Cambridge Journal of Economics 2009, **33,** 539–562
doi:10.1093/cje/bep032

From global imbalances to global reorganisations

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The world feels itself to be in transition, but to what is unclear. Will the liberal market model retain its normative primacy once some semblance of normality is restored, or will other varieties of capitalism, with a bigger role of the state, acquire more legitimacy? The answer depends partly on one's explanation for the current crisis. This essay argues, first, that global imbalances had too important a role to ignore, in contrast to a mainstream view that focuses on mistakes in monetary policy and financial regulation. It argues, second, that in light of global dynamics, the crisis is likely to become worse by early 2010—which, on the face of it, makes significant reorganisations of capitalism more likely. The third section lays out what should be done to reconfigure capitalism at national and international levels. The final section discusses the political economy of policy reforms in terms of the difficult translation from what should be done to what can be done. The broad conclusion is that in five years from now the liberal market model will have been restored to normative primacy and 'we must have more globalization' will again be the elite rallying cry; but the crisis will have left behind sufficient doubts about factual propositions and value priorities that political parties and economists advocating alternatives will have more scope than they have had for the past three decades.

Key words: Financial crisis, Global imbalances, Monetary policy, Financial regulation
JEL classifications: D30, E44, E50, E60, F01, F02, F30, F50, G15

'I would place the U.S. current account [deficit] far down the list of imbalances to worry about' (Greenspan, 2007, p. 347).

'The banks are fucked, we're fucked, the country's fucked', British cabinet minister, speaking off the record (quoted in Wintour, 2009).

'We cannot rebuild this economy on the same pile of sand', President Obama, April 2009 (Stevenson, 2009).

A man runs into the castle just as an executioner prepares to behead the king and shouts, 'Stop! Wait! Government's no longer the problem – it's the solution'. *New Yorker* cartoon, 9 March 2009.

Two executives sit at a conference table studying documents, and one says to the other, 'These new regulations will fundamentally change the way we get around them'. *New Yorker* cartoon, 9 March 2009.

Manuscript received 13 March 2009; final version received 14 May 2009.
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1. Introduction

Severe economic crises, like major wars, force the pace of change in economic regimes and inter-state relations. They redistribute wealth and power, benefitting some sectors, classes, states and international organisations, harming others. Today, six years into unwinnable wars in Iraq and Afghanistan and 22 months into what began as a first-world asset crisis and has mutated into a global economic crisis, the world feels itself to be in transition. The Anglo-American variety of capitalism is discredited; America's hegemonic role in the military, political and the financial realms since World War II is weakening; continental Europeans long used to American and British scorn for their 'nanny states' are standing up to American attempts at influence; China's government is beginning to contribute to the global debate on financial reform; the G20 has replaced the G7. Alignments are shifting, but towards what is unclear (Greenaway, 2009).

Are we moving away from the normative primacy of the 'liberal' capitalist economy (in which the state acts in a regulatory and facilitating role), and towards a 'governed' capitalist economy (with the state more involved in sponsoring structural change) or a 'coordinated' capitalist economy (with the state providing both extensive social policies to buffer the costs of change and the framework for organised actors to coordinate their investment decisions)?

Ten years ago, in response to the East Asian crisis, there was much talk of creating a 'new international financial architecture' (NIFA), including stronger global governance. It did not happen. Once it became clear that the East Asian crisis would not rebound from the periphery into the Atlantic heartland the normal 'issue-attention' cycle of politics reasserted itself and talk of major change evaporated. Instead, we got the Financial Stability Forum (FSF) and a lot of standards and codes of best practice in banking, accounting and data dissemination. This does not constitute a 'new regime'. The model of the liberal capitalist economy retained its primacy as global model, both at the level of factual propositions about the efficiency of markets and at the level of value priorities in favour of the belief that the pursuit of self-interest within the rules and conventions of society also promotes the public interest (Wade, 2007A, 2007B; Vestergaard, 2009).

However, looking back, we can see—following Karl Polanyi and Carlota Peretz—that cutting across the distinction between liberal, governed and coordinated capitalisms, is cyclical movement between regimes of more liberalism and regimes with more state and societal regulation, especially in markets for finance, land and labour. Since World War II the West has experienced two clear changes of capitalist regimes. The one established in 1945 sanctioned much more state 'interventionism' than before, with one of the state's main roles being to protect individuals against risks. The second, which can be dated at about 1980 and the Reagan and Thatcher governments, moved towards a new version of the liberal capitalist economy, in which one of the state's new roles was to help individuals profit from risk. Both regime changes were justified by changes in value priorities and in factual propositions about states and markets.

It seems that today a page has again been turned. Policies excoriated by the right—nationalisation, higher taxes, Keynesian economics, financial regulation—are suddenly back on the agenda of liberal capitalist economies. So the big question is whether we will add 2008 after 1945 and 1980. Or whether we will see, looking back, that we are in a 1999 moment, when the talk of radical change evaporates as the attention cycle of politics reasserts itself and the liberal model regains its primacy, with a bit more regulation of certain markets and perhaps 'a mushy collectivist pseudo-altruism' in the atmospherics.[1]

[1] The disparaging phrase is Samuel Brittan's, 'A catechism for a system that endures' (Brittan, 2009).

Much depends on how bad the crisis turns out to be. The shift towards an interventionist regime in 1945, with its emphasis on stabilising economic growth, reining in finance and protecting individuals from risk, occurred after a series of calamities big enough to produce an unprecedented consensus—before or since—that the old regime needed radical reform.

The shift towards freer markets in 1980 occurred after a decade of economic and political disruptions. The disruptions were nothing like as severe as in the 1930s and first half of the 1940s, of course, but they compounded the mounting anger of big investors, corporate executives and the political right due to the calamitous fall in the relative income of those at the top of the distribution. The top few percentiles of the US and UK income distributions had experienced decades of compression of their share of total disposable income. In the USA the income share of the top 1% fell from a peak of 23% in 1929 to about 8% in 1970, and stayed at around 9–10% through the 1970s, while the middle three quintiles experienced the biggest income growth. The hidden agenda of the Reagan/Thatcher revolution was to reverse this 'Great Compression' and allow income and wealth to be restored to their rightful owners at the top—combining market liberalisation with an array of state measures which had the effect, intended and unintended, of intensifying redistribution upwards (Baker, 2006; Palma, 2009).[1]

The Reagan/Thatcher policy changes were phenomenally successful, helping to produce the biggest upwards redistribution in the West in over a century. From 1980 the share of the top 1% in the USA took off like a rocket to regain 23% by 2006, about the same as the 1929 peak. In the seven-year expansion during the Clinton administration the top 1% of income earners accrued 45% of the total growth in pre-tax income. In the four-year expansion during the Bush administration the top 1% accrued 73% (Palma, 2009). To have achieved this in a smoothly functioning democracy is political artifice of the highest order, and it is no surprise that elites elsewhere raced to follow suite.[2]

Will the current crisis generate sufficient anger and political mobilisation that politicians change the rules so as to make it significantly less likely that bankers can go on pulling the wool over the eyes of the political and regulatory establishments, less likely that the top 1% can so divorce themselves from constraints of fairness and citizenship, and less likely that the world economy is so open to financial contagion?

[1] The proposition that 1980 marked the onset of a new global regime has to be qualified by the fact that some major economies moved much less slowly in this direction than the Anglosphere; but the Anglosphere called the shots in terms of 'global' policy norms (see Dore, 2000; Weiss, 2009). Linda Weiss (2009) qualifies the liberal, governed, and coordinated typology, stressing the polymorphous character of the state (liberal in some parts, stewarding the market in others, coordinating organised groups in others) even as the image of the 'liberal market state' has been most *influential* since the 1980s.

