Mr Vice Chancellor, Distinguished Guests, ladies and gentlemen. It is a double honour for me to be invited to deliver this lecture. Firstly, it is an honour to speak at this distinguished Malaysian university and secondly, it is a privilege to honour Tan Sri Dr Noordin Sopiee who I had the pleasure of knowing. We met briefly as graduate students at the LSE, 1970 or 1971 I think, when we were students in government and international relations and then
not again until 1984, when I first came to Malaysia and delivered a lecture for the Institute for Strategic and International Studies. Over the next two decades I came to know Noordin through attendance at the ASEAN ISIS Roundtables, our common membership of the Council for Asia Europe Cooperation and regular interaction at a range of track 2 diplomatic events in both Europe and Asia. He also served as a member of the board of, and published in, the journal I edit, *The Pacific Review*. It will come as no surprise that not only did I respect him as a thinker, and as a knowledge broker turning academic ideas into applied policy, but I also liked him as a person. He regularly teased me about what he called my ‘European Cartesian’ legal formalistic view of the world in general and regional economic integration in particular. We would joust over the different routes to cooperation in East Asia and Europe. Were he in the audience today he would be too polite to say ‘I told you so,’ but he would certainly be smiling at what I am about to talk about in this presentation.

Introduction

My presentation today is on the state of the global economy. Not the kind of tour of the horizon that you get from watching Bloomberg, CNN or BBC World. Rather I want to try to put the events of the last 5 years, from the time of the Global Financial Crisis that saw the collapse of Bear Stearns and Lehmann Brothers, into a wider contextual perspective. For the last 2 years we have been beset by the problems of the Eurozone and many of you will have been following the financial scandal in London last week; the forced resignation of Barclay CEO Bob Diamond over the rigging of the London Interbank Official Borrowing Rate (now known to everyone as the Libor.)

Why do I raise these three issues at the same time? They occurred over a period of five years. I raise them because they are all connected certainly indirectly and, in the case of the first and the third, directly. Along with GFC, the miss-selling of derivatives, the miss-selling of insurance products, recent IT failures, US banks rigging the municipal bond market and massive insider trading scandals in Japan, we have a wider systemic and potentially greater problem than one-off setbacks in global finance—collectively they reflect the dilemmas of a global market place in which the relationship between the real economy and the good society in what we think of as the ‘Western world’ and the financial sector has changed.

Over the last 25 years the financial sector has come to dominate the real economy in an asymmetrical and increasingly questionable, indeed irresponsible, manner. By real economy I mean what we grow, what we produce and what we exchange (the trading economy but not financial services). By financial sector I mean principally banking, but also the other ancillary national and global financial services that have grown along with banking in an era of globalisation. This dysfunctional relationship is reflective of a crisis in the market system. The behaviour of the financial sector reflects a cultural shift in what passes as legitimate activity in the market place. It also reflects a profound change in the relationship between
the sector and the state as its ultimate regulator—so much so that we can also talk about the loss of state sovereignty in its relationship with the financial sector. The market system that has become so widely, indeed nearly universally accepted since the end of the Cold War, and especially the financial sector, is in need of reform in the very heartland where it developed—Europe and the USA. If we cannot reform it, it will be unlikely that it is able to move beyond increasingly rapid iterations in the cycle of economic crises. In short no one, and certainly not governments, will be able to stabilise the system.

If I were to focus on the immediate problems of the day then the sound bite headline for the talk would be: ‘Which way to the ‘Gr-exit’ or the ‘Grexodus’ as the Economist (7 July, 2012) calls it—that is the exit of Greece from the Eurozone?’ And how do we cope with life after the Eurozone, or what is left of it after the crisis of Greece and now also Spain and maybe even Ireland and Italy is contained? There is no doubt that containing this crisis, or rather crises, is the major immediate global event of the day and we, that is the global institutions, not simply the Europeans do indeed need an emergency plan for this eventuality. But time is running out for an orderly Greek exit—the amicable divorce scenario, so favoured in Western society nowadays, as it is often referred to.

The European summer of 2012 offers an eerie resemblance to the New York summer of 2008. Perhaps more precisely, given that it is sovereign debt we are talking about this time in Europe, the capital flight from the Club Med countries is, for those of you who remember back, reminiscent of the crises of Latin America in the 1980s and Asia in the 1990s. But the effects of Greece’s departure from the Eurozone, if that eventuates, are difficult to predict precisely; except to say that, just as Lehmann’s collapse in 2008 had unexpected, as well as expected, consequences, Greece’s exit will have consequences beyond simply an expected collapse in other Sovereign Euro assets and a sapping of economic output and confidence elsewhere, including Asia—as we can already see in the slowdown in China. The greatest ‘known unknown’, to use Donald Rumsfeld’s famous expression, is the prospect of resurging nationalist sentiment and politics in Europe—that very phenomena that the European Union was established to combat at its inception. If we look at Greece and some central European members of the EU such as Hungary, this is a real and disturbing prospect.

At this stage we simply do not know whether the European Central Bank can contain the Euro crisis (although the omens are not good) and the IMF, or if other global leaders through bodies such as the G20 will be able to help contain the inevitable unexpected collateral consequences. The assumption must be, if the markets are our guide, that they won’t. What is clear at the time of writing is that the approach that has been adopted over the last two years, the ‘austerity’ approach, is thought not to have worked and pressure is growing to resort to a more Keynesian strategy—particularly apparent in Nobel Prize winner and influential columnist Paul Krugman’s new book, End this Depression Now.

