

FINANCIAL REGIME CHANGE?

SINCE THE 1930S the non-communist world has experienced two shifts in international economic norms and rules substantial enough to be called ‘regime changes’. They were separated by an interval of roughly thirty years: the first regime, characterized by Keynesianism and governed by the international Bretton Woods arrangements, lasted from about 1945 to 1975; the second began after the breakdown of Bretton Woods, and prevailed until the First World debt crisis of 2007–08. This latter regime, known variously as neoliberalism, the Washington Consensus¹ or the globalization consensus, centred on the notion that all governments should liberalize, privatize, deregulate—prescriptions that have been so dominant at the level of global economic policy as to constitute, in John Stuart Mill’s phrase, ‘the deep slumber of a decided opinion’.

The two regimes differed in the role allotted to the state, in both developed and developing countries. The Bretton Woods regime favoured ‘embedded liberalism’, as it was later called, which sanctioned market allocation in much of the economy but constrained it within limits set through a political process. The successor neoliberal regime, particularly associated with Reagan and Thatcher, moved back towards the norms of *laissez-faire* embraced by classical liberalism, and hence prescribed a roll-back of state ‘intervention’ and an expansion of market allocation in economic life. But it gave more emphasis than classical liberalism to the idea that competition is not the ‘natural’ state of affairs, and that the market can produce sub-optimal results wherever producers have monopoly power (as in Adam Smith’s observation that ‘people of the same trade seldom meet together [without concocting] a conspiracy against the public’).

Neoliberalism accordingly sanctioned state intervention not only to supply a range of public goods that could not be provided through

competitive profit-seeking (as did classical liberalism), but also to frame and enforce rules of competition, overriding private interests in order to do so; hence the ‘neo’. Its principal yardstick for judging business success was shareholder value, and its central notion of the national economic interest was efficiency as determined by competition in an economy fully open to world markets; there should be no ‘artificial’ barriers between national and world market prices, such as tariffs or subsidies to particular industries. Of course, at the level of policy, many tactical, pragmatic modifications were made to these principles, in order to subsidize corporations, channel more wealth to the rich, and stabilize the economy and society with covertly Keynesian policies.² But at the level of norms, the difference was clear.

In the realm of finance, neoliberal prescriptions were justified by the ‘efficient markets hypothesis’, which claimed that market prices convey all relevant information and that markets clear continuously—rendering sustained disequilibria, such as bubbles, unlikely; and making policy action to stop them inadvisable, since this would constitute ‘financial repression’. Milton Friedman and the Chicago School gave their name to this theory; but as Paul Samuelson said, ‘Chicago is not a place, it is a state of mind’, and it came to prevail in finance ministries, central banks and university economics departments around the non-communist world.

The shocks of the past year—another thirty years on from the last major shift—support the conjecture that we are witnessing a third regime change, propelled by a wholesale loss of confidence in the Anglo-American model of transactions-oriented capitalism and the neoliberal economics that legitimized it (and by the US’s loss of moral authority, now at rock bottom in much of the world). Governmental responses to the crisis further suggest that we have entered the second leg of Polanyi’s ‘double movement’, the recurrent pattern in capitalism whereby (to oversimplify) a regime of free markets and increasing commodification generates such suffering and displacement as to prompt attempts to impose closer regulation of markets and de-commodification (hence

¹ The term ‘Washington Consensus’, devised in 1989 by John Williamson to refer to a set of ten policy recommendations, came to be used in a much broader sense, encompassing financial deregulation, free capital mobility, unrestricted purchase of local companies by foreign companies, and unrestricted establishment of subsidiaries.

² Dean Baker, *The Conservative Nanny State: How the Wealthy Use the Government to Stay Rich and Get Richer*, Washington, DC 2006.

'*embedded liberalism*').³ The first leg of the current double movement was the long reign of neoliberalism and its globalization consensus. The second as yet has no name, and may turn out to be a period marked more by a lack of agreement than any new consensus.

Some caution is in order. There is a recurrent cycle of debate in the wake of financial crises, as an initial outpouring of radical proposals gives way to incremental muddling through, followed by resumption of normal business. Ten years ago the East Asian, Russian and Brazilian crises of 1997–98 struck panic in the High Command of world finance, and were followed by vigorous discussion around a 'new international financial architecture'. But once it became clear that the Atlantic heartland would not be affected, the radical talk quickly subsided. The upshot was a raft of new or reinvigorated public and private international bodies tasked with formulating standards of good practice in corporate governance, bank supervision, financial accounting, data dissemination and the like.⁴ Such efforts diverted attention from the issue of re-regulation, and the financial sector in the West was able to ensure that governmental initiatives did not include new constraints, such as limits on leverage or on new financial products. There was no change of norms regarding the desirability of lightly regulated finance.

