Financialization and development:
questions, answers, challenges

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4 September 2018

Map of topics

1. What is financialization?
2. Aren't financial markets better at allocating credit and risks than governments or IFIs like the World Bank?
3. What's wrong with having more finance in the economy?
4. Aren't developing economies riskier than advanced economies – more crisis-prone - because they are immature?
5. Shouldn't financial contract enforcement be a fundamental right across the globe?

1. Introduction: Financialization and the World Economy

Gerald A. Epstein

INTRODUCTION

In the last thirty years, the economies of the world have undergone profound transformations. Some of the dimensions of this altered reality are clear: the role of government has diminished while that of markets has increased; economic transactions between countries have substantially risen; domestic and international financial transactions have grown by leaps and bounds (e.g. Baker, Epstein and Pollin, 1998: chapter 1). In short, this changing landscape has been characterized by the rise of *neoliberalism, globalization,* and *financialization.*

All these definitions capture some aspect of the phenomenon we have called financialization. So here we will cast the net widely and define financialization quite broadly: for us, financialization means the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies.

Financialization: Richard Kozul Wright's list

- Increasing proportion of national income to financial sector
- Proliferation of esoteric financial products, shadow institutions
- Channelling of entrepreneurial energies to new financial products so as to manage risk
- Rights of the owners of financial assets beyond social accountability
- Financial markets determine what is good policy – short-termist

Financialization: Richard Kozul Wright's list

What is wrong with the increasing proportion of finance in profits, in corporations, in everyday life – is this just part of the shift to digitized world, modernity?

What is wrong with using esoteric financial products to manage risks – in a world of increasing risks? One side insures against risk, their counterparty bears it. And anyway, isn't the risk concentrated in developing economies, which are – as we all know – *riskier?*

Shouldn't the parties to a business contract be made to perform up to the terms and conditions of that contract, if they are able? Otherwise, doesn't the 'law of the jungle' prevail?

Who can determine the prospective value of a financial investment better than those who put 'money on the line'? Governments are not trustworthy; and everyday people have nothing at stake.

Who can determine the value of an investment project better than those who put ‘money on the line’?

- When government steps in, they distort ‘natural risks’, don’t they?
  - Example: look at what happened in the US when federal policy – the Community Reinvestment Act of 1977 – forced banks to make mortgage (home-ownership) loans to poor people.
  - Result: High-risk loans to high-risk people: Subprime crisis!
  - Lesson to be learned: history repeats itself – there is too much credit in recurring cycles… that’s the problem.
  - Risky loans to risky people, a financial system that was ‘Fragile by design’. It’s politics interfering in markets.

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FRAGILE BY DESIGN

THE POLITICAL ORIGINS OF BANKING CRISES & SCARCE CREDIT

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THIS TIME IS DIFFERENT

Eight Centuries of Financial Folly

CARMEN M. REINHART & KENNETH S. ROGOFF

"This is quite simply the best empirical investigation of financial crises ever published."
—NIALL FERGUSON, author of *The Ascent of Money: A Financial History of the World*

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Who can determine the value of an investment project better than those who put 'money on the line'?

- And the international financial institutions are even worse.
  - The World Bank gets on its do-gooder missions and builds incentives for every needy country to join in.
    - The "Year of Microcredit 2005"…

International Year of **Microcredit** 2005

Final Report

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    - The "Year of Microcredit 1995"…
    - "Universal Financial Access 2020" …

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GETTING TO
UNIVERSAL FINANCIAL ACCESS 2020

Goal: Adults globally have access to a transaction account

The World Bank Group committed over

$8B+

in new investments & operations

- The World Bank is a technical partner for 18 priority countries to develop **National Financial Inclusion Strategies**, and for other countries with financial inclusion commitments through the **AFI Maya Declaration**
- **Indonesia, Mexico & Mozambique** recently launched their National Financial Inclusion Strategy, with others to follow
- **IFC invested** in innovative projects:
  - **Ant Financial (China)** asset-backed securitization to provide access to **1.75M** new accounts
  - **MasterCard (Global)** settlement risk-sharing facility to provide access to **5M+** new accounts
  - **LAPO (Nigeria)** debt facility to expand Nigeria's largest MFI, adding **1M+** new accounts

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  - The World Bank gets on its do-gooder missions and builds incentives for every needy country to join in.
    - The "Year of Microcredit 1995"…
    - "Universal Financial Access 2020" …
  - What will those overpaid, pampered bureaucrats think of next?
  - Let the markets roll – and discipline will prevail!

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G St NW
G St NW
19th St NW
18th St NW
Edward R. Murrow Park
University Yard
100 ft
50 m

Who can determine the value of an investment project better than those who put 'money on the line'?

Financial competition rewards short-term considerations.

- The shift from 'buy-and-hold' (bank-based) to 'originate-and-distribute' (market-based) lending – separates the incentives of those who make *fees* from financial transactions from those who earn returns on loan or bond contracts.
- When 'normal' returns are low, returns on holding assets are low. The period of quantitative easing has seen a prolonged drought in 'normal returns'.

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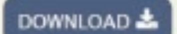
FRED Graph



1Y | 5Y | 10Y | Max 2003-06-11 to 2018-06-11

FRED — Effective Federal Funds Rate
— 10-Year Treasury Constant Maturity Minus Federal Funds Rate

Shaded areas indicate U.S. recessions Sources: Board of Governors, St. Louis Fed fred.stlouisfed.org

Send feedback

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Financial competition rewards short-term considerations.

