninformative about the mechanisms at work here. The pertinent consideration lies in the understanding of this self-referential system as a *complex*

system. Firstly, let's briefly recapitulate. Derivatives enable market participants to 'unbundle' risk: they offer market players the ability to reduce certain risks through 'hedging' and the 'immunization' of their portfolios by offsetting actions in associated markets. However, even within financial circles, there is a high degree of difference of opinion on the virtues or otherwise of these sorts of immunological strategies. A major concern is that the use of derivatives has in fact increased the level of risk and uncertainty in the financial system more generally. The interconnections amongst markets and market intermediaries are strengthened by derivative instruments. As a consequence, when there are shocks or even just hiccups in one market there is the strong possibility that they may well have impacts on other markets in ways which are difficult to identify and calculate, thus increasing market uncertainty, not to speak of the speed at which this is transmitted. This is indicative of the hypersensitivity of the system to its own internal conditions. Another facet here is the observation that derivatives cannot reduce the overall risk of the financial system but merely transform and reallocate risk.

Unsurprisingly, then, financial sector analysts in a number of OECD countries have expressed grave concerns about the risk of an overall *systemic* disturbance induced by the operations of derivatives markets. On these accounts, the immunology – unbundling risk – induces the same traits as the pathology – unpredictable risk – that it is supposed to manage. Indeed a paradox that is nonetheless a *creative* paradox. For this is the very 'thing' that makes this manner of risk management a self-reproducing, self-referential system, and gives it its unity. As a complex system its self-reproduction does not reside in conditions of equilibrium but in conditions of uncertainty. The so-called 'norm', the prudent use of derivatives, and the so-called 'exception', the highly speculative use of derivatives, together constitute the unity of the system; a unity or order that arises without hierarchy.

This is a complex system whose immunology is simultaneously its pathology. In this sense it is truly self-referential. Nonetheless, it does have 'real' ramifications well beyond its own systemic unity, even if the 'real' players inside this game feign ignorance or indifference to the 'costs' of the game beyond itself. More often than not these costs and debris are dumped in the lap of the political system – a system that has become less and less able to counteract such costs and fall-out precisely because of the contemporary system of risk management in global financial markets (cf. Luhmann, 1997).

Most of the critical literature is quite rightly concerned with the impact of global financial markets on national autonomy and independence, and, in particular, how the deregulation of financial markets rendered obsolete most of the tools of Keynesian macroeconomic management. Indeed, economic policy-making in the 1990s is less a question of managing the economy to meet the needs of citizens than it is a question of trying to smooth out the impact of volatile financial markets on the lives of citizens.

CONCLUSION

The neoliberal retort to this situation is that if 'citizens' wish to avoid being susceptible to this kind of outfall they should also become 'investors' and thus 'risk manage' their own assets – basically a strategy of *independence*, of immunizing oneself against the political system. Of course in this scenario those left behind without the capacity and/or resources to invest – those economically *dependent* on 'work' – remain outside the system and thus 'deserve' whatever they get (cf. Srubar, 1996). However, even the best laid plans of risk managing investors inside the new complex system run the risk of being transformed into yet another 'resource' or opportunity to be churned, valorized and perhaps vaporized. In this sense, the 'system' is indiscriminate about *who* is or is not an 'investor': even 'smart' banks can become 'victims' through the 'normal' operations of this new self-referential market. Maybe this type of self-devouring scenario is something not even Hayek could ever have dreamed of in his most spontaneous moment: pure and unfettered *systematic* randomness. People like Alan Greenspan have good reason to be edgy, even if their analysis remains within the limits of a neoliberal purview.

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Note

1. An earlier version of this appeared in *Arena Magazine* 25 (1996).

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