The impasse in Europe brings me to a major theme of my talk. The dilemma over which strategic choice to make—Hayekian austerity or Keynesian pump priming—occurs because
these are not simply questions of a technical financial nature fought out amongst economists. They are fundamental questions about how we secure what we might call ‘the ‘good society’ and about the ability of the key global actors (both national and multilateral) to engage in successful collective action problem solving in the face of recurrent crises. These are as much philosophical and political questions of policy choice as they are narrow technical economic ones. At the technical level there is the problem that the more bank debt governments guarantee, the less room there is for future manoeuvre. At the intellectual level the problem is that there is no unequivocal agreement within the policy community over what the correct extent of state involvement in the processes should be. By way of shorthand, let me say that the debate between Hayek and Keynes is still very much alive and this is definitely something worth understanding. The debate will be settled in the field of finance because at this moment in time finance, more than anything else has the ability to bring the system, not simply the system in Europe, but the whole system down.

So, the unifying question running through my comments today is simple. Can, and to what extent should, the global economy try to govern itself in the early 21st century? How do we calibrate, indeed tame, what is clearly a destabilising asymmetrical relationship between a hyper active and at times irresponsible global financial system (since whether we like it or not, that is what many of the actors in it have been of late) and the under-developed ability of governments to regulate it appropriately. And by ‘appropriately’, I mean in order that the economy overall (not just the financial sector) serves the well being of the community or a good society without stifling innovation—the seemingly unreachable equilibrium in the relationship between markets and governments for human society. If ever there was a time for reflection on the global distemper and the shortfall in global leadership, it is now.

I intend to reflect on this in three ways: firstly, a reflection on the role of sovereignty; secondly, a reflection on markets; thirdly, a reflection on what to do with the banks. While all three conversations have their origins in the history of the development of Europe, if properly understood, they are not just the musings of a professor of political science, they cast massive policy shadows for this part of the world in general and for states such as Malaysia, zealously enhancing its own sovereign statehood only some 50+ years after independence and in the early 21st century.

**On sovereignty in the 21st century**

Most analysts assume that the sovereign state, although not without challenge, remains the primary subject of modern international economic relations. Notwithstanding the late 20th century breathless prophecies of the hyper-globalists such as Kenichi Ohmae (1995) and other boosters of the ‘borderless world’, as well as the rise of other global economic actors, we still live in a world of states. Sovereignty remains national not global and the ability and right to legislate (again challenges notwithstanding, see Slaughter, 2004) remains primarily national not global and state policy makers insist on exercising this right - and doing so in
theory, if not always in practice, in the interests of society at large and not just those of the financial sector. The domestic polity continues to be the key provider of legitimacy. But today, both in the USA and in Europe, policy makers are struggling to explain to their citizens why ever greater rescue packages for the financial sector are inevitable—why did AIG receive more in what Joseph Stiglitz (2012) calls ‘corporate welfare’ in one month ($150 billion), than the whole of the US’s poor received in a 15 year period?

This specific immediate question actually goes to the heart of a much bigger question to be found in the relationship between states and their peoples in the modern era; that is, the question of duty of states towards those who they govern. A crucial historical function performed by the sovereign state has been the evolution of its role in the management of the national economy. Of course there are historically competing accounts of how states govern their economies, especially over the manner and extent to which governments should intervene in and regulate economic activity. However despite the many important ideological and normative differences, there has been a tendency, at least within the dominant liberal tradition of modern capitalism, to treat national economies as discrete systems of organisation more or less delimitated by the state’s territorial boundaries. These economies were conceived as largely self-contained, self-regulating systems of exchange and production (see Latham, 1997). This was as true for economic liberals such as Adam Smith and David Ricardo as it was for economic nationalists and mercantilists such as Liszt. Such thinkers were not, of course, blind to the fact that economic activity commonly spilled over national frontiers, but they tended to treat national economies as self-contained units in the international market.

The economy was thought to serve the community of the state in which it operated; its functions and benefits were defined in terms of the interests of a particular political society. Indeed, the very fact that states monopolised the right to tax within their boundaries further enhanced the correlation of the economy with the state’s boundaries. Once economic security was assured, a later general function of the modern state was to govern the economy in such a way as to promote the wealth and welfare of the community. Whereas liberals focused on the market mechanism as the surest and most efficient means of ensuring the liberty, security and prosperity of both individuals and the community, non-liberal approaches tended to emphasise the need for regulation and manipulation of economic activity in order to satisfy the social needs of the community. In addition, the state also played a crucial role in the guarantee of private property and the enforcement of contracts as essential legal elements in the governing of the economy.

At a larger normative level the boundaries of justice, in both its economic and political form, were thought to be coextensive with the legal-territorial jurisdiction, and economic and political reach of the state (see Linklater, 1998 and Walker, 1993). This was reflected in the progressive democratization of both government and polity and embodied in an unwritten social contract between government, business (including the financial sector) and the work-
force. This social contract did not guarantee that the economic benefits of the economic growth that accompanied the industrial revolution were shared equally, but that the benefits were distributed more widely and that access to increased prosperity that developed throughout the twentieth century was (in theory at least) open to the widest possible sections of the community. Of course the political consensus that developed in the major OECD countries (especially in its dominant Anglo American core) did not eradicate injustice and inequality, but the role of politics and the evolving regulatory instruments of the state was at least able to keep a sense of balance in the relationship between the workforce and the owners and controllers of industry and capital. It did so by addressing wrongs when the balance, especially in the relationship between capital and labour, became too asymmetrical in one direction or the other. The state’s role was to rectify market failure.

The preceding discussion is not simply an excursion into arcane political theory. Rather it offers us important insights into the limits of our current abilities, or rather our failure, to regulate the global financial system. Under conditions of globalization, defined as the liberalization of trade, the de-regulation of finance, the privatization of assets and the hollowing out of the state, the historical trends that gave the 20th century Atlantic societies their distinctive resolution of the social bond achieved by the sovereign state and in particular the modern welfare state have begun to unravel (for a discussion see Higgott and Devetak, 1999). The sovereign state is an historical product that emerged at a particular point in time, resolving social, economic and political problems. But with the passage of time, and the changed milieu in which states exist, it is no longer axiomatic for many that the sovereign state is the most practical or adequate means of organising modern political and economic life and providing the array of public goods normally associated with the welfare state.

