Financial markets: masters or servants?[1]

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Abstract

Throughout the history of capitalism, there have been tensions between financial institutions and the state, and between financial capital and the firms and households engaged in the production and consumption of physical goods and services. Periods of financial sector dominance have regularly ended in spectacular panics and crashes, often resulting in the liquidation of large numbers of financial institutions and the reimposition of regulatory controls previously dismissed as outmoded and unnecessary. The aim of this paper is to consider measures to restore financial markets to their proper role, as servants rather than masters of the market economy and the society within which it is embedded.

FINANCIAL MARKETS: MASTERS OR SERVANTS?

Trade, and markets of one form or another, have always been part of human society. Borrowing and lending are similarly ancient and ubiquitous. On the other hand, markets for trade in financial obligations such as debts and future sales and purchases are specific to capitalism. The key financial institutions of capitalism, such as fractional reserve banking, joint stock companies and regular markets for trade in government bonds, date, in their modern form, from the 18th century, although precursors can be found as early as the 15th century in Italy and the Netherlands.

Throughout the history of capitalism, there have been tensions between financial institutions and the state, and between financial capital and the firms and households engaged in the production and consumption of physical goods and services. In some periods, most notably in the decades after World War II, financial markets were reduced to a subordinate role, channeling household savings into credit for business investment and (relatively constrained) consumer credit, under tight public regulation. In other periods, including the decades since the 1970s, financial markets became, or at least seemed to become, all-powerful 'Masters of the Universe'.

Periods of financial sector dominance have regularly ended in spectacular panics and crashes, often resulting in the liquidation of large numbers of financial institutions and the reimposition of regulatory controls previously dismissed as outmoded and unnecessary. These panics have typically precipitated lengthy periods of recession or depression, with high unemployment and slow or negative economic growth.

The financial crisis that engulfed the global economy in 2008 has been, so far, an archetypal example of this process. The power, and pretensions, of financial markets in the decades leading up to the crisis exceeded anything that had been seen in the past. The magnitude of the crisis was similarly impressive, with losses of billions or tens of billions of dollars becoming routine daily events, and talk of trillions becoming commonplace. At several points, it appeared likely that the entire global financial system might collapse, and this danger has not completely passed as this manuscript is prepared for publication (March 2011).

The aim of this paper is to consider measures to restore financial markets to their proper role, as servants rather than masters of the market economy and the society within which it is embedded. The paper is organised as follows. The first section provides a background to the crisis, showing how the Bretton Woods system restricted financial activity and the potential for financial panics. The breakdown of Bretton Woods was followed by a massive expansion in the scale, scope and speculative nature of financial activity. I next describe the global financial crisis that began in 2008 and shows how it was driven by the complex, interlinked and uncontrolled nature of the financial system. The European 'sovereign debt crisis' of 2010 is a continuation of the global crisis, but has been used by financial markets in an attempt to reassert their power. Section 3 deals with the reform of the international financial system. The central argument is that the idea of a 'global financial architecture' is misconceived. The necessary system is one of national (or EU-level) financial regulation, co-ordinated through international institutions. It is argued, in Section 4, that the central goal of national financial regulation should be to constrain the size and power of the financial system to levels appropriate to its role as a provider of services, ultimately dependent on the backing of the state. Finally, some concluding comments are offered.

BACKGROUND

Periodic financial crises and panics have been a feature of capitalism ever since the South Sea Bubble, which brought an end to the first great experiment with joint-stock corporations. By the 19th century, financial crises replaced crop failures as the primary cause of economic distress. Some notable examples include the 'Long Depression' following the Panic of 1873 in the United States, and the 1890s depression in Australia.[1]

None of these crises, however, were comparable in their effects to the Crash of 1929 and the subsequent Great Depression. As well as producing a decade of misery and deprivation, the Depression helped bring Hitler to power in Germany and was therefore a major cause of World War II.

