'Financial Globalization' and the 'Crisis': A Critical Assessment and ‘What is to be Done’?

Grahame Thompson (Open University)

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Abstract:

Do we have a genuine global financial system? This article challenges the strong notion that the recent financial crisis was global in scope. It argues the international financial system is quite differentiated, being made up of domestic-national, supra-national regional and inter-national aspects. Given this alternative characterization of the financial system the implications for how to organize a regulatory response are pursued. Here the argument is that the principle of ‘distributed preparedness for resilience’ should guide this response not a new set of top-down global rules and norms organized once again by the institutions of global economic governance.

Key words: Financial crisis, financial globalization, regulation, money supply, events, distributed preparedness for resilience.

Introduction

This contribution examines and troubles the three crucial aspects of its title in turn; namely ‘financial globalization’, the ‘crisis’ and ‘what is to be done’’. The argument is that each of these terms is highly problematic and critical attention needs to be brought to bear on each of them. The article goes on to analyses why the existing explanatory frameworks for the financial crisis are at best partial and at worse wildly inadequate.

Financial Globalization?

Do we have a genuinely ‘global’ financial system? Strictly speaking financial globalization would involve a set of financial markets, exchanges and institutions which trade in financial instruments and channel global savings (wherever they are generated) to investment wherever the risk-adjusted rate of return is the greatest. In this way, financial institutions and markets intermediate between agents irrespective of their location or that of the institution or market. Such a liberalization of trade in financial assets would make countries irrelevant; asset prices, portfolios, and firm financial policies would no longer be in any way country dependent or necessarily tethered to domestic financial markets (Stulz 2005). But the reality is that these conditions are not met by the current international financial system, and are unlikely to be so for the foreseeable future (Hirst, Thompson & Bromley 2009, chapter 6; Thompson 2009). The rest of this section provides evidence for this and explains why there is no truly ‘globalized’ financial system. Subsequently it develops an alternative assessment and explores some of its consequences. This is important because unless
the real character of the international financial system is fully recognized it is difficult to suggest sensible measures that might be employed to address its shortcomings and deal with its failings.

A key element in this assessment relates to the way conventional economics goes about analysing the international economic system and globalization. Although there are many alternative specifications and nuances the basic approach continues to be one that models global economic welfare in a perfectly competitive world (though there are models of the kind considered in a moment that work with oligopoly). As the above outline of financial globalization indicates, many presumptions that are controversial and unrealistic would need to be built into such a modelling environment. Nevertheless such a modelling framework still drives the conventional understanding of the financial system as it operates in an international context. One of the specific approaches is to develop a computable general equilibrium model (or C-GEM), the characteristics of which can be used to illustrate many of the difficulties and misunderstandings associated with globalization as conventionally analysed.

Although such C-GEMs are too mathematically sophisticated and complex to be fully considered here at their heart is an expression in square brackets shown in equation (1) immediately below, which can be used to illustrate the basic approach (though this is not meant to be systematic).

\[
\Delta W_G = \left[ P_i^i x - P_{i(e)}^i W \right] \cdot \left[ P_n^N - P_{n(e)}^n W \right].
\]

Supposing we were interested in assessing the consequences for ‘global welfare’ (\(W_G\)) of the development of a truly barrier-less global economy – i.e. full global liberalization. This would involve comparing and then aggregating all the differences in actual prices of goods and services operating in different markets and countries with those prices prevailing in such a barrier-less, perfectly competitive world. For any particular good or service \(i\) in country \(X\) \((P_i^i X)\), the comparison is with the single price that would prevail for that good or service under conditions of perfect equilibrium at the world level \((P_{i(e)}^i W)\). These comparisons would be made for every

\[1\] Many of the themes developed here were first outlined in Thompson (2004). In addition the basis of the detailed arguments advanced about the recent crisis derive from my contributions to the Open Democracy web-magazine in 2008 (http://www.opendemocracy.net/article/some-contrarian-views-on-the-current-financial-crisis; and http://www.opendemocracy.net/article/international-contagion-under-national-leadership)

\[2\] For particular application of this technique by the World Bank see Essama-Nssah (2006)
good and service in each country \((P_{i,N})\) and the differences aggregated to compute the change in global welfare \((\Delta W_G)\) consequent upon the ‘introduction’ of a truly barrierless global market. In very simple terms this is what a C-GEM does and it provides the basis justification for considering the beneficial welfare effects of liberalization and globalization, one where there are no impediments to trade or financial flows.