Increasingly, the sovereign state is seen as out-of-kilter with the times as globalisation radically transformed time-space relations and altered the traditional coordinates of economic and, as we are seeing in contemporary Europe, political life. Contemporary long standing sovereign states are caught in the trap of having to recalibrate the social bond between themselves and their citizens that has been destabilized by the rapid globalization of the world economy that began in the last quarter of the 20th century and reached its tipping point with the onset of the current round of global financial crises that commenced in 2008. States are attempting to do this (and failing to do it) in a number of ways; especially in the attempt to regulate the financial system in the wake of the recent global financial crises. What this means is the ability to stabilise markets. But the USA and Europe will not do this as long as they do not understand the political as well as the economic complexion of markets.

In recent decades, states, and especially their regulatory agencies, have demonstrated an inability to learn. The global financial system is beset and challenged by herd mentality and
group think as the iteration of economic and financial crises become more common. Across
the old industrial world, debt, stagnant median wages and looming unfunded entitlement
liabilities, especially pensions, cast doubt upon the viability of "business as usual". And this
is not just a European problem.

For sure, over the past century we have made huge strides in our understanding of how
economies work. And yet we are only beginning to understand the importance of how we
govern them. If management is how we achieve certain goals, such as low inflation for
instance, then governance is how we work out what our goals should be, their relative
importance, and who bears the costs?

The distinction between economic governance and management and the limits of markets
and the need for government is not as well understood as it should be in the western
world’s corporate sector. Economic management has long tried to pass itself off as a
technical discipline to make markets work and this task is best performed by independent
experts, armed with MBAs and kept away from politics. Politicians and political parties
compete to be seen as good economic managers answering questions ‘who gets what when
how?’ These answers are invariably cast in economic terms in which the market makes the
appropriate determination. But these questions are not simply the preserve of economics
and economists. They cast massive policy shadows over the legitimacy, stability and
workability of political systems in the present era. So let me in this next section of my
address say something about markets and their relationship with politics.

On the Joy and Anguish of Market

Markets work well when, and only when, private and social returns are strongly aligned.
But markets are not currently working in the way their supporters would have us believe.
Markets are supposed to be efficient. In the financial world that is not currently the case.
When working, markets are the most efficient wealth producers we have ever known. The
market system as espoused by Adam Smith in the Wealth of Nations, is a joy to behold.
Markets have provided the world with the mechanism that has revolutionised productivity
and delivered hundreds of millions from poverty over the last two hundred years. No
system, and especially not communism, has done it better. But markets do not just develop
out of the ether. Markets are constructed. And as Adam Smith told us in his Theory of
Moral Sentiments, his less well known book, markets have no intrinsic moral character.
Thus, when left to their devices they can concentrate wealth, abuse workers, exploit
consumers, despoil the environment and generally create misery. It is the morality of men,
and it is usually men, or at times the lack of morality, that gives a market its purpose and it
is usually through governance (both formal and informal) that this morality is infused into markets. It is for this reason that markets need to have some form of regulatory agency.

But political deadlock, uninspiring leadership and low voter confidence all add up to suggest that Western political systems are currently incapable of dealing with the ‘who, what, why’ questions. This is because they are not simply narrow technical questions. This is perhaps our major failing of the current era. Adam Smith and the philosopher David Hume gave us the liberal market society. The progressive liberalisation of trade and the partial deregulation of finance in the first 40 years after World War Two constructed the global economy. But the welfare benefits that accrued from these processes have been challenged by some of the latest ‘innovations’ in a further deregulated financial sector; principally because it is now empirically understood that they have fostered inequalities in OECD countries in recent years. The demand that prosperity needs to be shared more equally (or conversely that the current pain emanating from the crises be shared more equally) is growing and will become a potent, if not indeed a toxic, political force.

Equality, or more precisely less manifest polarised inequality and the possibility of equal opportunity, should concern us more than they do. Why do I say this? Because I am an ardent supporter of markets. I also say it because I think the old Anglo Saxon market oriented societies of the Atlantic world—the USA and the UK especially—are in danger of undermining the principles and stability of society by the way they are avoiding tackling the problems of an out of control financial sector.

Deeply entrenched and seemingly intractable economic problems plague many industrialised economies, raising questions as to the viability of the dominant economic paradigm. Perhaps most problematically, Western political systems seem to be presently incapable of dealing with these serious issues. We are at a turning point in history, where the old way of doing things is less and less effective. Nowhere is this dilemma better illustrated than in the recent and continuing financial crises. Connections between people and financial institutions are fundamental for the development of the good society (see Shiller, 2012). Yet recent behaviour in the financial domain has been marked by the detachment of financial activity from the wider public interest and the separation of merit from reward. For some this behaviour reflects a ‘broken social contract’. As is well understood in both the USA and the UK, it is leading to increasingly less equal societies.

Markets are not working as Smith would have wanted. The pursuit of self interest is not, via the role of the invisible hand, leading to the well-being of all. The private benefits, most notably the returns to the rulers of the banking sector are not, as Smith would certainly have wished of those who claim to speak in his name, well aligned with social returns to the rest of society. Marginal productivity theory assumes that a person’s private reward and social contribution are equal. Note this is not an argument for equal reward. Marginal productivity theory also assumes people with a higher contribution receive a greater reward. When they are not aligned we talk of market failure. Clearly the rewards in the
financial sector, when measured against their contributions to societal well-being, or more appropriately the lack of it, represent market failure on a massive scale in the advanced OECD world and the UK and the USA especially since the GFC of 2008.