[2] Part of the trick was to make it 'common sense' that markets are smart and governments are stupid, that the private sector is inherently more productive than the public. Here are two illustrations of how far this assumption shaped empirical 'knowledge'. First, the Cambridge economist Michael Kitson was comparing productivity growth in the National Health Service and in the private health service in the mid 1980s. He found that after the early 1980s the productivity growth rate in the private sector jumped above that of the NHS and stayed a constant percentage above. Puzzled, he contacted the statistician responsible in the national statistical agency. The latter informed him that since productivity in health service was always difficult to measure apart from inputs, and since it was 'obvious' that the private sector was more productive than the public, he had simply added a plausible number of percentage points onto growth in the private sector. The productivity advantage of the private sector had no more basis than that. Second, David Stuckler, Lawrence King and Greg Patton (Stuckler *et al.*, 2009) show that the 'policy reform' index used by the European Bank for Reconstruction and Development (EBRD) to measure the progress of transitional economies on privatisation and liberalisation (of prices, imports) is systematically biased to support the proposition that countries with higher policy scores show subsequently higher economic growth. Whether the bias was intentional or not, it was presumably justified in the minds of EBRD staff by the same common sense.

The first section explains the global dynamics of the build up to crisis, in contrast to a mainstream view that the causes were related mainly to mistakes in US monetary policy and financial regulation. The second section explains why, in light of these global dynamics, the crisis is likely to become worse over the next year. On the face of it, the worse the crisis becomes the higher the chances for major reorganisations of capitalism. The third section suggests what some of the components of these reorganisations should be, at national and international levels. The final section discusses the political economy of policy responses, in terms of the difficult translation from what should be done to what can be done.

2. Causes of the crisis

The most popular explanation focuses on mistakes in monetary policy and failures of financial regulation. Will Hutton, John Taylor and Alan Blinder, for example, make arguments along this line. The implicit or explicit implication is that global imbalances had little or nothing to do with it, as though the existing payments imbalances would have been sustained had there been no failure of US and UK monetary policy or financial regulation (see Hutton, 2009, p. 8).[1] This is a comforting belief, because it implies there is nothing wrong with the larger system; we just have to learn not to make the same policy mistakes next time.

It is true that the crisis has not taken the form anticipated by those who have long worried about global imbalances: a run on the dollar in response to large US external deficits, followed by high interest rates causing a sharp growth slowdown until imports fall enough and exports rise enough for the USA to regain a sustainable external balance. China and other countries have been willing to go on buying enough US Treasuries and other dollar assets to finance the US deficits and sustain the dollar. Rather, global imbalances have had an important causal role not at the international level, in the form of currency recycling, but at the domestic level, in the form of credit recycling to the agents spending more than their income, who are the other end of the external deficit. The breakdown occurred in the credit recycling mechanism.

To put it crudely, if a country is sustaining an external deficit, the indebtedness must be either with the public sector (fiscal deficit) or the private sector (household and firm deficits). If the external deficit remains constant (or rises) and the fiscal deficit falls, there must be an offsetting increase in private indebtedness. In the USA after 2003 the fiscal deficit fell as a share of gross domestic product (GDP) so public borrowing dropped, the private sector deficit grew as expenditure exceeded income, and the current account deficit ballooned. Credit recycling to the private sector took the form of capital inflows going

[1] John Taylor—professor of economics at Stanford, Treasury undersecretary in the first George W. Bush administration, and author of the celebrated Taylor rule of monetary policy—argues that the crisis was caused because the Federal Reserve abandoned the Taylor rule in the early 2000s (Taylor, 2009). Taylor says that the Fed cut interest rates when the rule required them to be raised, which generated a housing boom and rising levels of mortgage debt, which ended in a bust. The bust was made worse in September 2008, when the Treasury announced the troubled asset relief programme, entailing massive government outlays with no clear rationale for their use and no effective oversight. This sparked panic, and the panic became self-generating. Everything else is just 'complications'. Taylor rejects out of hand the idea that global imbalances were somehow involved. Alan Blinder—professor of economics at Princeton and former vice chairman of the Fed—argues that '[I]t was largely a series of avoidable—yes, avoidable—human errors. Recognizing and understanding these errors will help us fix the system so that it doesn't malfunction so badly again. And we can do so without ending capitalism as we know it' (Blinder, 2009). Blinder's series of errors includes Taylor's main cause, as well as the failure to regulate over-the-counter derivatives, the decision of the Securities and Exchange Commission in 2004 to let securities firms raise their leverage sharply (to an average of around 33 units of liabilities to one of assets, from an earlier average of around 12 to 1), the failure to restrain the subprime mortgage surge, plus two more.

mainly into mortgage finance (for example, the central bank of China bought the securities issued by the government-backed mortgage lender Freddie Mac), creating a real estate boom, which enabled households to convert capital gains into consumption in excess of their incomes via extraction of equity, on a massive scale relative to GDP. The build up to crisis happened as this credit recycling mechanism ran out of control, like the sorcerer's apprentice, thanks to rising debt to income, the proliferation of complex and opaque financial products and the breakdown of confidence in counterparties; all enabled by regulators in the grip of extrapolative expectations, boosted in their confidence in light touch regulation by academic economists pushing the efficient market hypothesis. From this perspective we can begin to explain why the 'mistakes' in monetary policy and financial regulation were made. And we can appreciate the fine irony that the run *from* the bad financial assets generated by the credit recycling mechanism has resulted in a run *into* the dollar—pushing it in just the wrong direction needed to reduce the global imbalances.[1]

If global imbalances are too important to ignore, then the current policy responses nationally and internationally are focused too narrowly on the financial system and not enough on the imbalances and what lies behind them, including polarisation in national and international income distributions. Much more change will be needed to achieve a stably expanding world economy than correcting mistakes in monetary policy and financial regulation.

3. Will the crisis get worse?

The global crisis will probably become worse by the first quarter of 2010. For several more years economic growth will remain low and unemployment high; the international monetary system will become more disrupted; and the inter-state system will become more dislocated as governments try to export their unemployment elsewhere. There are multiple reasons in support of these predictions, some to do with past financial crises, others to do with current and near-future events.

3.1 The Great Depression

The counter-intuitive point about the Great Depression is that Keynesian economic policies, as in Roosevelt's New Deal, did not have much effect in reducing unemployment. The increase in government expenditure as a proportion of GDP was only about 5% of GDP (from 10–15% of GDP between 1929 and 1933 and sustained thereafter, while GDP fell by 25% to 1933). This is about the same size as the Obama stimulus package today. It had a relatively small effect on US unemployment through the mid and late 1930s (unemployment rose from 4% in 1929 to 25% in 1933 and fell slowly to 15% by 1940). Unemployment only fell sharply as government expenditure started to soar around 1939 in preparation for war, to reach 48% by 1943, when unemployment hit 2% (Freeman, 2009, which includes those on public relief jobs as unemployed).

3.2 Developed country financial crises since World War II

The conclusion from serious financial crises in Organisation for Economic Cooperation and Development (OECD) countries since World War II is equally dispiriting. With

[1] Wade (2007C) and P. Dorman, "The financial crisis through the lens of global imbalances", personal communication, from where comes the distinction between currency recycling and credit recycling. I also draw on discussions with John Llewellyn, formerly of Lehman Brothers. For more on causes and remedies see Wade (2008B).

reference to the averages for the five worst post-war crises, the stock market fell by 55% over 3.5 years, house prices fell 35% over 6 years and output fell by 9% over 4 years (Reinhart and Rogoff, 2008). If the current crisis follows these averages we will not see much recovery before 2011, taking 2007 as the turning point.

Now to current and near-future events. They suggest that the exploding US fiscal deficit plus the exchange of damaged assets for healthy ones (US Treasuries) may well precipitate a 'reverse tsunami' out of the dollar, putting the international monetary system at risk. Those long anticipating a dollar crash will have the consolation that they were eventually proved right even though they got the mechanism wrong.

