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The End of Liberal Finance? The Changing Paradigm of Global Financial Governance

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Has the global credit crunch shifted the foundations of global financial architecture away from the philosophy of 'neoliberalism'? In this article, we argue that the neoliberal project is most probably dead and buried, despite the apparent commitment, which we detail in this article, to the spirit of neoliberal thinking in economic thought. By analysing three constitutive elements of neoliberalism (its public, private and regulatory components) before and after the credit crunch, we reveal important geopolitical shifts which are likely to prevent a return to 'business as usual' in the world of finance. We find that the defining trend among these changes is the global rise of the Eurozone. Specifically, we argue that the ideal, Anglo-Saxon model of neoliberalism was viable because it was heavily subsidised from around the world. Accordingly, the key to the future of Anglo-Saxon neoliberalism lies with the willingness of European, East Asian and Middle Eastern creditors to continue extending their financial support to the Anglo-Saxon model of finance. We believe that they are unlikely to do so in the future. Spurred by the magnitude of the credit crunch, the rise of Europe is progressively weakening each of the three dimensions of Anglo-Saxon neoliberalism we identify in this article.

Keywords: Anglo-Saxon capitalism, crisis, Europe, finance, geopolitics, hegemony, neoliberalism, USA

Introduction

There is a certain paradox about the global credit crunch of 2007–9. On the one hand, it has been unprecedented in scope and scale, evolving into a generalised, systemic crisis of finance and the economy. On the other hand, however, the nucleus of the credit crunch – the US subprime crisis – was relatively simple in its origins, having been, as Nitzan and

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Bichler argue, a 'scam' of modern finance.[1] Notwithstanding the emerging diversity of interpretations of the crisis, the global credit crunch raised serious doubts about every single aspect of finance theory, policy and practice associated with a set of dogmas commonly described as 'neoliberalism'. Why is that?

We find several reasons for this. Firstly, the very core of the neoliberal dogma is premised on the belief in markets as the most efficient mechanisms of resource allocation. Thus, for instance, if financial markets are left to function freely, with little or no external interference, market distortions or imbalances should be rare and minimal. In reality, however, the idea of an innovative market mechanism for generating credit to the economy turned out to be a complete charade, as the 'efficient' financial market evolved into a gigantic Ponzi pyramid which, inevitably, had to collapse.[2] An estimated $50 trillion of 'wealth' – that is, the aggregated estimate of global decline in capitalisation – was wiped out during the crisis.[3]

Secondly, rather than allocating resources efficiently to the economy, as mainstream theory suggests, the financial markets proved to be much more adept at allocating resources to themselves. As a result, the credit crunch exposed the contemporary financial system as a gigantic rent-seeking mechanism that fed upon society as a whole to sustain itself. In other words, and contrary to the key tenets of neoliberal finance and economics, rent-seeking is not the exclusive realm of corrupt politicians: left to their own devices, the markets are equally, if not more, adept at extracting rent from society.[4]

Thirdly, the theory that 'greed is good' and that regulation is superfluous hinges on the proposition that the individual pursuit of self-interest is the best guarantee of systemic stability. Financial actors enter into transactions for pecuniary reasons and know better – so the theory goes – than regulators what the real value of an asset or the true health of

1. Jonathan Nitzan and Shimshon Bichler, *Capital as Power* (London: Routledge, 2009), 32. See also Robert Wade, 'The First World Debt Crisis of 2007–2010 in Global Perspective', *Challenge* (July–August 2008): 23–54; and William Black, 'CSI Bailout', *Moyers Journal*, 3 April 2009: http://www.pbs.org/moyers/journal/04032009/profile.html.

2. Joanna Chung and Brooke Masters, 'Age of Excess Fuelled the Rise of Ponzis', *Financial Times*, 5 May 2009; Anastasia Nesvetailova, 'Ponzi Finance and Global Liquidity Meltdown: Lessons from Minsky', Working Paper CUTP 002, City University London, February 2008.

3. Martin Wolf, 'US Foreign Policy and the Global Financial Crisis', *Financial Times*, 1 April 2009.

4. For a classic statement of rent-seeking, see James Buchanan, Gordon Tullock and Robert Tollinson, eds, *Towards a Theory of Rent-Seeking Society* (Austin, TX: Texas University Press, 1980). The rent-seeking literature never contemplated the idea that markets can also serve as rent-seeking devices.

an institution is, and thus ensure stability. Alan Greenspan hit the nail on the head when he confessed how shocked he was to learn that individual self-interest proved no guarantee of systemic stability at all.[5] Indeed, the crisis has shown that, contrary to neoliberal orthodoxy, individuals and institutions do not necessarily share the same goals. In a world of intensified labour turnover and competition for 'talent', individuals in pursuit of their own self-interest (i.e. bonuses) were all too happy to put their institutions at risk, believing either that they raised their own market value by doing so or that the institutions would ultimately be saved by the state – which they were. Worse, during the downturn, self-interest only exacerbated the crisis.

Fourthly, the credit crunch revealed that all the post-Bretton Woods systems of privatised financial regulation have failed miserably. To start with, Basle 2, while hardly implemented, proved to be pro-cyclical and is believed not only to have failed in maintaining the stability of the financial system, but actually to have aggravated the crisis. The credit rating agencies – profit-seeking companies whose role as privatised institutions of regulation was promoted by the Reagan administration to ensure market stability – failed most scandalously. Many of the so-called independent central bankers, removed and isolated from the humdrum of politics, as recommended by neoliberal ideologues, and placed in charge of monetary policy, proved to be woefully inadequate, failing to spot cracks in the system. Moreover, lacking a holistic vision and approach to economic policy-making, traditional monetary authorities appeared impotent to prevent the crisis. The IMF in turn, about the only institution with a global overview of the financial system, not only failed to anticipate and diagnose the crisis correctly and in time, but was painting a rosy picture of global economic prospects only months before the crisis erupted in August 2007.[6]

Finally, and most importantly, when the crisis started to unfold, most institutions affected by the turmoil came up with an unambiguous solution to the malaise: the 'state'. A minority of die-hard neoliberals, admittedly mostly those with little direct stake in companies or the economy, did advocate a market solution to the problem. But the failure of Lehman Brothers in September 2008 brought the global economy to such a precipice that it became clear that if any of the world's governments followed the principle of the free market and neoliberal ideology, the world would have seen a repeat of the depression of the 1930s or worse, and capitalism as we know it would have imploded.

Against this background, and as the green shoots of 'recovery' slowly emerge, it is not unreasonable to ask whether the crisis represents the end of the neoliberal era, or whether it was, as some pessimistic commentators

5. Alan Greenspan, Interview for CNBC, 31 July 2008.
6. International Monetary Fund, *Global Financial Stability Report*, April 2007.

begin to suspect, a brief interlude in the march of neoliberal globalisation. Had we written this article in October 2008, immediately following the collapse of Lehman Brothers, the answer would have been straightforward: yes, this is the end of neoliberalism. Now, a year later, the political forces and stakes that had been associated with the neoliberal project are clearly regaining confidence.

There are two diametrically opposed interpretations of what neoliberalism might be in essence. According to one interpretation, neoliberalism has manifested the state of the art in economic thinking of the past three decades. Accordingly, the debate about the future of neoliberalism is a theoretical and empirical discussion about the nature of the economic system as such.[7] In another view, economic theory merely serves to disguise political interests; neoliberalism, therefore, represents an alliance of social and political forces that have gained tremendously from political pursuits in the name of neoliberalism.[8]

Each of the two perspectives offers a different pathway towards an investigation of the future of neoliberalism. In the first view, one has to look into the heart of the theoretical debate within economics and enquire to what extent, if any, Keynesian and Minskyan political economy is now reshaping the nature of the analytical exercise in contemporary economics and finance. According to the second view, theoretical enquiry is not that important in and of itself. Rather, we need to examine the underlying interests that supported the neoliberal vision of the world and their ability to recover in the wake of the credit crunch, in order to see who is going to gain the upper hand in the continuing debate on post-crisis regulation.

We believe that the two perspectives tend to discuss only one dimension of the neoliberal project. We call it the *public* face of neoliberalism: a set of ideas primarily associated with the theories of Hayek and Friedman – however tense the relationship between the two camps might have been from time to time.[9] There are, however, two additional and equally important dimensions of the neoliberal project. To begin with, there is a less well known but equally crucial private dimension of neoliberalism centred on the complex and expanding network of institutions and modes of private governance. In the sphere of finance specifically, there is yet a third dimension to neoliberalism. Neoliberalism in its 'ideal'

7. John Campbell and Over Pedersen, 'The Rise of Neoliberalism and Institutional Analysis', in *Neoliberalism and Institutional Analysis*, eds John L. Campbell and Ove K. Pedersen (Princeton, NJ: Princeton University Press, 2001).

