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The Case for Divergence in the Governance of the Global Economy Sovereign Rules for Finance, Global Rules for Trade

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Introduction

At its inception, the G-20 provided important *crisis management* and a co-ordinated response to the subprime crisis of 2007-9. It has as yet however, prior to and up to the latest Cannes Summit, failed to establish itself as an agent of *crisis prevention*. In contrast to the majority of analysts that lament the inability of the G-20 to come forward with global rules for global finance, we will advance the heretical suggestion that this represents an opportunity rather than a problem. We suggest that diversity in financial regulation and what the Warwick Commission (2009) identified as the benefits of an 'unlevel playing field' would enhance, rather than weaken, the longer term stability of the international financial system. Financial regulation should and, for reasons we will explain via some important reminders of the historical and theoretical origins of sovereignty, will remain principally the preserve of national states.

By contrast, we strongly criticize the failure of further development of the multilateral trade regime, an area where global rules can continue to provide significant welfare gains for hundreds of millions of people the world over without testing the state-sovereignty relationship. The current energy expended on a search for global financial regulation, when contrasted with the minimal support accorded to supporting a multilateral trade regime (MTR), is misplaced We suggest a reversal of this current trend in favour of one that accepts the reality of state sovereignty and the need to re-assert it in the financial domain. We assert the need for diversity in financial regulation, but renewed global support for the MTR.

Rhetorical commitments to the completion of the Doha Round notwithstanding, all major players in the WTO have sidelined the MTR in favour of the pursuit of global financial regulation on the one hand and preferential trade agreements on the other. In the financial domain state policy makers and

regulators have all too often permitted the financial sector to dominate the debate and pursue its own, interest driven agenda. We argue that politicians and public policy makers must rediscover the advantages of, and ethics of, implementing an agenda that enhances the majority interests of their public constituencies. At the risk of pretentiousness we call for a public reclaiming of sovereignty by societies over their economic fate.

It is, however, not our aim to challenge the good intentions of policy makers—the road to hell, as they say, is paved with good intentions. Rather, we suggest that even if policy makers wish to make banking a less volatile, less risky sector of an economy, putting the majority of their eggs in the global regulatory basket is probably the wrong venture. In the G-20, since the first summit three years ago, we have seen little meaningful progress with regard to the prevention of future crises. G-20 protestations that it intends to toughen up regulation continue to lack credibility. Success on this count is always likely to be mitigated by the diverging interests of the participating economies and the ability of the financial sector to resist unwanted reform.

The November 2011 G-20 Summit in Cannes, and beyond, was and has been dominated by the European Sovereign debt crisis and very little was achieved with regard to crisis prevention. But even without the turmoil in Greece and other Southern European countries we argue that the G-20 would not have produced a blueprint for re-regulating finance, and we suggest that national states could and should move on and implement their own, tailor-made reforms. The explanation for this, developed in section one of the paper, is to be found in the wider impact of globalisation in general, and the GFC in particular, in shaping attitudes towards the state and what we understand by the concept of state sovereignty in the modern era. This is what we might call the political dimension of regulation and the importance of the domestic polity, primarily for legitimizing regulatory issues.

Section 2 follows with a brief analysis of the evolution of past crises. We suggest that one reason for the growing frequency and depth of crises has been the comprehensive dismantling of restrictions on capital flows and the globalization of finance. The third section addresses what we might call the 'structural limits' to the economic regulation of finance. But the global economy must be seen as a whole and although critical of the current global

approach to financial regulation, we are very much in favour of a functioning multilateral trade regime, which we briefly discuss in section four. Whilst not without faults, the trade regime has been beneficial for the poor, and the current trend of segmenting markets for trade in goods is both reducing aggregate welfare and socially unjust. By way of conclusion we raise several questions about the relationship of the need for financial regulatory reform to its wider socio-political context.

2. Sovereignty and legitimacy in the 21st century

What follows here is a brief excursion into some relevant, but often ignored, history and political theory. The reason being our assumption, indeed most analysts assumption, that the sovereign state, although not without challenge, remains the primary subject of modern international economic relations. Notwithstanding the late 20th century breathless prophecies of the hyper-globalists such as Kenichi Ohmae (1995) and other boosters of the 'borderless world' and the rise of other global economic actors, we still live in a world of states. Sovereignty remains national not global and the ability and right to legislate, again challenges not withstanding (see Slaughter, 2004) remains primarily national not global and state policy makers insist on exercising this right; and doing so in theory, if not always in practice, in the interests of society at large and not just those of the financial sector. The domestic polity continues to be the key provider of, an albeit increasingly strained, legitimacy. Both in the USA and in Europe, policy makers are struggling to explain to their citizens why ever greater rescue packages for the financial sector are inevitable. It is worth, therefore, putting the debate over domestic versus global regulation into a wider historical and socio-political context.