But herein lies the rub, so to speak. In contrast to the formation and use of C-GEM, the actually empirics of modelling international trade and investment \(\text{flows}\) usually involves the operationalization of a gravity model as specified in general terms by the second equation given below. Again this is used for illustrative purposes only\(^3\). What it shows are all the elements that keep the two main variables in equation (1) apart, so to speak (ie., \(P^i_x - P^{(e)}_{w}\)): what goes on in between these two variables and accounts for their differences.

\[
I_{ij} = a + b\left(\frac{GDP^i}{P^i}\right) + c\left(\frac{GDP^j}{P^j}\right) - d(D_{ij}) \\
+ e(BDR_{ij}) + f(LAN_{ij}) + g(COL_{ij}) \\
+ h(BLOC_{ij}) + k(LAW_{ij}) + l(CUR_{ij}) + u \cdots \cdots \cdots (2)
\]

The first line of equation (2) gives the basic gravity model variables. In this case investment flows between countries \(i\) and \(j\) \((I_{ij})\) --- but this could alternatively be trade flows -- are a positive function of the per capita income of the two countries and a negative function of the distance between them. But that is not the end of the matter because a series of control variables are added to account for institutional, cultural and geographic differences between countries that can also (partially) account for the amount of investment flows between them. Only the most common and important of these are used in this illustrative exercise. The variables on the second line indicate whether the two countries share a common border \((BDR)\), whether they share a common language \((LAN)\), and whether there is some colonial history between them \((COL)\). On the following line added dummy variables indicate whether the countries belong to a common trading bloc \((BLOC)\), whether there is a common legal framework \((LAW\ -- \ so \ that \ contracts \ can \ be \ confidently \ enforced)\), and finally whether the two countries share a common currency \((CUR)\). All these have been shown to significantly contribute to investment (and trade) flows between countries.

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\(^3\) For a thorough analysis of the use of gravity equations in modelling international trade see Rauch 1999.
(Hirst, Thompson and Bromley 2009). Other variables could be added and some subtracted as suits the analytical purpose or issue being confronted\(^4\).

The point about this discussion is that the cultural, institutional and geographical variables shown in equation (2) cannot just be wished away via a process of ‘liberalization’. The barriers they produce to international economic interactions (trade and financial) are real. They constitute part of the ‘structure’ of the system, and inhibit the full realization of ‘global’ welfare benefits. Indeed, the continued existence of countries with borders, territories and jurisdictions implies modelling the international system in a different manner, one that does not presume a single global market could somehow be conjured into existence: differences between P\(_i\)'s will always remain pertinent, even in the context of financial markets.

**Global or Supranational Regional?**

One of the problems with existing dominant approaches towards the analysis of the financial system is indicated by the data plotted in Figures 1 and 2.

[Figures 1 and 2 here]

These show typical measures of financial globalization: foreign assets and liabilities as a proportion of GDP and the external assets and liabilities of the banking sector only. In each case there seems to be an unproblematic growth of ‘financial globalization’. But the question to ask is exactly *where* all this activity is taking place? As presented the data is too aggregated (though the differentiation between the industrial economies and the emerging markets and developing economies shown in Figure 1 begins to unpack the issue).

Figure 3 breaks up the ‘global’ into the patterns of flows between geographical areas for 1999 and 2007 respectively (expressed as a percentage of world GDP) and shows the size of domestic financial assets in each area. What are we to make of this data?

[Figure 3a and 3b here]

Clearly between 1999 and 2007 there was a growth in the complexity of financial integration. But there is also a certain continuity. As might be expected – though this needs to be strongly stressed – it is the USA and greater Europe (Western Europe, UK, Russia and Eastern Europe) that dominate in terms of both flows and the size of domestic financial assets. And this position did not change much between 1999 and 2007. Even in 2007 – the eve of the crisis – just these two areas accounted for over 70% of global domestic assets and global flows (Thompson 2009). This is why the financial crisis could legitimately be described as a North Atlantic crisis not a global one (Thompson 2009; Nesvetailova & Palan 2009). And this description is reinforced

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\(^4\) In the equations for investment flows (FDI, equity) the distance variable (D) is a highly significant one (see Hirst, *et. al.* 2009, Table 6.9).
by the data included in Figure 4, which shows where financial write-downs of the banking sector happened over the crisis period. These were almost entirely accounted for by the Americas and Europe.