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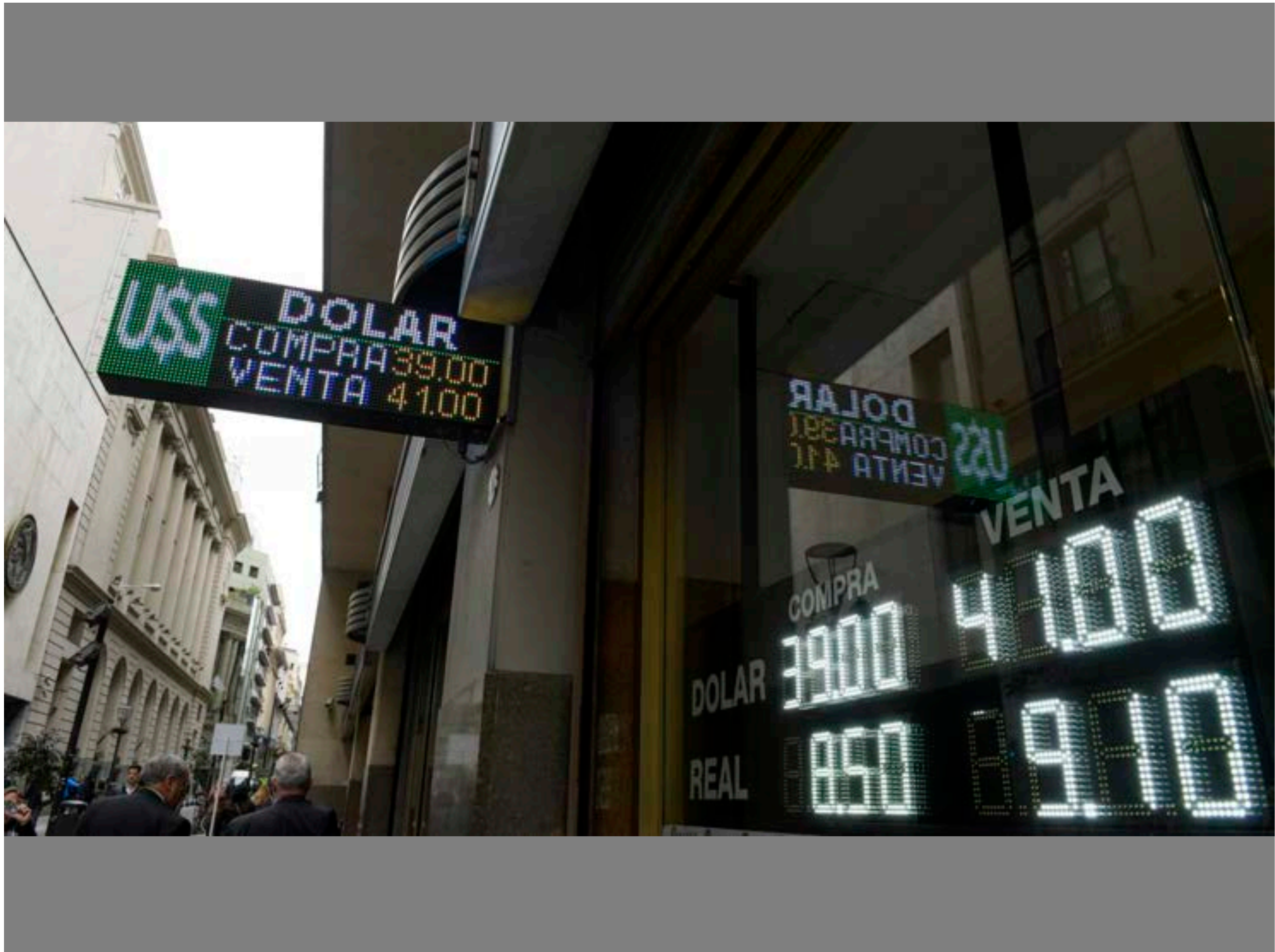
- When 'normal' returns are low, returns on holding assets are low. The period of quantitative easing has seen a prolonged drought in 'normal returns'.
- Then asset-seeking agents will look for assets they can 'buy low, sell high' – bubbles – or they will try to beat the market by "riding the bubble":
  - Find an asset above or below its trend price, and ride it, or take profits from volatility itself.
  - How does this work? Take a recent case, from a country far, far away ….


U$S
DOLAR
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VENTA 41.00
COMPRA
VENTA
DOLAR 39.00 41.00
REAL 8.50 9.10

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USD to ARS Chart
4 Sep 2013 00:00 UTC - 3 Sep 2018 21:05 UTC USD/ARS close:38.34274 low:5.69250
high:41.24730
45
35
25
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5
2014
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12h
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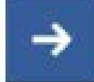
USD - US Dollar

ARS - Argentine Peso


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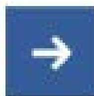
USD - US Dollar
ARS - Argentine Peso



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high:41.24730
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USD - US Dollar
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ARS - Argentine Peso

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ARS to USD Chart
3 Sep 2017 00:00 UTC - 3 Sep 2018 21:08 UTC ARS/USD close:0.02604 low:0.02424 high:0.05886
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ARS to USD Chart
27 Aug 2018 21:00 UTC - 3 Sep 2018 21:08 UTC ARS/USD close:0.02604 low:0.02424 high:0.03231
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ARS to USD Chart
2 Sep 2018 21:00 UTC - 3 Sep 2018 21:08 UTC ARS/USD close:0.02604 low:0.02591 high:0.02714
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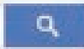

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Argentina

Argentina unveils austerity programme to stem crisis

President Macri admits 'emergency' after collapse of investor confidence

lauricio Macri: 'The world has told us that we are living beyond our means' © AFP

enedict Mander in Buenos Aires and Robin Wigglesworth in New York 3 HOURS AGO

If finance grows faster than the overall economy, won’t this just encourage growth?

- The ‘finance-growth’ literature has historically answered ‘yes’.

Journal of Economic Literature
Vol. XXXV (June 1997), pp. 688–726

Financial Development and Economic Growth: Views and Agenda

ROSS LEVINE
University of Virginia

I thank, without implicating, Gerard Caprio, Maria Carkovic, David Cole, Robert Cull, William Easterly, Mark Gertler, Fabio Schiantarelli, Mary Shirley, Bruce Smith, and Kenneth Sokoloff for criticisms, guidance, and encouragement. This paper was written while I was at the World Bank. Opinions expressed are those of the author and do not necessarily reflect the views of the World Bank, its staff, or member countries.

Does finance make a difference . . .? Raymond Goldsmith (1969, p. 408)

I. *Introduction: Goals and Boundaries*

ECONOMISTS HOLD startlingly different opinions regarding the importance of the financial system for economic growth. Walter Bagehot (1873) of financial factors in economic growth, while development economists frequently express their skepticism about the role of the financial system by ignoring it (Anand Chandavarkar 1992). For example, a collection of essays by the