Since the middle of the seventeenth century the sovereign form of state, often referred to as the Westphalian state system, has become hegemonic by a process of eliminating alternative forms of governance (Spruyt, 1994). Importantly for this paper, the modern state achieved a particular resolution of the social bond, hinged on the idea that political life is, or ought to be, governed according to the principle of sovereignty. From that time it was around the sovereignty of the state that modern political life was delimited. The concept of sovereignty thus functioned for over 300 hundred years to

focus and concentrate social, economic and political life around a single centre or site of governance.

This conception of politics dates back to the legitimation crisis of the late sixteenth and early seventeenth centuries. Writing in the middle of the seventeenth century Thomas Hobbes, for example, saw the political purpose of the sovereign state as the establishment of order based on mutual relations of protection and obedience (Hobbes, 1968). The sovereign acted as the provider of security while in return the citizen agreed to offer exclusive allegiance and obedience. There is therefore in this account an emphasis on sovereignty as the centre of authority, the origin of law and the source of individual and collective security. Citizens were bound together, whether for reasons of liberty or security, by their subjection to a common ruler and a common law. This basic structure of governance forged a social bond among citizens and between citizens and the state.

The institution of state sovereignty brought with it a spatial resolution which has given rise to a sharp distinction between the domesticated interior and the anarchical exterior of the state. In general terms, inside and outside came to stand for a series of binary oppositions that defined the limits of political and economic possibility. (Walker, 1993) The inside came to embody the possibility of peace, order, security and socio-political, and later economic, justice. The outside to represent the absence of what is achieved internally: war, anarchy, insecurity and injustice. Where sovereignty was present governance was possible; where absent governance is precluded. Modern political life was thus predicated on an exclusionary political space ruled by a single, supreme centre of decision-making claiming to represent and govern a political and economic community. State sovereignty was thus defined by the state's monopolisation of authority, territory and community (Linklater, 1998).

A crucial function performed by the sovereign state, and of central concern to this paper, was the evolving management of the national economy. Of course there are historically competing accounts of how states govern their economies, especially over the manner and extent to which governments should intervene in and regulate economic activity. However, despite the many important ideological and normative differences there has been a tendency, at least within the dominant liberal tradition of modern capitalism, to

treat national economies as discrete systems of organisation more or less delimited by the state's territorial boundaries. These economies were conceived as largely self-contained, self-regulating systems of exchange and production (see Latham, 1997b). This was as true for economic liberals such as Adam Smith and David Ricardo as it was for economic nationalists and mercantilists such as Liszt. Such thinkers were not, of course, blind to the fact that economic activity commonly spilled over national frontiers, but they tended to treat national economies as self-contained units in the international market.

The economy was thought to serve the community of the state in which it operated; its functions and benefits were defined in terms of the interests of a particular political society. Indeed, the very fact that states monopolised the right to tax within their boundaries further enhanced the correlation of the economy with the state's boundaries. Once economic security was assured, a later general function of the modern state was to govern the economy in such a way as to promote the wealth and welfare of the community. Whereas liberals focused on the market mechanism as the surest and most efficient means of ensuring the liberty, security and prosperity of both individuals and the community; non-liberal approaches tended to emphasise the need for regulation and manipulation of economic activity in order to satisfy the social needs of the community. In addition the state also played a crucial role in the guarantee of private property and the enforcement of contracts as essential legal elements in the governing of the economy.

At a larger normative level, the boundaries of justice, in both its economic and political form, were thought to be coextensive with the legal-territorial jurisdiction, and economic and political reach (reflected in the progressive democratization of government) of the polity and embodied in an unwritten social contract between government, business (including the financial sector) and the work-force. This social contract did not guarantee that the economic benefits of the economic growth that accompanied the industrial revolution were shared equally but that the benefits were distributed more widely and that access to increased prosperity that developed throughout the twentieth century was (in theory at least) open to the widest possible sections of the community. Of course the political consensus that developed in the major

OECD countries (especially in its dominant Anglo American core) did not eradicate injustice and inequality but the role of politics, and the evolving regulatory instruments of the state, was at least able to keep a sense of balance in the relationship between the workforce and the owners and controllers of industry and capital. It did so by addressing wrongs when the balance, especially in the relationship between capital and labour, became too asymmetrical in one direction or the other.