[Figure 4 here]

What is more, of all the losses of over US$1bn incurred by 35 separate financial institutions up until August 2008 only one of these was outside of the USA or Europe (National Bank of Australia at just under $1.bn) (The Guardian August 9th, p.32-33) and similar data is shown by the Financial Times (www.ft.com/bailouts; ‘Government bail-outs’, accessed 22 January 2009). Thus for all intents and purposes the financial crisis was not a truly global one. It was an inter-national one centered on the North Atlantic economies with only one or two exceptions. And the reasons are obvious from the analysis of what a global financial system would look like, and the data shown in Figure 3.5 If the system were truly global then losses of this magnitude would already have had a devastating impact ‘globally’ on commercial banks in many other countries, but this has not happened.

So we need to draw an important analytical distinction here; between an inter-national economic structure (note the hyphen -- not an 'international’ one) and a global economic structure (Hirst, Thompson & Bromley 2009, chapter 1). An inter-national economy is an economy made up of a series of individual national economies that interact between themselves mainly via elements like trade interdependency, investment integration and migration (trade, investment and labour flows across borders). The most significant feature of this -- though not the only one -- would still be these separated national economies that interact between themselves.

On the other hand a global economy would be an economy that existed as a single economy in its own right somewhat beyond the interacting individual national economies. This economy would be driven by market forces and competition between 'footloose' economic agent (companies, banks, financial institutions, individuals) that are not clearly tethered to any single national economy but which would take the global arena as their sphere of operations: producing, sourcing, marketing etc., and moving their operations across the globe according to the profitable opportunities that present themselves anywhere. This mirrors the description of financial globalization outlined above. These two types of economy are 'ideal types' -- a kind of conceptual model -- that do not exist as such in practice or on the ground, so to speak. They provide an abstract image of two different possible types of economy.

5 As of December 2008 the Financial Times estimated that the total costs of the ‘global’ bailout had already risen to US$8,000bn, but other estimates suggested this might be as high as US$30,000bn for the USA alone (http://www.usnews.com/blogs/capital-commerce/2008/9/22/bailout-prevents-great-depression-20.html). All of this must remain somewhat speculative of course. But what is more certain is that the vast bulk of these losses were incurred in a very few countries.
In this context contagion between different markets and national economies could be a feature of either these two types of economy. There has been large scale contagion during the crisis, and there is little doubt that the international economy is in a deepening recession (perhaps even moving towards a depression). But contagion – between different markets and between different countries -- has been a feature of all financial crises ever since the Tulip speculative bubble of 1637. There is nothing particularly new about this. However, measuring the degree of contagion during financial crises is complex and controversial. There are several approaches. All estimate correlation coefficients between different markets in different countries. But correlation coefficients do not necessarily say anything about causation, so further analysis is conducted to isolate the transmission shock associated with an international disturbance from that associated with a purely domestic disturbance (to establish the degree of ‘international contagion’ only). But this could be caused by there being ‘underlying’ macroeconomic variances between countries, or trade disturbances, or simply because of ‘news shocks’ (see Fernández-Izquierdo & Lafuente 2004; Nikkinen, Omran, Sahlström & Äijö 2006; Serwa & Bohl 2005 for representative examples of these approaches). So contagion – the transmission of shocks – should not be confused with interdependency – the existence of high correlations (Eichengreen, Rose and Wyplosz 1999). But contagion is quite compatible with either an inter-national economic structure or a global one as defined above; it is not necessarily associated just with ‘globalization’.

The Impossible Conditions for a Genuine Global Financial System

The bottom line in respect to this consideration of the extent of financial integration and globalization is to stress the structural limits to this process once again. As long as there remain different currencies tied to different domestic financial systems, i.e. no single global currency; no proper global central bank to act as lender of last resort for this single currency; and only a few countries that can borrow on the international markets in their own currency to finance their economic activity while the vast majority of other countries must borrow in someone else’s currency, there is a necessary structural disjuncture between domestic and international financial systems which cannot be bridged (Arestis & Basu 2003; Arestis, Basu & Mallik 2005). This is the structural basis of all the uncertainties and risks in the international financial system, and these conditions will not go away in the foreseeable future. These structural constraints inhibit the formation of a genuinely global financial system, leaving a much more differentiated system of national domestic, international financial, and supra-national regional relationships and interactions that need to be viewed in their specificity and singularity rather than as a single coherent ‘system’.

And this serves to raise a very important point about the future of financial globalization and the consequences for the renewed global regulatory standard setting debate, particularly in the case of financial globalization. The consequence of the remarks above is to suggest that full financial globalization is impossible without such a single global currency, and given that such a single currency is most unlikely
(indeed, for the foreseeable future politically impossible), then there will be no full ‘global’ financial internationalization. This looks like an impossible dream.