Systemic tremors

When the Bank for International Settlements (BIS) said in its June 2007 Annual Report that 'years of loose monetary policy have fuelled a giant global credit bubble, leaving us vulnerable to another 1930s slump', its analysis was largely ignored by firms and regulators, notwithstanding the BIS's reputation for caution. As recently as May 2008 some commentators were still arguing that the crisis was a blip, analogous to a muscle strain in a champion athlete which could be healed with some rest and physiotherapy—as opposed to a heart attack in a 60-a-day smoker whose cure would require surgery and major changes in lifestyle.

The events of September 2008, however, make it hard to avoid the conclusion that we have entered a new phase. Financial market conditions

³ Karl Polanyi, *The Great Transformation*, Boston 2001 [1944].

⁴ For further details see Robert Wade, 'A New Global Financial Architecture?', *NLR* 46, July–Aug 2007; and 'Global Financial Regulation Versus the Engines of Financial Instability', in Philip Arestis and John Eatwell, eds, *Issues in Finance and Industry*, Basingstoke, forthcoming.

in much of the OECD have sunk to their lowest levels since the banking shut-down of 1932, which was the single most powerful factor in making the 1929 downturn and stock market crash become the Great Depression. (Some 11,000 national and state banks failed in the US between 1929 and 1933.) One bond trader described the current situation as ‘the financial equivalent of the Reign of Terror during the French Revolution’.⁵ In these circumstances, the efficient markets hypothesis and the prescriptions derived from it have been thoroughly discredited.

In particular, the second fortnight of September of this year saw not one but three ‘game-changing’ convulsions in the world’s most sophisticated financial system. These do not include the nationalization of Freddie Mac and Fannie Mae: giant though they are, these ‘quasi-government institutions’ had an established claim to a public safety net. Rather, the first upheaval was the run on two more of the big five Wall Street-based broker-dealers or investment banks, following the earlier run on Bear Stearns—in each case followed by the banks’ demise. Only Morgan Stanley and Goldman Sachs remain standing—for the time being—and they have switched their legal status to that of bank holding companies, which means they will be subject to closer regulation than before. The bankruptcy of Lehman Brothers in mid-September trapped the funds of mega-investors, ratcheting up the panic throughout financial markets and shutting down credit flows even for normal business. It could have especially far-reaching consequences, since Lehman had a huge volume of derivative business, and there has never been a default of a counterparty to derivative contracts on anything like this scale.

The loss of three of the five giants fundamentally changes the politics of international finance, because these investment banks were immensely powerful actors in the political process—not only in the US but also in the EU. From their London bases, the US investment banks had a shaping influence on the content of EU financial legislation in Brussels. The upside of their disappearance, then, is that it weakens one major obstacle to financial re-regulation.

The second September game-changer was the US Treasury’s bail-out of AIG for a promised \$85 bn. AIG was not just America’s but the world’s biggest insurer. Since it stood outside the banking system, its bail-out

⁵ John Jansen, ‘America’s Reign of Terror’, SeekingAlpha.com, 2 October 2008.

broke through the firewall separating financial intermediaries from the 'real' economy. The contagion is now likely to spread to other insurers, and to thousands of highly leveraged hedge funds, as lock-in periods expire at the end of the next two quarters and investors are able to withdraw their funds. The third great convulsion outdid even the second: in the most dramatic government rescue operation in history, the US Treasury announced a plan to buy up to \$700 bn of toxic securities from troubled banks, at a price well above current market value. Remarkably, it was improvised almost on the spot—Secretary Paulson's original proposal ran to only three typed pages—indicating that the Treasury had been convinced that it could muddle through without a contingency plan. As proposed, it would have given Wall Street almost unrestrained access to public revenues at little cost. At the end of September the bailout was rejected by the House of Representatives, and subsequently modified by the Senate, both parts of Congress alarmed at the public's fury in an election year. The version approved by Congress in early October promises to make a larger share of any subsequent profits into public revenues, but nonetheless uses tax revenues to socialize the losses of the finance sector—an unprecedented hand-out to those responsible for the crisis in the first place.