Meeting in Bretton Woods, New Hampshire in 1944 to plan a postwar economic order, the Allied governments were determined to avoid a repetition of the disasters of the interwar years. Although the most radical proposals for financial reform, put forward by John Maynard Keynes, were rejected by the US government, the financial system that emerged from Bretton Woods was far more tightly restricted than any in the past.

The Bretton Woods system supported, and was supported by, Keynesian macroeconomic policies, operated at the national level with the aim (largely achieved for several decades) of maintaining full employment, price stability and fiscal balance.

Even during this postwar boom, the financial sector sought and found ways to undermine and avoid controls and regulations. The emergence of the 'Eurodollar" market in the 1960s, which facilitated trade in $US denominated financial instruments outside the control of the US Federal Reserve, was a crucial step in this respect.[2]

After Bretton Woods

The inflationary upsurge of the late 1960s rendered untenable key aspects of the Bretton Woods system, most notably the fixed US dollar price for gold. Although a variety of responses might have been possible, the gradual erosion of financial controls in the 1960s paved the way for a complete breakdown in the 1970s. Fixed exchange rates were replaced by attempts at flexible management, and then gave way to freely floating rates. Controls on international financial flows were relaxed, and ultimately abandoned. National financial systems were deregulated.

By the 1980s, almost nothing was left of the Bretton Woods system. Governments had little option but to obey the dictates of global financial markets, expressed most notably through the judgments of ratings agencies such as Standard & Poor's and Moody's. The volume of international financial flows grew to levels that had previously been unimaginable, then kept on growing even faster. By some measures, when the bubble burst in 2008, the total outstanding volume of financial assets was over a quadrillion dollars. [3]

By 2007, financial corporations accounted for 40 per cent of US corporate profits. The bulk of income growth in the United States over the period since the 1970s accrued to high income earners, an increasing proportion of whom derived their income directly or indirectly from the financial sector. In particular, those in the top 1 per cent of the income distribution approximately double their share of income. Within that group the top 0.1 per cent did disproportionately well. Similar, though less extreme, developments took place throughout the developed world. [4]

Nevertheless, by the mid-1990s, the beneficence of financial sector dominance seemed evident to all, particularly in the United States. Booming stock markets encouraged an atmosphere of triumphalism epitomized by such writers as Thomas Friedman[5] and Edward Luttwak. [6]

But the first signs of failure were becoming apparent. The global financial system was threatened in 1998 by the failure of Long Term Capital Management, a hedge-fund with leveraged borrowings in the trillions. The danger was averted by a bailout, hastily organized by the US Federal Reserve. The bubble and bust in dotcom stocks in the late 1990s repeated the pattern on a larger scale.

Bubble, bust and bailout

Although no-one predicted the exact course of the global financial crisis that began in 2008, a substantial minority of economists pointed to the unsustainability of the imbalances in the US and global economy that developed from the late 1990s onwards, and predicted that the resolution of those imbalances would require a painful adjustment and probably a recession, followed by more restrictive regulation of the financial system.[7]

By contrast, the dominant market liberal ideology encouraged the view that booming asset markets were benign. The massive growth in the volume of international financial transactions was seen as reflecting the (presumptively rational) voluntary choices of borrowers and lenders, and as a way of diversifying risk internationally. Like other aspects of the financial system that developed during the bubble era, this reasoning was reminiscent of the deacon in Oliver Wendell Holmes' poem who tried to build a carriage (the 'wonderful one-hoss shay') that could never break down, on the theory that a system always fails at its weakest spot.

> The way t' fix it, uz I maintain, Is only jest T' make that
> place uz strong uz the rest".

As applied to the global financial system, the 'one-hoss shay' theory provided two systems of protection against failure. First, risks were widely dispersed throughout the global financial system, so that a localized failure in any one economy could not cause significant loss to investors with highly diversified portfolio. Second, central banks extended 'too big to fail' protection to any institution large enough to be critical to the sustainability of the system as a whole.

The only way a system of this kind could fail was through a total global collapse. As Holmes' poem, written in 1858, described the end of the one-hoss shay

> went to pieces all at once,– All at once, and nothing first,–
> Just as bubbles do when they burst.