The preceding discussion is not, we hasten to add, simply an excursion into arcane political theory. Rather it offers us important insights into the limits of our current abilities to regulate the global financial system. Under conditions of globalization, defined as the liberalization of trade, the de-regulation of finance, the privatization of assets and the hollowing out of the state, the historical trends that gave us the distinctive resolution of the social bond achieved by the sovereign state and in particular the modern welfare state have begun to unravel (see Devetak and Higgott, 1999). The sovereign state is an historical product that emerged at a particular point in time, resolving social, economic and political problems. But with the passage of time, and the changed milieu in which states exist, it is no longer axiomatic for many that the sovereign state is the most practical or adequate means of organising modern political and economic life and providing the array of public goods normally associated with the welfare state.

Increasingly, the sovereign state is seen as out-of-kilter with the times as globalisation radically transforms time-space relations and alters the traditional coordinates of economic and, as we are seeing in contemporary Europe, political life. Contemporary modern sovereign states are caught in the trap of having to recalibrate the social bond between themselves and their citizens that has been destabilized by the rapid globalization of the world economy that began in the last quarter of the 20th century and reached its tipping point with the onset of the current round of global financial crises that commenced in 2008. States have been, and are, attempting to do this in a number of ways. The one on which we focus the next section of the paper is the attempt to regulate the financial system in the wake of the recent global financial crises. In many ways it represents a case study of the limits of state

policy capacity (state sovereignty in fact) in the face of de-regulated capital markets and is for us the litmus test of the ability of the modern capitalist state to rein in what George Packer, looking at the contemporary USA, identifies as the perverse effects on democracy in particular and the social bond in general of the rise of the lobbying power of 'Organized Money' that facilitated the de-regulatory urge of the last several decades (Packer, 2011: 25-29) and what Conservative MP Jesse Norman, in a remarkable essay looking at the UK, calls the rise of 'crony capitalism' (Norman, 2011)

For both of these impeccably credentialed establishment analysts, behaviour in the financial domain has been marked by the detachment of financial activity from the wider public interest, and the separation of merit from reward. Given the space they occupy on the political spectrum (no Marxists they) it is worth quoting from both of them at some length. Packer describes what he sees as the 'broken contract' and the 'mocking of the American promise' by which 'organized money' between 1979 and 2006 grew its wealth by 256 percent and tripled its share of national income to 33 percent, a figure tellingly last reached in 1928. Inequality in the OECD in general and the Anglosphere most tellingly, has grown rapidly over a similar period (see OECD, 2011 and Lansley 2011). As John Plender (again, no Marxist he) notes in *The Financial Times*,

> '… the wealthiest Americans have collected the bulk of the last three decades' income gains. Much the same is true for the UK. In both cases, most of the spoils have gone to finance professionals and top executives' (Plender, 2012: 2).

Accompanying this empirical shift in wealth and rising inequality is for Packer and further and equally significant transformation '…of morals and manners … [and] … deeper changes in norms of responsibility and self-restraint' (Packer, 2011:29-30). In similar vein for Jesse Norman, rent seeking replaces value creation and wealth is created risk free (for the few) as moral hazard rips. Short termism and immediate returns undermine long standing norms of fairness and a just return and indeed call the moral basis of capitalism into question:

> 'The result is that real capitalism – the greatest tool of economic development, wealth creation and social advance ever known – has been wrongly identified with rampant financial speculation. ... Ever since Edmund Burke, conservatism has seen society not merely as a means to satisfy individual wants, but as a compact between past, present and future generations to preserve and enhance the social order.' (Norman, 2011: 4-6 passim)

For both these authors a characteristic of recent global financial crises, as we suggest in the next section, is a near abdication of sovereignty by the state over the control of their financial sectors as they have become progressively freed of 'appropriate' regulatory constraint. We stress the word 'appropriate' here meaning not regulation for regulation's sake; but regulation to ensure that the social contract that developed over the last three centuries to underwrite the social bond between states and their citizens does not become totally unraveled.