Repercussions

Falls in the US and UK property markets, meanwhile, continue to drive the downward spiral. The US futures market is estimating a 33 per cent drop in US prices from peak to trough (based on the Case-Shiller Home Price Index), with the trough still a year away. The UK, which since 2000 has had the second biggest property bubble after the Japanese land bubble of the 1980s, may experience a 50 per cent fall from peak to trough; but even this would leave house prices higher than in 1997 as a multiple of income. As the credit contraction spreads across sectors and across regions, the damage to the real economy is growing, as measured by rising unemployment—in the US, the jobless total has risen by 2.2 million in the last 12 months—and slowing consumption; though it is surprising how gradually this has taken place since mid-2007. As of early October 2008, the crisis has swept into many continental European banks, which had previously prided themselves on having escaped the turmoil.

So far, however, the crisis has remained centred on the Atlantic economy, and there has as yet been little blow-back from East Asia. Indeed, it is

notable that extreme illiquidity in Western financial markets co-exists with overflowing savings and foreign exchange reserves in East Asia and the petro-economies of Russia and the Gulf. Yet another feature of the current crisis that makes it unprecedented is the fact that the West is pinning its hopes for recovery on fast growth in the developing world, especially East Asia—and that Western banks seeking to avoid bankruptcy are increasingly looking for capital injections from these countries, and from the sovereign wealth funds of such states as China, Dubai and Singapore, among others.

Japan, the world's second largest economy, looks thus far to be relatively unscathed. There are few signs of a credit crunch, although growth stands almost at zero. The short explanation for this is that Japanese banks remained very cautious after the bitter experience of the 1990s, when they were obliged to clean up after the 1980s bubble. They have been criticized at home and abroad for holding too much cash and too little debt; a recent example from the *International Herald Tribune* makes plain the norms that have dominated Anglo-American and therefore 'global' economic policy over the past three decades:

The country has a \$14 trillion pile of household savings . . . This blessing has also been a curse to investors . . . Japan's wealth shields it from pressures to meet global standards of economic growth or corporate profitability. This is what allowed the country to accept near-zero growth rates in the 1990s and what allows the survival of Japanese corporate practices like valuing employees and clients over shareholders.⁶

China, however, is another story. Since 1980 it has experienced several booms followed by sharp slumps; despite the phenomenal improvement in its economic performance in the last decade, a further slump is quite possible. One potential source of trouble is the PRC's accumulation of vast quantities of US asset-backed securities whose value has fallen precipitously; in June 2007, US Treasury data estimated the value of these to be \$217 bn. Another is the high ratio of non-performing loans in Chinese banking—more than 6 per cent in the last quarter of 2007, according to official data. A third is high inflation, especially in food prices. Other East and Southeast Asian investors are also thought to be holding large quantities of toxic securities. This suggests that there could sooner or

⁶ Martin Fackler, 'Japan Mostly Unscathed by Global Credit Crisis', *International Herald Tribune*, 22 September 2008.

later be a blow-back from East Asia into the US and Europe, generating another downward twist.

Causes of the crunch

If the wars in Iraq, Kosovo and Afghanistan were one expression of American post-Cold War triumphalism, globalized finance, launched during the Clinton Administration, was another. The mainstream press boasted that the US financial system had broken through the sound barrier and was now operating in a new dimension, as it undertook more and more dazzling gambles. They were right to emphasize the novelty of the way in which US finance operated in the 2000s, and the sense that it had no limits. The deeper causes, however, lay in economic developments. In much of the Western world the rate of profit of non-financial corporations fell steeply between 1950–73 and 2000–06—in the US, by roughly a quarter. In response, firms ‘invested’ increasingly in financial speculation, and the US government helped offset the resulting shortfall of non-residential private investment by boosting military spending (the Pentagon’s annual budget happens to be around the same as the figure put on the Treasury’s recent rescue plan).

In addition, foreign currency markets have since 2000 persistently driven exchange rates in the wrong direction, causing many economies running large external deficits to experience currency appreciation, and others running surpluses to experience depreciation or no change. External deficits and surpluses have grown, increasing the fragility of the global economy. However, commentators who insist that the present turmoil is simply the latest in a long line of crises driven by bubble dynamics miss the point that this time, the asset bubble was propagated across the world through securitization technology and the ‘originate and distribute’ model of banking, which only came to fruition in the 2000s. The model encouraged high leverage, complex financial instruments and opaque markets, all of which put this crisis in a league of its own.