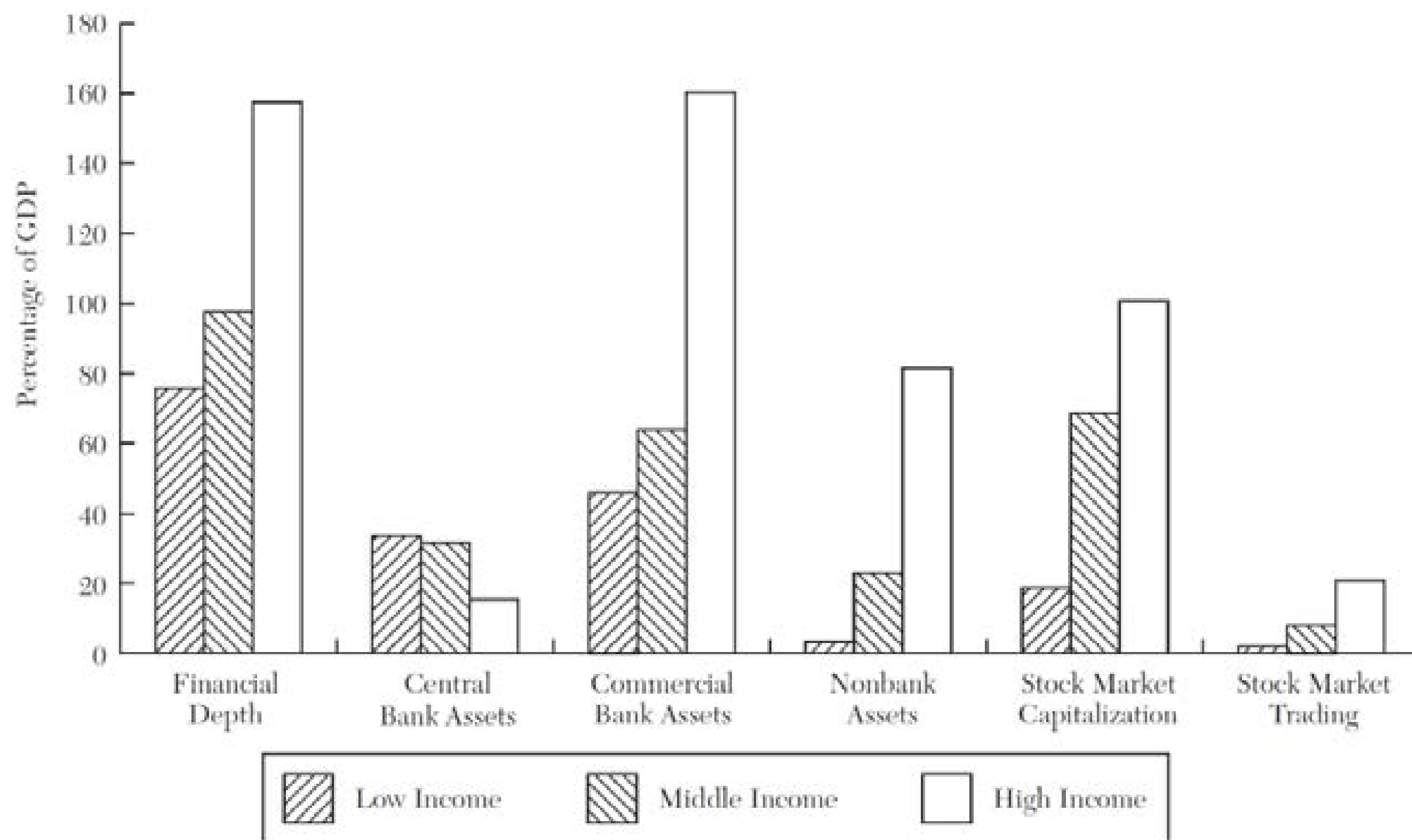


Figure 2. Financial Structure in Low-, Middle-, and High-Income Economies, 1990

Sources: IMF (*International Financial Statistics*), IFC (*Emerging Markets Data Base*), and individual country reports by central banks, banking commissions, and stock exchanges.

Figure 1. A Theoretical Approach to Finance and Growth

Assumption is that there exist projects which markets can discover – through mechanisms that can reduce these costs.

No attention to non-market allocation of credit, such as state planning and development strategies. Also, intermediaries here have no nationality.

Assumption is that aggregate demand is unimportant, and that private owners will be most responsible in managing risk.

Here, capital accumulation here – profit-making, whether in financial or non-financial sectors – is assumed to lead to industrial innovation.

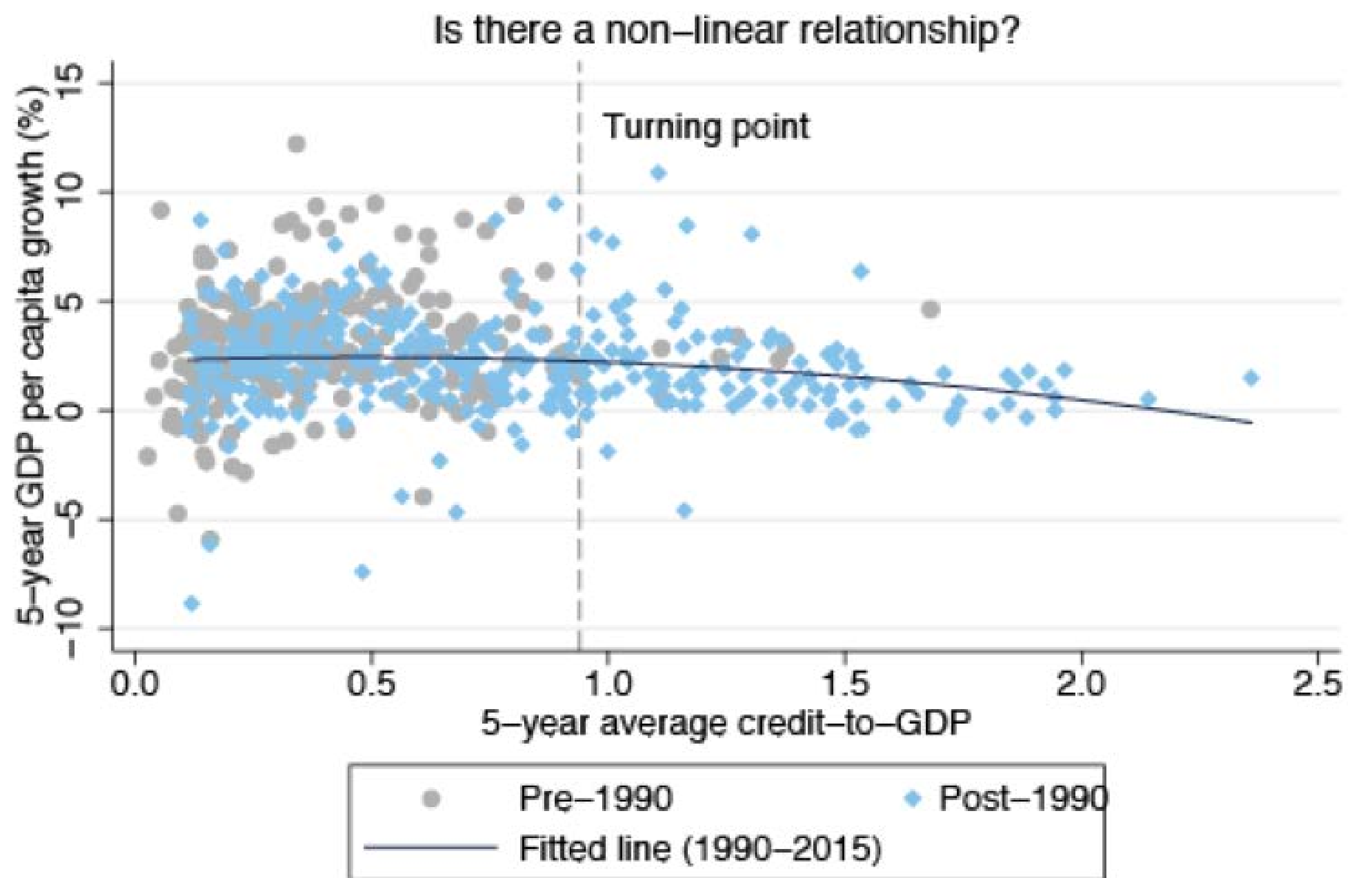
If finance grows faster than the overall economy, won't this just encourage growth?