3. Financial crises and the collateral damage caused by globalized finance

3.1. Building regulation on false assumptions

Much has been written of late about the attempt to develop global standards of best practice as a way of stabilising the global financial sector. With hindsight these attempts have not resulted in a more stable international financial system. To give but one example here, the main standard, Basel II, has not prevented the two most recent crises—the sub-prime crisis and the crisis in Europe. Rather, both crises have been fuelled by ill-designed rules. For instance, whilst Basel II required banks to set aside capital according to pre-defined risk criteria, it failed to consider the potential need to have liquidity available in the event of panic. Thus, after the Lehman shock in September 2008, solvent banks were forced to fund themselves from an illiquid position due to their inability to sell assets into collapsing markets (Levinson 2010: 81). In addition, Basel II was far too lenient towards mortgage lending. Before 2007, lending to home owners had been a low-risk business. Rather, regulators around the world assumed that lending to medium-sized and large corporations was the riskier activity—a judgement not borne out by hindsight. Regulators failed to discourage the so-called securitization of loans, i.e. the bundling of individual loans into tradeable securities. Indeed, in many

countries, this process was actively encouraged and many financial institutions choose to opt for securitization rather than follow prudent banking procedures and set aside additional capital for new loans.

Basel II and III specifically tried to develop a rule-book to ensure a global level playing field. But the drawback was that all players followed the same, or at least similar, strategies in a manner which amplified the crisis. As BoE senior executive Andrew Haldane noted:

> 'The level playing field resulted in everyone playing the same game at the same time, often with the same ball. Through these channels, financial sector balance sheets became homogenised. Finance became a monoculture. In consequence, the financial system became, like plants, animals and oceans before it, less disease-resistant' (Haldane 2009: 18).

The dual failure of markets and regulation prior to the US crisis is now, by and large, acknowledged. Whether reflection on the appropriate path of future regulation is commensurate with the magnitude of the failure is less clear. Time and again, in the aftermath of financial crises policy makers vow to get it right. This is a well-known pattern. The idea that the next crisis will be avoided by "better" regulation is as inevitable as financial crises themselves. Notwithstanding the title of Reinhart and Rogoff's book, *This Time is Different* (2009), there is as they note, a reoccurring pattern of hubris, and not only in the financial markets themselves. In the past, state authorities have put new regulation in place in the hope that this time will indeed be different, But simultaneous with new regulation, the financial sector begins, invariably successfully, to explore new avenues to circumvent regulation. Although a new actor, the G-20s efforts to introduce new regulation reflect a similar pattern to that found in the responses to earlier crises.

Two main factors account for these repeated failures. First, financial regulation by definition is based on past experience. Reform is an exercise in shutting the stable door after the horse has bolted. New regulation invariably fails to envisage, or is pre-empted by, new developments in finance. Whilst the utility of so-called innovation in finance is not always obvious, new instruments certainly create new challenges to supervisors, and they regularly fail.

Second, rules, be they national or global, can be and frequently are traduced by financial sector lobbying. Time and again bankers have succeeded in pressuring policy makers to accede to what Gordon Brown in the UK famously called “light touch regulation” and what in the USA Hacker and Pierson (2010) describe as ‘winner take all politics’ which privileges the very rich and the ability of organised interests (in this instance organised money) to triumph over the median voter in the political process, determining favourable outcomes from the policy process (and the ensuing consolidation of wealth in the US of the very rich). Packer details how the preferred policy positions of organised money—generically meaning favourable regulation and minimal oversight of the financial domain—have been assiduously adopted by US governments of both persuasions over the last 25 years (Packer, 2011: 25-29). And, as we now know, the US banking community’s prevention of the US Congress from regulating the burgeoning derivatives markets in favour industry standards for self regulation is now widely understood to have contributed to the 2008 GFC. In the words of the Financial Crisis Commission

> ‘The enactment of legislation in 2000 to ban the regulation by both federal and state governments of over-the-counter derivatives was a key turning point in the march towards financial crisis’ (Financial Crisis Commission, 2010 xxiv, also Tett, 2009).

Of course, the financial sector is but one sector of Hacker and Pierson’s ‘winner take-all society’. But it has become an increasingly politically influential. One effect of the financial sector’s successful lobbying efforts has been the introduction of ‘race-to-the-bottom’ policies by decisions-makers intent on not losing business to other financial sectors. The most commonly used justification here is the reference to the need for a ‘level playing field’ at the global as opposed to the national level. The argument being that unless the rest of the world, or at least the G-20, implements certain rules, any tightening of regulation at the national level will result in the deterioration of the competitive position of that country’s financial sector.