Too much stress has been laid specifically on the housing bubble, as though it was a necessary and sufficient condition of the crisis. It was only one part of a much wider run-up of debt. Table 1, overleaf, shows the ratio of debt to GDP for the US economy as a whole, and for the two most indebted sectors—households and finance—for 1980 and 2007.

TABLE I. *US debt as a percentage of GDP*

	1980	2007
<i>Overall</i>	163	346
<i>Households</i>	50	100
<i>Finance</i>	21	116

Source: *Financial Times*, 24 September 2008.

The overall ratio more than doubled, and that for the financial sector increased more than fivefold.

The toxic combination of debt, asset bubble and securitization technology was itself enabled by lax regulation. The locus of the blow-up was not unregulated hedge funds, but supposedly regulated banks. Until recently it was acceptable in the eyes of the authorities for investment banks to operate with a debt to equity ratio of 30–35:1. It is no exaggeration to say that the crisis stems from the biggest regulatory failure in modern history. Many politicians and commentators are stressing that ‘we are all to blame’—the international economy, bankers, investors, ratings agencies, consumers. But this simply diverts attention from those whose job it was to regulate: the regulators and the political authorities who sanctioned them.

The UK’s role in the crisis deserves emphasis, because contrary to conventional wisdom, the dynamics at its heart started there. The Thatcher government set out to attract financial business from New York by advertising London as a place where US firms could escape onerous domestic regulation. The government of Tony Blair and Chancellor Gordon Brown continued the strategy, leading Brown to boast that the UK had ‘not only light but limited regulation’. In response, political momentum grew in the US over the course of the 1990s to repeal the Depression-era Glass–Steagall act, which separated commercial from investment banking. Its repeal in 1999 produced a de facto financial liberalization, by facilitating an unrestrained growth of the unregulated shadow-banking system of hedge funds, private equity funds, mortgage brokers and the like. This

shadow system then undertook financial operations which tied in the banks, and it was these that eventually brought the banks' downfall.

The striking thing about the UK Financial Services Authority, set up with great fanfare by Brown in 1997, at the same time as he granted the Bank of England semi-autonomy in monetary policy, is that it has sweeping jurisdiction over the British financial sector—in contrast to the US system of multiple and fragmented regulators. Yet it regulates diffidently, and was evidently intended as little more than window-dressing. Howard Davies, the FSA's first chairman, described its guiding principle with striking candour: 'The philosophy from when I set it up has been to say, "Consenting adults in private? That's their problem, really."⁷ Hence the FSA, in its covert and successful bid to attract US companies to London, allowed banks and insurance companies operating from the City to do so with much less capital than similar organizations in New York. Its commitment to light and limited regulation meant that to deal with British financial markets one-third the size of those in the US, it had eleven times fewer enforcement agents than the Securities and Exchange Commission (SEC)—98 as compared to 1,111.

It is ironic that the crisis may end up saving Brown from having to resign as prime minister. Yet it is now clear that his aversion to financial regulation, and his lack of concern about the housing bubble—which in the period since Labour came to power has made the UK's economic performance look much better than it would otherwise have done—are deeply implicated in the build-up to the crisis. For a decade, the combined tails of the housing market and financial sector have wagged the dog of the British economy. As in the US, consumption grew much faster than GDP, financed by rising debt, thanks to booming house prices. A grateful electorate returned the Labour government to office twice in a row.

Governmental responses

The downward spiral of credit contraction is being driven by a pervasive collapse of trust in the entire structure of financial intermediation that underpins capitalist economies. With debt levels running high and the economic climate worsening, many enterprises in the real economy must be close to bankruptcy; hence lenders and equity buyers are staying out of the market. Governments have therefore moved to stabilize credit

⁷ Jesse Eisinger, 'London Banks, Falling Down', Portfolio.com, 13 August 2008.

markets by taking steps to encourage buyers to re-enter the market for securities—most notably the US Treasury, with its \$700 bn bail-out scheme. Several European states have moved to steady the banking sector, with Ireland, Greece, Germany, Austria and Denmark guaranteeing all savings deposits in early October 2008. Competition rules have been set aside, as governments foster mega-mergers. In the UK, the recent merger of HBOS and Lloyds TSB creates a bank with a 30 per cent share of the retail market.