And that, more or less, is what happened.

In scale and scope, the crisis was larger than any financial failure since the Great Depression. The estimated losses from financial failures amounted to $4 trillion or about 10 per cent of the world's annual income. Losses in output from the global recession have also amounted to trillions, and recovery has barely begun.

Unlike the Great Depression, this crisis was entirely the product of financial markets. All of the checks and balances in the system failed comprehensively. The ratings agencies offered AAA ratings to assets that turned out to be worthless, on the basis of models that assumed that asset prices could never fall. The entire ratings agency model, in which issuers pay for ratings, proved to be fundamentally unsound, but, these very ratings were embedded in official systems of regulation. Crucial public policy decisions were, in effect, outsourced to for-profit firms that had a strong incentive to get the answers wrong.

The bailouts undertaken by the US and European governments in late 2008 only reinforced the bad incentives in the system. Financial sector participants kept most of the rich rewards they had reaped during the bubble years, when their activities had massively distorted the allocation of investment capital, and thereby reduced the sustainable growth rate of the economy. The terms on which public credit was extended for worthless assets were so generous that the financial sector has led the way in the recovery of corporate profits. Unsurprisingly, given these incentives, the behavior of the financial sector has changed hardly at all as a result of the crisis.

The European debt crisis

The role of financial markets in the European 'sovereign debt crisis' provides a good illustration of the extent to which the financial sector has reasserted its claims to mastery over the economy. In nearly all respects, the crisis is the result of the financial excesses of the bubble era and of the costly misallocation of resources it created.

Many of the European governments most severely affected by the crisis were in fiscal balance or surplus in 2007. The slide into deficit can be attributed to:

* The direct and indirect costs of financial sector bailouts (most notable in Ireland);

* The loss of revenue from the financial sector and from housing following the bursting of the bubble (most notable in Spain); and

* The fiscal impact of the general economic downturn and the cost of stimulus and relief measures.

Even in Greece, where fiscal profligacy was a primary cause of the crisis, financial enterprises were both leading accomplices in the evasion of eurozone fiscal targets and leading beneficiaries of the EU bailout. While ordinary Greeks have been forced to accept austerity measures, the US, German and French banks that made unsound loans can expect to be paid in full.

Yet the financial sector has presented itself as the guardian of fiscal probity, with ratings agencies downgrading public debt, and bond markets demanding cuts in public expenditure, invariably targeted at those who benefited least from the bubble.

[8] The most striking examples include the United Kingdom where the cost of the bank bailout is being used to justify ever-harsher treatment of the homeless and unemployed and Ireland where the government plans to sell most of the assets of the National Pension Reserve Fund (created to finance public service and social

welfare pensions) to pay off creditors of failed private banks. Elsewhere in Europe, 'austerity' proposals have generally been more reasonable, with a primary focus on proposals to enhance tax revenue and measures to reduce the cost of retirement incomes policies, mostly by increasing the age of retirement.

Budgets must balance in the long run, and policies of this kind are, to some extent, a necessary response to a real reduction in the net worth of governments as a result of the financial crisis. Nevertheless, the demands of the financial sector for austerity have produced an undesirable focus on measures to reduce budget deficits in the short term, at a time when the depressed state of the European economy implies the need for stimulus.

A striking example is that of the increases in Value Added Tax rates adopted in Spain, Portugal and other European countries. A far more sensible policy would have been to announce an increase in the VAT rate, deferred for two to three years. The effect on long-term fiscal balance would be only marginally smaller than that of an immediate increase. On the other hand, a deferred increase would stimulate demand in the short-term, as consumers seek to beat the tax increase. Such a temporary stimulus is exactly what is needed.