This rhetoric has been exploited not just by the financial sector, but indeed also by policymakers, who have been known to give the interests of banks preference over the interests of wider society. And the existence of strong Wall Street-Treasury relationships amongst the finance professionals in both

the public and private sector in the USA since the 1980s has been well demonstrated (see for example, Wade and Veneroso, 1998). Similarly in the UK, especially since the time of the Big Bang in 1986, policy makers have joined with the City of London in extolling the virtues of deregulated capital markets. None of this should come as a surprise to those versed in some basic political science or institutional economics. Anthony Downs (1957) and Mancur Olson (1982) demonstrated years ago the political power of the lobbying power of special interest groups and distributional coalitions. They also demonstrated the negative economic and social effects (increased inefficiency and rising inequality) of their influence if it became asymmetric.

But globalization, narrowly defined as the increase of economic transactions between nations due to the lowering of hurdles for trade and finance, by its very logic, reduces the policy space of individual states. Increasing interdependence and deregulation (to a greater or lesser extent) is not a bye product of globalisation but part of its essence. From the end of the Bretton Woods regime in the 1970s more and more OECD countries scrapped restrictions on capital flows. The only debate around key instruments of deregulation, such as capital market liberalization, was about the pace of change not the need for change itself. In most countries, capital account liberalisation was subject to little or no debate within the wider domestic polity.

In the European Union, supporters of unrestricted capital flows were confronted by little opposition. Integration enjoyed widespread political support, and there was no differentiation made between the integration of markets for goods and labour and capital markets. Economies like Spain and Ireland, on joining the monetary union were unable to protect themselves against dramatic rises in capital inflows. In the event, both economies were subject to the ensuing boom in real estate and the national authorities had no real instruments to combat economic overheating. Let us consider the specific case of Spain.

Roughly 10 years after Spain emerged from decades of authoritarian rule, it joined the EU. Until it joined the eurozone in 1999, authorities were able to manage developments in the financial sector. The combination of membership in the Eurozone, the ensuing dramatic reduction of the level of both nominal and real interest rates and unrestricted capital flows generated an

unsustainable boom in real estate. Capital inflows reached unprecedented levels. Between 2006 and 2008, the current account deficits of Spain – reflecting capital inflows of the same magnitude – were between 9.0 and 10.0 percent of GDP.[1] Capital inflows of such a magnitude would inevitably pose a risk to any economy. Being locked inside the eurozone and driven by prevailing neo-classical thinking, Spanish policy makers observed the unfolding drama powerless to do anything to check it.

These drawbacks of multilateral rules have become evident in the European crisis from 2009 on. The Eurozone left participating economies with too few instruments to fight a credit boom. In Ireland and Spain in particular, authorities were unable to halt the expanding real estate bubbles. They had no tools at their disposal: interest rates were set at a uniform level by the ECB in Frankfurt, and other remedial courses of action such as taxes to restrict or slow capital inflows were not permitted under European rules. As we now know, the two economies exhibited market failure of enormous dimensions. Even attempts by Spanish authorities to tighten supervision of local banks were ineffective; bypassing national rules by borrowing elsewhere in the Eurozone was not only relatively straightforward, neither did it entail currency risk.

3.2. The consequences of scrapping capital controls

> 'Wall Street's financial firms have obvious self-interest in a world of free capital mobility since it only enlarges the arena in which to make money' (Bhagwati, 1998:11).

For most members of a given society, in contrast to the habitués of Wall Street, the restriction or otherwise of capital flows is a marginal issue. Apart from holidays and the occasional transfer for a distsant nephew's birthday, cross-border capital flows do not impact on wider society. Stable, non-volatile exchange rates are much more important for the community at large. Volatility of exchange rates affects all sectors of the economy that are either exporting or competing with imports. As Robert Mundell noted as early as 1963, an impossible trinity exists in monetary policy and the policies of recent years reflect the growing political influence of those parts of societies—financial

[1] OECD, Economic Outlook 89 database.

firms—that benefit from unrestricted capital flows at the expense of those that would benefit from stable exchange rates. What do we mean by this?

As Mundell suggested, of the three goals that monetary policy aims to achieve (stable exchange rates, unrestricted capital flows, independence of domestic monetary policy) only two are achievable at the same time (Mundell, 1963 and for a discussion of the trinity on exchange rate policy see Obstfeld et al. 2005). In democratic societies, the independence of domestic monetary policy, that is the ability of a central bank to raise or lower interest rates according to domestic economic developments, is an indispensable instrument of policy.[2] Thus, there is a simple political choice: either unrestricted capital flows or stable exchange rates. In the era of Bretton Woods, capital flows were restricted, which reflected the weaker position of the financial sector and the relative greater importance of manufacturing industry in OECD countries. The turn to unrestricted flows reflected the changing symmetry in this relationship and, supporting Packer and Hacker and Pierson's arguments about the rise of organised money, the growing influence of the financial sector over the domestic policy process.