3.3 The US Congress will block more funding for bank recapitalisation and will also block bank nationalisation

Recent reports say that the US government needs much more money to rescue the banks than it is currently authorised by Congress to spend for this purpose (Luce, 2009A; *Financial Times*, 2009). The current bank rescue policies do not sufficiently recapitalise the banking system, and without a functioning banking system the US will not achieve sustainable growth. Even 22 months after the credit crisis began many sound companies are still finding it difficult to get loans. However, Congress is in no mood to approve more public funds for bank bailouts. And there is even less political support for the alternative solution—nationalising the big insolvent banks, whether openly or in the guise of taking them into receivership. As Paul Krugman says,

> It's very hard to rescue an essentially insolvent bank without, at least temporarily, taking it over. And temporary nationalization is still, apparently, considered unthinkable. (Krugman, 2009A)

The USA is likely to stumble on with its big 'zombie banks', which are recapitalized by enough to keep them solvent but not enough that they can expand lending while maintaining the thicker capital cushions that newly risk-averse investors are demanding. This is a recipe for continued stagnation, *despite the fiscal stimulus.*[1] But the strategy is good for the financial oligarchs. It uses taxpayer funds to make low-interest loans to private investors willing to buy up troubled assets in the hope of boosting the price of toxic assets—letting investors profit if asset prices go up and walk away if prices fall substantially.

On the other hand, at least the American government is acting. European governments have done rather little, even though it is clear that German banks—to take just one case—are holding vast quantities of toxic assets, which have been barely marked to market, to the point where the whole German banking system is probably insolvent (Tett, 2009). Yet the German and other European governments seem to be proceeding with a zombie bank strategy even more than the Americans, leaving Europe plagued with doubts about its financial system.

3.4 US public debt is out of control

Public debt is out of control, as tax revenues collapse and public expenditure soars (for bank bailouts, stimulus plans, Detroit rescues, health care reform) (Crutsinger, 2009). The federal budget deficit in the fiscal year 2009 will probably be three to four times bigger than in the previous fiscal year—itself a record. The same is happening at all other levels of government, from states to counties and townships. As the cost of borrowing rises, still

[1] The US Treasury hopes that credit directly from the Fed and from government-backed lenders like Freddie Mac will provide a substitute for a healthy banking system until the combination of virtually no-cost deposits and relatively high lending rates allows the banks to rebuild balance sheets.

more borrowing is needed to pay the interest, crowding out private investment, and making the USA dependent on the willingness of governments and investors to stuff themselves with US Treasury bills. There is a non-trivial risk of US debt default—or if not default then a severe devaluation of the dollar, which leaves investors almost as badly off.

True, the major ratings agencies continue to grade US federal debt as AAA. But scepticism is warranted given that the ratings agencies are profit-maximising private companies, all American owned, and that they have been paid millions of dollars for their federal government debt ratings. The crisis has revealed that the agencies are prone to massage their ratings upwards in the interests of maximising profits (*Seeking Alpha*, 2009). Moody's, a leading rating agency, was the single most profitable firm in the S&P500 in 2004–2007.

Any other country with America's debts would have to bring in the Paris Club of creditor nations to negotiate between its government and lenders. The US government's privilege of paying its debts in its own currency rather than in someone else's softens the pressure on it to cut its deficits and get its banks working. The US central bank can just print even more money than it has been doing, reducing the pressures for adjustment and raising the potential for a later inflationary surge. The outcome could be stagflation in the USA and damage to countries that hold dollar assets in their foreign exchange reserves.

3.5 Unemployment in the US is soaring, half of households have insufficient savings to sustain expenses for more than one month, and the rate of house foreclosure continues to rise

Unemployment has been rising at the rate of over 500,000 a month for several months, and the total now exceeds 10% of the labour force using international rather than American definitions of unemployment. Several recent polls have found that almost half of US householders say they could cover their expenses for at most one month without a paycheck (Waters, 2009). House foreclosures continue to increase, depressing house prices further and throwing more households into negative equity. Rising unemployment and rising house foreclosure combine in a vicious circle to prolong the fragile state of the financial system.[1] The US population till now has remained remarkably quiescent, but this could change.

3.6 China's efforts to escape the 'dollar trap' raise the chances of a dollar crash

The three US propositions show why the US government has a strong distress demand for more foreign loans, particularly from the giant surplus country, China. US political leaders and experts are hoping and expecting that China, already the biggest foreign buyer of US Treasury bills and dollars, will continue to buy even more—and prevent a dollar crash. In 2008 China bought almost half of total foreign purchases of US Treasuries. It currently holds some $1.5 trillion of US$-denominated assets (equivalent to about one third of China's GDP), thanks to its giant export surpluses over many years.

But Bejing is moving in the opposite direction as it tries to escape the 'dollar trap'. Public opposition has been growing within China to its continued bankrolling of fabulously rich

[1] One in nine houses now (March) stands empty, thanks to frenetic boom-time building. Recent reports suggest that another type of mortgage is now in trouble, even though it is an 'old fashioned' mortgage held to maturity by the issuing bank and not securitised. It is the 'acquisition, construction and development (ACD) loan to developers to buy land, add infrastructure, and build housing and commercial buildings. ACD loans account for 8.4% of US bank loans. The rate of foreclosure on ACD loans is rising rapidly, redoubling the difficulties of stabilizing the US financial system' (Saft, 2009).

America—and Americans are 'lucky' that China is an authoritarian state that has, till now, overridden this opposition. But now the government is very worried about a sharp fall in the purchasing power of its enormous reserves (Global Europe Anticipation Bulletin, 2009; Krugman, 2009B; Dyer, 2009).

Its strategy for escaping the dollar trap is designed to reduce its dollar assets without triggering a mass sell off. First, it has more or less stopped buying US Treasuries (and then only short-term ones), even as the Obama administration is issuing more and more of them in order to finance its growing deficit. Second, it is selling dollars and buying non-dollar assets, some of it secretly. The recent study by Brad Setser and Arpana Pandey for the Council on Foreign Relations suggests that Beijing has sold between $50 and $100 billion of US$-denominated assets every month since late 2008, and bought assets like minerals, farmland, energy and corporate stocks in European and Asian (not American) companies (Setser and Pandey, 2009; Zembia, 2009). It has bought these assets at rock-bottom prices, thanks to the recession, and at a time when the US dollar has much more value than it is likely to have in another six months. China is also making big loans to oil companies in Russia, Brazil and Abu Dhabi, which will be repaid in oil; more loans to The Association of Southeast Asian Nations (ASEAN) states; currency swap agreements with five ASEAN countries and now also Argentina. Its exports to India and South Korea each increased by about 30% in 2008.

The third component of the dollar escape strategy is to inform other countries that they should be prepared to cooperate in the move away from the Dollar Standard and avoid an 'every state for itself' struggle. China is particularly interested in securing cooperation from states in Latin America, Africa and Asia. Hence on the eve of the G20 summit meeting in early April 2009 Bejing sent out the message to the USA and the world that the world should move away from the dollar as the international currency and to a new system based on a 'super-sovereign reserve currency' such as the International Monetary Fund's (IMF) Special Drawing Rights (SDRs), comprised of a basket of several major currencies.

The upshot of China's dollar escape strategy is that the USA is finding it increasingly difficult to meet its growing demand for foreign loans. This raises the risk of the Fed printing dollars (by buying US Treasuries); or of a severe devaluation of the dollar; or of an outright default. Any of these outcomes would intensify the breakdown of the international monetary system. For example, as the Fed prints money it puts pressure on other currencies to appreciate, forcing other central banks to expand their own money supply, resulting in negative real interest rates everywhere and serial devaluations of major currencies.

Pity the native Taiwanese, who constitute 85% of Taiwan's population, caught in the middle. A majority have no wish to become Chinese subjects. But the Chinese government is using its financial leverage over the US government to advance its over-riding foreign policy objective of incorporating Taiwan. The deal is that if the US government presses the Taiwan government to move towards incorporation (without a referendum) China will not dump the dollar.