Of course there are many calls for a single global currency, mainly by American economists who see this as a way of further bolstering the international position of the US dollar (e.g. Rogoff 2001; Cooper 2007; see also Tobin 1998). And it is also important to recognize that the call for a single global currency is not a new phenomenon. In the previous period of globalization during the second-half of the 19th Century there were feverish discussions about the possibility of inaugurating a single ‘global’ currency, originally based upon the Latin Monetary Union of 1865 (Einaudi 2001). There were conferences in Berlin in 1863 though the debate began in earnest as Napoleon III called an international monetary conference in 1867. But the vision of the 1860s was never realized (Bordo & James 2006) as the proposals foundered upon incompatible political differences as to exchange rate conversion procedures and administrative means to ‘manage’ monetary policy and banking activity. The lesson of this episode should not be lost on the current debate, however. It demonstrates that money involves matters of sovereignty, indeed political issues are at the core of both the creation and the operation of money (Knapp 1924; Keynes 1930; Goodhart 1998; Ingram 2004, 2006). Without getting into a long history or analysis, the definition of money, the creation of money, and the operation of money require a political authority to issue it and provide for its credibility. The implications of this is that there is a need for a ‘big government’ with a ‘strong central bank’, and clear ‘lender of last resort’ facilities, to manage the financial cycle by constraining the boom and softening the slump. This is as necessary in an international setting as in a national one. Without all of these conditions, money and finance will not operate ‘efficiently’, let alone optimally.

Under these circumstances the introduction of new global banking and credit worthiness standards may be desirable -- even necessary -- but they are also impossible under a regime of financial liberalization and floating exchange rates. Whilst there are different currencies, not all of which are used as either international transaction currencies or as the standard of prices and asset values, uncertainty rules in financial markets, which necessitates the introduction of various credit worthiness standards to try to govern this. However, these standards are inherently unstable given the need for the less developed and emergent market countries (the vast bulk, in fact) to earn foreign currency and finance their commercial activity through the issuance of assets not denominated in their own currencies. As we have seen above, this opens up a necessary structural ‘rupture’ or ‘separation’ a), between the ‘domestic’ and the ‘international’ financial systems of countries, and b) between those able to finance their activity in their own currency and those who cannot.

Such an inherent instability means that there are great pressures to opt for some kind of regional response. This provides for the big government, strong central bank and lender of last resort facilities so necessary for some form of financial stability. The EU is the current ‘home’ for such a response, and not just in the case of monetary
developments. This is not the place to discuss the enormous range of standard setting initiatives being promulgated from within the EU. These not only affect intra-EU economic and other activity, but are having important effects on the wider international standard setting environment. In many respects the EU is the main active player in developing ‘international’ standards as the US remains reluctant to initiate or participate in any standard setting processes that do not meet its own narrow interests and advantage, and while East-Asia is still in the early days of forging common rules and norms. However, as has been argued above at various levels more and more financial standard setting looks to be becoming ‘sub-global’ in character even as current trends are not unambiguous (Thompson 2005).

A final point to make in this section is that the ‘global’ character of the crisis was largely a media constructed event, though it was aided by politicians who have bought into the globalization story for basically domestic political reasons: it provides an excuse when necessary for them to off-load blame and to discipline their citizens in the name of ‘international competitiveness’. In addition almost every ‘City’ commentator has a vested interest in claiming global aspect to the crisis since this bolsters the scope of their activities. But also -- and perhaps most disappointingly -- many academic commentators fell for this story since they are themselves mesmerised by the prospects and spectacle of a new epochal rupture, one that allows them to indulge their skills as critical analysts of profoundly changing events. Never ones to miss an opportunity for hyperbole and exaggeration, for all of these parties a ‘global crisis’ sounds so much better than an ordinary and boring multi-domestic or international one.

The Crisis

Crises always expose the underlying character of situations and events. They are intriguing - even attractive - occasions since they provide a glimpse into the very structure of the system. Indeed, there is probably a subliminal desire for crises: they enable decisive action to be taken, leadership to be exercised, hands to be rung, mistakes to be exposed, blame to be apportioned. They break the normal pattern of the mundane.

Crises are also periodic ‘events’. But what exactly is an event? Things are always happening but events seem something more, something beyond the ordinary – an

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6 A blatant instance of this was Gordon Brown (the UK Prime Minister) who in an interview for the BBC Radio 4 ‘Today’ programme on 23 January 2009 argued that the financial crisis was solely the result of irresponsible lending in the USA. He also reiterated fourteen times that this was a “global financial crisis”, presumably something being faced in the same way by everyone.