- The 'finance-growth' literature has historically answered 'yes'.
- Some 'dissidents' within this literature now say 'no'.

Finance and growth: The direction of causality

Eilyn Yee Lin Chong, Ashoka Mody, Francisco Varela Sandoval 17 January 2017

Figure 3 Private credit-to-GDP ratio and growth



If finance grows faster than the overall economy, won't this just encourage growth?

- The 'finance-growth' literature has historically answered 'yes'.
- Some 'dissidents' within this literature now say 'no'.
- But there is a deeper truth here: finance can grow so big that its leading firms – the megabanks – become a millstone around a country's neck.

From symbiotic finance to the escape of finance

- Are financial firms dependent on the real economy, or autonomous? The "finance/growth" literature investigates how F (finance) affects GDP: $Y = f(N, K, F)$. Does more finance, ΔF, lead to ΔY.
- When finance is economically productive it has productive spillovers: it augments the pace of accumulation/circulation of capital.

M	–	C (MP,LP) …C'	–	M'
Equity, working-capital finance	Trade credit, Risk-management	Consumption credit	Expansion finance	

- Finance has productive spillovers: It is also bounded in size, as F – given any state of technology - is limited by the scale of accumulation, and its activities by the needs of accumulation.
- Here is symbiotic finance – earning income based on real-time flows in commodities, goods markets.

1. From symbiotic finance to the escape of finance

- But what the $Y = f(N, K, F)$ approach leaves off, is that $\Delta F \rightarrow \Delta Y$ is not the only relationship at work.
  - What if ΔF also leads to $-\Delta K$, slower real capital growth, due to less loan-making to SMEs and innovators without collateral?
  - And what if ΔF absorbs a part of public spending; and in crises, monopolizes liquidity, starving non-financial firms of bridge financing?
- Then $\Delta F \rightarrow -\Delta Y$, as ΔF has negative spillovers on non-financial sector growth. If its activities are independent of the real sector, then its size is limited only by its capacity to manage its leveraging, combined with the availability of liquidity.
- Then finance serves itself, not the non-financial economy, and is partially parasitic.

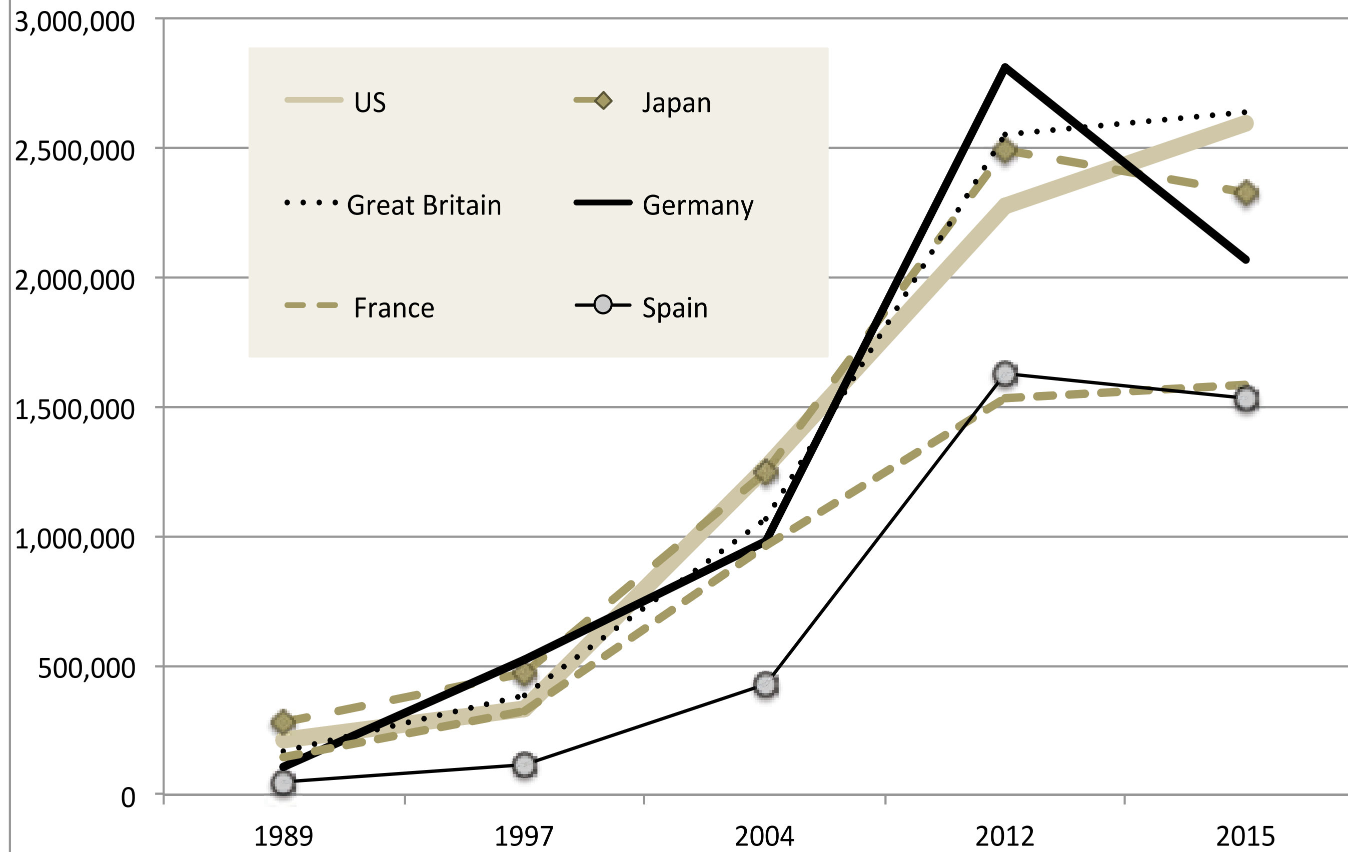


Figure 3: Assets of largest bank, in US $M, selected countries,
1989, 1997, 2004, 2012, and 2015
3,000,000
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
US
Japan
Great Britain
Germany
France
Spain
1989
1997
2004
2012
2015

Isn't financial risk concentrated in developing economies, which are – as we all know – *riskier?*

- We look at the mainstream principal-agent literature on why debt crises happen in developing economies… putting this into an historical, institutional context.