The sheer monopoly power of such new financial conglomerates is likely to prompt a stronger regulatory response. Another key area to watch in terms of gauging the robustness of governmental responses is the market for Over the Counter (OTC) derivative contracts—which Warren Buffet famously described in 2003 as ‘financial weapons of mass destruction’. Buffet went on to say that, while the Federal Reserve system was created in part to prevent financial contagion, ‘there is no central bank assigned to the job of preventing the dominoes toppling in insurance or derivatives’. In the event that more regulation of the OTC market is implemented—even in the minimal form of requiring the use of a standard contract format and registration of the details of each contract with a regulatory body—Brooksley Born will have some satisfaction. She was head of the Chicago Futures Trading Commission in the late 1990s, and proposed in a discussion paper that the OTC market should come under some form of regulation. Alan Greenspan, SEC Chairman Arthur Levitt and Treasury Secretary Robert Rubin were so angry at her for even raising such an idea that they sought Clinton’s permission to have her fired; in January 1999 she duly resigned for ‘family reasons’.

Beyond such immediate, fire-fighting responses, the crisis has also drawn attention to the matter of the system’s overall stability—and specifically to the impact of international financial standards on national systems. A furious debate has been under way in recent years about international accounting standards. Both the leading sets used by listed companies around the world—the US Generally Accepted Accounting Principles and the International Financial Reporting Standards (also known as IAS)—require listed companies to ‘mark to market’; that is, frequently to revalue their assets at current market prices or, if the assets are illiquid and have no market price, to revalue them according to the cost of guaranteeing them. Defenders of this method—principally investors—tendentiously call it the ‘fair value’ standard (who could

oppose ‘fair value?’), arguing that its adoption is crucial to maintaining investors’ confidence in firms’ published accounts.⁸

Critics, including the International Institute of Finance—the main lobbying group for bankers—counter that it amplifies booms and busts. During downswings ‘fair value’ accounting obliges banks to record a drop in asset value which may be unjustified by economic ‘fundamentals’. To maintain their solvency ratios they are then obliged to raise new capital at high cost or reduce lending. Upswings, meanwhile, permit banks to boost their balance sheets beyond levels justified by ‘fundamentals’. But the alternative methods of ‘mark to historical prices’ or ‘mark to model’, in which each firm uses its own model to estimate shadow prices, are in turn open to attack. Warren Buffet observed that ‘mark to model’ tends to degenerate into ‘mark to myth’, while Goldman Sachs in June 2008 resigned its membership of the IIF in protest at the prospect of a move to what it called Alice in Wonderland accounting.

Critics of ‘mark to market’ tend to conflate the important distinction between accounting standards and prudential standards. The former are concerned with the information provided to shareholders and others about the ‘integrity’ of the market; their function is to ensure continuous and accurate information on the situation of companies as the basis for investment decisions. Prudential standards, on the other hand, focus on financial stability, and on preventing financial actors from behaving in ways that put stability at risk. Maintaining this distinction, and overhauling some prudential standards, is important in the current context.

Credit and credibility

One type of prudential standard ripe for revision concerns banks’ capital adequacy. The Basel II standard of capital adequacy, which came into force at the start of 2007 after some nine years of negotiation, marked a shift from the external regulation of Basel I to self-regulation—making it an invitation to careless behaviour and ‘moral hazard’ at a time when big banks are more confident than ever that they will be bailed out by the state. Basel II requires banks to use agencies’ ratings and their own internal risk-assessment models—both of which have been shown to be

⁸ Nicolas Véron, Matthieu Autret and Alfred Galichon, *Smoke & Mirrors, Inc.: Accounting for Capitalism*, Ithaca, NY 2006.

pro-cyclical and to have failed spectacularly in the run-up to the present crisis—while raising capital standards during periods of illiquidity, precisely when banks are less able to meet them. Moreover, experience of Basel I and simulation of the effects of Basel II suggest that both sets of rules tip capital flows from developed-country banks to the developing world in favour of short-term bank credit, the most dangerous kind.⁹ Basel II also raises the cost of finance for banks in the global South relative to those in the developed world, cementing the competitive advantage of the latter. Incremental revision of Basel II will not address any of these issues; for that, wholesale renegotiation will be required.