7 Thus, echoing a point made above, the media loves them; it chases them, helps construct them, and revels in them: ‘breaking news’, ‘global tremors’, ‘the worst day on Wall Street since…’, etc. Crises are enthusiastically embraced by the media when they erupt.
unexpected eruption. In the social world events display two related aspects: first they break on-going processes by establishing ‘differences’ between before and after; second they draw together ‘dispersions’, seemingly creating a momentary unity amongst a range of different instances and contexts -- but at the same time precisely preserving that dispersion by exposing its distribution. Summing up, events might be described as an occasion for the ‘dispersed unity of differences’.

How are any of these remarks pertinent from the point of view of the recent (and ongoing) financial crisis? First the crisis exposed the real nature of the monetary system. The extreme measures adopted by the authorities -- the ‘nationalization’ of large sections of the financial system -- indicates to a basic structural truth of capitalism. The only way to gain control of the money supply is for there to be a socialized financial system. This may sound paradoxical – and it is!! But in a capitalist system where credit is the basic form of money, controlling the money supply is always crucial but also problematical. The money supply (credit) is crucial because that economic agent who has money has command over resources. As a result there is always an intense political struggle over controlling the money supply; between the ‘public authorities’ on the one hand and private economic actors in the financial system on the other. This was exposed very acutely during the debate about ‘monetarism’ in the 1970s and 80s. The monetarist argued the authorities could ‘manage’ the economy simply by controlling the money supply. But central bankers knew differently. Though they never quite couched it in these terms, the central bankers knew they could not control the money supply. That was in the hands of private economic agents – who, of course, jealously guard this capacity at all costs.

An additional -- and related -- aspect of ‘events’ would be to stress their specific political character. According to Badiou (2001) and Rancière (1999) genuinely political events are those that declare a radical equality. They announce an equality where there had previously been a deep inequality. They right a wrong (Thompson 2007). In the context of the financial crisis being discussed here, this would manifest itself in the way such events seem to demonstrate a unity in the diversity they display, and the way they open an opportunity to put right things that had, up until then, been going very much awry.

In the contemporary crisis the emphasis on the private control of the money supply was signalled by the call from several leading UK monetarists for the government to once again borrow from the commercial banks to create money (to prevent a potential deflationary spiral from emerging): “Money being destroyed by the collapse in bank lending to the private sector must be made good by bank lending to the public sector…. If banks’ claims on the private sector fall, the initial effect on the other side of the balance sheet is a matching decline in their deposit liabilities (ie, the quantity of money). In these circumstances there is a risk of a debt-deflationary spiral. If so, the right policy response is for the government itself to borrow from the banks…… If the government borrows from the banks on an appropriate scale [….] we believe that a wider recovery can be reconciled with reductions in the private sector’s indebtedness to the banks.” (‘Government must borrow from banks to create money’ Financial Times letters, December 31 2008, p.10.) This approach is an indirect challenge to the idea of ‘helicopter money’ -- as explained by Martin Wolf (FT December 17th, p.11) and in Willem Buiter (2008). The creation of helicopter money would involve the government selling Treasury Bills to the Bank of England (not the private commercial banking sector), which would then become assets of the Bank. The Bank could then create liabilities to match these assets in the form of expanding the monetary base (‘printing money). That cash could be used to purchase the TBs, so the government would have money directly to hand to use as it wished (substitute for tax cuts, give away, use to purchase resources, etc.). This would locate the creation of an addition to the money supply firmly with

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To control the money supply would have meant socializing the financial system, the complete opposite of the monetarist’s policy prescription of liberalization and deregulation. But therein lies the paradox. Instead, the central bankers tried to manage the financial system, and influence private economic actors – and the economy beyond – via an interest rate policy. But interest rates affect the demand for money in the first instance, not its supply. Thus the authorities never implemented ‘monetarism’ proper because they knew they could not. Rather they adopted an interest rate based policy, which was clearly only partially successful. As we have seen subsequently, however, private economic agents relished their renewed capacity to ‘control the money supply’ by indulging in an orgy of credit creation.