8. Gerard Dumenil and David Levy, *Capital Resurgent* (Cambridge, MA: Harvard University Press, 2004).

9. Stanley Fischer, 'Friedman versus Hayek on Private Money: Review Essay', in *Jonathan Swift: The Critical Heritage*, ed. Kathleen Williams (London: Routledge, 1996).

form – as represented by the US economy in the past two decades or so – appeared to be economically successful not least due to massive inflows of foreign capital. It has been widely known and discussed for a long time that the foreign holdings of US Treasury bonds played a critical role in sustaining the consumer-led pattern of economic growth in the US. What is less widely known is that there have been other forms of inflows that helped subsidise the American consumer. These include foreign holdings of US agency debt, held primarily by East Asian governments, as well as US-originated Collateralised Debt Obligations, or CDOs, which, as the first decade of the 21st century progressed, were increasingly sold to European banks.

The exact figures for the three forms of foreign inflows into the US are still in dispute, yet if we tot up existing estimates, they amount to nearly $5 trillion, a non-negligible figure by any standard. These foreign holdings of US debt helped maintain a lower rate of interest in the US, unwarranted by the economic fundamentals.[10] The low-interest-rate environment, in turn, helped sustain the 2002–7 housing and credit boom. Foreign inflows ensured, in addition, that the subprime crisis in the US, which initially appeared confined to the epicentre of modern 'investment banking' (namely, the US and the City of London), soon engulfed all the major creditors of the US in a global web of credit lines (namely, the East Asian, Middle Eastern and European economies, Russia and, by late 2008, the entire world).

Considering the scope and the magnitude of the credit line extended to the US in the run-up to and in the wake of the credit crunch, the key to the future of Anglo-Saxon neoliberalism depends less, we argue, on the continuing belief in theory or ideology and more on the willingness of the creditor states (and their banking communities) to continue renewing these credit lines, which, we believe, they are unlikely to do in the future. Hence, we conclude, the neoliberal project is most probably dead and buried, despite the apparent commitment – which we detail in this article – to the spirit of neoliberal thinking in economic thought.

In order to substantiate our claim, we investigate current proposals for financial reforms and, more specifically, the narrative and discourse of the post-crisis debate itself. In what follows we argue that the important geopolitical shifts that had preceded the crisis and are among the most significant underlying structural causes of the credit crunch are likely to prevent a return to 'business as usual'. The geopolitical changes we are referring to include not only the much-debated palpable shift of power to the East, but also the growing importance of the largest and most underestimated economy in the world, the Eurozone. It is this trend, we

10. Francis Warnock and Veronica Cacdac Warnock, 'International Capital Flows and US Interest Rates', *Journal of International Money and Finance* 28, no. 6 (October 2009): 903–19.

believe, that is the defining geopolitical change in the short to medium term. Spurred by the magnitude of the credit crunch, the rise of Europe is progressively weakening each of the three dimensions of the Anglo-Saxon neoliberalism we identify below.

The Private, Public and Regulatory Dimensions of Financial Neoliberalism

In the midst of the wreckage created by the global credit crunch, it seems uncontroversial to argue that, as a philosophy and an ideology, liberalism faces serious challenges today. Yet when it comes to international economic policy or to discussions about future global governance institutions and structures, the significance of such challenges is much less apparent. Indeed, the rise of the so-called authoritarian capitalist regimes across the fastest growing economies in the world (China, Singapore, the Gulf states and possibly Russia) has been one of the most intriguing developments in the world economy in the past decade or so. At the same time, it is notable that these countries have adopted, at the very least in the conduct of foreign economic policy, a fairly conventional liberal stance and some of the principles of global governance. In other words, it is not liberalism as such that is being challenged; it is, rather, the ideas, concepts and policy aims of an ideology commonly dubbed 'neoliberalism', including the concepts and ideas associated with the so-called 'Washington Consensus', that seem to have been discredited for good.

Neoliberalism as an economic ideology came to prominence towards the end of the 1970s, particularly with the advent of the Thatcher government in the UK and the Reagan administration in the US. The concept of neoliberalism is, of course, contested, as, in fact, is the idea that the past three decades witnessed the rise of neoliberal ideology. The conventional, or public, face of neoliberalism may be described as 'a time of market deregulation, state decentralisation, and reduced state intervention into economic affairs in general'.[11] It is this public face of the neoliberal ideology that is commonly perceived as synonymous with neoliberalism more generally.

The 'private' face of neoliberal financial theory, in turn, includes complex, highly technical probabilistic theories that go under such titles as the Capital Asset Pricing Model (CAPM) and Black-Scholes options pricing model and, perhaps surprisingly, the regulatory dimension of

11. Campbell and Pedersen, 'The Rise of Neoliberalism', 1. See also Dumenil and Levy, *Capital Resurgent*; Stephen Gill, 'Globalisation, Market Civilisation, and Disciplinary Neoliberalism', *Millennium* 24, no. 3 (1995): 399–423; David Harvey, *A Brief History of Neoliberalism* (Oxford: Oxford University Press, 2007); Duane Swank, 'Tax Policy in an Era of Internationalization: Explaining the Spread of Neoliberalism', *International Organization* 60 (2006): 847–82.

international capitalism. Interestingly, since the late 1990s the latter has been distancing itself from the theoretical foundations of finance and economics. The two dimensions of neoliberalism, public and private, have been developing along somewhat independent paths, giving neoliberal ideologues an opportunity to insist that the crisis of today was caused not by the failure of neoliberal theory, but because of mistakes in its implementation. Hence, they argue, the solution to neoliberalism is none other than . . . neoliberalism.

As a policy prescription, the public face of neoliberalism contrasts sharply with the previous widely accepted paradigm of international governance described by John Ruggie as 'embedded liberalism'.[12] The concept of embedded liberalism reflected a new understanding within liberal thought of the importance of state intervention in the economy in order to ensure liberal values such as free trade among nations and market openness. Most remarkably, the dominant theory during the period, voiced so eloquently by John Maynard Keynes and then applied to a degree in the principal financial institutions of post-Second World War governance, was the idea that free trade among nations could only be sustained if international finance was highly regulated and controlled.[13] For that purpose, the era of embedded liberalism, as defined by the institutions and policies of the Bretton Woods system, explicitly sought to impose capital controls on the movement of money, capital adequacy ratios, as well as a fixed exchange regime among the leading currencies in the world. At the same time, micro- and macroeconomic policies were aimed first and foremost at achieving full or near full employment at home and developmental goals abroad.

In contrast to the post-war policy framework, neoliberalism advocated an extreme form of international free trade regime both in corporeal assets (i.e. goods as well as services) and in incorporeal or financial assets (such as debt instruments, stocks and bonds). At the same time, and in clear contrast to the public face of neoliberal theory, over the past two decades the US – an apparent bastion of neoliberal ideology – has been pushing hard to strengthen the international regime of regulation and control of trade in intangible assets, which include goodwill, logos, trade names and intellectual property rights. Neoliberalism was never, therefore, about deregulation as such. In fact, the advance of global finance to new terrains and heights over the past three decades was only possible due to the strong commitment to a specific set of policies and regulatory

12. John Ruggie, 'International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order', *International Organization* 36 (1982): 397–415.

13. Eric Helleiner, *States and the Reemergence of Global Finance* (Ithaca, NY: Cornell University Press, 1994).

principles.[14] In other words, the public face of the neoliberal ideology advocated deregulation of domestic financial markets, the removal of restrictions on the movement of capital internationally, the gradual shift of international financial governance away from states to 'private' institutions such as the Bank of International Settlements, and the continuous encouragement of innovation in the financial market.

During the neoliberal era the focus of macroeconomic policy has been radically shifted away from the goal of full employment (considered to be harmful due to the theory of a natural rate of employment, above which strong inflationary pressures begin to manifest) towards an almost exclusive goal of maintaining low inflation targets. Inflation was seen as the source of all evil, for three reasons. Firstly, if, as neoliberal ideologues insist, the market is a far superior mechanism of resource allocation to its alternatives (i.e. the state or traditions/conventions), then inflation distorts the essential role of the market as an information mechanism mediating between consumers and producers. This, the theory held, was the trigger of odd outcomes, such as the combination of inflation and economic stagnation (stagflation) as experienced in the 1970s. Low inflation was considered a key instrument in ensuring that the market, including the financial market, performs its role and function.[15]

Secondly, following the seminal work of Friedman and Schwartz of Chicago University,[16] Keynesian theory of investment was rejected in favour of the quantitative theory of money that stipulated that inflation was a purely monetary phenomenon. As such, inflation is caused by an over-supply of money, or 'printing of money' which was typically perpetrated by politicians pandering, or so it was assumed, to their domestic constituencies and failing to either consider or be prepared to make tough choices in the area of public expenses. Inflation was seen, therefore, as symptomatic of government intervention in the economy as advocated by Keynesian economics.