So this is where we come to the question of the relationship between governments and markets. In theory, governments should correct market failure, but they never get it exactly right. For nearly 50 years after the Great Depression—what is often referred to as the period of the embedded liberal compromise, where many states followed the teachings of John Maynard Keynes at home and Adam Smith abroad—governments in the West got it mostly right. It leads us to pose the question as to why the period since then—the period of deregulation that began in the 1980s—has seen an increasing iteration of financial crises in the succeeding 3 decades. In effect, government’s getting it mostly wrong. For authors such as Jo Stiglitz, the answer is clear. Government failures to correct for market failure since then ‘...were no accident: the financial sector used its political muscle to make sure that market failures were not corrected and the sector’s private rewards remained well in excess of their social contributions’ (Stiglitz, 2012: 35).

In the US and the UK over the last 3 decades the ability of the financial sector to get its own way and protect its own interests, rather than those of society more generally, has been truly remarkable. This process is described in the economic and political science literature as ‘regulatory capture’, in which the interests of the sector and the regulatory agencies have become aligned (for an excellent discussion see The Warwick Commission, 2009). The most obvious way that this comes about is via the revolving door that sees influential positions in the regulatory agencies occupied by senior figures from the sector, in this case the financial sector, concerned. The driving factor is not necessarily money (although stepping back into the sector from a regulatory agency is usually very well rewarded). Rather it is ‘cognitive capture’ of the mindset of the regulators in such a way that keeps regulation to a minimum.

The other factor of course is the ability to stave off regulation through the power of wealth and lobbying. The US banking industry can muster 2.5 lobbyists for every US representative and in 2012. It is possible that banking’s influence in the UK in 2012, if that is possible, is even greater. In the City of London there are 26 industry bodies, 129 organisations and nearly 1000 people employed directly in the financial sector lobbying government and the regulators on behalf of sector interests. Sixteen percent of the House of Lords (126 peers) have direct declared financial links to the banking industry. This, of course, is above and beyond the day-to-day activities of the City of London Corporation whose very raison d’être is to represent the City and lobby government on behalf of the collective interests present in the city (http://www.thebureauinvestigates.com/2012/07/09/revealed-the-93m-city-lobby-machine/). In short, what I and others across the political spectrum are saying is not very radical. Markets forces are real but they are shaped by politics and especially by the influence of rich and powerful special interests that inculcate specific social norms into the governmental and regulatory system. And the last 30 years has seen a significant
transformation in norms, more simply perhaps ‘...of morals and manners ... [and] ... deeper changes in norms of responsibility and self-restraint’ (Packer, 2011: 29-30).

Rent seeking has replaced value creation and wealth is created risk free (for the few) while the many carry the cost in what is now widely known as ‘moral hazard’. This short-termism, and the search for immediate returns, can be dated back to the ‘Big Bang’ that democratised and electrified stock trading in London in 1986 and the repeal of the Glass-Steagall Act that had separated investment and retail banking in the USA in 1999. From that time long standing norms of fairness appeared to have been undermined. Perhaps more importantly, it has given rise to a challenge to the moral basis of capitalism that the second half of the 20th century (from the time of the Great Depression), had done so much to dispel. As one UK Conservative MP, and I stress Conservative, notes in a recent pamphlet:

‘The result is that real capitalism – the greatest tool of economic development, wealth creation and social advance ever known – has been wrongly identified with rampant financial speculation. ... Ever since Edmund Burke, conservatism has seen society not merely as a means to satisfy individual wants, but as a compact between past, present and future generations to preserve and enhance the social order.’ (Norman, 2011: 4-6)

At the risk of sounding overly dramatic, the future of Western liberal style capitalism is at a crossroads. And interestingly the current crisis in western liberal capitalism—captured in theory as free markets and limited government—coincides with a new form of emerging state-led capitalism in this part of the world. This is not a contradiction in terms. Indeed, state capitalism can claim the most successful recent state in its camp (China).

**Banks and the State**

So let me say something about the question of the banks—and their relationship with the regulators—or the sovereign state in effect. I say this because in large part the current crisis has been fuelled by a near abdication of sovereignty by the state over the control of their financial sectors as they have become progressively freed of ‘appropriate’ regulatory constraint. ‘Appropriate’ here means not regulation for regulation’s sake; but regulation to ensure that the social contract that developed over the last three centuries to underwrite the social bond between states and their citizens does not become progressively unravelled.

The dual failure of markets and regulation prior to the US crisis is now, by and large, acknowledged. Our current ability to develop an appropriate path of future regulation is less clear. This is not surprising. It is not easy. Time and again in the aftermath of financial crises policy makers vow to get it right. This is a well-known pattern. State authorities put new regulation in place in the hope that this time will indeed be different. But simultaneous with
new regulation, the financial sector begins, unsurprisingly and invariably successfully, to explore new avenues to circumvent regulation. Although a new actor, the G-20s efforts to introduce new regulation reflects a historically similar pattern to that found in the responses to earlier crises.

Two main factors account for these repeated failures. First, financial regulation by definition is based on past experience. Reform is an exercise in shutting the stable door after the horse has bolted. New regulation invariably fails to envisage, or is pre-empted by, new developments as firms work to reduce market competition. By the time new regulation comes in other ways of exploiting market power, and especially market imperfections, are emerging.

Second, rules, be they national or global, can be and frequently are undermined by successful lobbying. Time and again bankers have succeeded in pressuring policy makers to accede to what Gordon Brown in the UK famously called “light touch regulation” and what in the USA Hacker and Pierson (2010) describe as ‘winner take all politics’ that privileges the very rich and the ability of organised interests (in this instance organised money) to triumph over the median voter in the political process, determining favourable outcomes from the policy process (and the ensuing consolidation of wealth in the US of the very rich). Packer details how the preferred policy positions of organised money—generically meaning favourable regulation and minimal oversight of the financial domain—have been assiduously adopted by US governments of both persuasions over the last 25 years (Packer, 2011: 25-29). And, as we now know, the US banking community’s prevention of the US Congress from regulating the burgeoning derivatives markets in favour industry standards for self regulation is now widely understood to have contributed to the 2008 GFC. In the words of the Financial Crisis Commission:

‘The enactment of legislation in 2000 to ban the regulation by both federal and state governments of over-the-counter derivatives was a key turning point in the march towards financial crisis’ (Financial Crisis Commission, 2010 xxiv, also Tett, 2009).