3.7 World trade and export-led growth strategies are collapsing, surplus countries face big obstacles in expanding domestic demand, and many 'emerging market' economies are in deep trouble

World trade is collapsing much faster than expected—and much faster than predicted on the basis of the past relationship between world trade and OECD growth. The gigantic US external deficit (as big as India's GDP in 2006) is falling at the fastest rate on record, which, on the face of it, is good news, but the fall reflects not rising exports but falling imports (even after taking account of the fall in oil prices). Some 740 ships idle at anchor near Singapore harbour as of mid May 2009, unable to find cargo.

The engine of recovery in the world economy therefore has to be a country or region other than the USA, whose own recovery will be more gradual and based on growth overseas. But Japan, the world's second biggest economy, experienced a contraction in the last quarter of 2008 at an annualised rate of 13%; and manufactured exports, which account for half of manufacturing output, were more than a third lower in value in December 2008 than in the previous December. China has mounted a significant stimulus package, but faces big obstacles in quickly expanding domestic demand. The day after Bejing sent the message to the world about moving away from the Dollar Standard it sent another message suggesting that China's high savings rate is immutable, rooted in Confucian values, and that now is 'not the right time' for the USA to save more. By implication, *the USA* must rescue the world (and China) by increasing its consumption and piling on even more debt. Yet if China and the other big surplus countries do not quickly expand domestic demand, global imbalances will only intensify and recovery will be more elusive, including in China.

Many emerging market economies are in or on the verge of financial crisis. The list includes: in Europe, Latvia, Estonia, Lithuania, Hungary, Bulgaria, Romania, Turkey, Ukraine; in West Asia, Armenia, Azerbaijan, Belarus, Georgia, Moldova; in South and East Asia, Pakistan, Indonesia, South Korea; in Latin America, Ecuador, Argentina, Venezuela. That covers 750 million people.

3.8 The G20 summit achieved little, and inter-state cooperation remains fragile

The achievement of the G20 summit in early April 2009 was to bring countries representing the other 85% of the world's population to the top table of global economic governance. It is now difficult to revert to the earlier formula of G7 Plus Five, by which the G7 invited political leaders from five 'systemically important' developing countries to join them for breakfast or lunch on one day of their summit and then send them on their way. Gone are the days when a small number of rich countries automatically makes the rules for others to follow (Gallagher, 2009).

Other than that, the G20 leaders achieved little in concrete proposals or common direction. They agreed on the need for tough action on tax havens, hedge fund transparency and top salaries in financial corporations, but came up with nothing concrete. They agreed to increase the lending resources of the IMF by US$500 billion; but made no mention of the problem that Obama's commitment of US$100 billion depends on Congressional approval, and Congress is unlikely to approve. Even the announced US$250 billion for facilitating world trade was mostly the sum of existing export aid, not new support.

At least the outcome was not as bad as that of the World Economic Conference in 1933 in the depths of the Great Depression, also held in London, which broke up in disarray after a month of deliberations; but perhaps this relative success of 2009 was because it lasted only one day.

In short, there is a high probability of another 'tipping point' by the first quarter of 2010 similar to the one in September 2008. It will be marked by a dollar crisis in the context of continuing falls in world trade, continuing rise in US budgetary deficits, continuing hesitation of China about funding US deficits, continuing high unemployment, and perhaps rising social unrest in many countries, including even the USA'.[1]

4. What should be done?

Thinking about the direction of public policy can be organised with the matrix shown in Figure 1.

I put to one side the immediate issues of sorting out the current mess (Wade, 2009A) and concentrate on the longer-term ones, the ones Obama was talking about when he said, 'We cannot rebuilt this economy on the same pile of sand' (see epigraphs). Space constraints mean that the discussion has to be breezily summary, touching on only a few points.

4.1 Restructure finance

Finance should be restructured so as to (i) stabilise financial intermediation, which is a critical public good in a capitalist economy, and (ii) direct it to seek profits in the real economy rather than in 'finance financing finance'. More broadly, the aim is to reduce the extent to which global economic activity—global demand—depends on financialisation: on house price inflation to boost household consumption, on the switch from pay-as-you-go pension schemes to funded pensions, on privatisation to raise government revenues and on complex and opaque financial instruments.

	National & sub-national	Regional	Global
Sort out the current mess			
Restructure finance			
Respecialize economies			
Reduce global imbalances			
Reduce income concentration			
Reform global governance			
Reeducate economists			

Fig. 1. *Actions and actors in reorganising capitalism.*

[1] As of mid May, the media is full of reports of 'green shoots of recovery'. Many analysts claim that the US rate of decline is slowing and will shortly hit bottom, the recession ending by late 2009. They emphasise that the fiscal and monetary stimulus is just beginning to impart strong momentum. But until the US jobs market improves it is difficult to see consumer spending growing sustainably. Even when the financial sector is fixed enough to sharply ease the supply and price of credit, households with damaged balance sheets may not respond. A significant rise in lending is unlikely for another year. As for China, it shows some positive indicators, including purchasing managers indices for April, which reached the highest level since October 2008. But at least as good an indicator of the near-term future is power output. China's power output in April 2009 was 3.6% lower than at the same time in 2008, having fallen for many months in between. The outlook in Japan and most of Europe remains bleak.

Here are several reform components intended to downsize and restructure finance towards these objectives.

- Separate saving and consumer banking from risky investment banking. A more stringent version of the Glass–Steagall Act could be the model.
- The savings and consumer organisations should do narrow, boring banking. They should make loans mainly out of deposits, do their own due diligence, hold most of the loans on their own books and they might, in addition, hold government bonds plus some blue-chip stocks. They should not employ physicists or financial engineers. More of them should be run on a 'trust' basis, as non-profits, perhaps as cooperatives or mutuals.
- Investment banks—also hedge funds, trusts and the like—could innovate and speculate within much wider regulatory limits, but should not be allowed to trade with regulated banks. They should include both public and private banks, with the public ones having some democratic accountability and exercising discipline over the private ones. The key organisational challenge is then to ensure that public ownership does not imply political influence over individual loans, as distinct from steering finance into more productive and socially valuable parts of the economy. Investment banks should be required to operate with less leverage than the 30:1 ratio, or even higher, which the big US and UK banks were operating with.
- To reduce the information asymmetry between sellers and buyers, new financial products should be approved by a regulator, to ensure that their risk characteristics can be readily determined by a third party.
- All activities should be recorded on the balance sheet; nothing should be off balance sheet.
- More emphasis should be given to competition as a disciplining force, because regulation tends to be undermined during booms. No bank should be allowed to grow 'too big to fail'. Anti-trust legislation should be revised so that it can tackle not only firms so big as to affect prices but also banks so big that the government cannot allow them to fail. Banks that fail should be allowed to fail, with the shareholders wiped out (but depositors protected), rather than—as has been routine since the 1980s—bailed out.
- The current mismatch between globalised finance and national governance is unviable. Because global governance is unlikely to be substantially improved (see below), finance should be made less globalised. No bank should be allowed to grow across borders beyond the limits of the reach of its lender of last resort (which implies that the regulation of 'branches' and 'subsidiaries' has to be clarified).
- Regulators should redefine their principals and 'customers' to be the taxpayers, not the banks.
- To tackle the fallacy of composition at the heart of the existing regulation system (the assumption that if each organisation is within prudential limits the system as a whole is sound),[1] establish a system of macro-prudential regulation integrated with the existing micro system, which would increase banks' capital–asset ratios during booms and cut them in busts.[2]

[1] The fallacy ignores the high correlation of risk, exemplified by what could be called the Lehman Brothers trap: investors invested in multiple hedge funds and assumed they had spread risk, without knowing that the hedge funds had Lehman as prime broker.

[2] But the prudential advantages of this countercyclical measure for banks have to be weighed against possible costs of it forcing non-financial companies to raise more of their external finance in the form of debt rather than equity during a boom.