Thirdly, following the same logic, economic failure was seen as a product of market distortions typically introduced by states and

14. Jamie Peck argues that 'the practical content of neoliberal reform strategies is often quite "interventionist", albeit in different ways': Jamie Peck, 'Geography and Public Policy: Constructions of Neoliberalism', *Progress in Human Geography*, 28 (2004): 395. For discussion of neoliberalism as a new regulatory architecture, see David Levi-Faur, 'The Global Diffusion of Regulatory Capitalism', *Annals of the American Academy of Political and Social Science* 598 (2005): 12–32; and Phillip Cerny, 'The Infrastructure of the Infrastructure? Towards Embedded Financial Orthodoxy in the International Political Economy', in *Transcending the State–Global Divide: A Neostructuralist Agenda in International Relations*, eds Ronen P. Palan and Barry Gills (Boulder, CO: Lynne Rienner, 1994).

15. Friedrich von Hayek, *The Road to Serfdom* (London: Routledge, 1944).

16. Milton Friedman and Anna Schwarz, *Monetary History of the United States, 1867–1960* (Princeton, NJ: Princeton University Press, 1971).

'rent-seeking'politicians. Combating inflation was used as a code-word for 'depoliticising' monetary policy, for taking politicians 'out of the market' and thus removing their ability to distort the basic market mechanism. For this purpose, monetary authority was delegated to the institution of an independent central bank that was, at least nominally, isolated from the political process and hence able to take, or so it was argued, a longer view of the needs of a market economy.

This, in brief, was the essence of the public face of neoliberalism. The private face of financial economics had little to do with these larger ideological issues, although it did share the basic assumptions of theories of market efficiency and the like. In order to understand the significance of this gulf between the public and private faces of neoliberalism, it is important to analyse the essence of financial capitalism. In an advanced economic system with a sophisticated financial sector, all assets are financial: they are denominated as capitalisation of 'expected future profits and interest payments, adjusted for risk and discounted to their present value'.[17] Since the value of all assets is future determined and by definition uncertain, financial theory sought to employ statistical modelling techniques based on probabilistic theory to determine the value of financial assets. Such complex mathematical formulae were far beyond the ability of your average economist to comprehend, and hence financial institutions began to employ specialist mathematicians and physicists, who often knew nothing about, and certainly had little interest in, the economy as a whole (this should not be interpreted to suggest that economists did). They, together with the 'research and development' departments of the major banks and other financial institutions, dreamed up what were described as sophisticated financial products, supposedly capable of routing risk out of the system. In reality, however, some of these innovations served primarily for tax and regulatory avoidance purposes,[18] and were masked by complex statistical formulae that many banks' managers appear not to have understood.[19] A large proportion of these financial instruments were booked 'offshore' and many of the deals were conducted on an 'over-the-counter' (OTC) basis. As a result, these two largely unregulated spaces, or secrecy spaces, emerged as the habitus of modern finance.[20]

17. Nitzan and Bichler, *Capital as Power*, 8.

18. James van Horne, 'Of Financial Innovations and Excesses', *Journal of Finance* XL, no. 3 (1995): 621–31.

19. Joel Kurtzman, *The Death of Money: How the Electronic Economy Has Destabilized the World's Markets and Created Financial Chaos* (New York and London: Simon & Schuster, 1993); Gillian Tett, *Fool's Gold* (London: Little, Brown, 2009); Robert Guttman, *Cybercash: The Coming Era of Electronic Money* (Basingstoke: Palgrave Macmillan, 2003).

20. Ronen Palan, Richard Murphy and Christian Chavagneux, *Tax Havens: How Globalization Really Works* (Ithaca, NY: Cornell University Press, 2010).

These developments were widely associated with progress, or 'financial innovation', and innovation is, by definition, a good thing. Very few people understood the actual innovations; the few who did – like Warren Buffett, who made a fortune out of derivatives trades – warned against such weapons of mass financial destruction back in 2003.[21] The wider, popular impression of the thriving financial market was one of great energy, vibrancy, creativity and, crucially, wealth creation on an unparalleled scale. It seemed that while China, Japan and the like would have to compete in the production and manufacturing of goods, the Anglo-Saxon countries could excel and would remain prosperous throughout the foreseeable future by concentrating on the 'services' industry, including, first and foremost, the finance sector. Importantly, the ultimate socio-economic benefits of financial innovation had been celebrated widely and firmly, despite the increasingly frequent financial crises.

Conceptually, financial innovation has little to do with the public side of neoliberalism. Yet the spiral of financial innovation, institutionally and in terms of market developments, appeared to confirm the thesis that market innovation, energy and wealth creation are only attainable when markets are allowed to evolve without intervention. For instance, the credit boom of 2002–7, driven by the advance of securitisation and re-securitisation techniques in finance, was commonly interpreted as a sign of a new age of efficient risk management. In parallel to the buoyancy of the Anglo-Saxon housing and credit markets, the financial boom affirmed the private side of neoliberal ideology. Until, that is, the black September of 2008.

At the same time, and long before the tentacles of the credit crunch paralysed the world economy, the ideology of neoliberalism has been a subject of great controversy, both at home and abroad. Opponents of neoliberal financial policy, led by Keynesian scholars such as Susan Strange and Victoria Chick, argued that the liberalisation of finance would only encourage speculative finance and undoubtedly end in disaster. Internationally, as a developmental policy, neoliberalism was associated with its specific incarnation under the aegis of the so-called 'Washington Consensus'.[22] The latter, in turn, has been severely criticised for its role in impeding development and entrenching poverty throughout the so-called emerging market economies.[23]

In the sphere of finance in particular, since the early 1980s the wave of financial crises (the debt crisis of 1982, the stock market crash of 1987,

21 Buffett, Warren, 2003, "What Worries Warren. Avoiding a Mega-Catastrophe", *Fortune*, March 3, 2003.

22. John Williamson, 'The Strange History of the Washington Consensus', *Journal of Post Keynesian Economics* 27, no. 5 (2004): 195–206.

23. Peter Gowan, *The Global Gamble: Washington's Faustian Bid for World Dominance* (London: Verso, 1999); Susanne Soederberg, *The Politics of the New International Financial Architecture: Reimposing Neoliberal Domination in the Global South* (London: Zed Books, 2004).

the Tequila crisis of 1994–5, the Asian and Russian crises of 1997–8, the dotcom implosion of 1999–2000, the Argentine default of 2001 and several seemingly isolated financial crises of recent years) has raised serious questions about monetarist theory and neoliberal economic policy. Yet even against this background, there is little doubt that the current financial meltdown poses the most serious challenge to the paradigm of financial deregulation and market efficiency to date. The mounting revelations about the policy, regulatory and theoretical deficiencies of neoliberalism are clearly all around us – in the media, in the pronouncements of politicians, as well as in the agenda and policy decisions of important multilateral gatherings such as the G-20 forum. But are we really witnessing the end of a neoliberal era in international finance?

Neoliberal Financial Regulation

In retrospect, cracks in the neoliberal financial governance were apparent a long while ago, becoming most evident in the wake of the 1982 debt crisis. Although it is misleadingly known as the 'Third World' debt crisis, the financial collapse of 1982 was, in fact, the first generalised crisis of the offshore financial market, or the Euromarket.[24] It exposed something that existing financial regulations deemed impossible – namely, that far from maintaining adequate reserve ratios as stipulated by national financial regulations, practically all the major financial institutions had built up mountains of debt by lending to each other in the offshore financial market. As a result, they ended up lending three or four times their deposit base. The financial system was utterly insolvent. The solution to the crisis took the form of an intervention led by the US Treasury that sought to maintain confidence in the market despite the apparent insolvency of the entire system. Concurrently, and far away from the glare of publicity, new plans for regulation were being hatched. These were aimed at a return to a system of capital adequacy ratios, though this time not through multilateral negotiations or national regulations but through a 'voluntary' system of regulation organised by a private regulatory body – the Bank for International Settlement (BIS), or the so-called 'central bankers' bank'.

The resulting international regime of financial regulation became known as the Basle 1 Accord. In addition to its direct impact on the international banking system, Basle 1 was significant in pointing the way for future

24. Michael Dooley, 'A Retrospective on the Debt Crisis', in *Understanding Interdependence: The Macroeconomics of the Open Economy*, ed. Peter Kenen (Princeton, NJ: Princeton University Press, 1995); Miles Kahler, 'Politics and International Debt: Explaining the Crisis', *International Organization* 39, no. 3 (Summer 1985): 357–82; Ronen Palan, *The Offshore World* (Ithaca, NY, and London: Cornell University Press, 2003).

privatised models of regulation of international finance. Yet it was severely criticised by financial institutions for having failed to account for market innovation and differentiation of risk. Eventually the Basle 1 Accord was replaced by Basle 2, which supposedly was built around greater sensitivity to market conditions. The evolution of Basle 2, in turn, typifies the general development of financial regulation during the last two decades.