- Then, we consider why debt crises are structural phenomena on a global scale, and why we are now seeing developing country after developing country plunge into debt crisis, currency devaluation, and the social and political chaos that generally follows.

Latin American debt buildup in 1970s-1980s: institutional background

The credit-market supply side:

- Eurodollar recycling of oil-rich countries' surpluses to oil-poor countries came into being at the time of the two oil shocks in the 1970s (1973-74 and 1979-80).
- Nations with large reserves of natural resources and "untapped development potential" were regarded as great targets for these recycling loans.
- Large US and to a lesser extent Japanese banks were competing for new product markets. In the US case, their loss of blue-chip corporate customers plus the impact of disintermediation had them looking for new borrowers.

Latin American debt buildup in 1970s-1980s: institutional background

The credit-market demand side:

- Latin America was perfect – esp. the big 3 of Brazil, Argentina, Mexico: big markets, resource-rich nations.
- Loans could be packaged using offshore facilities, esp. Euro-market branches: so little foreign-exchange impact for lending nations.
- The price of this lending for the Latin American nations was a shift in their lending regimes: "financial repression" toward openness.
- The lending was launched at a fierce pace. BankAmerica and Citibank, for example, competed to have the lead -- $3 bn each.

Latin American debt buildup in 1970s-1980s: institutional background

The crisis road

- Things went well in the 1970s. Walter Wriston, Citibank CEO, wrote in 1977: "Countries don't go bankrupt."
- Then came the 1981-82 recession and Paul Volcker's sky-high interest rate policy: interest rates exploded, and commodity prices dropped.
- As Carlos Diaz-Alejandro put it in his posthumous *JDE* paper, "Goodbye financial repression, hello financial crash."
- Mexico defaulted in August 1982; then Peru, then others.
- The Lost Decade followed in Latin America. Its leading industrial firms were virtually eliminated from the global scale.

The consensus mainstream view about why the Latin American debt crisis happened

A consensus global North view emerged: for example:

- Stiglitz, Eaton, and Gersovitz, "The Pure Theory of Country Risk," *European Economic Review* 1986
- "We seek to articulate very general principles for looking at the most essential problems posed by international lending. … what happens to a loan is a result of a series of decisions, not the mechanical realization of some outcome" (481, 483).
- Willingness to pay is the issue, not ability to pay. Why? Countries don't go bankrupt – there is plenty of collateral available. And this depends on the borrower's *beliefs* about the lender's resolve to (1) penalize borrowers, and (2) lend in the future.

That is, borrower's welfare depends on the benefit from the loan, L, and on whether it repays (rL, that is, interest rate r times L) or whether it defaults (and has to pay penalty P*).

The borrower compares the 2nd-period utility of these two states:

$U_d = U(L,P^*)$ if she defaults or

$U_{P^*} = U(L, r(L))$ if she repays.

The borrower repays if $U_d < U_{P^*}$; substituting, repay if $rL < P^*$.

Conclusions: (1) borrowers may be credit-constrained – they may want more credit at rate i than bank is willing to provide them.

(2) Penalties are never imposed. If there are no penalties, there is no lending, not a rash of defaults.

Authors' conclusion: "our analysis leads to a view that it is surprising that there has been as much lending to developing countries as there has been, not that there is not more." (512)

Basic logic of cross-border macro balance

- But credit crises are structural at a global scale.
- Flows across borders must balance for every spatial area:

  Current account = -[Capital inflows] + Δreserves

  Current account = trade flows plus repatriated profits, debt flows, remittances by guest workes
- Trade flows between any two countries need not balance; nor capital flows; etc. But: the sum of all trade flows within the system must equal zero for any time period
- The sum of net capital in- and outflows must equal zero.
- If (n-1) countries have current-account surpluses, the nth country must be in deficit.

Cross-border flows for nation-states:

Note that capital inflows = foreign(ers') savings, or S_F

Then let X = exports, M = imports, Δreserves as ΔR; so:

$$X - M = - S_F + \Delta R \qquad \textit{(eqn 1)}$$

So if $X > M$ and ΔR, $S_F < 0$

Macro equilibria for nation-states:

Then, every nation has a macro equilibrium condition:

Aggregate Demand = Aggregate Supply

$$C + I + G + X = C + S + T + M$$

[C = consumption, I = investment, G = govt spending, S = savings, T= taxes]

Then, $I + (G-T) = S - (X-M)$

Basic logic of cross-border macro balance

This "GDP/national balance" has a border-crossing term:

$$I + (G\text{-}T) = S \mathbf{- (X\text{-}M)}$$

Now recall our border-crossing balance:

$$X - M = -\, S_F + \Delta R$$

Substitute the latter into the former so all the information is captured in one expression. Rearranging:

$$I + (G\text{-}T) = S \mathbf{+ S_F - \Delta R} \quad \textit{(eqn 2)}$$

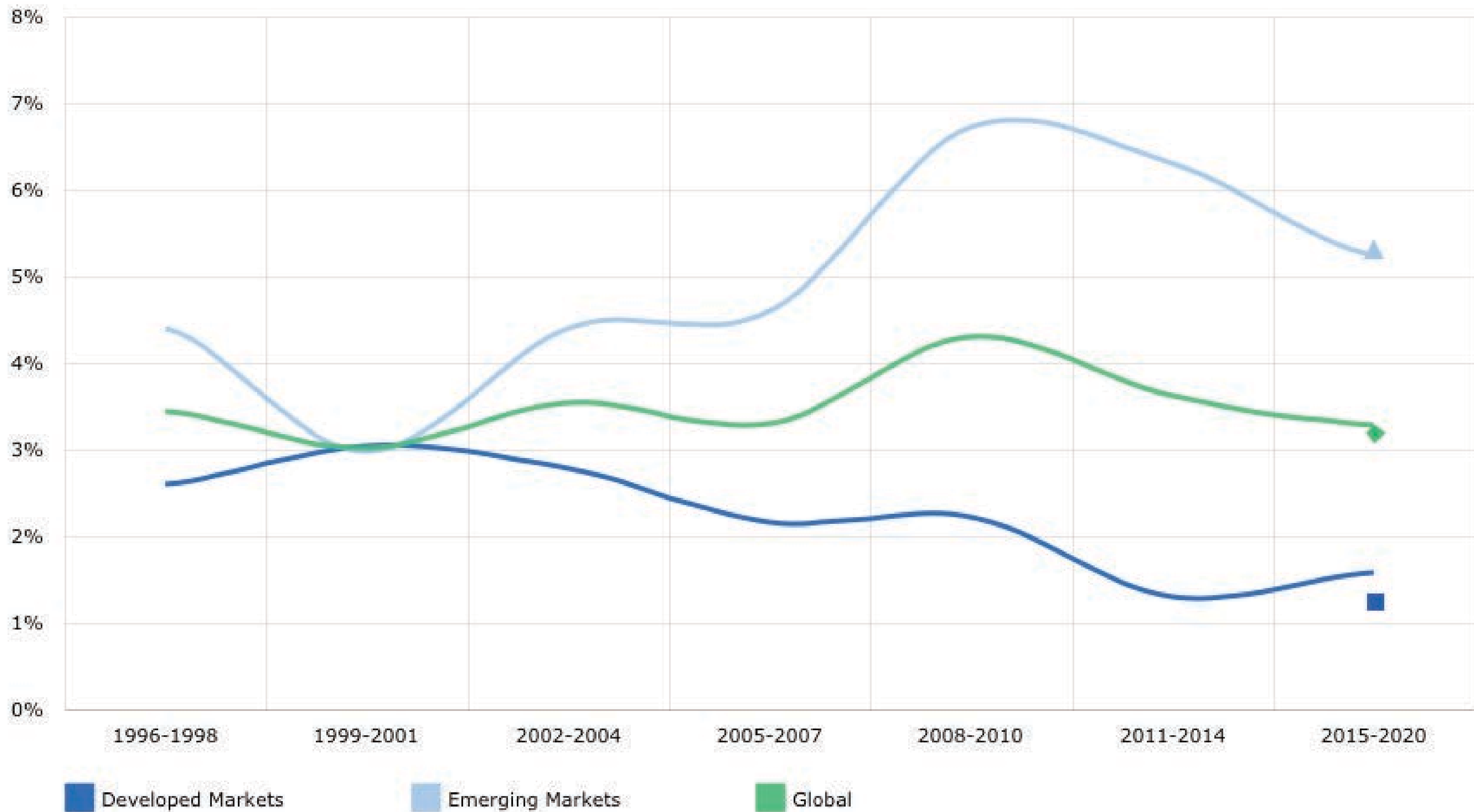
Here is the 'master' equation: "what must be financed" = "what is available to finance it with."

Every spatial area has to solve this problem, in each time-period.

Basic logic: what the IMF wants

Follow these rules:

- If you have zero (public) debt to pay and a balanced budget ($G = T$), then seek cross-border balance.
- If you have (public) debt to pay and cannot balance your budget ($G+rD > T$), then you have a deficit and a credibility problem. So you need $X-M>0$.
  - Either global growth speeds up or your growth slows down.
- This analysis and its conclusions are 'technical'.
- The difficulty is that there are at least two mutually inconsistent ways of understanding how economies grow and the role of finance therein.



Taken from “Global Macro: Pros and Cons of Getting Stuck in the Middle,” Morgan Stanley Research, September 11, 2015; section entitled “Emerging-Market Drag.”

Balance of Payments and International Investment Position, 2009-16 (US $B)
450
400
350
300
250
200
150
100
50
0
-50
-100
2009
2010
2011
2012
2013
2014
2015
2016
Advanced Economies
Emerging and Developing Economies

Balance of Payments and International Investment Position, 2009-16 (US $B), First Subtraction
300
200
100
0
-100
-200
-300
-400
-500
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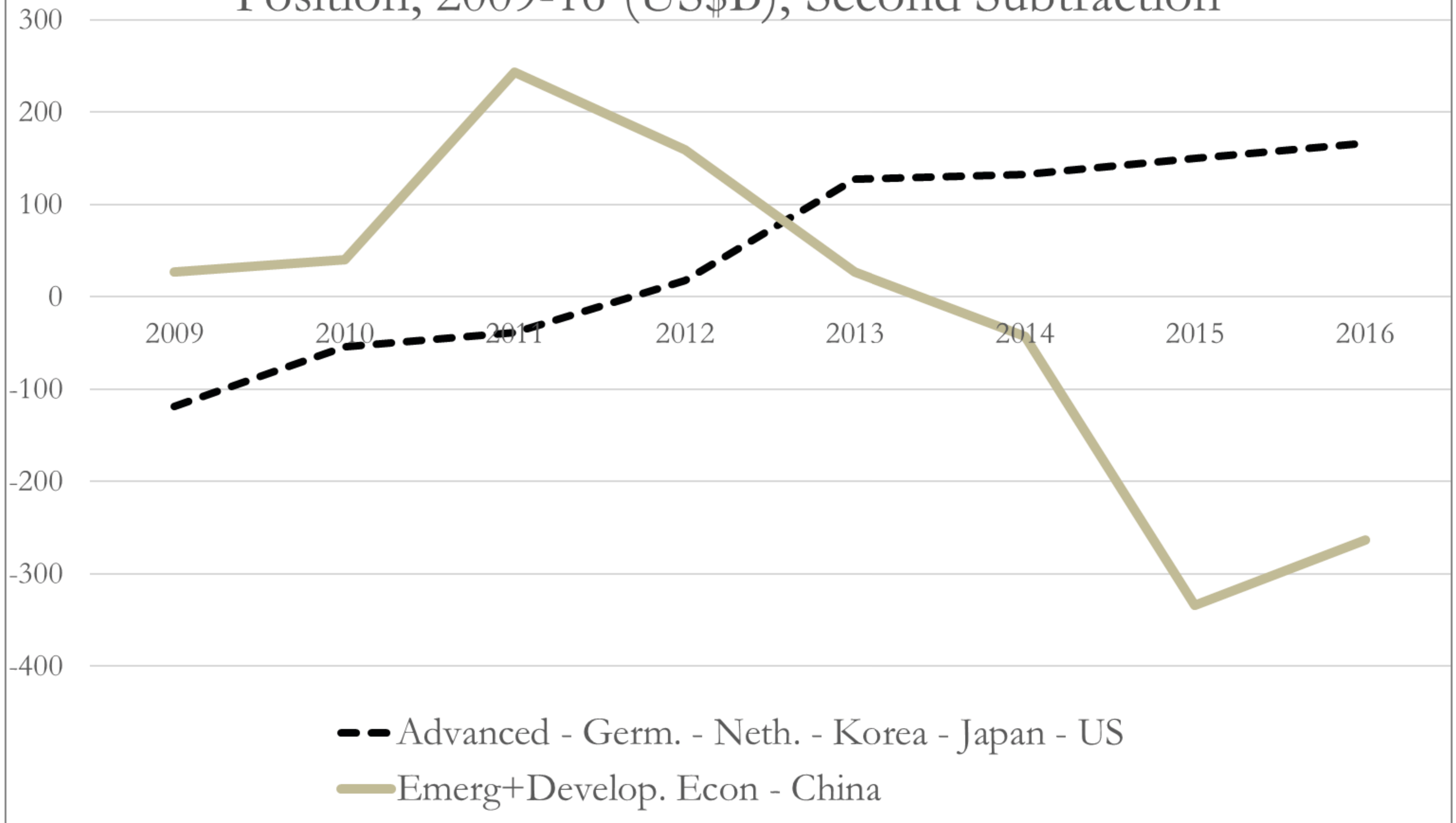
Advanced - Germany - Netherlands - Korea - Japan
Emerg+Develop. Econ - China