4.2 Respecialise economies

A lot of production capacity is now seen to be misaligned with demand. Developed countries that built up large financial sectors or large construction sectors in the boom of the 1990s and 2000s have to grow new activities; and even those that did not specialise in this way must now respecialise in line with the coming technological revolution—the end of the fossil fuel economy. Clearly, low-carbon technologies, public transport, life-time education and health care are new growth areas, with lots of scope for more intensive application of ICT technologies. The USA has to increase its domestic production capacity in order to substitute for imports and increase exports. Economies oriented towards export surpluses have to rely more on domestic demand, so that they can grow without US households becoming more indebted.

This raises the question of the role of the state in accelerating movement out of declining sectors and fostering the growth of new sectors. 'Public planning' and 'industrial policy' have become toxic phrases, but we need some of their substance (and less of 'financial policy', meaning the automatic favouring of finance). This is not a matter of returning to 1970s-style controlling sectors and 'picking winners'. It is a question of how to combine the appropriate role of entrepreneurs in spotting economic opportunities (as they spotted opportunities in ICT and in revitalising declining dockland areas) with a more coordinated process of formulating agreement about directional thrust, involving representatives of the interests whose concerns come together to constitute the 'common good'—bringing them together in repeated interaction to the point where they moderate sectional interest in line with an emerging notion of the national interest.

In other words, the question is how to institute a type of capitalism with more coordination through political mechanisms than has been normal since 1980 (Wade, 2004). The first step is to figure out how to talk about these issues without mentioning 'public planning' and 'industrial policy', either of which automatically closes down discussion.[1]

I shall not discuss the even bigger issues around respecialising developing countries—except to say that the world needs a 'time out' on a new global trade and investment deal, contrary to what the G20 leaders urged when they called for the rapid completion of the World Trade Organisation's (WTO) Doha Round. The Doha Round proposal is fundamentally flawed in terms of developing countries' interests. Indeed, we need to revisit the Uruguay Round agreements, because some of them severely constrain the use of industrial policy instruments of the kind relevant to developing countries building basic industries, while others sanction industrial policy instruments of the kind relevant to developed countries forging ahead in high tech industries (Wade, 2003; see also Wade, 2006A; Weiss, 2005).

4.3 Reduce global imbalances

Reform to reduce global imbalances has to deal with at least two big issues: one is the dollar as the international reserve currency, and the other is the combination of floating or flexible exchange rates and free capital movement.

On the first, the ability of the USA to run very large current account deficits—thanks to the dollar still accounting for two thirds of all foreign exchange reserves—has turned out to be a calamity, and a large part of the explanation for the current financial crisis. The dollar will probably remain the world's premier currency for some years, despite China's dollar

[1] A former Treasury official, now Master of an Oxford college, declared, 'We know industrial policy couldn't have worked in East Asia, because we tried the same thing here and it failed' (personal communication, 2000).

trap escape strategy, not least because the current alternatives—the euro, the yen and gold—remain unattractive. But a significant expansion of SDRs is becoming more feasible than it has been, because the US government—the main obstacle—has come to see expanding SDRs as in its own national interest, as a way to raise the purchasing power of developing countries and to help the USA export its way out of recession (Wade, 2002).

In the longer run, we should work towards a global currency unit, with a name less clunky than 'SDRs' (perhaps 'bancor', as Keynes suggested) (Wade, 2006B). It would be based on the inflation-adjusted real GDPs of the major economies. Governments and companies would issue bonds denominated in the global unit and hold them in their reserves. If coupled with the creation of an international clearing agency (as Keynes also proposed), countries could make cross-border payments in their own currency, with the payments settled inside the clearing agency using the global unit as the numeraire, or base unit of measure. Exchange rate changes would be made in-house in line with changes in reserves, at regular intervals. Exchange rates would reflect costs of production and demand for goods and services, not speculation against future movements (Wade, 2000A).

The post-Bretton Woods combination of flexible exchange rates and free capital movements has failed spectacularly in keeping the world economy stable. Again and again countries' exchange rates have been driven in the opposite direction from that needed to reduce global imbalances: deficit countries have often experienced real exchange rate appreciation and surplus countries, real exchange rate depreciation or no change (UNCTAD, 2007). Iceland is just an extreme case of a more common pattern; it ran double digit deficits for much of the 2000s and the krona appreciated (Wade, 2009B).

As is well known, developing countries, in aggregate, have built up massive foreign exchange reserves partly to defend themselves from panicky capital withdrawal, which are costly in terms of their own development and which add to global imbalances. The only 'emerging market' region to be a net capital importer in the 2000s was Eastern and Central Europe, and it is now facing the same meltdown as other emerging market economies earlier faced when they opened up to capital surges in and out at the urging of the US Treasury and the IMF (Wade, 1998, 2000B).

We should grant the legitimacy of restrictions (not just regulations) on capital flows, and develop multilateral rules for their use. We should take encouragement from Keynes' triumph at Bretton Woods, about which he said,

> Not merely as a feature of the transition, but as a permanent arrangement, the plan accords to every member Government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodox.... (quoted in Pauly, 1997).

He considered capital controls as the single biggest achievement of the Bretton Woods conference. Re-legitimising capital controls today is in the broad interests of the West, as well as developing countries, as a way to protect against the disruption of hot money fleeing from the more unstable periphery. The next and bolder step is to establish global arrangements to coordinate symmetrical adjustment policies for deficit and surplus countries - a subject needing a whole new essay.

4.4 Reduce income concentration

Any talk about reducing income inequality, and specifically income concentration at the top, runs against the prevailing uninterest in inequality among economists, or even opposition to doing anything about it, as expressed by, for example, Willem Buiter, professor of economics at the London School of Economics:

[Absolute] poverty bothers me. Inequality does not. I just don't care. (Buiter, 2007)[1]

American and British politicians have been equally relaxed. Labour Prime Minister Tony Blair was asked in the run up to the election of 2001, 'Prime Minister, is it acceptable for the gap between rich and poor to widen?'. Blair twisted and turned and tried to avoid the question, which the interviewer kept repeating, and eventually came out with,

I know it's not your question, but it's the way I choose to answer it. If you end up going after those people who are the most wealthy in society, what you actually end up doing is in fact not even helping those at the bottom end. (Landlsey, 2006)[2]

As an outcome of their 'winner take all' income distributions the USA and the UK are about the most unequal of the developed countries (in terms of the Gini coefficient and the top 1% to median). They also have the lowest rates of intergenerational social mobility in a sample of eight developed countries (Blandon *et al.*, 2005). They are at the very bottom in a ranking of child well-being in 21 rich countries, according to a UNICEF study (UNICEF, 2007). The USA has about the highest prison population per 100,000 national population in the world, Britain the highest in the European Union (EU). Yet American and British politicians and economists stride the world telling others to adopt the liberal capitalist model.

Buiter's and Blair's opinion notwithstanding, high inequality in developed countries has a range of well documented negative effects. It drives debt-fuelled consumption and through this channel contributes to global imbalances; not to mention its effects on depletion of the planet's resources, on violence, obesity and many other indicators of quality of life, health and deprivation, as shown in the new book by Richard Wilkinson and Kate Pickett, *The Spirit Level: Why More Equal Societies Almost Always Do Better* (Wilkinson and Pickett, 2009; see also Held and Kaya, 2007).

Yet under the British Labour government, in office from 1997 to the time of writing (2009), inequality and social immobility in the UK have been so eclipsed from public discussion that people tend to be clueless about the state of affairs. When asked if they agree that 'In this country the best people get to the top whatever start they've had in life', 49% of respondents agreed and only 43% disagreed in a poll in 2008. In fact, a middle-class child is 15 times more likely to stay middle-class than a working-class child is likely to move upwards (Toynbee, 2008; Irvin, 2008).