Increasingly, financial regulation has evolved not as an application of theory-based prescriptions but rather, pragmatically, as a number of institutional adaptations to the market process which were designed to make it work at any cost. During the 1980s and early 1990s, for instance, emerging market economies striving to integrate into the global financial system had to follow the principles of the Washington Consensus rather closely. In the wake of the 1990s' crises, on the other hand, the affected economies assumed a degree of discretion over their financial and monetary strategies, marking a certain departure from some of the neoliberal dogmas of the 1980s. In the context of advanced capitalism, however, financial regulation took the form of a 'light-touch' approach. The institutional separation of powers between the central bank and a financial supervisory body (in the UK case, the Bank of England and the Financial Services Authority, or FSA, respectively) only reinforced this tendency, in the process highlighting the lack of theoretical coherence of today's financial regulatory paradigm.

The crises of the late 1990s became a watershed in the process of financial globalisation. Aside from throwing the emerging markets into a severe economic recession, the crises have also undermined the position of key financial regulatory bodies, such as the IMF and the World Bank. According to many observers, the crises of the late 1990s became the first serious crisis of globalisation,[25] signalling the end of the neoliberal era.[26] Internationally, a significant outcome of the financial implosions of the 1990s was a series of regulatory initiatives and plans, known as the New International Financial Architecture (NIFA). NIFA was in vogue briefly, from 1999 until the 9/11 attacks diverted the attention of policy-makers away from finance-related problems into other areas. Apart from setting up a plethora of forums and committees charged with various tasks of financial supervision (the G-20 forum, the Financial Stability Forum,[27] various Basle-centred groups and committees, etc.), the efforts of the financial architects did not bear much fruit.

The core of NIFA remained market-centred, aiming to facilitate financial innovation, liberalisation and competition even further. The bodies

25. For example Heribert Dieter, 'Crises in Asia or Crisis of Globalisation?', Working Paper 15/98, University of Warwick: Centre for the Study of Globalisation and Regionalisation (Coventry, November 1998).

26. Christian Chavagneux, *Les Dernières heures du liberalisme: Mort d'une idélogie* (Paris: Perrin, 2007).

27. Renamed the Financial Stability Board in the wake of the credit crunch.

and committees that were set up under the NIFA umbrella, in turn, remained poorly coordinated and weak in terms of their juridical status and their powers to enforce standards. Equally important, with regard to its focus, NIFA has targeted mainly the 'emerging markets' – places notorious for their financial and economic troubles – and hence completely overlooked the possibility that a devastating financial malaise could also engulf the economies of the so-called highly sophisticated, 'financialised' capitalism.[28]

In this instance, history is a useful indicator of how effective, and how tough, attempts to re-regulate finance can aspire to be. Since the late 1970s, almost every crisis – economic and financial – invariably rekindled calls for a 'new Bretton Woods' system, while more recently, in the late 1990s to early 2000s, the injustices of globalising markets fuelled anti-globalisation movements across the world. However, despite the intensifying waves of financial disasters and growing tensions within the economies of advanced capitalism, the paradigm of market-driven progress has not been seriously challenged and, up to now, has firmly shaped the 'constitution of global capitalism'.[29] Even if critics like Hyman Minsky appear to be taken seriously in the time of crisis, few remember their warnings once the financial cycle and market confidence are restored.

In retrospect, three aspects of the NIFA debate of the 1990s proved important. Firstly, it is true that the memories of the crises were quickly eroded by the subsequent credit boom and, with the architecture of the new framework never fully agreed upon, the NIFA debate soon lost its sense of urgency.[30] Yet, however limited its ambition, the NIFA of 1999–2001 did signal an awareness among the policy-making community of the need for a new regulatory framework in the international financial system. Indeed, while heavily criticised, one key result of the NIFA initiatives – the so-called post-Washington Consensus – could be considered a (small) step away from the neoliberal orthodoxy of the 1980s and 1990s at the level of the IMF and the World Bank.[31] In that sense, NIFA

28. Soederberg, *The Politics of the New International Financial Architecture*; Ben Thirkell-White, 'The International Financial Architecture and the Limits to Neoliberal Hegemony', *New Political Economy* 12, no. 1 (March 2007): 19–41; Robert Wade, 'A New Global Financial Architecture', *New Left Review* 46 (July–August 2007): 113–29.

29. Stephen Gill, 'Globalisation, Market Civilisation, and Disciplinary Neoliberalism', *Millennium* 24, no. 3 (1995): 399–423; Jakob Vestergaard, *Discipline in the Global Economy? International Finance and the End of Liberalism* (London: Routledge, 2009).

30. This particular point is gaining extra weight in the post-credit crunch climate as many commentators are worried that the longer we hesitate over radical action, the sooner the lessons from this global credit crunch will be forgotten.

31. David Williams, *The World Bank and Social Transformation in International Politics: Liberalism, Governance and Sovereignty* (London: Routledge, 2008).

already signalled the end of the neoliberal consensus, or at least the very extreme end of this consensus, that appeared to reign supreme in the 1980s and 1990s.

Secondly, and equally importantly, the discussion in the various regulatory forums that made up NIFA has not been conceptually driven, and over time has diverged from some of the orthodoxy of neoclassical financial economics that lay at the heart of the neoliberal consensus.[32] Although the trend was seldom noticed at the time, the major pillars of financial regulation debates were built rather pragmatically, on the basis of learned experience, and increasingly diverged from some of the key principles of economic theory. Indeed, as financial economics became more abstract, there was simply no comprehensive theory of financial regulation to guide policy-makers. Existing theories, in turn, failed 'to define the range of regulatory models, the causes of regulatory failure, and how to measure and prevent it'.[33]

We find two reasons for this lack of conceptual vision behind financial regulation. Firstly, as the sphere of finance was becoming more and more opaque, traditional regulatory tools and methods were becoming progressively inadequate in ensuring supervision and regulation of new financial practices. In other words, few regulators really knew what was going on: the growing complexity of modern finance meant that there was very little formal understanding of the dynamics driving the international credit system. Secondly, while at the level of the BIS and other regulatory institutions (even the IMF) research had been done in the area of asset price inflation and credit risks, and while the dangers of the exploding credit markets had been pointed out in various discussion papers and research publications, this work proved to be too sensitive and for political reasons never found its way into the official policy language of the time.

The third important aspect of the NIFA debate of the 1990s was that, as noted above, while international in aspiration, the NIFA of 1999–2001 mainly focused on one specific part of the global financial system: the emerging market economies. Its key principles centred on the notion that it is the public sphere of political economy, or the state, that accounts for major crisis in the world of global capital markets. As such, NIFA never sought to address the problems that were brewing in the 'private' arena of finance – the highly obscure yet exciting world of modern financial innovation. At its core, therefore, NIFA has always been pro-market,

32. See, for example, Carlos Pelaez, *Regulation of Banks and Finance: Theory and Policy after the Credit Crisis* (Basingstoke: Palgrave, 2009).

33. Carolyn Currie, 'A New Theory of Financial Regulation: Predicting, Measuring and Preventing Financial Crises', *Journal of Socio-economics* 35, no. 1 (February 2006): 48.

reflecting Alan Greenspan's presumption that actors' self-interest ensures market stability.[34] And this, we argue, is where the problem lies.

Subsidised Neoliberalism: The Subprime Crisis and Anglo-Saxon Capitalism

As noted above, NIFA never sought to address the brave new world of risk management and its systemic consequences. Yet it is this very arena of finance that turned out to be the epicentre of the global credit crunch of 2007–9. Although mechanically the crisis was generated by the enormous frauds of the subprime, it would never have reached its global magnitude were it not for the newly invented instruments of financial recycling. In essence, therefore, the credit crunch is the crisis of privately invented 'money', or rather what was assumed to be money.[35]

The credit boom of 2002–7 was centred on the idea of infinite market liquidity. This belief was nothing other than a delusion that blinded financiers into taking on multi-billion dollar parcels of debt. This delusion led politicians, regulators and homebuyers to believe that global capitalism had entered into a new era of resilience and prosperity based on deregulated credit, 'scientific' risk management and financial sophistication. As in the case of any other financial bubble of the past few decades, the idea was held up by many distinguished economists in prestigious universities who maintained that at long last an entirely new economic system had emerged, leaving, once and for all, the boom and bust pattern of 'older' capitalism behind us.[36]

What these prophets of the latest 'new economy' failed to notice, however, was that the liquidity of the financial market, particularly in the US financial system, was underpinned by enormous inflows of funds from around the world. Some of the sources of these inflows were easy to identify, some less so.[37] The most widely known dimension of the financial subsidy has been the considerable holding of US Treasury bonds by foreign investors, mainly the Japanese, Chinese and Middle Eastern governments. Mainland China is currently the largest holder of

34. Alan Greenspan, 'We Will Never Have a Perfect Model of Risk', *Financial Times*, 16 March 2008; Greenspan, Interview for CNBC.