Balance of Payments and International Investment Position, 2009-16 (US$B), Second Subtraction
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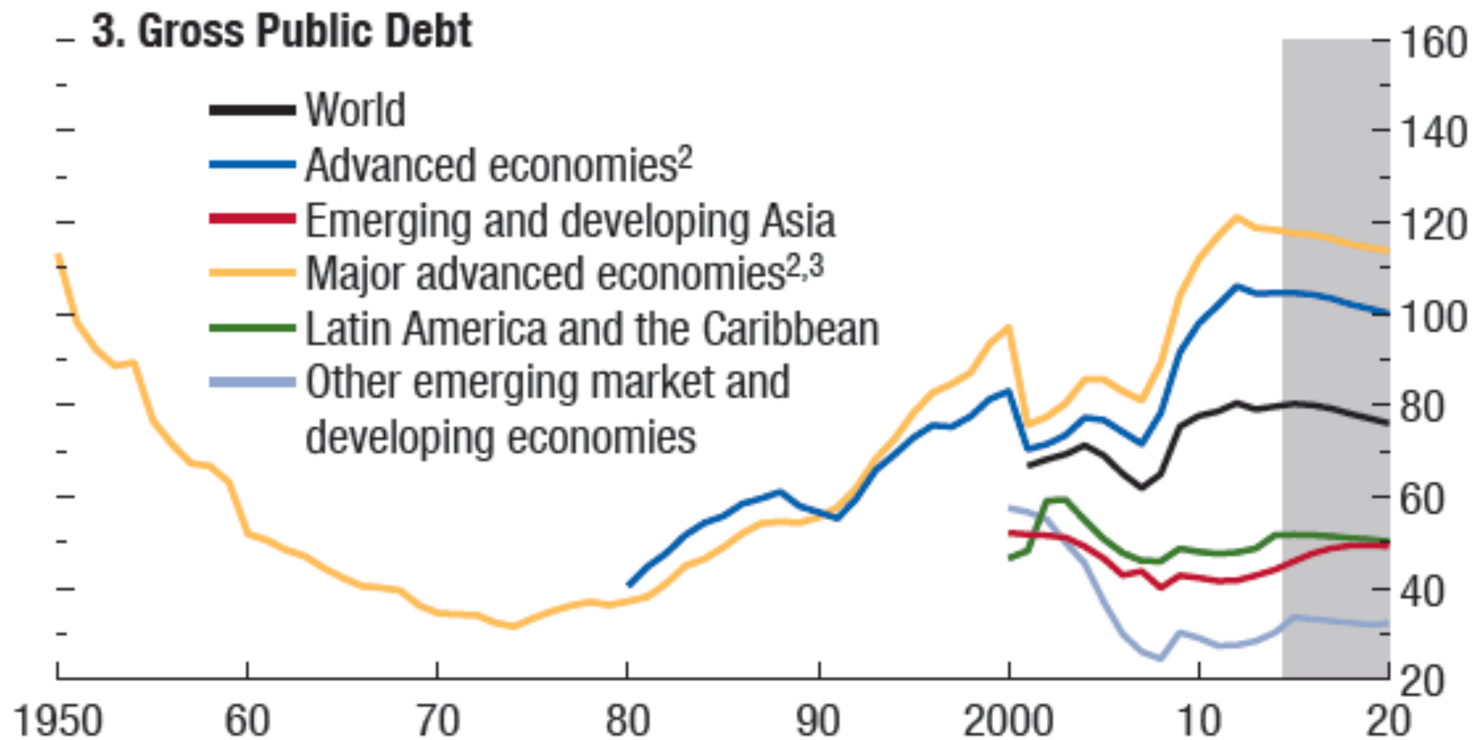
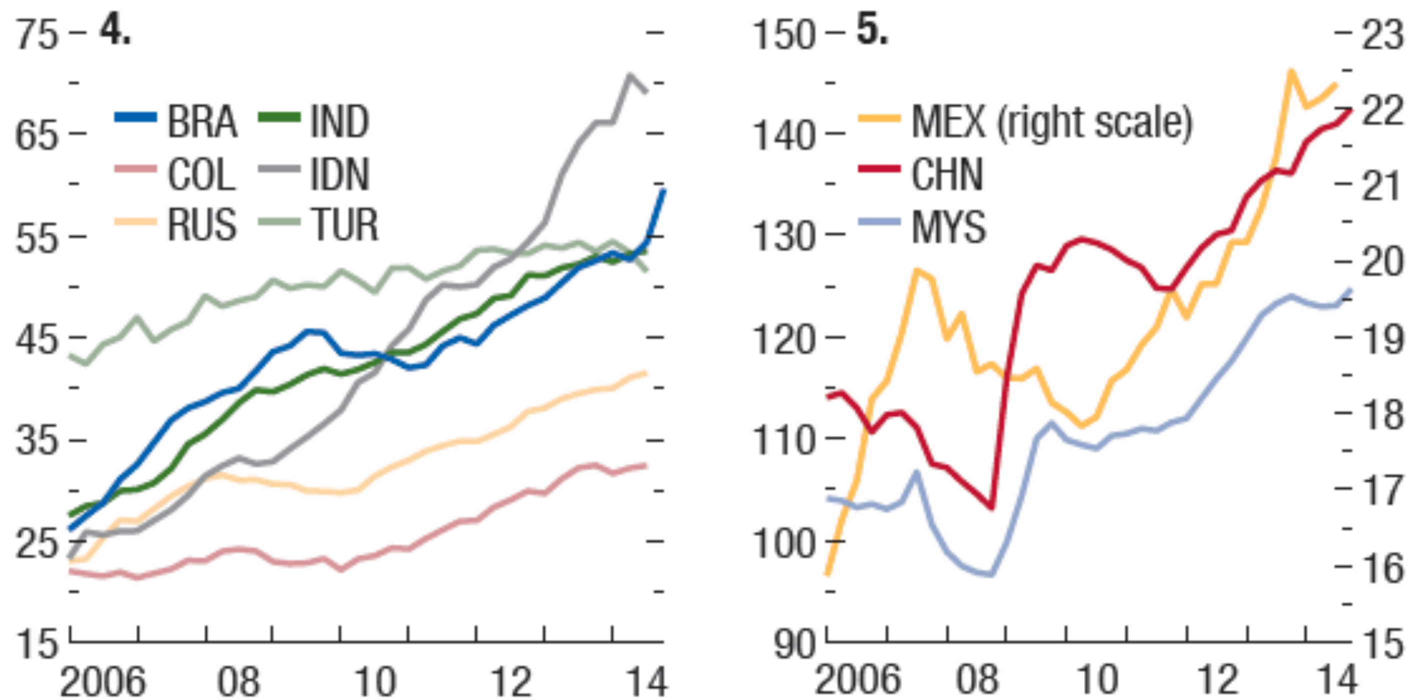
Emerg+Develop. Econ - China