Non-governmental organisations in western countries should be putting much more effort into raising public awareness of the extent of inequality and social immobility, and sponsoring debate about fairness. One problem is that 'incomes policy', like 'industrial policy', has become a toxic phrase, and the question is how to talk about the issues without using that phrase. Corporate governance reform can push in the right direction, by reducing the extent to which boards are composed of backscratching friends. Raising the marginal rate of taxation to 40% on incomes above $5 million, rising gradually to 56% on incomes above $50 million, would help to cut the share of the top 1% in the US income distribution back to what it was in 1990, before the finance-driven boom.

Developing countries typically have much higher inequality than in the West (Gini coefficients of 0.5 and above, compared to 0.35 and below, a remarkably stable difference

[1] On the cognitive and moral maps of senior Wall Street executives see the short sharp novel *Moral Hazard*, by Kate Jennings (2002).

[2] The UK Labour Party government's finance minister Alistair Darling declared 'I'm not offended if someone earns large sums of money. Is it fair or not? It is just a fact of life.' When then asked to define his politics, he replied, 'Pragmatic. I believe passionately in living in a fair country and treating people properly, with proper respect and fairness' (Aitkenhead, 2008).

over many decades), which itself hinders the expansion of national and global demand. All the western countries have all their income deciles in deciles 10 and 9 of the world income distribution, as also does South Korea. But Brazil's deciles 10 and 9 are in decile 9 of the world distribution while its decile 1 is in decile 3 of the world distribution. China's deciles 10 and 9 are in decile 8 of the world distribution, its decile 1 in decile 2 of the world distribution. India's decile 10 is in decile 7 of the world distribution, its decile 1 in decile 1 of the world distribution (Korzeniewicz and Moran, 2009, figures 1.4 and 5.2; see also Wade, 2008A). This is a measure of income inequality both within developing countries and between them and developed countries; and it is a fundamental cause of global imbalances—as well as the intense desire among 85% of the world's population to hop across a rich country or EU border by any means legal or illegal.

4.5 Global governance reform

It is now widely accepted, at least at the level of principle, that developing countries must have more representation in global organisations—not only ones like the IMF and World Bank but also ones which set standards such as the International Organization of Securities Commissions (IOSCO), which as of 2008 includes two Canadian representatives but no Chinese or Indian representatives in its key Technical Committee, where standards are set, and the FSF, which includes the Netherlands and Italy but not China and India (Davies and Green, 2008).[1] Raising the representation of developing countries is much easier said than done, however, because the oligopoly of countries that runs these organisations resists diluting its power except under extreme duress. After all, it took Japan's Ministry of Finance several years of strategising to raise its voting share in the World Bank from number 5 to number 2, in the first half of the 1980s (Wade, 1996). And that was just a readjustment of shares within the G7. The whole of the G7 has tended to unite against dilution of its aggregate share.

There is no question that the world needs an informal, non-law-making, body that brings together finance ministers at regular intervals, several times a year (they all face a similar set of issues stemming from global financial connectivity). There is also no question that the expansion to the G20 represents a big improvement on the G7. Yet in the longer term the G20 is of uncertain viability. For one thing, it is too big to be effective in building personal relations and a sense of ownership (central bank governors as well as finance ministers often sit at the top table). To keep it from degenerating to little more than a photo opportunity it should have no more than about 15 principals. Second, however well the 20 member countries meet criteria of representativeness, the process by which they were selected was of questionable legitimacy, a reflex of the G7 world. They were selected in 1999 by Timothy Geithner at the US Treasury in a transatlantic telephone call with his counterpart at the German Finance Ministry, Caio Koch-Weser. Geithner and Koch-Weser went down the list of countries saying, Canada in, Spain out, South Africa in, Nigeria and Egypt out, and so on; they sent their list to the other G7 finance ministries; and the invitations to the first meeting went out.[2] Third, the G20 has no procedures for rotating membership; countries are in or out, permanently.

[1] The FSF has now (2009) decided to admit all the G20 countries.

[2] It was not quite as unilineal as this. Both principals had taken soundings from other governments before their telephone call. As one of the principals said, 'We talked to the South Africans about their role in the continent', after which they decided that South Africa would be the best country to represent it. (They did not similarly consult with the Nigerians or the Egyptians.) Personal communication.

What should be done? Europe should reduce its country-by-country representation in the G20 and other global governance fora in order to get the total down to around 15. Second, to soften the cleavage between 'in or out' about half of the 15 positions should be assigned to the top countries permanently, the other half to constituencies of countries. The non-permanent members would each serve for a reasonably long period (perhaps five years) in order to check free riding and foster their responsibility for the collective decisions of the organisation. Third, the G15 should have a beefed-up mobile secretariate based in the country currently holding the chairmanship (rather than in the IMF or the OECD, as has been proposed).

4.6 Re-educate economists

Surveys of American economists conducted in 1980, 1990 and 2000 show a high degree of consensus on propositions about free international trade and capital flows and floating exchange rates (but less consensus about macroeconomic propositions, because of disagreements about Keynesian, monetarist and supply-side propositions).

In 2000, for example, almost three quarters of respondents said 'generally agree' to the proposition 'Tariffs and import quotas usually reduce the general welfare of society' (the other choices were 'agree with provisos', 'generally disagree' and 'no response'). To the proposition, 'Flexible and floating exchange rates offer an effective international monetary arrangement', 61% said 'generally agree' (Fuller and Guide-Stevenson, 2003).

The survey questions do not cover the domain of the 'efficient market hypothesis'—that financial markets are efficient and self-adjusting, so that 'light touch regulation' is all that is needed. But it is a fair bet that a high proportion of respondents would have agreed with propositions of this kind. If so, the acceptance of this set of beliefs within the profession contributed to the unchecked rise of financial fragility, which in turn drove the crisis.

In any case, the teaching of economics, especially financial economics, should be revised so as to incorporate more from behavioural economics, and so as to inculcate pluralism in the epistemology of the discipline (including tolerance of non-mathematical reasoning). After all, the dominance of the neoclassical monoculture is relatively recent, dating from around 1960, before which American economics was more plural. Now that the Cold War is over and won by the West, the case for the neoclassical monoculture is long since past (Wade, 2009C).

The re-education of economists would in turn make it harder for Wall Street to exercise veto over policies it does not like. As Simon Johnson, professor of economics at the Massachussetts Institue of Technology (MIT) and chief economist of the IMF in 2007–2008, says in 'The quiet coup' (Johnson, 2009), Wall Street gained political power not only by lobbying and campaign financing, but also by promulgating the belief that what was good for Wall Street was good for the country, and by arranging dense interchange of personnel so that the policymakers in Washington and London shared the same finance-centred world view (while other industries like tobacco, cotton, Hollywood could not boost their influence by appealing to such a belief to anything like the same extent and had to rely more heavily on lobbying and money).[1] The self-serving Wall Street belief was legitimised from the academy by economists championing the efficient market hypothesis; and the same belief blocked learning from feedback on the consequences of the policies.

[1] Despite playing on a field tipped in their favour, the top 25 US originators of sub-prime mortgages spent almost US$370 million in Washington over the past decade on lobbying and campaign donations as they tried to ward off tighter regulation (Luce, 2009B).

5. What can be done?

Wish lists are easy. What are the chances that powerfully entrenched interests will be overcome, that governments will cooperate, that China will take on global responsibilities?

The two big regime changes since World War II were propelled not only by the magnitude of the preceding disruption but also by the existence of enemies. The New Deal and Bretton Woods regimes were a response to the threat posed, abroad, by Nazi Germany and Stalin's Russia and, at home, by trade unions and extreme political parties. The Reagan/Thatcher transformation was helped by invoking the Soviet Union as the external enemy and trade unions as the internal enemy. Today, no external or internal enemy is sufficiently dangerous to forge an elite consensus for regime change (Palma, 2009). The amount of regime change depends on a more precarious balance of forces in favour and those opposed.