Among the many victims of the crisis, then, is the dominant ‘global’ model of financial architecture of the last two decades, the credibility of which has been seriously damaged. All three of its main pillars malfunctioned in the run-up to the current crisis. Firstly, a financial services regulator is supposed to protect bank depositors and consumers from unsound behaviour by individual firms, such as holding inadequate reserves; as we have seen, however, regulation was lax in the extreme. Second, financial markets are meant independently to allocate investment capital and consumer credit between individuals, firms and states, with little influence from government; but the opacity created by leveraging and complex financial engineering resulted in market meltdown and eventual state rescue.

The third pillar is the maintenance of monetary stability—defined as keeping a tight lid on inflation—by the central bank. Focusing on the retail price index, central banks opted to keep interest rates very low and permit fast credit growth, lulled by low price inflation due to cheap imports from China. The rapid growth of credit blew out asset bubbles, especially in housing—which many central banks ignored, since their mandate was confined to consumer prices. Indeed, they and the politicians behind them applauded the housing boom because it propelled sharp increases in GDP. The new regime that emerges from the ongoing crisis, then, is likely to include attempts to revise the role of the third pillar by expanding the mandate of central banks, and ensuring they give more weight to asset prices. Since the interest rate is a very blunt instrument, central bankers and regulators will have to rely on an expanded set of prudential measures. Examples would include a requirement for new

⁹ Jean-Marc Fiquet and Delphine Lahet, ‘Les Accords de Bâle II: quelles conséquences pour le financement bancaire extérieur des pays émergents?’, *Revue d’Économie du Développement*, no. 1 (March 2007), pp. 47–67.

financial products to obtain regulatory approval, to ensure that their risk characteristics can be readily determined by a third party; or a demand that any organization that can expect a public safety net—and especially public deposit insurance—should submit to controls of its loan portfolio, so as to reduce credit to ‘overheating’ sectors.¹⁰

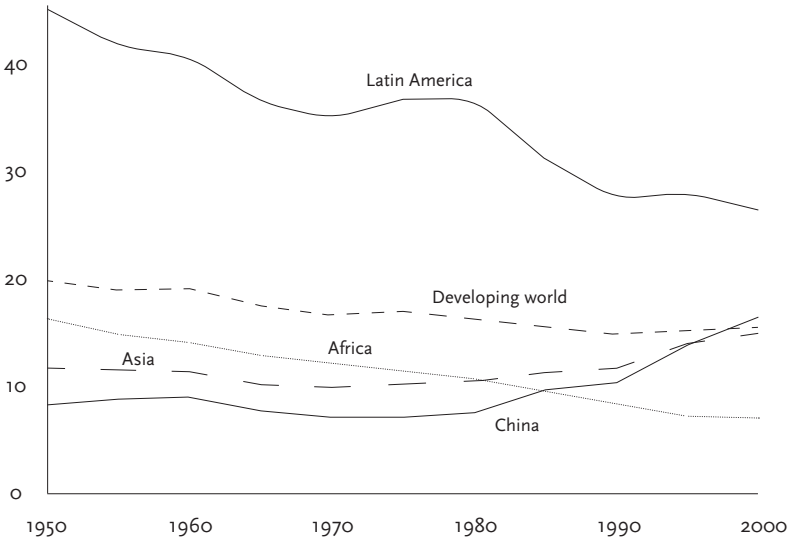
Demise of the consensus?

Neoliberal economics has powerful antibodies against evidence contrary to its way of seeing things. However, the current crisis may be severe enough to awaken economists from the ‘deep slumber of a decided opinion’, and render them more receptive to proof that the post-Cold War globalization consensus has strikingly weak empirical foundations. According to the conventional view, in the decades after 1945, governments routinely ‘intervened’ in the economy, especially in developing countries where import-substituting industrialization was the norm. While the developed world liberalized, the global South kept to ISI and, consequently, its relative economic performance lagged. But as of around 1980, under encouragement from the World Bank, IMF and the American and British governments, developing countries increasingly adopted the prescriptions of the globalization consensus and switched to a strategy of market-friendly, export-led growth and supply-side development. As a result, their performance improved relative not only to the past but also to that of the developed countries; they finally began to catch up. This empirical evidence in turn validated World Bank and IMF pressure on their borrowers to adopt neoliberal policies.