REFORMING THE INTERNATIONAL FINANCIAL SYSTEM

The aftermath of the crisis has produced a range of efforts to improve upon the systems of financial regulation that failed so spectacularly in 2007 and 2008. The most important instance is that of the proposed Basel III Accords on banking supervision. The draft rules reverse many of the presumptions that informed the 'light-handed' approach of the Basel II system, which failed spectacularly in the global crisis. Basel III involves a substantial increase in bank capital requirements. More importantly, the 'risk-based' framework of Basel II, in which banks were largely free to make their own judgments about the riskiness of their capital base has been replaced by more prescriptive requirements to hold specific capital assets.

These efforts have not, however, been informed by any rethinking of the role of the financial sector. As a result, they amount to an attempt to repair and recreate the pre-crisis system, fixing the obvious defects while maintaining the status of the financial sector as the core of economic activity. Ideally, in this view, the financial sector would retain its role of mastery over investment decisions and public policy, while avoiding the excesses of the past.

Such an approach is doomed to failure. Even while the crisis was at its worst, there were regular examples of excess, such as massive payouts and lavish junkets for executives of bailed-out banks. Now that, for the financial sector at least, the crisis is effectively over, the return to pre-crisis attitudes and behavior is gathering pace.

Starting from the view of the financial sector as a servant of the broader economy and society rather than as a master would produce a radically different approach to its regulation. A whole series of presumptions that have characterized the failed regulatory approaches of recent decades would be reversed. Most notably:

* The financial sector should be regarded as the biggest single source of economic risk rather than being the pre-eminent social institution for risk management; and

* Financial innovation should be regarded as harmful unless it can be shown to be beneficial, rather than *vice versa*.

* Growth in the financial-sector share of the economy should be regarded with concern rather than celebration;

* Financial markets must be regulated as interlinked national markets rather than as a global market transcending national boundaries.

A successful approach to global financial regulation must rely primarily on co-operation between the US Federal Reserve and the European Central Bank, which between them account for more than 90 per cent of currency reserves and economies producing around a third of global output. Although the UK and Japan remain as significant financial centers, the severe fiscal and regulatory problems they face suggests that they are unlikely to be in a position to play an independent role in the restructuring of the global financial system for some time to come. Other members of the G20 are similarly constrained.

Financial innovation

The process of financial innovation, involving either the creation of new financial instruments or the design of new financial strategies for firms (often termed 'financial engineering') was a central feature of the era of market liberalism. The growth of finance has been almost unstoppable. Seemingly major financial crises like the stock market crash of 1987 or the NASDAQ crash of 2000 stimulated the development of yet more innovative responses. Even the exposure of spectacular fraud at the Enron Corporation, which had been nominated by Fortune magazine as 'America's most innovative' for six years in succession, did little to dent faith in the desirability of innovation.

It is now clear that unrestricted financial innovation played a major role in the advent of the financial crisis, by facilitating the growth of unsound lending and by undermining systems of regulation. There is an inherent inconsistency between unrestricted financial innovation and a regulatory system aimed at preventing the failure of financial systems or at insuring market participants against such failures. Guarantees create 'moral hazard' by allowing financial institutions to capture the benefits of risky investments, while shifting some or all of the losses to government-backed insurance pools.

Moral hazard can only be offset by the design of regulatory mechanisms that discourage excessive risk-taking. But, as the literature on mechanism design has shown, the effectiveness of such mechanisms depends on the existence of stable relationships between the observable variables that are the subject of regulation and the risk allocation that generates these observables. Financial innovation changes the relationship. In the presence of moral hazard, therefore, there is an incentive to introduce innovations that increase the underlying level of risk while leaving regulatory measures of risk unchanged.

It follows that the only sustainable approach to financial innovation is one in which proposed innovations are introduced only after the implementation of necessary changes to regulatory requirements and risk measures. If reliable risk measures cannot be computed, the associated innovations should not be permitted.

Obviously, this approach is directly opposed to the Basel II system which sought to control the total risk exposure of regulated banks, while maximizing the freedom of financial institutions to benefit from financial innovation. The failure of that system is reflected in the substantially more prescriptive approach of Basel III. However, despite the substantial tightening of restrictions in Basel III, the underlying presumption in favor of financial innovation remains. It is this presumption that needs to be reversed if financial regulation is to be effective.