35. Anastasia Nesvetailova, 'The Crisis of Invested Money: Liquidity Illusion and the Global Credit Meltdown', *Theoretical Inquiries in Law* 11, no. 1 (January 2010): 125–47.

36 Anastasia Nesvetailova, *Financial Alchemy in Crisis: The Great Liquidity Illusion* (London: Pluto, 2010).

37. Anton Brender and Florence Pisani, *La Crise de la Finance Globalise* (Paris: Editions la Découverte, 2009); Herman Schwartz, *Subprime Nation: American Power, Global Capital, and the Housing Bubble* (Ithaca, NY: Cornell University Press, 2009); Warnock and Warnock, 'International Capital Flows and US Interest Rates'.

US Treasuries, controlling, as of November 2009, $789.6 bn. It is followed by Japan ($757.3 bn), the UK ($277.5 bn), oil exporters ($187.2 bn) and the Caribbean banking centres ($US 179.8 bn).[38] In November 2009 total foreign holdings of US Treasuries amounted to $3597.5 bn.

Here, it is notable that the figures for the UK (which include, significantly, the Channel Islands) and the Caribbean banking centres largely represent the holdings of US Treasuries in tax havens, and hence the ultimate ownership of these bonds is unknown. Yet it is reasonable to assume that a proportion of the holdings is American. Hence we would put the amount of 'subsidy' provided by foreign holdings of US Treasury bonds in the $3 trillion bracket – a figure well known and certainly a cause for concern, both for US government officials and economists studying the problem of 'global imbalances'.[39] One direct effect of the foreign holdings of US government paper has been the support that this credit line has provided to a consumer-driven pattern of economic growth in the US. This issue has been examined in much of the recent literature and warrants no further discussion here.[40]

Less visible were other inflows of capital that were revealed as the crisis began to unfold. In terms of sheer volume, most important were foreign holdings of agency-issued Mortgage-Backed Securities (MBS), namely those issued by quasi-governmental lending institutions (the Federal National Mortgage Agency, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac). By 2008 these amounted to approximately $1.5 trillion (or 23 per cent) of agency debt.[41] Warnock and Warnock suggest that the Treasury data (on which Schwartz relies) consistently overestimate foreign holdings. Nonetheless, they come to the conclusion that the combined effects of foreign inflows, namely Treasury bonds and agency debt holdings, 'have had a statistically and economically significant impact on U.S. long-term rates'. More specifically, they argue that:

> by depressing long-term U.S. rates, [foreign inflows] have spurred U.S. economic activity. In a world of substantial inflows into U.S. bonds, Fed policy is less restrictive than otherwise. At a sectoral level, one expects the most interest rate sensitive sectors, such as housing, to bear the bulk of this

38. Department of Treasury/Federal Reserve Board, 'Major Foreign Holders of Treasury Securities': http://www.ustreas.gov/tic/mfh.txt (accessed 9 March 2010).

39. Barry Eichengreen, *Global Imbalances and the Lessons of Bretton Woods*, Cairoli Lectures Series (Cambridge, MA: MIT Press, 2007).

40. Robert Shiller, *The Subprime Solution* (Princeton, NJ: Princeton University Press, 2008); George Soros, *The New Paradigm for Financial Markets* (New York: Public Affairs, 2008); Graham Turner, *The Credit Crunch* (London: Pluto, 2008); Anthony Gamble, *The Spectre at the Feast: Capitalist Crisis and the Politics of Recession* (Basingstoke: Palgrave Macmillan, 2009).

41. Schwartz, *Subprime Nation*, 16.

> effect. Indeed, we show (not surprisingly) that U.S. mortgage rates are also depressed by the foreign inflows.[42]

In other words, the authors believe that the foreign flows allowed the Fed to maintain a less restrictive policy and, in addition, ensured that 'real' interest rates, the ones paid by companies and consumers, were roughly 50 points lower than was warranted by the fundamentals. In the years prior to the crisis, the higher rate of growth of the US economy as compared to a slower pace of economic growth in continental Europe was taken as 'proof' of the merit of the neoliberal model. However, the authors suggest that the apparent superior performance of the US economy was at least partly due to the foreign inflows and had little to do with the neoliberal model as such.[43] The reverse is also true. Indeed, as we argue in this article, if foreign inflows into the US economy, particularly the foreign holdings of agency debt, decline after the crisis, then presumably the extra stimulus to the US economy provided by the low interest rates would cease to be available.

Another – and even less visible – channel of capital into the US was the European recycling of American subprime CDOs. One of the surprising dimensions of the unfolding crisis was that, initially, European banks lost more from the American subprime crisis than American banks. In fact, according to the Institute of International Finance, as of July 2008 European banks have borne slightly over 50 per cent of the total losses from the crisis, while American banks accounted for 'only' 36 per cent. The reason for the discrepancy was that American banks were able to sell on subprime-related CDOs in growing volumes to European banks, particularly in the later years of the bubble (2006 and 2007). By 2007 European banks' holdings of CDOs overtook those of American banks and stood in excess of $300 billion.[44] The sale of CDOs, we argue, constituted another source of inflow of funds to the US economy. The discrepancy between the US and European exposure to CDOs was also reflected in the eventual map of losses from the credit crunch. In December 2009, according to the calculations of the Bank of America Merill Lynch, Europe's exposure to all major troubled US financial institutions through synthetic CDOs was consistently larger than that of the US itself (see *Table 1*).

Altogether, if we add up all these foreign holdings of various types of American debt, they amount to roughly $5 trillion of foreign inflows into the US economy. The obverse also holds true: had the American banks been unable to pass on their CDOs to European banks (as was the case

42. Warnock and Warnock, 'International Capital Flows and US Interest Rates', 904.

43. Ibid.

44. Anastasia Nesvetailova and Ronen Palan, 'A Very North Atlantic Credit Crunch: Geopolitical Implications of the Global Liquidity Crisis', *Journal of International Affairs* 62 (Fall/Winter 2009): 165–85.

Table 1: Global synthetic CDO exposure to troubled US financial firms.

	Fannie Mae*	**Freddie Mac***	**AIG**	**LEH**	**Washington Mutual**
USA	143	51	861	994	803
Europe	187	159	1153	1364	1047
Asia Pacific (excluding Japan)	22	17	142	119	154
Japan	36	24	167	157	155

Note: The data in the table represent exposure to either Fannie Mae or Freddie Mac. In addition, global synthetic CDO tranches had combined exposure to both names in an amount of 815 US tranches, 749 European tranches, 75 Asia Pacific tranches and 114 Japanese tranches.

Source: Tracy Alloway, '"More Bad News" on Bank CDO Exposures to Come, BofAML says', *FT Alphaville*, 22 December 2009 (data from S&P).

with the East Asian banks), then the subprime pyramids would have either collapsed earlier or, at the very least, been much smaller in size.

Such a mountain of credit inflows reveals three issues about the nature of the global credit crunch. Firstly, there was a pervasive delusion of wealth in the US during the period 2002–7. The apparent 'success' of the innovative financial mechanism in the US during that period – viewed at that time as testimony to the creativity and energy of a relatively deregulated market – was largely based on the ability of financial institutions to transform these inflows of debt into 'liquid' capital, most immediately in the subprime industry but also at the broader level of the securitisation-driven financial boom. Secondly, the magnitude of the inflows explains why the credit crunch could have remained neither a mere subprime crisis nor a US/City of London crisis. The geography of the 'sponsors' of the US economy implies that the subprime fiasco was bound to affect the US creditors as well, hence transforming itself into a global crisis. Thirdly, the $5 trillion or so of inflows suggests that geopolitics will play a crucial role in shaping the new regulatory map of post-crisis finance and the global political economy. After all, it was the US that after the Second World War ensured that it was creditors, rather than debtors, who would dictate the terms of international financial governance.[45]

To put it crudely then, Anglo-Saxon liberalism functioned as an apparently successful model into the first decade of the 21st century not least due to the massive amount of credit inflows from East Asia, the Middle East and Europe into the financial systems of the USA and the UK. Our thesis is that the future survival of the Anglo-Saxon model depends largely on the ability and, more importantly, willingness of the creditor states to continue subsidising Anglo-Saxon capitalism. We are very doubtful they will. But before examining the geopolitical map of the crisis, let us briefly examine current plans for financial regulation.