Since the end of Bretton Woods, capital flows have risen dramatically. But we note that there has been a particularly sharp rise of flows in the decade before the US crisis. World current account imbalances (the half-sum of all deficits and surpluses of the 181 countries in the database of the IMF) had been relatively stable between the early 1970s and 1997; in that period, they oscillated at around 1.2 percent of global GDP before growing to about 3 percent of global GDP between 1997 and 2007 (Brender/Pisani 2010: 24). The current account deficits of capital importing countries (notably the USA) and the surpluses of capital exporting countries (notably, but not only, China, Japan, Germany) rose dramatically--a dangerous development that we have argued elsewhere requires regulatory responses (Dieter and Higgott 2010).

A key issue here is the utility of capital inflows for an economy. In the 1970s, when restrictions on capital flows were still widely applied, liberal economists suggested that unrestricted flows would benefit the poor. Capital, it was

[2] Under the gold standard, the political climate was of course different. Trade unions were non-existent or much weaker, and policy makers had more freedom to set interest rates according to external economic conditions.

argued, would flow from capital-rich economies to countries were capital is scarce, primarily developing economies (see Eatwell, 1997). Why would that happen? The underlying theory was, of course, the efficient-market hypothesis, essentially arguing that financial markets process all available information. Thus, markets will realize that a more efficient use of capital will be found in developing economies, rather than in established, developed markets. Of course, some capital does flow in and out of developing countries, but in the first decade of the 21st century the direction of capital flow has been upstream; most notably from poorer economies to the USA where, as we know, it financed unsustainable levels of consumption.

Recent research has confirmed the strongly diverging utility of different types of capital inflows. An analysis of capital flows to about 100 countries in two different time periods, 2000-2005 and 2006-2010 confirms the positive contribution that foreign direct investment can make to economic development but there is no conclusive evidence both for portfolio investment and short-term debt. The latter can even have negative effects on growth, particularly in phases of financial turmoil (Aizenman et al. 2011: 18). The diverging effects of different types of capital inflows are hardly surprising.

The key question is that of use. Is it used for financing investment or consumption? With regard to economic development, inflows that finance consumption (or failed investments) are most problematic. FDI is therefore better placed than other types of inflow to generate income for debt service. Portfolio inflows can generate income for debt service, but this is more difficult for foreign debt. In recent years, inflows into the USA, Spain or Greece have more often than not financed consumption rather than investment.

With hindsight, restrictions on certain kinds of inflows would have helped to keep these economies on a more sustainable track. And as we now understand, these failures have resulted in consequences for the countries that have failed to consider the negative effects of capital flows. This is more a failure of politics than economics. In their desire to advance the cause of their financial sectors, policy makers have failed to defend the interest of the wider society.

By way of example, the dramatic developments in Iceland have underlined the need for an approach that considers the potentially disadvantageous effects

of irresponsibly loose financial regulation. With a population of a mere 320.000 people Iceland has become the victim of an ill-fated expansionist strategy of a small number people in its financial sector. For a few years, ambitious Icelandic bankers attempted to conquer international markets, with the catastrophic consequences of which we are now aware. No other country has demonstrated the validity of the aphorism that ‘banks grow abroad but die at home’ more clearly than Iceland.

Many market participants had the illusion that the Icelandic government had the ability to back the operations of Iceland’s internationally operating banks. The (tragically wrong) assumption was that this conventional approach to banking supervision was sufficient. This standard approach in banking regulation is called home-country regulation. Banks are supervised by national authorities, and in the event of trouble the national government and the country’s central bank come to the rescue. However, this turned out to be impossible when the three banks operating out of Iceland required liquidity. The Icelandic government could provide them with unlimited amounts of krona, but not with foreign currency. This borrowing abroad in foreign currency by Icelandic banks is as ‘original sin’ when identified in developing countries. The national authorities could not provide sufficient support when liquidity dried up on international markets and the business models of Icelandic banks were no longer viable.