Controlling risk in the financial sector

Given an unlimited public guarantee for the liabilities of these institutions, a permissive attitude to innovation is a guaranteed, and proven, recipe for disaster, offering huge rewards to any innovation that increases both risks (ultimately borne by the public) and returns (captured by the innovators).

Post-crisis financial regulation must begin with a clearly defined set of institutions (such as banks and insurance companies) offering a set of well-tested financial instruments with explicit public guarantees for clients, and a public guarantee of solvency, with nationalization as a last-resort option. Financial innovations must be treated with caution, and allowed only on the basis of a clear understanding of their effects on systemic risk.

In this context, it is crucial to maintain sharp boundaries between publicly guaranteed institutions and unprotected financial institutions such as hedge funds, finance companies, stock broking firms and mutual funds. Institutions in the latter category must not be allowed to present a threat of systemic failure that might precipitate a public sector rescue, whether direct (as in the recent crisis) or indirect (as in the 1998 bailout of Long Term Capital Management). A number of measures are required to ensure this.

First, ownership links between protected and unprotected financial institutions must be absolutely prohibited, to avoid the risk that failure of an unregulated subsidiary will necessitate a rescue of the parent, or that an unregulated parent could seek to expose a bank subsidiary to excessive risk. Long before the current crisis, these dangers were illustrated by Australian experience with bank-owned finance companies, most notably the rescue, by the Reserve Bank of Australia, of the Bank of Adelaide in the 1970s.

Second, banks should not deal in unregulated financial products such as share investments and hedge funds.

Third, the provision of bank credit to unregulated financial enterprises should be limited to levels that ensure that even large scale failure in this sector cannot threaten the solvency of the regulated system.

In the resulting system of 'narrow banking', the financial sector would become, in effect, an infrastructure service, like electricity or telecommunications. While the provision of financial services might be undertaken by either public or private enterprises, governments would accept a clear responsibility for the stability of the financial infrastructure.

Another important regulatory adjustment will be the end of the system by which prudential regulation has been, in effect, outsourced to ratings agencies such as Standard & Poor's and Moody's. Agency ratings have been enshrined in regulation, for example through official investment guidelines that require regulated entities to invest in assets with a high rating (AAA in some cases, investment grade in others) or provide those responsible for making bad investment decisions with a 'safe harbor' against claims of negligence if the assets in question carried a high rating. For these purposes at least, an international, publicly-backed non-profit system of assessing and rating investments is required.

Constraining the size of the financial sector

The first objective must be to ensure that exchange rate movements reflect the economic fundamentals of trade and long-term capital flows, rather than the vicissitudes of financial markets. The most promising candidate here is the idea, long-advocated and long-resisted, of a small tax on financial transactions, commonly called a Tobin tax. [9]

A tax at a rate of 0.1 per cent would be insignificant in relation to the transactions costs associated with international trade or long term investments. On the other hand, daily transactions of $3 trillion would yield revenue of $30 billion per day, or nearly $1 trillion per year. Since this amount exceeds the total profits of the financial sector, an effective Tobin tax would imply a drastic reduction in the volume of short term financial flows. It follows that the revenue from a Tobin tax, while significant, would not be sufficient to replace the main existing sources of taxation, such as income tax.

The large literature on the Tobin tax has identified some problems with the simple proposal for a tax on international financial transactions. First, it is possible to replicate spot transactions on foreign exchange markets with combinations of forward, futures and swap transactions. To make a Tobin tax effective, it would have to be applied to all financial transactions, including domestic transactions. During the bubble era, when the few remaining taxes on domestic financial transactions were being scrapped to facilitate the growth of the financial sector, this was seen as a fatal objection. It has become apparent, however, that the destabilizing effects of explosive growth in the volume of financial transactions are much the same, whether the transactions are domestic or international.