This orgy of credit creation was brought to a sudden halt by the ‘credit crunch’. Indeed, credit creation (money supply) almost stopped. This provided the opportunity - and indeed the very necessity - for the authorities to confirm the basic truth of the above remarks by nationalizing large sections to the financial system so as to try to kick start the money supply process again. In extremis deep structural characteristics are revealed. And as a consequence of this nationalization administrative means of distributing credit have emerged. Indeed, this administrative mechanism was written into the very terms of the nationalization moves. The commercial banks and other financial institutions involved were instructed to allocate credit in various ways: to existing mortgagees (delay or abandon foreclosures) or to small businesses. And many more claims along these lines – for administrative allocation of credit in a very general sense – subsequently emerged. Thus we have seen other vulnerable financial institutions seeking help, and large industrial companies radically undermined by the recession to claim their share of support. All this is a consequence of nationalizing the financial system; administrative methods for the creation and allocation of credit take over from the market.

Secondly this was a genuine event in that it galvanized all parties into action. And in a ‘period of the exception’ the location of sovereign power was once again (ex)posed.

The public authorities in the first instance (because the Bank of England is a joint stock company whose shares are all owned by the Treasury).

10 Thus the authorities in effect conducted a ‘Keynesian’ monetary policy not a ‘monetarist’ monetary policy. Indeed, in the 2009 crisis, interest rates have been forced down to almost zero, where monetary policy stops. In principle this enables the government to purchase anything at zero cost to itself (since it can borrow at zero cost) and to spend as much as it likes.

11 However, one of the problems more generally has been whether the nationalized banks – let alone the non-nationalized ones – have acted to pass on any easing of credit condition to their customers. Generally they failed to do this – a consequence of having ownership but not full control in the case of the nationalized banks, which may be an emergent pattern in the financial system. Further nationalization plus the exercise of control (or ‘governance’) may be the answer.

12 Thus Gordon Brown almost became a ‘Schmittian sovereign’ for a while (‘He who decides in the exception’: Schmitt 1998 – in his New York Times column on 12 October Paul Krugman described Brown’s decisive action in the UK as the potential saviour of the world financial system!). This is
So it was nation-states that came to the rescue of their financial systems, not some mythical global response. And this also exposed the basic dispersion of the international financial system. These responses were different and particular: specific to the characteristics of each national financial system. At its basic the international financial system remains just that – still an inter-national one organized between national economies. It is towards the implication of this different reading of the nature of the financial system and its crises for regulatory reform that the next section explores.

**What is to be done?**

As John Kay has reminded us (if such a reminder were ever needed) national economies, international financial markets and businesses are complex, dynamic, non-linear systems, about which it is almost impossible to make specific predictions (Kay 2009). It is foolish to pretend otherwise. Thus the argument here is that if financial crises are fundamentally ‘irrational’ -- driven by ‘excessive exuberances’, ‘animal spirits’, ‘bandwagon effects’, ‘bubbles’, Ponzi schemes, exotic calculative technologies, and the like -- then we should prepare ourselves in quite a different manner than so far for the next crisis – because there will one.

Given the analysis so far, the first lesson to be learned is that further ‘global’ rules to try to tame the financial beast are very unlikely to be successful. This is not an argument against strong regulatory rules but only against these always being conceived as necessarily global in scope because the financial system is thought to be global. If it is not – and indeed will continue not to be so – then a different response is called for. Analysis of the financial system conducted elsewhere – and of the ‘real’ economy beyond -- suggests the trajectory of development is largely supra-nationally regional in organization and not global, and with continued strong nationally base characteristics (Hirst, Thompson & Bromley 2009, chapter 6; Thompson 2009; Agur 2008). If this is so, supra-national regional and nationally based responses would be more sensible. This would allow for these to be tailored to the specific conditions and features of such regional or national financial confutations; it would enable agreement on what to do to be reached more easily since fewer players are involved; and it

somewhat of an exaggeration, of course, since the very existence of the UK state was not in question (though it might have been more the case of Iceland’s Geri Haarde).

13 In part this ‘irrationality’ can be illustrated by the way that options contracts (which are important in the derivatives markets) are priced – in fact necessarily ‘miss-priced’. Two key assumptions for valuing options are that the volatility of returns is constant and their distribution is log-normal (Black & Scholes 1973; Merton 1973). In practice neither of these assumptions is likely other than by pure chance: usually returns are volatile and unexpected combinations of events disrupt their distribution. This means that strictly speaking options can only be ‘correctly’ priced ex-post, when the contact has matured (because then the actual volatility and distribution would be known). These problems have given rise to a complex debate about options pricing (e.g. Mehring 2005; MacKenzie 2006).
would encourage ‘regulatory innovation’ since different regulatory frameworks would arise. Some (managed) regulatory competition is no bad thing. In a moment I’ll address what could be thought to be one of the major drawbacks of this structure: it might allow or further encourage clever financial operators to find and exploit the gaps left within it, precisely the problem experienced with past regulatory structures. But as a first step a thorough ‘audit’ of what the main financially affected countries have done in their individual responses to the crisis should be conducted. This would provide a necessary information base on what each country had already installed in terms of domestic regulatory structures before the crisis hit, how robust they proved to be, and what has since been done to reform them. The objective here would be to initiate a period of ‘mutual learning’ – not in some top down manner driven by the (now largely discredited) global institutions of financial governance but from a bottom up one, by listening to the range of different responses that were extant and later introduced at the national level.