The sector successfully battled measures to enhance transparency; ensuring that much of what it did in derivatives trade took place in the world of shadow banking. Of course, the financial sector is but one sector of Hacker and Pierson’s ‘winner take-all society’. But it has become increasingly politically influential. One effect of the financial sector’s successful lobbying efforts has been the introduction of ‘race-to-the-bottom’ policies by decision-makers intent on not losing business to other financial sectors. The most commonly used justification here is the reference to the need for a ‘level playing field’ at the global, as opposed to the national level. The argument being that unless the rest of the world, or at least the G-20, implements certain rules, any tightening of regulation at the national level will result in the deterioration of the competitive position of that country’s financial sector.
This rhetoric has been exploited not just by the financial sector, but indeed also by policymakers, who have been known to give the interests of banks preference over the interests of wider society. And the existence of strong Wall Street-Treasury relationships amongst the finance professionals in both the public and private sector in the USA since the 1980s has been well demonstrated (see for example, Wade and Veneroso, 1998).

Similarly in the UK, especially since the time of the Big Bang in 1986, policy makers have joined with the City of London in extolling the virtues of deregulated capital markets. None of this should come as a surprise to those versed in some basic political science or institutional economics. Anthony Downs (1957) and Mancur Olson (1982) demonstrated years ago the political power of the lobbying power of special interest groups and distributional coalitions. They also offered the theoretical demonstration of the negative economic and social effects (increased inefficiency and rising inequality) of their influence if it becomes too asymmetric. This theory has been born out empirically in the recent history of the lobbying prowess of the financial sector in the world’s two major financial cities—New York and London.

The message to take from this bit of history is to recognise the limits of global regulation and the importance of domestic regulation. For more than two decades, the dominant view in the debate on financial regulation has suggested that global rules, and only those, can make the financial system safer and more stable whilst at the same time not stifling innovation or undermining the prevailing neo-liberal ideological impetus of the globalised era. We need a diverse, not a one-dimensional, regulatory landscape. While such an approach will not automatically prevent financial crises, the effects of turmoil might be mitigated because, as we know from biology, diversity stabilises complex systems, whereas monocultures transmit and more easily exacerbate shocks (see Wade, 2009).

Of course, if the record of regulators and academics in identifying future risks were better than history tells us it has been, then the case for diversity would be weaker. But as numerous crises demonstrate, the assumption that authorities learn from past mistakes has time and again not only been wrong, it has led to hubris and turbulence. There is no evidence that our ability to predict future risk is so well developed that the implementation of more global standards in finance will contain it. Standardisation does not equal stabilisation. It is not impossible that more global rules could enhance further global crises.

Andrew Haldane, Executive Director for Financial Stability at the Bank of England, interprets the financial system as a ‘complex adaptive system’ (2009: 3). He suggests that four mechanisms influence its stability or otherwise: connectivity, feedback, uncertainty and innovation (Haldane 2009: 8). All four of them have the potential to turn a hitherto stable system into an unstable one. Let us look at them in turn. Connectivity of participants in financial markets, facilitated by cross-border capital flows, can serve as a shock absorber, but only within a certain range; past a certain, hard-to-predict point, connectivity turns into contagion:
‘... beyond a certain range, the system can flip the wrong side of the knife-edge. Interconnections serve as shock-amplifiers, not dampeners, as losses cascade. The system acts not as a mutual insurance device but as a mutual incendiary device. ... Even a modest piece of news might be sufficient to take the system beyond its tipping point.’ (Haldane 2009: 9).

And indeed we have seen numerous examples of the Janus-headed dimension of connectivity. At first benign and seemingly non-problematic, cross-border financial flows suddenly turn from sources of relatively cheap finance into unmanageable liabilities. For instance, years of financial flows into Asian economies prior to the 1997 crisis appeared to be a blessing, only to become a liability when the tide turned. Similarly, for years before subprime, connectivity—hailed by Alan Greenspan as a new era in finance—was considered to be unproblematic. But when the tipping point was reached, the American virus infected financial systems the globe over. This view is reinforced by Adair Turner who argued the GFC was assisted by a belief that the financial system had become ‘more stable and the amplitude of economic cycles less pronounced precisely because of financial market developments ... [but in fact] ... which we now believe led to the crisis’ (Turner, 2009: 85)

To understand the power of feedback, Haldane refers us to epidemiology. The speed with which crises, or diseases, spread very much depends on the perception of market participants. Their views ‘construct’ the crisis. The reaction of market participants to financial crises thus determines the rate of transmission of that crisis (Haldane 2009: 12). And as we know, financial markets have a tendency to be characterized by herd behaviour: first greed, than panic (Wood 1988). Both work as feedback loops.

Uncertainty is the third factor in Haldane’s analysis. Networks generate chains of claims, and whilst in boom times the question of counterparty exposure is often ignored, in the event uncertainty creeps in. In addition, who is at the end of the chain is crucial says Haldane: Bernhard Madoff or Warren Buffet? Modern finance has done at lot to conceal counterparty exposure and thus increased uncertainty. The widespread use of over-the-counter derivatives, in essence private contracts between two parties without authorities or other market participants knowing about them, has been a key factor. Consider the surprise that hit many, including the US government, when the full exposure of AIG (the world’s largest insurer) to credit default swaps became clear the day after Lehman Brothers collapsed. ‘Counterparty risk is not just unknown, it is almost unknowable (Haldane 2009: 14).