45. Susan Strange, *Casino Capitalism* (Oxford: Blackwell, 1986).

Economics and Regulation in Light of the Credit Crunch

The global credit crunch has raised serious concerns about the state of the discipline of economics. Indeed, many observers of the crisis view it as evidence of the profound fallacies and absurdities of the key tenets of mainstream economics.[46] The credit crunch, in other words, is as much the crisis of the economics profession as it is the crisis of securitisation. Or is it?

On the one hand, academic economists remain defensive about their profession and its key assumptions. In May 2009, for instance, N. Gregory Mankiw, a Harvard economist and author of one of the key textbooks in macroeconomics, argued: 'Despite the enormity of recent events, the principles of economics are largely unchanged.'[47] On the other hand, economists also claim, with some justification, that using existing tools of economic analysis, they could easily have shown that the subprime market was bound to collapse, and that the new techniques of risk calculation were nothing of the sort, but instead merely recycled and reshuffled risk.[48] It is a fact, though, that as the storm was gathering over the global financial system, most of them chose not to do so.[49]

We find that the reasons for this trend are systemic rather than behavioural. Most of the research in finance during recent years was focused on modelling actors' behaviour, and thus ignored the systemic nature of financial markets. The individuals who did warn against the dangers of the credit boom (like Nouriel Roubini[50] and Claudio Borio of the BIS[51] or even George Magnus of UBS) often did not have a model to speak of and, without a model, alas, they were dismissed as mere pessimists. When in 2005, for instance, Raghuram Rajan, then the chief economist of the IMF, warned about the crisis looming over the global financial markets, Lawrence Summers – now an adviser to President

46. For example, Robert J. Barbera, *The Cost of Capitalism: Understanding Market Mechanism and Stabilizing Our Economic Future* (New York: McGraw-Hill, 2009); and John Cassidy, *How Markets Fail: The Logic of Economic Calamities* (London: Alan Lane, 2009).

47. Cited in Floyd Norris, 'Global Crisis Yields Books Worth a Read', *International Herald Tribune*, 26–7 December 2009, 11–12.

48. See, for instance, Willem Buiter and Anne Sibert, 'Deflationary Bubbles', *Macroeconomic Dynamics* 11, no. 4 (September 2007): 431–54.

49. Willem Buiter is a notable exception to this trend.

50. Nouriel Roubini, 'Revised Q2 GDP Figures: Much Worse Than the Headline ... Beware of the Spin Doctors', 30 August 2006: http://www.rgemonitor.com/blog/roubini/archive/2006–08/.

51. Claudio Borio, 'Market Distress and Vanishing Liquidity: Anatomy and Policy Options', BIS Working Paper no. 158, July 2004, Basle: Bank for International Settlements.

Obama – dismissed Rajan's paper as 'largely misguided', saying that it could harm the world by encouraging unwise regulation.[52]

Unsurprisingly, therefore, in light of the credit crunch, the claim that mainstream economics has all the right tools to interpret the crisis and develop a response to it increasingly becomes less and less believable. First of all, although it may sound odd, there is no theory of finance *as a system* in mainstream economics. Developments in finance simply do not conform to a conventional neoclassical model of the economy founded on perfect competition and complete information. Unlike any other market, the financial market has its own unique dynamics – which was the key point of Keynes and Minsky. Indeed, the financial system is built around risk and information; it trades in expectations and promises; it also, crucially, trades in debt (and thus confidence). As such, the financial markets are defined by their own, endogenous rhythm that sets them aside from any other economic sphere. Secondly, modern finance is performed by mathematicians and physicists rather than economists, however contested the theories of the latter might be.[53] The dynamics of any given financial system, however, are not abstract; they are defined by the institutional and political context. As a result, finance is a complex, future-oriented socio-political system that could not be further away from the market for retail goods or even services.[54] That makes the key assumption of mainstream economics – that all markets are essentially the same – simply wrong.

All this means that the credit crunch must have dealt a serious blow to the theoretical foundations of 'neoliberal economics' and the dominant approach to managing crises. But has it? It is too early, of course, to speak with a degree of confidence about the impact of the credit crunch on the economic profession as a whole. Yet our very impressionistic account suggests that at the level of the general paradigm of 'neoclassical economics' not much has changed. At the level of theory, in the midst of the imploding financial markets and banking systems in 2008, there was a seemingly serious debate about a return to Keynesian norms of financial regulation and a Minskyan framework for understanding finance. Yet with a feeble recovery under way in parts of the world economy, the sombre messages of Keynesianism appear to have been forgotten very quickly.

At the level of finance practice, the same techniques of investment banking are re-emerging yet again. Only now they are equipped with

52. Norris, 'Global Crisis Yields Books Worth a Read', 12.

53. Donald McKenzie, *Material Markets: How Economic Agents Are Constructed* (Oxford: Oxford University Press, 2009); Donald MacKenzie, Fabian Muniesa and Lucia Siu, eds, *Do Economists Make Markets? On the Performativity of Economics* (Princeton, NJ: Princeton University Press, 2007).

54. Avinash Persaud and John Nugee, 'Redesigning Financial Regulation', in *Global Finance in the New Century: Beyond Deregulation*, eds Libby Assassi, Anastasia Nesvetailova and Duncan Wigan (Basingstoke: Palgrave, 2007).

new models, supposedly even more 'sophisticated' and hence allegedly capable of solving the 'pricing mismatches' of financial instruments revealed by the crisis. The quants, in turn, are back at their desks cooking up new financial vehicles – only competition has declined and hence both the opportunities and the profits are larger.[55] There is even talk of a new speculative bubble, spurred by the environment of unprecedentedly low interest rates. These and other post-crisis developments suggest that the credit crunch, despite its ostensible severity, has been understood in mainstream economics as a cyclical event, the sort of market failure that does occur occasionally,[56] but ultimately has the effect of bringing the system towards a long-term equilibrium.[57] This mainstream reading of the crisis therefore implies that the post-credit crunch world needs to 'fine-tune' financial regulation[58] in order to save the essence of banking and finance and prevent a similar crisis in the future.

An important dimension of the continuing post-crisis debate supports our rather pessimistic impression of the long-term impact the credit crunch will have on mainstream economics. The G-20 plan for strengthening the global financial system is disappointingly reminiscent in tone of its fruitless predecessor, the NIFA of the late 1990s. Indeed, as stressed in the G-20 communiqué:

> Regulators and supervisors must protect consumers and investors, support market discipline, avoid adverse impacts on other countries, reduce the scope for regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the marketplace.[59]

Formulated in this way, the parameters of state–market interaction are precisely the notions commonly associated with the neoliberal project. Thus while acknowledging a series of human and systemic failures in finance that contributed to the credit crunch, the current policy discussions about the future of finance fail to address the ability of financial engineers to transform obscure debts into 'liquid' assets. We find that behind such reluctance lies the fact that the ability to 'liquefy' and trade toxic debt – the process at the very core of the credit crunch – has been commonly interpreted as 'financial innovation'. Even in times of severe crisis,

55. Renee Carmona and Ronnie Sircar, 'Financial Mathematics '08: Mathematics and the Financial Crisis', *SIAM News*, Society for Industrial and Applied Mathematics, 10 January 2009: http://www.siam.org/news/news.php?id=1509.

56. As opposed to systematically, which is what Keynesians believe.

57. For a synthesis of views, see Carmen Reinhart and Kenneth Rogoff, 'This Time Is Different: A Panoramic View of Eight Centuries of Financial Crises', NBER Working Paper no. 13882, March 2008.

58. Rather than change the structure of the financial system as a whole.

59. G-20, 'Progress Report on the Actions to Promote Financial Regulatory Reform Issued by the US Chair to the Pittsburgh G-20 Summit', 25 September 2009: http://www.g20.org/Documents/pittsburgh_progress_report_250909.pdf.

it appears, it is too controversial to challenge the idea of an innovative mechanism of the free market. Indeed, the authors of the Geneva report, one of the high-profile policy publications on the crisis, are certain about the ultimately beneficial role of financial innovation:

> Our preference is for light-touch regulation (with one exception on housing loan-to-value ratios . . .). In general, restrictive control of financial intermediation stifles innovation and, especially if government starts to intervene with direct controls over bank lending, interferes with the appropriate allocation of capital.[60]

Generally, therefore, the mainstream solutions to the global credit crunch are based on the cyclical theory of financial crisis and on the belief that the market mechanism, with appropriate assistance from the state, can balance itself out. The regulatory and policy adjustments necessary for stabilisation and recovery, in turn, should not compromise the abiding principles of free competition:

> It is important, indeed crucial, that any reforms in, and adjustments to, the structure of markets and regulation not inhibit our most reliable and effective safeguards against cumulative economic failure: market flexibility and open competition.[61]

According to cyclical theories of the crisis, the real challenge of the global credit crunch is its sheer magnitude. As a result, in the emerging debate over an appropriate regulatory response the talk is of 'fine-tuning' the existing principles of financial policy and governance, importantly, without killing off the underlying drive for financial innovation, competition and liberalisation of markets. The logic behind these proposals is that, as a principle, risk-taking is a healthy and positive part of economic activity, but for reasons specific to the period 2002–7 risk has been mis-priced and misallocated. The better approach to financial regulation in the future should therefore compensate for these flaws, without undermining the key benefits of innovative, privatised finance.