The fact that a Tobin tax on international financial transactions would be integrated with taxes on domestic transactions suggests that, in all probability, revenue would be collected and retained by national governments. However, suggestions that at least some of the revenue could be used to fund global projects such as the international development goals of UNCTAD remains worthy of consideration.

The second problem is that the tax would require global co-operation, to prevent financial market activity from migrating to jurisdictions that did not apply the tax. Although this will remain a problem in the post-crisis world, it is likely to be much less severe than indicated by earlier discussions. The number of separate jurisdictions that would need to agree has been substantially diminished by the emergence of the euro.

As part of the resolution of the crisis, it seems inevitable that most remaining European currencies, with the possible exception of the British pound, will disappear, and that a Europe-wide regulatory system will emerge. The number of separate jurisdictions with well-developed financial systems is therefore likely to be very small, with the European Union and United States being overwhelmingly dominant. Furthermore, successful resolution of the sovereign debt crisis will involve a substantial and growing role for fiscal transfers within the eurozone, beginning with the **European Financial Stability Facility.**

Thus, the EU will be more and more comparable to the US in economic terms.

As in the case of tax evasion, the problem of 'offshore' financial centers, such as Caribbean island states, is unlikely to be a serious stumbling block. The free market dogmas that prevented action to preserve the effectiveness of financial regulation in the late 20th century have lost much of their force. A Tobin tax on transactions among complying jurisdictions may have to be supplemented by a punitive tax, at a rate of, say 10 per cent, on transactions with non-compliant jurisdictions. This would ensure that non-compliant jurisdictions were excluded from global financial markets, though the penalty would be modest as regards trade and long term investment flows.

The new financial architecture: global or international?

The first step towards a sustainable financial architecture is the recognition that the idea of a 'global financial architecture' is both misleading and unattainable. The starting point for any financial architecture must be the institution that acts as lender of last resort for others. This function is, and is likely to remain, one undertaken by national governments and their central banks.[10] It follows that there can be no global financial architecture. Rather national systems of financial regulation must be linked and integrated to produce a sustainable international financial architecture.

The first requirement for such an architecture is that there should be no 'offshore' financial system, outside the agreements that govern the international financial architecture, but nevertheless allowed to transact with institutions inside the system.

This issue has already arisen in relation to international tax avoidance and evasion, and will arise in an even more acute form in relation to the Tobin tax, discussed below. Fortunately, the OECD has already made substantial progress on tax avoidance and the approach here will serve as a model for financial regulation.

The OECD prepared an internationally agreed tax standard allowing countries to choose their own tax rates, but requiring exchange of information to prevent avoidance and evasion. Jurisdictions which implemented the standard were placed on a white list, while those that refused were placed on a black list. Countries that promised to implement the standard but had not yet done so were placed on a grey list. Blacklisted jurisdictions were threatened with sanctions, largely unspecified, but sufficiently effective that, by October 2009, no jurisdictions surveyed by the OECD global forum remained on the blacklist.

The tax standard is inadequate in many respects, and open to the evasive tactics for which tax havens are famous. Nevertheless, it seems clear that standards will be tightened progressively, and that no jurisdiction will be willing to risk the consequences of refusal to implement them.

The Financial Stability Board, established after the 2009 G-20 London summit to strengthen prudential oversight of capital, liquidity and risk management provides the potential to apply the tax haven model to 'regulatory havens' offering lax financial regulation. As with taxation, the process will undoubtedly be slow. Nevertheless, the powers of the G20 financial regulators are sufficient to ensure that evasion of financial regulation through the use of offshore transactions can be prevented. It remains to be seen whether, in the absence of immediate crisis, governments will find the political will required to resist the demands of financial institutions for light-handed regulation.

These new developments raise fundamental questions about the role of existing international organizations, most importantly the IMF. The IMF has historically acted to preserve the interests and power of the global financial sector. IMF interventions, presented as 'bailouts' of indebted countries have typically imposed terms only marginally more favorable to the country concerned than the outcomes they would incur through default. The real beneficiaries have been lenders. After a brief conversion to policies of Keynesian stimulus, in the deepest phase of the global financial crisis, the IMF is again acting as an advocate of 'austerity' in the interests of bondholders.