Clearly, the present financial crisis is deep and very serious – indeed for the banking sector in particular it may be the worst crisis since the 1930s, and it has spilled over into the real economy of those countries most closely affected. But financial crises come and go – this is not the first such crisis and nor will it be the last. And here we need to reflect upon the typical ‘financial-crisis cycle’ as I would term it. It is a little difficult to know where exactly to analytically break into this cycle but for convenience I’ll do this with the phase involving ‘financial innovation’ since this is a central part of the existing concerns. Financial innovation always raises many fears as it takes hold which are well documented and discussed at the time. Warnings are offered as to their likely downside effects but these warnings are, of course, never properly headed by authorities or regulators (for reasons outlined in a moment). But this leads to a second phase as the crisis largely brought about by these innovations hits the system. This results in a great deal of fire-fighting (as recently and at present) to try to gain control of the crisis and prevent it spreading. It leads to a lot of hand-wringing, immediate soul-searching, recriminations, and so on (“Why didn’t we see this happening or head the warnings, etc?”). As the crisis subsides this is followed by a longer analytical diagnostic post-mortem phase. What were the reasons for the crisis? Who or what was to blame? What lessons can be learned and what done to prevent a further crisis? This is a difficult phase because there is never agreement about causes or consequences. However, alongside this, or just behind it, the ‘authorities’ begin to act, putting into place a discussion about measures needed to prevent another crisis of this type. This phase requires a political mobilization to gather momentum amongst the effected parties. And this is the most difficult and lengthy phase because getting a consensus about what to do never easy. Eventually, some consensus is reached, however, which usually means a very watered down and minimalist set or regulatory responses are agreed and gradually implemented. But meanwhile, of course, the system has moved on and a new set of financial innovations has taken hold, so the responses to the previous crisis now being gradually implemented look as though they are unnecessary or addressing yesterday’s problem.
And the fact that the authorities are still grappling with the regulatory consequences of that previous round of innovations means their focus is not on the existing round or the threats these now pose. So the cycle continues.\textsuperscript{14}

I was once at a conference where I asked a panel of regulators and central bank governors what could be done, if anything, to break this cycle and their response was intriguing. They said that this was an ‘existential question’ and that such existential questions could not be answered! On reflection, however, I think this answer should be taken seriously. Perhaps the mind-set of such bank governors and regulators is so focused on traditional responses that they cannot jump out of that mind-set and see that the system is actually ‘existential’ in the sense that it is ‘irrational’.\textsuperscript{15} It is not, therefore, amenable to systematic and calculative responses where the IMF’s Financial Stability Forum or BIS Basel Committee simply begins another round of negotiations for a comprehensive and consistent set of new global regulatory norms and rules to be adhered to by everyone (as suggested in Mattli & Woods 2009 for instance). Rather what is needed is a realization that financial insecurity is going to continue to be a fact of life; involving as it does ‘excessive exuberances’, ‘animal spirits’, ‘bandwagon effects’, Ponzi schemes, and so on. If this is so what is needed is to organize a highly flexible regulatory regime of ‘distributed preparedness for resilience’, one that does not presume a single centre from which a new elaborate global regulatory regime emanates (Collier & Lakoff 2008).\textsuperscript{16} This approach would have to pay particular attention to the necessarily fragmented nature of financial regulation -- given the range of initiative as suggested earlier -- in an attempt to forestall any exploitation of the gaps within it. But it would need to recognize that the crisis represented only a tempor\textsuperscript{ary} dispersed unity of differences as suggested above, not a permanent one, so that the underlying distribution of differences continues. To address this would involve a lot of contingency planning and attempts to coordinate the disparate array of ‘local’ (supra-nationally regional or national in our case) organizational and partial initiatives, requiring the application of improvisational skills and ingenuity. This approach -- which Collier (2008) terms enactment based assessment -- is contrasted to the traditional archival-statistical approach which relies on assembling knowledge from already known risks and past patterns of events. The

\textsuperscript{14} See Reinhart 2008 and Reinhart & Rogoff 2008 for the way the ‘financial-crisis cycle’ has reproduced itself over many centuries, and the failure of the regulatory authorities to come to terms with this.