Finally, innovation, at different times, can contribute to both the stability and fragility in financial systems. In fact, we think that innovation in finance has to be sharply separated from the real economy. In finance, innovation is often a euphemism for increased complexity and less transparency. Indeed, it would be our contention that the unalloyed utility of innovation in finance remains to be demonstrated. Take, for example, some of the
‘innovations’ that contributed to the 2007/2008 crisis in the USA. One particularly opaque and dangerous instrument has been the ‘squared collateralized debt obligation’, or CDO. An investor in a CDO would have had to read in excess of one billion (!) pages to understand the product.

There is cautionary note here. It may be time to start thinking of financial crises as systemic events rather than accidental ones. According to Hyam Minsky (1997: 13), ‘increased availability of finance bids up the prices of assets relative to the prices of current output, and this leads to increases in investment’. In short, economic boom changes the behaviour and the expectations of market participants. When a boom develops, standards change and risks are ignored. This pattern of over-confidence has been observed many times in the last 30 years; as in the Japanese twin bubble—real estate and share prices—in the 1980s, where the rise of asset prices relative to current output was reflected in the ever increasing number of years an employee in Japan would have had to work for his or her dwelling. The bubble burst in 1990.

But Minsky’s minority view was disregarded by mainstream economics, which continued, and in many quarters still continues, to believe in the superior rationality of financial markets and their ability to process information efficiently. By contrast, Minsky (1977:15) argued that ‘... a capitalist economy endogenously generates a financial structure which is susceptible to financial crises, and ... the normal functioning of financial markets in the resulting boom economy will trigger a financial crisis’. Developments since the 1970s give more credence to Minsky’s financial instability hypothesis than it received at the time of its development and especially since the GFC’s challenge to the efficient market hypothesis.

Minsky’s way out of this impasse was the consolidation of ‘good financial society’, in which the tendency of business and bankers to engage in speculative activity was constrained (Minsky, 1977, p. 16). What he failed to provide, sadly, was an idea how this goal could be achieved. In part, we would suggest this is because he lacked an understanding of the political and social theory of the sovereign state. An understanding of how to retain, develop or re-create the ‘good (financial) society’ requires the skills and resources of the historian, philosopher and the political theorist; resources that have been too little valued, understood even, in the contemporary neo-classical economists tool kit.

This lack of a political theory to accompany economic theory limits our ability to understand the struggle to enhance state policy capacity (state sovereignty in fact) in the face of de-regulated capital markets. Eradicating this limitation is, in many ways, the litmus test of the ability of the modern capitalist state to rein in what George Packer (2011: 25-9), looking at the USA, identifies as the perverse effects on democratic government and decision making of the rise of the lobbying power of ‘Organized Money’ that facilitated the de-regulatory urge of the last several decades.
For Packer, and indeed other impeccably credentialed establishment analysts (see Norman, 2012), behaviour in the financial domain has been marked by the detachment of financial activity from the wider public interest, and the separation of merit from reward. Packer describes what he sees as the ‘broken contract’ and the ‘mocking of the American promise’ by which ‘organized money’ between 1979 and 2006 grew its wealth by 256 percent and tripled its share of national income to 33 percent, a figure tellingly last reached in 1928. Inequality in the OECD in general and the Anglosphere most tellingly, has grown rapidly over a similar period (see generally OECD, 2011, on the USA see Stiglitz, 2012, on the UK see Lansley, 2011).

As John Plender (no Marxist he) notes in The Financial Times, ‘... the wealthiest Americans have collected the bulk of the last three decades’ income gains. Much the same is true for the UK. In both cases, most of the spoils have gone to finance professionals and top executives’ (Plender, 2012: 2). And as Joseph Stiglitz (2012), Nobel Prize winning economist puts it: ‘...never in the history of the planet have so many given so much for so’. For these authors, and they reflect a growing tide of analysis in similar vein from across the political spectrum, a characteristic of recent global financial crises is a near abdication of sovereignty by the state over the control of their financial sectors as they have become progressively freed of ‘appropriate’ regulatory constraint. I stress the word ‘appropriate’ here meaning not regulation for regulation’s sake; but regulation to ensure that the social contract that developed over the last three centuries to underwrite the social bond between states and their citizens does not become totally shattered.

Getting this right is not only a task for government regulators but also shareholders. What is needed is serious cultural change in the world of finance. Frankly, there is no better place than the City of London to start; whether there is the political will to do so is of course another question. How the UK responds to the Libor scandal will give us a clue to the longer term prospects for reform. But in addition to giving regulators more teeth there is a clear need for shareholders to drive change and be willing to accept lower returns and profits in return for a cleaner, more ethical business model. Sadly, arguments about the need for cultural change are often a sign that obvious practical solutions are missing.

Before the Big Bang the City of London was clubby, snobbish, sexist, racist, and lazy, but with a gentile respect for the market. Post the Big Bang—things changed. It may have become less clubby and more democratic, but the key driver became money. Massive compensation and incentives, both personal and corporate, drove the deterioration in both standards and behaviour. The major cultural shift has to be to break the link between compensation and behaviour. This needs changes in both power of shareholders and regulators. Can we restore a culture of responsibility and probity? The answer to that depends on whether we can reach a happy medium in the relationship between legitimate network capitalism and crony capitalism. The financial and governmental sector in the West was only too happy to
criticise Asia for this at the time of the Asian financial crisis (see Higgott, 1998), but in actual fact they have been in many ways worse.

What we do now know is that massive global banks are not only too big and too interconnected to fail, but they are also too big to manage. It is not just a question of scale, but also complexity—too many moving parts. Moreover boards, and even top executives, are too removed from day to day activity to know about and control what is happening. If we are to believe Bob Diamond that is. But more likely is an explanation that suggests that top executives actually have little interest in what is going on in boiler rooms, for that is the sources of their exorbitant reward structure.