When Iceland’s three bigger (hardly big) banks started their aggressive expansion, they used short-term liquidity from international financial markets to provide for their financing needs, emboldened by policy makers who permitted the financial sector to grow with little oversight. By 2008, the banks’ assets equalled near to 1000 percent of the national GDP; that is ten years of economic activity. When the collapse of the financial sector came the Icelandic government had no choice but to let it happen. The significance of the example is that other countries sporting equally inflated financial sectors may be faced with similar choices at some stage in the future. UK banks for instance, had assets equalling 450 percent of British GDP in 2008 (Buiter 2008: 280), and the collapse of one or two of them would have brought the UK’s finances to the brink. The Swiss authorities are confronted with an even more problematic situation. The assets of UBS and Credit Suisse were 660

Percent of Swiss GDP (Buiter 2008: 280). The Swiss response has been to discipline them. Swiss authorities are asking for a “Swiss finish”, a whopping six percent of additional core capital. Effectively, these two banks will have to set aside 19 percent capital for their operations from 2018 on. The key point here for our argument is that Switzerland has departed from a uniform banking approach at the global level because its policy makers considered the global financial rules too lenient for the protection of the national, as opposed to the sector, interest.

3.3. Crises revisited: What can be learned?

> ‘The tendency to transform ‘doing well’ into a speculative boom is the basic instability in a capitalist economy’ (Minsky 1977: 13).

What can we learn from the preceding discussion? That financial crises are systemic, rather than accidental events. According to Hyam Minsky (1997: 13), ‘increased availability of finance bids up the prices of assets relative to the prices of current output, and this leads to increases in investment’, In short, economic boom changes the behaviour and the expectations of market participants. When a boom develops, standards change and risks are ignored. This pattern of over-confidence has been observed many times since Minsky made his initial observation; as in the Japanese twin bubble—real estate and share prices—in the 1980s where the rise of asset prices relative to current output was reflected in the ever increasing number of years an employee in Japan would have had to work for his or her dwelling. The bubble burst in 1990.

Minsky’s insights reflected a ‘minority position’ disregarded by the neoclassical mainstream, which continued to believe in the superior rationality of financial markets and their ability to process information efficiently. By contrast, Minsky (1977:15) suggested that financial stability cannot be achieved and that ‘... a capitalist economy endogenously generates a financial structure which is susceptible to financial crises, and ... the normal functioning of financial markets in the resulting boom economy will trigger a financial crisis’. Developments since the 1970s give more credence to Minsky’s financial instability hypothesis than it received at the time of its development and especially since the GFC’s challenge to the efficient market hypothesis.

Minsky's way out of this impasse was the consolidation of *'good financial society'*, in which the tendency of business and bankers to engage in speculative activity was constrained (Minsky, 1977, p. 16). What he failed to provide, sadly, was an idea how this goal could be achieved. In part, we would suggest this is because he lacked an understanding of the political and social theory of the sovereign state. An understanding of how to retain, develop or re-create the 'good (financial) society' requires the skills and resources of the historian, philosopher and the political theorist; resources that have been too little valued, understood even, in the contemporary neo-classical economists tool kit

4. Consequences for financial regulation

4.1. The limits of global regulation

For more than two decades, the dominant view in the debate on financial regulation has suggested that global rules, and only those, can make the financial system safer and more stable whilst at the same time not stifling innovation or undermining the prevailing neo-liberal ideological impetus of the globalised era. Our contrasting view would give preference to tailor-made national and/or regional level solutions. A diverse, not a one-dimensional, regulatory landscape would be the result. While such an approach will not automatically prevent financial crises, the effects of turmoil might be mitigated because, as we know from biology, diversity stabilises complex systems, whereas monocultures transmit and more easily exacerbate shocks.

Of course, if the record of regulators and academics in identifying future risks were better than history tells us it has been, then the case for diversity would be weaker. But as numerous financial crises have demonstrated, the widespread assumption that authorities are able to learn from past mistakes has time and again not only been wrong, it has led to hubris and turbulence. There is no evidence that our ability to predict future risk is so well developed that the implementation of more global standards in finance will contain it. Standardisation does not equal stabilisation. It is not impossible that more global rules could result in further global crises.

Andrew Haldane, Executive Director for Financial Stability at the Bank of England, interprets the financial system as a 'complex adaptive system' (2009: 3). He suggests that four mechanisms influence the stability of the

network: *connectivity, feedback, uncertainty and innovation* (Haldane 2009: 8). All four of them have the potential to turn a hitherto stable system into an unstable one. Let us look at them in turn. Connectivity of participants in financial markets, facilitated by cross-border capital flows, can serve as a shock absorber, but only within a certain range; past a certain, hard-to-predict point, connectivity turns into contagion:

> '... beyond a certain range, the system can flip the wrong side of the knife-edge. Interconnections serve as shock-amplifiers, not dampeners, as losses cascade. The system acts not as a mutual insurance device but as a mutual incendiary device. … Even a modest piece of news might be sufficient to take the system beyond its tipping point.' (Haldane 2009: 9).