\textsuperscript{15} An existential moment in this context would be a crisis that lacks purpose, meaning or authentication, leading to anxiety, disorientation and confusion in the face of the seeming randomness, absurdity and volatility of events.

\textsuperscript{16} Here the lessons from natural disaster planning are introduced. And although in its own terms this has been problematic (eg. in the case of the flooding in New Orleans in 2007) in principle it provides an important alternative conceptual apparatus for thinking about crisis management (Grossi & Kunreuther 2005).
task would be to map the vulnerabilities and network the relationship between them. And this regulatory world would always need to expect the unexpected.

And whilst it will be difficult for those states that have socialized large sections of their financial systems to return these to private ownership quickly, this is not necessarily a priority. It may be that a newly formulated regulatory regime will require a continued presence of public ownership of significant parts of the financial system, if nothing else because of the analysis above indicating the difficulty of kick starting the credit/money production process without it. And this may be the only effective way to deal with the continued dispersed character of the international financial system and to prepare for the resilience necessary to deal with new unexpected eruptions as they happened, because these will happen whatever is done.

Of course, such a response along these lines is unlikely. More likely is for the traditional financial-crisis cycle to kick in once again. But imaginative thinking about the future to try to create a robust alternative conception is absolutely necessary, even if the precise terms of what has been suggested here proves wanting. However, this can hardly be worse that the recent madness.

References


17 This problem is almost recognized by Martin Wolf when he laments the failure of conventional economic analysis to have spotted the oncoming crisis: “The difficulty was that we all tend to look at just one bit of the clichéd elephant in the room. Monetary economists looked at monetary policy. Financial economists looked at risk management. International macroeconomists looked at global imbalances. Central bankers focussed on inflation. Regulators looked at Basel capital ratios and then only inside the banking system. Politicians enjoyed the good times and did not ask too many questions. What of commentators? They tended to indulge the fantasy that the above knew what they were talking about….. One big lesson of this experience is that economics is too compartmentalized and so, too, are official institutions. To get a full sense of the risks, we need to combine the worst scenarios of each set of experts.” (‘An embarrassing admission’ FT, December 29, 2008, p.12)


Figure 1: ....

**Figure 2:** Foreign assets and liabilities as share of GDP
Industrial Group and Emerging Markets/Developing Countries Group, 1970-2004

![Chart](image)

Note: Ratio of sum of foreign assets and liabilities to GDP, 1970-2004.
Source: P.Lane and G.M. Milesi-Ferretti, 2006, The External Wealth of Nations (Mark II), CEPR Discussion Paper

Figure 2: External bank assets and liabilities
Figure 3 (a) and (b): Financial Flows Between Major Economies 1999 and 2007

Notes: External assets/liabilities “ex. off shore centres” exclude financial centres (Bahamas, Bermuda, Cayman Islands, Isle of Man, Jersey and Netherlands Antilles). The data cover banks’ unconsolidated gross international on-balance sheet assets and liabilities. They are based on the residence of the reporting institution and measure the activities of all banking offices residing in each reporting country. Such offices report exclusively on their own unconsolidated business, which thus includes international transactions with any of their own affiliates. BIS reporting banks include banks residing in Australia, Austria, the Bahamas, Bahrain, Bermuda, Brazil, the Cayman Islands, Chile, Denmark, Finland, Greece, Guernsey, Hong Kong SAR, India, Ireland, Isle of Man, Jersey, Korea, Luxembourg, Macao SAR, Mexico, the Netherlands Antilles, Norway, Panama, Portugal, Singapore, Spain, Taiwan and Turkey. Detailed information on breaks in series is available on the BIS website under http://www.bis.org/publ/bks/index.htm Source: Ferguson et al. (2007), Ch. 6.
The web of cross-border investments in 1999...

Lines show total value of cross-border investments between regions*, 1999

Figures in bubbles show size of total domestic financial assets, $ billion

* Includes total value of cross-border investments in equity and debt securities, lending and deposits, and foreign direct investment.

Source: McKinsey Global Institute analysis

...had grown significantly stronger by 2007

Lines show total value of cross-border investments between regions*, 2007

Figures in bubbles show size of total domestic financial assets, $ billion

* Includes total value of cross-border investments in equity and debt securities, lending and deposits, and foreign direct investment.

Source: McKinsey Global Institute analysis

**Figure 4: Bank Write-downs During the Crisis.**