Source: IMF staff estimates.
[1]Euro area countries (Greece, Ireland, Italy, Portugal, Spain) with high borrowing spreads during the 2010–11 sovereign debt crisis.
[2]Data up to 2000 exclude the United States.
[3]Canada, France, Germany, Italy, Japan, United Kingdom, United States.



Sources: Haver Analytics; IMF, International Financial Statistics (IFS) database; and IMF staff calculations.
Note: Data labels in the figure use International Organization for Standardization (ISO) country codes.
[1]Deflated by two-year-ahead WEO inflation projections.
[2]Credit is other depository corporations' claims on the private sector (from IFS), except in the case of Brazil, for which private sector credit is from the Monetary Policy and Financial System Credit Operations published by Banco Central do Brasil.

National Law vs Internationalized Property Rights: The ‘Law of the Jungle’ in Global Finance

- Begin with the 1980s’ U.S. “triple financial crisis”
- 1970s ➔1980s: inflation, oil-price spikes, high interest rates, double-dip recession, oil-price collapse, leading to:
  1. 1982: The thrifts providing most mortgage finance were either insolvent or illiquid or both; this led to deregulation in 1982 that led to speculative developments, many of which collapsed
  2. August 1982: Latin American debt crisis (U.S. money-center banks insolvent, six nations in sovereign debt crisis)
  3. Asset-bubble collapse in “oil-patch” states, resulting in July 1982 failure of Penn Square Bank and, in May 1984, to first ‘electronic bank run’ on Continental Illinois Bank (Chicago)

The 1980s' U.S. "triple financial crisis"

- Resolution of these triple crises:
  1. Continental Illinois: Concerns over CI and over all money-center banks' insolvency (LA crisis) led to September 1984 declaration that 11 banks were "too big to fail"
  2. Latin Amer. Crisis: Creation of Brady bonds, collateralized by US Treasury bonds that were in turn borrowed from IMF or World Bank (or bought by borrower nation)
- Implications:
  1. You now have a category of banks that has escaped national govt oversight insuring their actions add to commonwealth
  2. Each Brady bond was uniquely negotiated; no single solution was available, and national law superceded

“Conflict of laws” and bankers’ collusion

- Buchheit and Reisner (1988) describe as a “fairy tale” a situation before a judicial tribunal where an advocate for a party involved in a sovereign debt restructuring addresses their remarks, “To the International Banking Community”:

  > “For example, the hundreds or thousands of credits that purport to be covered by a restructuring request will have been separately negotiated between borrowers (both public and private sector) and individual banks or, in some cases, ‘syndicates’ of banks lending pursuant to a single loan agreement. These banks, located in countries all over the world, are subject to differing regulatory and disclosure regimes, and have distinct lending and credit review policies and widely divergent practices in important areas such as loan loss reserve provisioning.”

“Conflict of laws” and bankers’ collusion

Lee Buchheit (1988):

- “The enormity and complexity of sovereign debt problems preclude individual banks from negotiating adjustments to their own credit exposure in isolation from fellow lenders.
- “patterns of accepted inter-creditor behavior in these circumstances have evolved without any statutory or regulatory guidelines for reorganizing the financial affairs of a sovereign borrower comparable to domestic bankruptcy or insolvency laws.' What has happened, therefore, has happened only through a consensus among the participants, without the benefit of any outside policy-making authority or enforcement mechanism.”

“Conflict of laws” and bankers’ collusion

Lee Buchheit (1988):

- “The effect of the sovereign debt crisis on inter-creditor relationships has been dramatic and rapid. The international banking community has learned to act as a more or less unitary creditor group. The international banking community has also devised methods to suppress anxieties regarding preferential treatment of certain individual banks, encourage unanimous participation in exercises that are by their nature unanimously unpopular, and discipline those members of the community who may show tendencies toward unacceptably unilateral behavior.”
- What is crucial is that “credit agreements should reflect the banks' entitlement to regard themselves as lenders to the country as a whole, not just separate borrowers within the country”

Lee Buchheit, fairy godmother to finance ministers in distress

Go-to expert for debt-ridden nations on why Spain is the euro's biggest problem, and why he prefers working for debtors

Josephine Moulds

The Guardian, Tuesday 12 March 2013 13.28 EDT

Lee Buchheit: 'The market moves so fast. Hedge funds have the attention span of a Peruvian chinchilla' Photograph: Karen Robinson

Global finance: a higher power

- By acting as a single interest in negotiations with individual borrowers. They avoid any joint-action cabal by borrowers; they also avoid the prospect of continual renegotiations carrying forward into the future. With the Brady bond solutions, the deals have all been cut, and these will end only in debt repayment or debt repudiation. The "certainty" that was indicated as so necessary in the height of the crisis was achieved.
- The principles laid down – bankers' unity in constituting a distinct interest; the opacity of banks' deals to preserve the integrity of the financial relationships they have constructed; the priority given to private negotiations in globalized financial markets, over those of the citizenry in borrower nations – define an approach to the co-existence of global finance and nation-states that subjects Commons' national commonwealths to the prior claims of what is evidently a higher power, in the neoliberal era.

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