5.1 US politics

According to a recent news report,

> Mr Obama has begun to sketch a vision of where he would like to drive the American economy, once this crisis is past. His goals include diminishing the consumerism that has long been the main source of economic growth in the United States and encouraging more saving and investment. He would redistribute wealth toward the middle class and make the rest of the world depend less on the U.S. market for its prosperity. And he would seek a consensus recognizing that an activist government is an acceptable and necessary partner for a stable, market-based economy. (Stevenson, 2009)

This is probably the first time since Roosevelt, or perhaps Lyndon Johnson, that an American president has talked of 'activist government' in a positive rather than negative way, presenting the government as complement to a stable market economy rather than as rival.

However, for all the honeymoon goodwill invested in President Obama, US politics remains intensely polarised between Democrats and Republicans, each concerned primarily to short up their electoral base. The Republican party moves determinedly to the right at a time when most moderates have stepped to the left. Obama's fiscal stimulus bill passed the House of Representatives without a single Republican vote. Rush Limbaugh, the Republican talk show host and an unofficial leader of the Republican party, declared that he would sooner see the country fail than Obama succeed, prompting John McCain, the Republican presidential candidate in the 2008 election, to issue the unusual statement that 'I don't want him [Obama] to fail in his mission of restoring our economy' (quoted in Friedman, 2009). Half of the US population now lives in counties where Democrats or Republicans win national elections in landslides, up from about one third in the 1960s and 1970s (Kristof, 2009). Underlying the cleavage is a gut attachment on the part of many Republicans, and even some Democrats, to tax cuts at home and pre-emptive wars abroad—attachments anchored in the notion of the moral society as an aggregate of self-reliant individuals and neighbourhoods linked by a shared commitment to 'freedom' and the flag (Lakoff, 2002). People of this world view are viscerally opposed to the Obama stimulus package and help for the banks.[1]

[1] The US is exceptional among developed countries for the strength of its anti-intellectualism, of which fundamentalist religion is one of the spurs. Only 26% of Americans accept some version of the theory of evolution, 42% say that all living beings, including humans, have existed in their present form since the beginning of time, and two thirds want creationism to be taught in public schools with or without the theory of evolution (Pew Forum on Religion and Public Life, 2003). These facts are fundamental for understanding American economics and American foreign policy.

A less familiar cleavage in US politics is between the 'oligarchic' and the 'establishment' fractions of the capitalist elite, which cross cuts the Republican/Democrat divide. The oligarchic fraction seeks to protect a structure favouring upwards income redistribution, in the name of 'free markets', and it has drawn much of its membership from the finance sector during the past two decades. Prominent contemporary figures include George W. Bush, Alan Greenspan,[1] Robert Rubin, Arthur Laffer and Timothy Geithner, now US Treasury Secretary, who as chairman of the New York Fed presided over the Wall Street bubble after 2002, and who earlier was the US Treasury's 'point man' in the US/IMF misdiagnosis of the Asian crisis.[2] The establishment fraction, on the other hand, sees the government's role as being to secure a distribution of income, wealth and opportunity that protects the overall stability of the system; it is happy to use devices like progressive taxation and a public welfare state to secure this objective; and in the past two decades has become critical of the dominance of finance and the New Wall Street System. It embodies the spirit of Lampedusa's protagonist in *The Leopard*, 'If we want things to stay as they are, things will have to change'. Leading figures include Paul Volcker, James Baker, George Mitchell, George Soros, Bill Gates and, earlier the quintessential establishment figure, George Kennan.

President Obama's recent budget, with its emphasis on investment in infrastructure, alternative energy, education and a national health system, represents a victory—at least at the level of discourse—for the establishment fraction. But the oligarchic fraction, allied with a more populist elite in Congress, is focused on jump-starting personal consumption with short-term measures, largely ignoring the dangers of even higher debt. And it has won a victory in the Treasury's continuing avoidance of nationalisation of the big banks, in favour of the taxpayer bailout strategy described earlier.

The outcome of these struggles, especially for the subsequent ability of finance to continue to shape the US type of capitalism, is not a foregone conclusion. It is clear that the oligarchic elite will fight tooth and claw to restore finance and the larger neoliberal order. Having accrued such disproportionate gains under the rules of this order it will oppose moves to strengthen the capacity of the state to discipline the economy. A recent cartoon captures the mood by showing two CEOs looking at a chart of plunging GDP, and one says to the other, 'We can only hope that it turns around before there's time to learn any lessons' (*International Herald Tribune*, 21 April, 2009).

But the oligarchs are the object of fierce public anger, and the state has become deeply involved in rescuing them. By the end of September 2008 three of the five big investment banks—which together almost dictated public policy in the relevant domains in the US, UK and the EU—were no longer standing; and the biggest insurance company in the world, AIG, was effectively bankrupt and on state life-support. On the other hand, the fact of being 'too big to fail' itself gives the oligarchs considerable power to exercise something like a veto over relevant public policy by threatening that they will fail—and cause vast collateral damage—if the government takes actions they do not like.

[1] Yet Alan Greenspan, the Ayn Rand-following former governor of the US central bank, has even called for the banks to be taken into public ownership temporarily.

[2] Geithner, as president of the New York Fed, proposed at a June 2008 meeting with other leading stewards of US finance that the Congress should give the US president authority to guarantee all debt in the banking system, making taxpayers liable for trillions of dollars. As Treasury Secretary he has put this bailout idea into practice step by step, in order to save US financiers from their own mistakes (and in the hope that the same will save the US economy). The president of the New York Fed is selected by a board dominated by the CEOs of big Wall Street banks, whom the Fed is meant to regulate (Becker and Morgenson, 2009).

5.2 Multilateral cooperation

The deep contraction has stimulated more nationalism than multilateral cooperation. The US government shows every sign of sticking to its long-established tendency to act unilaterally on matters it defines as either 'national security' or 'economic security' (now one and the same in the current crisis), and cooperate only insofar as others agree with it; the attitude known as 'my way or the highway'.

As for the EU, *The Financial Times*' Philip Stephens says, 'There have been few moments when the EU has looked at once so fearful and so lacking in political leadership' (Stephens, 2009). The German government, best placed to lead, is dragging its heels on a serious stimulus package and displaying none too cooperative attitudes to other European states, its beggar-thy-neighbour attitude summed up by economics minister Michael Glos, who said at the end of November 2008, 'We can only hope that the measures taken by other countries ... will help our export economy' (quoted in Munchau, 2008). The British government has played its accustomed spoiling game in blocking moves towards stronger pan-European financial regulation, for the sake of the City.[1] On matters of foreign policy—dealing with China, for example—the EU's 'big three' (France, Germany, UK) are often at odds, each trying separately to coddle up to China as 'China's favourite European', and when China tries to play them off against each other they each tend to look the other way, trying to capitalise on each other's misfortune.

Imprudent lending by Austrian, Italian and Greek banks into eastern Europe is another source of stress. Austrian banks lent an amount equal to 70% of Austria's GDP into eastern Europe, much of which now looks likely to be in default (Ahamed, 2009). The Austrian central bank and Austrian taxpayers do not have the capacity to bail out the foolhardy banks, and the Austrian government hopes to persuade the French and German governments to do so. The French and German governments are far from happy with the invitation, but they may feel hostage to the need to avoid financial meltdown in Austria, which might boost Austria's extreme political movements. The governments of Italy and Greece are also hoping that Europe will assist their banks, which made almost equally foolhardy loans to eastern Europe.[2]

More fissures have developed between the older members and the newer ones in eastern and central Europe. In much of the latter the wrenching falls in living standards are fuelling right-wing nationalist parties. The Prime Minister of Hungary warned of 'a new Iron Curtain' descending on Europe, and called on the older members to give the newer members a large bailout (quoted in Erianger and Castle, 2009).