As Ocampo (this issue) observes, the World Bank and the regional development banks also have an important role to play in countercyclical responses to financial crises. The experience of the recent crisis showed the need for more rapid and flexible responses.

CONCLUSION

Like previous episodes of finance-dominated capitalism, the bubble economy that emerged in the 1990s has ended in disaster and depression. Despite the support of sophisticated economic theories, 'best practice' national and international regulation, and the almost unbounded information flows made possible by technological advances in computing and telecommunications, the global financial sector has proved just as vulnerable to fraud and failure as in the days of the South Sea Bubble.

Economically and socially sustainable growth will be possible only if the financial sector is forced back into the role of servant rather than master. This will not be easy to achieve. Despite their spectacular collective failure, and evident dependence on government handouts for survival, the leaders of the financial sector remain both wealthy and powerful. So far they have successfully resisted all but the most limited encroachments on their power and freedom.

They have, however, lost their most important asset: the aura of infallibility that surrounded 'the markets'. While ordinary citizens may find it difficult to conceive an alternative to financial market dominance, they no longer believe that a finance-dominated economy ultimately works for the benefit of all. Given a properly articulated program of reform, it should be possible to mobilize sufficient public support, and anger, to overwhelm the defenses raised by these 21st century 'malefactors of great wealth'.

AFTERWORD

The financial crisis that began in 2007 is, in many ways, the mirror image of the serial crises of the late 1990s. Those crises arose in 'emerging markets' and followed a broadly similar pattern. Following the prescriptions of the 'Washington consensus', a developing country would liberalize capital markets and experience an inflow of capital and an upsurge in economic activity, earning the praise of commentators and international institutions alike. Then, difficulties would emerge, and capital inflow would be replaced by capital flight.

The resulting crisis was blamed on the inadequacies of the country in question. The most common diagnosis was ‘crony capitalism’, a system in which investments depended on personal relationships and opaque deals, as opposed to the transparent institutions and deep financial markets of the US and other developed countries. A more charitable diagnosis, which came to much the same thing, referred to failures in sequencing that arise when financial markets are liberalised while labor and product markets are not.

Regardless of the diagnosis, the policy conclusion was always the same. Governments should adopt the standard package of IMF reforms, placing the burden of adjustment on their domestic populations, while ensuring that foreign creditors were paid in full. Once the adjustment was complete, capital market liberalisation could continue.

The success of countries like Malaysia, which defied this advice, and the withering criticism of the adjustment program put forward by, among others, Krugman and Stiglitz[11] prompted some reassessment from the IMF and, even more, the World Bank.

Nevertheless, and despite widespread agreement on the need for a ‘new global financial architecture’, the global push towards liberalized and lightly regulated financial markets did not stall. On the contrary, and despite the embarrassing fiasco of the dotcom bubble in the United States, the power and prestige of the financial sector grew apace, to the point where it accounted for 40 per cent of corporate profits (themselves a growing share of national income) by 2007.

Positions were reversed in 2007. The crisis began at the centre of capitalist finance, the United States, with the collapse of a speculative property boom driven ultimately by financial innovations developed by the leading Wall Street banks. Innovative instruments such as Collateralized Debt Obligations proved to be, in the words of Warren Buffett, 'weapons of financial mass destruction'. European banks were heavily exposed to US financial assets, and suffered substantial damage, exacerbated by the collapse of property bubbles in several European countries.

Outside the US and EU damage was much more limited. The primary exposure of less developed countries (and of peripheral developed economies such as those of Australia and Canada) was through the loss of exports, as trade volumes collapsed in the wake of the September 2008 meltdown. However, the impact of the export shock was delayed sufficient to permit the effective use of fiscal stimulus, notably in Australia and China.