We have long worked with an assumption of the benefits of conglomeration of investment, commercial and retail banking built on an assumption of obvious synergies. Now even that judgement is changing. Much academic research suggests that banks are valued at less collectively than the sum of their individual parts. Leverage, risk taking and mark to market accounting has accounted for the massive bank profits of the last decade much more than increased efficiency and productivity. There are fewer benefits from conglomeration than was assumed. When considered alongside recent events surrounding Libor rigging, this merely adds another nail to coffin of integrated banking model. Do we need to see them split up is not now a radical question.

But if the strategy to overcome the ‘too big to fail’ dilemma is to go back to some kind of Glass Steagall division between retail and investment banking, in effect to break up the banks, then another problem arises. It becomes a sequencing issue. Is breaking the banks up probably too difficult to do in the contemporary era of financial instability? Radical moves to restructure the sector are back on the agenda, but a gradual programme of unpacking - probably by ring fencing investment banking from retail banking - may be the first stage.

Against this background, an agnostic view of banking regulation (global or national) is prudential. We will never be able to know what the risks of future developments will be, and even if tough rules are implemented, we can safely assume that the financial sector will find ‘innovative’ ways around them. For example, the current proposal to require extra amounts of capital from so-called systemically relevant banks creates an incentive to carve up big financial firms into smaller units. While many observers hoped after the 2008 GFC that ‘too-big-to-fail’ banks will obey and implement new regulatory measures that would make them less profitable than their smaller peers, neither past experience nor current practice has provided sufficient evidence to sustain this claim.

While it now seems plausible to expect that there will be a departure from large, integrated banks into smaller units, this may not result in the lowering of risk, unless the newly created smaller banks follow diverging strategies, or regulators permit the simultaneous bankruptcy of several medium-sized banks. Stricter regulation of the financial sector has not contributed to the stability of the international financial system. Basle I, introduced in the
late 1980s when Japanese banks were the rising stars in finance, prevented none of the crises of the 1990s—neither the Mexican crisis of 1994/95 nor, more importantly, the Asian crises of 1997/98. Indeed, the crises in Asia should have been a reminder for policy makers in the OECD of the impact of hubris on unchecked financial markets. Not one single major market participant spotted the emerging GFC. Rating agencies started to worry only when the situation had already visibly deteriorated and then only contributed to the deepening of the crisis by iterated downgrading of the affected economies.

The final factor to be put in the mix alongside the need to re-examine regulation and rethinking the culture of the banking industry, is the broader issue of a need to re-examine the ideas that have underpinned the de-regulatory urge of the last 30 years. As Jagdish Bhagwati noted long before the subprime crises and the various crises in Europe, the assertion that free capital flows and de-regulated financial markets represented the ideal option was always an essentially ideologically driven, self-serving assumption propagated by the sector. If it was appropriate, as he argued over 14 years ago (1998: 12) that the burden of proof should be imposed on those advocating it rather than those opposing it, then it is doubly appropriate in 2012. Moreover, let us note regulation is a legal and legitimate instrument of policy for sovereign states, should they so choose to use it. That governments may not have used these instruments where arguably they should have done is explained, I have argued, by politics (and especially the lobbying power of the sector) not, as Stiglitz (2012) persuasively argues because it is incontrovertibly good economic theory; in contrast to trade liberalisation we might add.

But even in a post Libor rigging era limitations on regulation will remain. Tougher regulation at national or regional levels will continue to be exposed to intensive lobbying. Players will relocate (or threaten to relocate) to less restrictive market places. It was ever thus. And it is indeed capital's choice to do so should it wish; just as it is the sovereign right of governments to ignore these threats and regulate should they so wish.

**Conclusion**

In this paper I have attempted to combine some political theory with international economics—an unusual combination but one essential, I would argue, if we are to capture the complexity of the contemporary dilemmas that led us into the global financial crises. Implicit in this is an assumption that if scholars are to assist in taking us beyond these crises then we must avoid the neo-classical economic monoculture that dominated the economics discipline over the last several decades (see McNamara, 2009). For it was in this context, emboldened by the ideological support of the ‘science of economics’, that the Anglo-American financial sector was able to practice the financial engineering that became hegemonic in the 20 years from the end of the Cold War to the GFC.
There was no counter-veiling power to the ideas of economics. They might have existed, indeed they do, but they were not articulated. No alternative set of intellectual arguments were mustered in favour of appropriate regulation. Public regulators became timid, subordinated and the hand-maidens of organized money. In the struggle between market power and rules based behaviour the intellectual ammunition that the economist supplied to the financial sector was not provided to the regulators in equal measure by either the lawyer or the political philosopher. Astute observation of what was happening subordinated to the scientific seduction of algebra. This imbalance was not without consequence. It left an intellectual, some would say moral, void that permitted the ascendancy of an ideas base and a political machinery that under-pinned Packer’s ‘organised money’, Norman’s ‘crony capitalism’, and Hacker and Pierson’s ‘winner take all’ society, with the subsequent weakening of the social bond between the modern state and its citizenry in countries such as the USA and the UK.

As a consequence, the struggle between financial power and rules based behaviour will continue to be a hallmark of the present system. It will not be overcome by any substantive developments in global governance writ large; this is wish fulfilment, the pietistic chimera of the cosmopolitan theorist. Even on the smaller, more practical canvas of 21st century economic institutional multilateralism, cooperative collective action problem solving will remain constrained by both national and international politics (see Higgott, 2012). The G20 may have acted as something of a crisis buster at the height of the GFC and it will continue to be a forum for setting an agenda for serious discussion of how best to manage the global economy. It is part of the plurality of the arenas of regulatory discourse. But it is not in this forum that the ultimate regulation of risk in the global economy can and will be determined. That role will, and indeed must, for the reasons of sovereign primacy adumbrated in this paper, remain primarily the preserve of sovereign states. Co-ordination in the global financial system is to be encouraged but responsibility for regulation, reflecting Rodrik’s (2011) ‘paradox of globalisation’, should remain largely a ‘host country’ activity if we are to re-democratize regulation.