The array of international organisations—the United Nations, WTO, IMF, G7, G20—show more disintegration than integration. The IMF, which had been in a free-fall to irrelevance (its loan portfolio fell by 90% in the four years before 2008), has got a new lease of life, but it has already nearly run out of lending resources. The present talk of boosting IMF reserves by US$500 billion is feeble when world foreign exchange reserves are of the order of US$7,000 billion. The G20 finance ministers, meeting in Washington DC in late April 2009, failed to commit even to paying the amounts that their political leaders had declared just three weeks before in the London summit. Most surplus countries

[1] For example, British representatives insisted on making the de Larosiere Group report bland (De Larosiere Group, 2009).

[2] As for southeast Asia, the former secretary general of ASEAN, Rodolfo Severino, said that the response to the crisis in Southeast Asia 'looks like every country for itself. But it's not too late to seize the opportunity' (quoted in Fuller, 2009).

have only small voting shares, and are unlikely to gift significant amounts to the organisation as long as they remain marginal. As for the G20, it is no more than a talk shop and, as noted, many excluded countries question its legitimacy.[1]

5.3 China

China is insistent that it must be accorded full respect as a major power; but also insistent that other states—with whom it wishes to sit at the high table—must not encroach on its freedom of action. Bejing, until very recently, has been notably hesitant to take on the responsibility to provide global public goods.[2]

However there is good global news from China. First, the government has belatedly embarked on a sizable stimulus package, which emphasises the impoverished inland provinces. The regional emphasis is a response to the fact that the urban/rural income gap is of the order of five or six to one (taking account of unequal access to basic public services), and the crisis will probably widen the gap even more as tens of millions of migrant workers stream back to their villages from shuttered factories in eastern China. Second, Bejing is at last starting to develop a full medical insurance policy for the vast rural population, intended to cover 90% of it by 2011. This is excellent news for the Chinese population and the world economy in the longer run. Wider medical coverage should help to lower the domestic savings rate and stimulate domestic demand, which in turn should mitigate the tendency towards global imbalances.

5.4 The missing left

Another point that pushes towards the conclusion that the oligarchic elite and neoliberal norms will prevail once the cognitive fog lifts—that the normal attention cycle will operate in this case too, with a bit more regulation added on—is that the broad left has been, for the most part, 'missing in action'. The dominance of the neoliberal paradigm, and its carriers in universities, think tanks, governments and the media has been so complete for the past two decades in the West that alternative ideas and their developers remain on the margins, far from good currency. 'Labour' and 'social democrat' politicians were no more suspicious of the bankers' claims than those of the right—the extreme case being the British Labour Party, whose whole leadership bought the claims completely.

Media ownership is partly to blame. In Britain, the public is exposed to a foghorn of distinctly right wing views, and a handful of proudly right wing newspaper owners exercise a powerful influence on the outcome of national elections.[3] Right wing national newspapers have about 76% of total sales, not-right wing newspapers (including the *Financial Times*), 24%. It is a fair bet that much the same applies in other developed countries. The significance is captured in the Swahili proverb, 'Until the lions have their own historians the history of hunting will be written from the standpoint of the hunters'.

[1] On the effect of the breakdown of inter-state cooperation in the late 1920s in paving the way for the damaging economic responses which accelerated the Great Depression see Boyce (2009), also Blyth (2002).

[2] In this context it is helpful that the World Bank recently revised downward China's purchasing power parity GDP by almost 40% and revised upward its extreme income poverty headcount by 65 million (other observers say the true increase is more like 300 million) (Chen and Ravallion, 2008).

[3] James Murdoch, groomed to take the helm from father Rupert, rarely gives interviews and never political opinions. But in a recent interview with an *Economist* magazine, he spat out that politicians 'of a statist inclination . . . have a great opportunity' to reshape the world in the face of the economic meltdown (Barker, 2009).

Now we have a 'backlash' against deregulated, race-to-the-bottom capitalism, but a backlash does not constitute an alternative model. There is no latter-day Keynes or Kalecki, no latter-day Cambridge, England.[1] Without a new theoretical foundation (comparable to Keynes' in the 1930s or the neoliberal paradigm of the 1980s), the 'new pragmatism' prevailing in some western capitals—with its sanctioning of ostensibly Keynesian policies—will be easily rolled back to the well defended default position once some semblance of normality is restored: free market institutions, free market beliefs and redistribution upwards. If this default position brings bad recessions and social misery once every two or three decades for much of the world but personal fortunes to those in the top few percentiles of the income distribution, it is a fair bargain in the eyes of those at the top. A lawyer described by *The New York Times* as a 'Wall Street eminence grise' assured an audience in May 2009 that the future of Wall Street would be little different from its recent past, because 'I am far from convinced there was something inherently wrong with the system' (Krugman, 2009C). A future Conservative government in Britain will make quite sure that the City is regulated no more than Wall Street.

5.5 Global governance and national diversity

For all that, there are reasons for optimism that the liberal model of capitalism will be significantly moderated. One has to do with the distinction Keynes failed to make when he said that 'the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas [especially those of defunct economists]'. Keynes' 'ideas' cover both factual propositions and value priorities, and the causation between them goes both ways. This crisis has—seemingly—thoroughly discredited factual propositions about the efficiency and self-regulating tendencies of financial markets. The discrediting may feed into a discrediting of the associated value priorities of acquisitive individualism, offering more scope for political parties advocating different value priorities. It will be worth watching to see whether the 2010 survey of American economists' views shows a softening of agreement with the normative and positive propositions of liberalism.

The second reason has to do with the expanded scope for national diversity. The shock of the crisis emanating from the most sophisticated financial market, the loss of US leadership, the entry of new states at the top table of global economic governance, and the sheer difficulty of getting a strong global regulatory framework may all encourage more effort to develop stronger national regulation and supervision, combined with light agreement on directional principles at the global level and denser agreement at the regional level (Latin America, Southeast Asia, for example).

This would promote the principle of subsidiarity and the legitimacy of a diversity of regulatory frameworks, a diversity able to respond to differences in country preferences and in levels of development (a diversity that expresses different trade offs between financial stability and financial innovation, between simplicity and complexity, between allocation of capital by profit-maximising firms and allocation by state banks, for example) (Rodrik, 2009; Berger and Dore, 1996).

Conversely, the same things that make a strong global regulatory response unlikely provide an opportunity to step back from the globalisation project aimed at creating a whole world economy functioning like that of the USA, where nation states have no more influence over cross-border flows and internal political economy arrangements than US

[1] But see a collection of 22 essays, most by Indian economists, in *Economic and Political Weekly* (2009).

states have over theirs.[1] We should give up on the attempt to frame universal operational rules, like the Basel I and Basel II agreements on capital adequacy. We should give up on the attempt to spread a single variety of capitalism through the WTO, the IMF and the World Bank, and instead take the General Agreement on Tarrifs and Trade (GATT) and shallow integration as the model (Wade, 2003). 'Middleware' is a useful metaphor. Middleware is software that connects software components and applications, allowing parts of a large organisation to choose software decentrally and at the same time maintain interoperability with other parts of the organisation—as distinct from one giant programme spanning the whole organisation and decided centrally.

The crisis does not signal the end of capitalism, nor will it be remotely comparable to the Great Depression as a source of social misery. But it *is* generating more pressure for intellectual, organisational and normative change than, say, the Asian crisis of 1997–99. The 'establishment' elite has come to question the proposition that financial markets self-regulate each other and even question some of the virtues of acquisitive individualism. Establishment elites and the broad left around the world can exploit the new ambiguity to push serious reforms through the political process. We should draw encouragement from Thomas Paine's steely optimism in dark times. He said in a pamphlet called *The Crisis*,

> Tis surprising to see how rapidly a panic will sometimes run through a country. All nations and ages have been subject to them. Yet panics, in some cases, have their uses; they produce as much good as hurt.

Or in the modern language of Rahm Emmanuel, Obama's chief of staff, 'You never want a serious crisis to go to waste'.

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[1] 'It cannot make sense to fragment the world economy more than it already is but rather to make the world economy work as if it were the United States . . .' (Wolf, 2004).

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