The trouble with this story is that it is largely wrong. Figure 1, overleaf, shows the average income of a number of regions relative to that of the North, expressed in purchasing power parity dollars (PPP\$), from 1950 to 2001. Latin America and Africa display a relative decline both before and after 1980; Eastern Europe, not shown, tracks the Latin America line. China, at the bottom of the graph for most of the period, starts to rise in the 1980s and continues thereafter, reaching the average for the South by 2001; the Asia line rises a little, too, after a lag—but this also includes China, which accounts for a large part of its ascent.

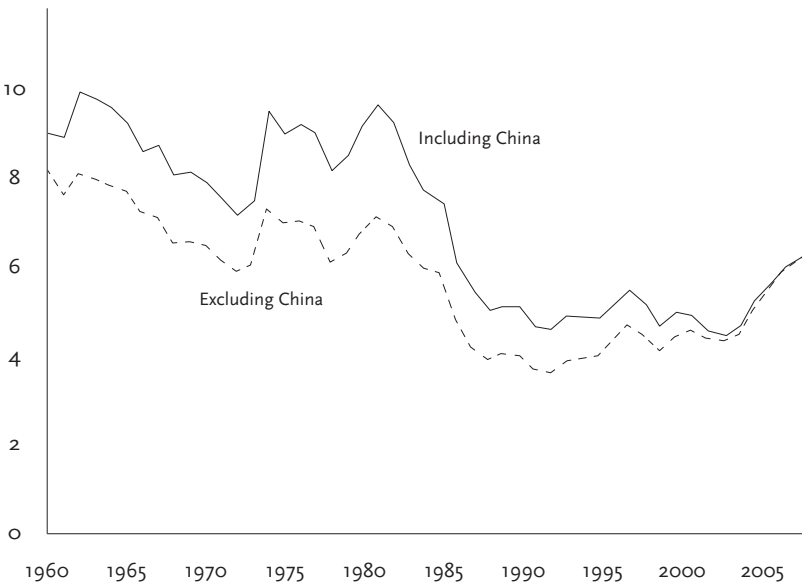
¹⁰ Stephen Bell and John Quiggin, ‘Asset Price Instability and Policy Responses: The Legacy of Liberalization’, *Journal of Economic Issues*, vol. 40, no. 3 (September 2006), pp. 629–49.

FIGURE 1. *Income of world regions as a proportion of Northern incomes*



Percentage of income per capita expressed in PPP\$. Source: John Ravenhill, ed., *Global Political Economy*, Oxford 2008, box 12.1.

FIGURE 2. *Global South GDP per capita as % of that of Advanced Countries*



Calculated using current prices at market exchange rates. Source: Alan Freeman, 'The Poverty of Statistics and the Statistics of Poverty', *Third World Quarterly*, forthcoming, based on IMF, *World Economic Outlook*.

Figure 2, opposite, shows the average income of the developing world, excluding the 'transitional economies' of the former Soviet bloc, as a proportion of that of the North, expressed in market exchange rates. The top line represents the whole of the global South, the bottom line the global South excluding China. In both cases, the trend from 1960 to 2008 is very different from that postulated by the globalization narrative. The ratio was higher in the period before 1980, fell steeply during the 1980s, flattened out at a low level during the 1990s, and had a small uptick after 2004 because of the commodity boom induced by rapid growth in the PRC. With incomes expressed in terms of PPP, the trend line is consistent with the globalization narrative, turning upwards in the early 1980s and continuing to ascend thereafter; but exclude China and the trend is much the same as in Figure 2.¹¹

The notion that globalization generates catch-up growth, then, rests principally on the rise of China. Yet the policies Beijing has pursued are far from identical to those endorsed by the Washington Consensus; it has followed the precepts of Friedrich List and of American policy-makers of the nineteenth century, during the US's catch-up growth, more than those of Adam Smith or latter-day neoliberals. The state has been an integral promoter of development, and has adopted targeted protection measures as part of a wider strategy for nurturing new industries and technologies; it is now investing heavily in information systems to help Chinese firms engineer their way around Western patents.