One possible way of improving financial governance being discussed in the post-credit crunch context is the so-called 'new macroprudential approach'. Unlike the pre-crisis paradigm of financial regulation that targeted mainly quantitative, microeconomic indicators of financial stability, the macroprudential framework focuses on qualitative parameters of financial risk. In this, the new approach is ambitious indeed: it aims to compensate for the deficiencies of the institution-by-institution regulatory focus and incorporate the systemic parameters of financial stability into the scope of financial regulation. The new macroprudential focus

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60. Mathias Brunnermeier, 'Deciphering the 2007–2008 Liquidity and Credit Crunch', *Journal of Economic Perspectives* 23, no. 1 (2009): 10.

61. Greenspan, Interview for CNBC.

is premised on the apparently serious realisation that the institution-by-institution-based, microprudential supervision has not worked. Potentially, therefore, the macroprudential framework is a long-needed step away from the pre-crisis vision of financial regulation.

Overall, however, the proposal, while ambitious, is vague on concrete detail. Firstly, while at the core of the macroprudential approach is the idea of better managing 'systemic risk' in finance, there is currently very little formal understanding, especially at the international level, of what 'systemic' risk might be and, crucially, how it develops in the course of an economic cycle.[62] Secondly, the 'macroprudential' approach, as John Plender argues,[63] derives from the assumption that had macroeconomic analysis played a larger role in governing finance during the 2002–7 credit boom, the crisis might have been averted. Under closer scrutiny, this argument is quite naïve: for a while now, macroeconomic governance has been based on obsolete, national-based statistics and the assumptions of monetarism. The world of finance, however, has moved economies far beyond national boundaries, making macroeconomic targeting and even analysis somewhat old-fashioned in the age of obscure financial engineering. Thus while the idea of incorporating qualitative indicators of risk in the framework of financial governance is promising, the practicalities of such a proposal remain vague, both conceptually and politically.

On the whole, therefore, it does *appear* that the credit crunch has not shaken the foundations of the neoliberal paradigm of financial governance and hence the private face of the neoliberal project we identified above. Although the crisis has brought to the surface many inconvenient facts about the validity of orthodox economic models and approaches to financial regulation, the core premise of neoliberal finance – the notion of the efficient market and the benefits of financial innovation – remains unchallenged. Alternative approaches to financial regulation meanwhile, although back on the discussion table, are yet to be agreed and tested in order to constitute a viable alternative to neoliberal finance. In other words, the announcements about the death of neoliberalism in the world of finance seem premature.

Anglo-Saxon Capitalism versus the World

Or so it seems. Scratch the surface of post-crisis developments, and it becomes evident that another important process is taking place. Here we note a second – much wider – group of post-crisis reflections that

62. Paul Davies, 'Banking Goes Bananas – Efficiency and Brittleness in Finance', Keynote Address to the Workshop on Securitisation, Risk and Governance, City University London, 6–7 May 2009, mimeo.

63. John Plender, 'Insight: Re-regulation Won't Curb Worst Excesses', *Financial Times*, 26 May 2009.

encompasses policy discussion at various levels, and includes dialogue with private financial actors. With some variations, what defines these views is their critical attitude to some of the new financial practices and products that became the defining features of the latest bout of financial securitisation and 're-securitisation'. These practices, it is argued, have made the system as a whole less transparent and more obscure, not only aggravating the gap between the regulators and financiers but also creating opacity within the financial markets themselves. According to Francesco Papadia, director-general of markets operations at the ECB, 'securitisations have become ridiculously complex. Structures should become simpler, plain-vanilla deals.'[64] It is this complexity – or, more bluntly, obscurity – of finance that needs to be addressed by the new post-crisis regulatory paradigm. It is notable that such criticism has been stronger in Europe than in the US, although many heterodox American political economists have long been raising doubts about the exigencies of deregulated finance.[65] Unfortunately though, despite the apparent failure of orthodox economics in anticipating and understanding the global crisis, heterodox economists are yet again absent from the current policy discussion in the US and UK.

The heart of the matter, according to these (rather pessimistic) views, is that, left to its own devices, the financial system tends to become speculative and generates strong incentives for unreasonable risk-taking. Lack of transparency that arises from the use of 'innovative' techniques, such as offshore special purpose vehicles or over-the-counter trading, and the sheer complexity of financial instruments, only serves to aggravate these tendencies. The solution, therefore, lies in a comprehensive set of coordinated regulations on all the factors contributing to the obscurity of

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64. Gillian Tett and Alice van Duyn, 'Under Restraint', *Financial Times*, 7 July 2009.

65. See, in particular, Victoria Chick, 'Some Reflections on Financial Fragility in Banking and Finance', *Journal of Economic Issues* XXXI, no. 2 (1997): 535–41; Gary Dymski, 'Afterword: Mortgage Markets and the Urban Problematic in the Global Transition', *International Journal of Urban and Regional Research* 33, no. 2 (2009): 427–42; Gary Dymski and Robert Pollin, 'Hyman Minsky as a Hedgehog: The Power of the Wall Street Paradigm', in *Financial Conditions and Macroeconomic Performance: Essays in Honour of Hyman Minsky*, eds S. Fazzari and D. Papadimitrou (Armonk, NY: M.E. Sharpe, 1992); Jan Kregel, 'The Natural Instability of Financial Markets', Levy Institute Working Paper no. 523, December 2007; Hyman Minsky, *Can It Happen Again? (*Armonk, NY: M.E. Sharpe, 1982); Martin Wolfson, 'Neoliberalism and the International Financial Instability', *Review of Radical Political Economics* 32, no. 3 (2000): 369–78; Martin Wolfson, 'Minsky's Theory of Financial Crises in a Global Context', *Journal of Economic Issues* (June 2002): 393–400; Randall Wray, *Money and Credit in Capitalist Economies: The Endogenous Money Approach* (Aldershot: Edward Elgar, 1990); Randall Wray, 'Endogenous Money', Levy Institute Working Paper no. 512, 2007.

finance and the ambiguity of its functions. The range of factors includes the various platforms in which these markets evolved, offshore and OTC deals, the instruments used in generating complex derivatives trades and, crucially, the financial actors themselves. This is the view that is currently on the ascendant in continental Europe.

In this context it is interesting to note that the G-20 meetings in London (May 2009) and Pittsburgh (September 2009) show, if anything, that a rift opened up between the Anglo-Saxon countries, on the one hand, and France, Germany and possibly China on the other – although China's official policy on these matters is not easy to ascertain.[66] Regarding the key lessons and policy challenges posed by the credit crunch, it seems that the US managed to frame the discussion around a popular, if misguided, 'naughty Asians' theory of the financial crisis.

The theory, long advocated by Ben Bernanke,[67] suggests that disruptions in the global saving patterns perpetrated by the East Asian economies, particularly China, which maintain the value of their currency artificially low and discourage consumption, resulted in a global 'liquidity glut'. The resulting flow of capital into the advanced economies, in turn, led to the severe underestimation of risks and hence contributed to the credit bubble in the Anglo-Saxon countries.[68] The solution to these imbalances harks back to the classical 'three locomotive' scenario advocated by the US in the 1970s. Although there is recognition – perhaps for the first time in US policy circles – of the need to raise saving ratios and encourage domestic production, the US still demands that China and other capital exporters respond to the Anglo-Saxon crisis by increasing domestic consumption.

At the same time, this is only one side of the story. Other dimensions of the post-crisis policy debate show that the Anglo-Saxon world itself is no longer united. In the UK, there is evidence of an important battle between the Bank of England, which is increasingly siding with the British Conservative Party, and the FSA, apparently closer to the current Labour government.[69] Although in the run-up to the credit crunch both institutions performed equally poorly in their respective tasks of safeguarding financial stability, the current change of tune is intriguing

66. Sam Jones, 'UK slams EU hedge fund rules', *Financial Times*, 7 July 2009.

67. Ben Bernanke, 'The Global Saving Glut and the US Current Account Deficit', Remarks at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, 10 March 2005; Ben Bernanke, 'The Crisis and the Policy Response', Stamp Lecture, London School of Economics, London, 13 January 2009.