In contrast to the ambiguous effects of the deregulation of the financial sector, in theory and practice, both economic theory and historical practice have shown time and again the welfare-enhancing benefits of fewer restrictions in trade. For any country, the overall welfare benefits of trade far outweigh possible negative dimensions for a specific sector. Lets us not forget that one consequence of the Great Depression of the 1930s was a massive and debilitating era of protectionism that the GATT and subsequently the WTO over 45 years did so much to diminish.

In the most recent era, the liberalisation of trade has enabled countries like China, India and Vietnam to contribute to and benefit from a deeper international division of labour. Hundreds of millions of workers in developing economies have worked their way out of poverty by producing for global markets. We still observe the worst cases of poverty in
countries that continue to try to protect their citizens from a more liberal approach to trade. And of course the industrialised societies have benefitted over time as well. Consumers would not enjoy the same range of goods and services if there were significantly less trade. Central bankers would have had a much harder job in controlling inflation if China and other emerging economies would not have provided cheap manufactured products. All these are tangible benefits of the global historical trend towards freer trade.

It is thus ironic and regrettable that we have observed a declining commitment to the norms and practices of the multilateral trading system and a proliferation of bilateral and regional preferential trading arrangements (PTAs) such as the now much hyped Trans Pacific Partnership. The World Trade Organisation is currently challenged by the unwillingness of the United States of America and other key players to support the conclusion of the Doha Round. Whilst the WTO continues to fulfil a range of important functions—and the Russian Federation became the 154th member in early 2012—the organisation has lost support from its previous core constituency. Protectionism did exacerbate after the 2008 GFC and many OECD-countries are defecting to alternative strategies, especially PTAs. These agreements are making international trade more complex and are unlikely to facilitate a deeper international division of labour, notwithstanding that the vast majority of scholars and practitioners continue to acknowledge that global rules for trade continue to be the first-best of approaches to trade governance.

And contrary to my critical remarks I am also in favour of banks, but I am against banking conglomerates. Indeed we need responsible finance to help deliver the good society. But the moral hazard that sees large banks borrow extensively and use the funds irresponsibly because taxpayers are on hand to bail them out must stop. Banks must be ‘simple enough and small enough to be manageable; focussed enough in their activities to avoid the conflicts of interest that come from large scale crony capitalism and small enough to be allowed to fail’.

If the basic question of modernity has been how to reconcile capitalism and mass democracy, then this is now a problem for all countries not just those of the OECD world. Different parts of the world are tackling it differently and the assumption that the only way is the liberal democratic way is under challenge. Alternative systems are in operation. The state led capitalism of the kind to be found in China and Singapore is proving increasingly attractive in other less-developed forms in other parts of Asia and Africa. The current crisis is more a crisis of the West.

The system that emerged from the wreckage of two World Wars in the Atlantic world in the twentieth century was a hybrid structure that combined economic and political liberalism within a mixed economy WHAT came to be known as the ‘embedded liberal compromise’. Such a compromise, as Harold Laski of the LSE noted “... provided enough solid benefit to ordinary citizens to make its preservation a matter of urgency to themselves”. It was capitalism, but capitalism tempered and limited at home by the power of the democratic
state and sensitive to the goals of social stability and national solidarity." At the international level, there was a post-war order of mutually supporting liberal democracies with mixed economies. The system stressed not transcendence but compromise, not utopia but (only) a framework within which citizens could pursue their personal betterment. It has been a massive historical success.

But it was always, and still is, a work in progress. The structure still stands, but it has seen better days. The Atlantic powers have to decide if it is worth saving. Can they build a new liberal compromise? This is not a scholarly question. It is an empirically practical one, the answer to which casts massive shadows over the way people will live their lives. The question is double barrelled. It is about both what to do and how to do it. It goes to the heart of the relationship between the citizen and the state in the early 21st century—and in many parts of the world including, but not only, the USA, Europe and the UK, this is an increasing angry and unstable relationship.

Do we need to build a new 'liberal compromise' in the minds of a new generation, a changed compact, for a changed world? The fundamental message of the success of the post-war order seems to have been lost over the last couple of decades; that is, that economic and financial systems, every bit as much as political systems, are social constructions created by societies in theory, if not always in practice, to meet the needs of society. They should be built as much by ‘philosophers’ as Wall Street’s so-called ‘rocket scientists’. We need to move beyond what has been the central problem of the financial sector over the last decade or so—that capital necessary for real, substantive, and low risk, economic and commercial activity and insurance has been given to speculators to play with, and they have done so with greed and reckless irresponsibility. We need to secure a better balance in the relationship between finance and ‘real’ economic activity.

The solution to this problem is as easy to identify as it is difficult to achieve. We need to get the relationship between the market and the state right. The market as an instrument of allocation and coordination surpasses all other mechanisms devised by man. But it is no more than a mechanism or machine. And like all machines it requires steering, regulating and servicing every now and then if we are to get the best, as opposed to the worst, out of them. To extend Ha Joon Chang’s metaphor (2010: 253) markets, like cars can come in different shapes and sizes—there is no one size fits all, as some fundamentalists would have us believe. Markets, like cars, can function for good or evil depending on how they are used. Markets, like cars, can be improved—better breaks, bigger engines, improved fuel. Markets, like cars, can be driven better if driving habits are improved. Markets, like cars can satisfy needs. But they need to be looked after. We have not looked after them.

Understanding, and making provision for how we satisfy these needs—particularly inter-generational justice, cross-national justice and social justice more generally (and note by justice, I do not mean equality, I mean fairness) must be part of our wider equation. Meeting these needs more effectively is the key to maintaining the legitimacy of modern
political systems. Political and economic systems that are not flexible enough to maintain their legitimacy are eventually challenged by alternative systems, historically with disastrous consequences for all concerned; as inter-war Europe demonstrated.

References