The American Economic Association carried out surveys of its members' opinions in 1980, 1990 and 2000.¹² The results indicate a broad consensus on propositions about the desirable effects of openness and the harmful effects of price controls. For example, in all three surveys the proposition that 'tariffs and import controls lower economic welfare' elicited very high agreement; in 1980, 79 per cent of US economists said they 'agree' with the statement, as distinct from 'agree with qualifications' or 'disagree'. (Economists in four continental European

¹¹ In his 2004 book *Why Globalization Works*, Martin Wolf does not present evidence of this kind. The nearest he comes is a table (8.1) giving growth rates for seven regions and several time periods from 1820 to 1998, which shows that six out of the seven regions had *lower* growth rates between 1973–98, the era of globalization and outward orientation, than between 1950–73, the previous era of state intervention and ISI; but Wolf does not comment on this decline.

¹² Dan Fuller and Doris Geide-Stevenson, 'Consensus among Economists: Revisited', *Journal of Economic Education*, vol. 34, no. 4 (Fall 2003), pp. 369–87.

countries were also surveyed in 1980; only 27 per cent of French economists said they agreed with the same statement.) It seems a safe bet that the 2010 survey will report significantly less agreement about the desirability of free trade, free capital movements and other forms of economic openness—providing concrete evidence of a weakening of the globalization consensus among US economists, and further support for the conjecture that we have entered a new regime.

Rethinking the model

In times of crisis, arguments that had previously been on the margins can gain greater currency. If the disappearance of three out of five big investment banks indicates the seriousness of the present turmoil, it also provides an opportunity to broaden the range of possibilities for an overhaul of the way global finance operates; the fall in pension funds and declining house prices should also enlarge the constituency for major reform. Scholars today face the challenge of rethinking some of the basic intellectual models that have legitimized policy over the past three decades. The fallout from complex, opaque financial products may persuade many of the benefits of a substantially smaller financial sector relative to the real one, and perhaps of a ‘mixed economy’ in finance, where some firms would combine public and private purposes—operating more like utilities than profit maximizers.

But more fundamentally, the globalization model itself needs to be rethought. It over-emphasized capital accumulation or the supply side of the economy, to the detriment of the demand side (since the stress on export-led growth implied that demand was unlimited).¹³ The failure of catch-up growth, seen in Figures 1 and 2, stems in part from neoliberalism’s lack of attention to domestic demand, reflecting the dominance of neoclassical economics and the marginalization of Keynesian approaches. Developing domestic and regional demand would involve greater efforts towards achieving equality in the distribution of income—and hence a larger role for labour standards, trade unions, the minimum wage and systems of social protection. It would also necessitate strategic management of trade, so as to curb the race-to-the-bottom effects of export-led growth, and foster domestic industry and services that would provide better livelihoods and incomes for the middle and working classes.

¹³ Thomas Palley, ‘Developing the Domestic Market’, *Challenge*, vol. 49, no. 6 (November–December 2006), pp. 20–34.

Controls on cross-border flows of capital, so as to curb speculative surges, would be another key instrument of a demand-led development process, since they would give governments greater autonomy with regard to the exchange rate and in setting interest rates.

The recent strengthening of regional integration processes, meanwhile, should direct attention away from global standards and arrangements which, because of their maximal scope, are necessarily coarse-grained at best. Regional trade agreements between developing countries have distinct advantages over multilateral trade deals, whose terms often serve to break open economies of the global South while preserving intact protections for industry and agriculture in the North. Regional currencies—such as the Asian Currency Unit being discussed by East Asian states, based on a weighted average of key local currencies—could act as a benchmark independent of the US dollar, reducing vulnerability to market turbulence on Wall Street.¹⁴

Global economic regimes need above all to be rethought to allow a diversity of rules and standards, instead of imposing ever more uniformity. Rather than seeking, in Martin Wolf's terms, to make the whole world attain the degree of economic integration found within the federal structure of the US, such that nation-states would have no more influence over cross-border flows than US states have over domestic transactions,¹⁵ we might draw inspiration from an analogy with 'middleware'. Designed to enable different families of software to communicate with each other, middleware offers large organizations an alternative to making one program span their entire structure; it allows more scope for a decentralized choice of programs. If the second leg of the present 'double movement' turns out to be a period from which consensus is largely absent, it may also provide space for a wider array of standards and institutions—economic and financial alternatives to the system-wide prescriptions of neoliberalism. This may give the new regime that emerges from the current upheavals greater stability than its predecessor. Whether it provides the basis for a more equitable world, however, will remain an open question—and an urgent challenge—for some time to come.

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¹⁴ Wade, 'The Case for a Global Currency', *IHT*, 4 August 2006.

¹⁵ Wolf, *Why Globalization Works*, p. 4.