68. Krishna Guha, 'Paulson Says Crisis Sown by Imbalance', *Financial Times*, 1 January 2009.

69. George Parker and Chris Giles, 'UK's Darling Seeks Global Banking Deal', *Financial Times,* 19 January 2010.

indeed. The FSA is taking a far stricter approach to market regulation, siding decidedly with continental European views. Indeed, following the experience of France, in late 2009 Alistair Darling, Chancellor of the Exchequer, imposed a one-off 50 per cent tax on bankers' bonuses over £25,000.

More recently a clear rift has also surfaced at the Bank of England itself. Governor of the Bank Mervin King has adopted the 'European' view that modern banking combines two major functions – namely, the traditional 'utility' function whereby banks serve as the key channel of the national and international payments system and intermediate between lenders and borrowers, and a modern investment banking function which, King argues, is nothing but a 'casino'. Accordingly, Mr King advocates separating the two functions in order to ensure that gamblers are no longer in a position to undermine the entire financial system and thus the public good of financial stability.[70] This vision, of course, has been the main message of Keynes' theory of finance or, more recently, that of Susan Strange. Reminiscent of the Glass-Steagall Act of 1933, this proposal, along with the idea of a Tobin tax currently on the agenda of the world's finance policy-makers,[71] could not be further away from the principles of market efficiency and the key tenets of orthodox economics.

Deep rifts have also emerged in the US, where in January 2010 the Obama administration announced the most radical crackdown on Wall Street since the 1930s. The plan, in some ways echoing UK and European ideas about separating 'utility' and 'casino' banking, aims to ban banks' proprietary trading activities and divest their internal hedge funds and private equity groups. All three types of financial transactions have become strongly associated with the gambling facet of contemporary finance. It remains to be seen what the real consequences of Obama's plan might be for the American financial system, but observers have commented that the reform could undermine the efforts to ensure international coordination of the post-crisis financial reform.[72]

70. Chris Giles, 'King Attacks Line on Bank Reform', *Financial Times*, 21 October 2009.

71. This article is being prepared (January 2010) as the world's finance ministry officials are due to meet in London to discuss the options for a new system of financial regulation. These include a levy on banks to cover the implicit insurance they receive from the taxpayer, or a so-called Tobin tax on transactions. We are very doubtful the Tobin tax will be agreed upon by all parties: for political reasons, historically, the idea of a tax on financial transactions has remained purely academic. If it *is* introduced though, this could be the most radical political step to regulate finance in the post-Bretton Woods era and would reinforce our argument about the end of neoliberalism in finance.

72. Gillian Tett, 'Pitchforks Take on Terminators', *Financial Times,* 21 January 2010.

Mirroring these and other internal conflicts, there is clear evidence that the Franco-German view as represented at G-20 meetings is on the ascendant. As we saw above, the same G-20 London communiqué, on the one hand, repeats some of the conventional neoliberal mantras and, on the other hand, drastically expands the scope for international regulation and cooperation, promising that 'all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight'.[73] The communiqué calls, for the first time in any discussions on financial regulation over the past 30 years, for tighter regulation of tax havens, accounting standards and credit rating agencies. Interestingly, all three are explicitly 'European issues', debated at length among the key members of the EU zone for the past decade or so but rarely flagged as concerns in the Anglo-Saxon countries. Indeed, and in line with the prevailing mood in the EU zone – and in contrast to current debates in the Anglo-Saxon countries – the G-20 proposed new regulations on all aspects of the international financial system: the regulation of institutions, the regulation of markets (offshore and OTCs) and the regulation of the private auditory and regulatory mechanisms of the neoliberal era (credit rating agencies, accounting standards and so on).

The post-crisis G-20 communiqués, therefore, combine two apparently contradictory trends. On the one hand, the language used by global policy-makers is the traditional language of mainstream economics or, put differently, the very theory that provided the theoretical underpinnings to the neoliberal regulatory environment. At the same time, in terms of the substantive proposals, and for anyone schooled in classical neoliberal ideals of market deregulation, decentralisation and reduced state intervention, the G-20 plans for financial reform clearly represent an unambiguous departure.

This suggests that the EU countries, led by the Franco-German alliance, are playing a far more important and active role in defining the future regulatory structure of global finance than is often acknowledged. It also stands to reason that China, which has already adopted the European version of accounting standards over the American one, might be siding with a European perspective on financial regulation rather than with the free-for-all Anglo-Saxon variant. Within the Eurozone, there is growing concern that while countries such as Spain and Germany adopted a prudential approach to financial regulation before the crisis – with the result that German and, in particular, Spanish banks were effectively prevented from joining the securitisation orgy – they were still drawn into an Anglo-Saxon-led financial crisis through the 'back door', that is, their London branches.

73. G-20, 'Declaration on Strengthening the Financial System – London Summit', 2 April 2009: http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

So whereas Deutsche Bank, for instance, was highly regulated in Germany, its London subsidiary was an active player in the securitisation market, which eventually pulled the entire bank into the maelstrom of subprime-related losses. In the case of Spain, the dynamics were more complex. Historically, Spain adopted a more stringent regime of financial regulation (in response to the Argentine 2001 crisis that impacted heavily on the Spanish banking system). As a result, during the years of the credit boom the Spanish financial system was heavily criticised for being non-dynamic and conservative. But once the crisis struck, Spanish banks fared well, with some of them emerging among the largest banking groups in the world. Yet the Spanish economy is another matter, having been affected by its own version of the housing bubble. France, too, is a distinct case, as leading French banks used their London subsidiaries to bypass French regulations. These EU countries ended up suffering from the losses incurred by a financial system they never approved of. Their tactics are clear: either reform the world's financial system (which was their very clear aim in the series of G-20 gatherings) or, alternatively, find ways of shielding their own banking systems from Anglo-Saxon-led deregulated finance. At the time of writing, it is the European approach to tighter financial regulation that appears to be setting the tone in the post-crisis multilateral gatherings. What the future holds is unclear.

Conclusion

In this article, we have identified and examined the public, private and regulatory components of neoliberalism in finance before and after the credit crunch. We have argued that while the public dimension of the neoliberal dogma appears to have survived the financial meltdown, at least in economic and policy-making circles in the Anglo-Saxon countries, its two other private and regulatory constitutive elements were irreversibly shaken by the financial implosion. Indeed, two years after the crisis first shattered the world markets, the tone of the debate within the economics profession suggests that neoliberal ideology has not been dented as severely as one would expect. The economics of neoliberalism have changed and, with them, we believe, so has the fate of neoliberalism as the dominant ideology of global governance.

At the same time, we acknowledge that plans and announcements at international gatherings such as the G-20 rarely tend to amount to concrete policy or institutions.[74] Although at first sight the global credit crunch has

74. The G-20 Pittsburgh progress report does suggest that all the measures agreed in London are now being taken ahead (G-20, 'Progress Report on the Actions to Promote Financial Regulatory Reform Issued by the US Chair to the Pittsburgh G-20 Summit').

destroyed the last foundations of the neoliberal project, the reality of the post-crisis world is clearly more complex. For instance, while many commentators foresee an imminent China-orchestrated demise of the dollar as the world currency, China itself is caught in many dilemmas. It has invested heavily in US Treasuries and in the quasi-nationalised agency bonds (such as Fannie Mae and Freddie Mac) and thus has a clear interest in maintaining the US dollar at some level. At the same time, reliance on US consumers is a problem for China, and there are already signs of a shift towards an endogenous mode of development. Yet generally, it seems unlikely that China will let the US repeat the Japanese experience of sliding into a prolonged recession.

The nuances in post-crisis financial regulatory initiatives highlighted above are also suggestive. In terms of the current regulatory proposals, the European states, led by France and Germany, are clearly setting the tone for a series of far more comprehensive rules and regulations in finance. Yet at the same time, as a result of the post-crisis banking reform, American banks appear to be stronger and more competitive than their European counterparts, many of which are still sitting on 'toxic' securities. Moreover, all the major players have a clear and unambiguous interest in the health of the US economy (but far less in the health or success of the City of London). Also, while the tone and language of many post-credit crunch initiatives appear to have departed from earlier dogmas of the efficient market theory of finance, it is likely that few of them would materialise into effective tools for dealing with systemic risk in the very near future.

Against this background, the shift of power from the Anglo-Saxon core to Europe and East Asia is evident. It is also clear that the global credit crunch has been a catalyst in this process. Emboldened by the green shoots of recovery, Anglo-Saxon governments may resist deep changes to the international architecture of finance, but it appears increasingly unlikely that European or East Asian governments will be prepared to continue subsidising the Anglo-Saxon economies and supporting their commitment to 'neoliberalism'. All told, it seems to us that the neoliberal project that reigned supreme in the 1990s is well and truly dead.

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