As a result, negotiations over a new global financial order take place under conditions very different from those that prevailed in the late 1990s. The developed countries as a group, and particularly the BRIC countries possess the leverage that goes with rapid economic growth and successful macroeconomic management. Conversely, the US and EU are constrained by their internal difficulties, and (not unrelated) a high degree of political paralysis.

Potentially, therefore, the G20 process offers the chance for developing and transitional countries (DTC) and others outside the US and EU to play a major role in determining the future direction of the global financial system. They could choose to back proposals that would return the financial sector to its proper role as a servant of economic activity, as has been advocated in this paper.

Such proposals would fit naturally with the suggestions of Ocampo for a development friendly reform of the international financial architecture. Ocampo's suggestions can only be implemented if power is taken out of the hands of financial corporations, and if central banks act to protect the global public interest rather than to maintain, at all costs, an unsustainable and inequitable financial system.

Alternatively, DTC countries could seek a restructuring in the interests of their own nascent financial sectors, dominated at this stage by sovereign wealth funds. Rather than trying to bring the global financial sector under control, they could, in effect, settle for a larger slice of the rents it generates

At present, as Wade observes, the potential power of the DTC remains just that. Developing and transitional countries have no coherent position, or even the aspiration to present one represented by older groupings like the G77 and the Non-Aligned Movement. Wade observes that individual DTC countries act in a Westphalian fashion, but in fact it is hard even to discern a coherent national interest.

As Ocampo observes, the opportunities for reform created by a major crisis are too rare to be let slip. At this stage, however, there is little evidence of any will to seize them.

Notes

1 An extensive list of such crises is given by Charles Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises, (*New York: John Wiley and Sons, 2000).

2 The gradual deregulation of this period was described in detail by Marc Robinson and John Quiggin, “Retreat From Social Control: Financial Deregulation Since World War Ii,” *Journal of Australian Political Economy,* 18, (1985):9–16.

3 Thomas Piketty and Emanuel Saez, “Income Inequality in the United States, 1913-1998*,” *Quarterly Journal of Economics*, 118(1), (2003):1–39.

4 Anthony Atkinson and Andrew Leigh, “The Distribution of Top Incomes in Australia,” *Economic Record*, 83(262), (2007):247–61, Thomas Piketty and Emanuel Saez, “The Evolution of Top Incomes: A Historical and International Perspective,” *American Economic Review,* 96(2), (2006):200–05.

5 Thomas Friedman, *The Lexus and the Olive Tree: Understanding Globalization, (*New York: Farrar Strauss Giroux, 1999).

6 Edward Luttwak, *Turbo Capitalism: Winners and Losers in the Global Economy, (*New York: Harper Collins, 1999).

7 Stephen Bell and John Quiggin, “Asset Price Instability and Policy Responses: The Legacy of Liberalization,” *Journal of Economic Issues,* XL(3), (2006):629–49.

8 A particularly striking example of financial sector unwillingness to learn from experience was that of Timothy Ash, of the Royal Bank of Scotland. Speaking about the IMF rescue package for Ukraine, Ash observed “We hope the fund is maintaining its push for a more flexible exchange rate, far- reaching reforms in the banking sector, and more privatization” (quoted in Krasnolutska and Martens 2008). A few weeks before this comment was made, RBS had been nationalized as a result of failed speculation and catastrophic mismanagement.

9 The idea was first put forward by James Tobin, “International Monetary Reform: Sand in the Wheels,” *For Neue Zurcher Zeitung*, July, (1988), and discussed further in Mahbub ul Haq, Inge Kaul and Isabelle Grunberg, Th*e Tobin Tax: Coping With Financial Volatility, (Ox*ford, U.K.: Oxford University Press, 1996)

10 The eurozone, where national governments run their own prudential policies but share a common central bank.

11 Paul Krugman, “ Capital control freaks: How Malaysia got away with economic heresy”*, Slate*, (Sept 27, 1999) http://www.slate.com/id/35534, Joseph Stiglitz, *Globalization and Its Discontents*, (New York, W. W. Norton & Company, 2003(.