And indeed, we have seen numerous examples of the Janus-headed dimension of connectivity. At first benign and seemingly non-problematic, cross-border financial flows suddenly turn from sources of relatively cheap finance into unmanageable liabilities. For instance, years of financial flows into Asian economies prior to the 1997 crisis appeared to be a blessing, only to become a liability when the tide turned. Similarly, for years before subprime, connectivity—hailed by Alan Greenspan as a new era in finance—was considered to be unproblematic. But when the tipping point was reached, the American virus infected financial systems the globe over. This argument is reinforced in the Turner Review (2009) who argued that the GFC was assisted by the erroneous belief belief that the financial system had become 'more stable and the amplitude of economic cycles less pronounced precisely because of financial market developments ... {but in fact] ... which we now believe led to the crisis' (Turner, 2009: 85)

To understand the power of feedback, Haldane refers us to epidemiology. The speed with which crises, or diseases, spread, very much depends on the perception of market participants. Their views 'construct' the crisis. The reaction of market participants to financial crises thus determines the rate of transmission of that financial (Haldane 2009: 12). And as we know, financial markets have a tendency to be characterized by herd behaviour: First greed, than panic (Wood 1988). Both work as feedback loops.

Uncertainty is the third factor in Haldane's analysis. Networks generate chains of claims, and whilst in boom times the question of counterparty exposure is often ignored, in the event uncertainty creeps in. In addition, who is at the end of the chain is crucial says Haldane: Bernhard Madoff or Warren Buffet? Modern finance has done at lot to conceal counterparty exposure and thus increased uncertainty. The widespread use of over-the counter derivatives, in essence private contracts between two parties without authorities or other market participants knowing about them, has been a key factor. Consider the surprise that hit many, including the US government, when the full exposure of AIG (the world's largest insurer) to credit default swaps became clear the day after Lehman Brothers collapsed. 'Counterparty risk is not just unknown, it is almost unknowable (Haldane 2009: 14).

Finally, innovation, at different times, can contribute to both the stability and fragility in financial systems. In fact, we think that innovation in finance has to be sharply separated from the real economy. In finance, innovation is often a euphemism for increased complexity and less transparency. Indeed, it would be our contention that the unalloyed utility of innovation in finance remains to be demonstrated. Take, for example, some of the 'innovations' that contributed to the 2007/2008 crisis in the USA. One particularly opaque and dangerous instrument has been the 'squared collateralized debt obligation', or CDO^2. An investor in a CDO^2 would have had to read in excess of one billion (!) pages to understand the product.

Against this background, we suggest an agnostic view of banking regulation (global or national). We will never be able to know what the risks of future developments will be, and even if tough rules are implemented, we can safely assume that the financial sector will find 'innovative' ways around them. For example, the current proposal to require extra amounts of capital from so-called systemically relevant banks creates an incentive to carve up big financial firms into smaller units. While many observers appear to hope that 'too-big-to-fail' banks will obey and implement new regulatory measures that would make them less profitable than their smaller peers, past experience does not provide sufficient evidence to sustain this claim. It is plausible to expect that there will be a departure from large, integrated banks into smaller units. Yet this may not result in the lowering of risk, unless the newly created

smaller banks follow diverging strategies *or* regulators permit the simultaneous bankruptcy of several medium-sized banks.

As mentioned before, previous global initiatives for stricter regulation of the financial sector have not contributed to the stability of the international financial system. Basle I, introduced in the late 1980s when Japanese banks were the rising stars in finance, prevented none of the crises of the 1990s—neither the Mexican crisis of 1994/95 nor, more importantly, the Asian crises of 1997/98. The crises in Asia should have been a reminder for policy makers in the OECD of the impact of hubris on unchecked financial markets. Not one single major market participant spotted the emerging crisis. Rating agencies started to worry only when the situation had already visibly deteriorated and then only contributed to the deepening of the crisis by iterated downgrading of the affected economies. The parallels for the later American and European crises, while all too obvious, were missed or ignored as Americans and Europeans enjoyed their short-lived moment of long-term resentment-inducing *schadenfreude* (Higgott, 1998) rather than returning to more prudent banking at home.

4.2. A policy recommendation

Our proposal to reverse current emphasis in global economic governance needs to be specified and put into context. Three key messages emerge from the financial crises of the last decades. First, financial innovation in most cases is little more than modern alchemy that pretends to being able to create wealth via financial engineering. It may indeed do so but, empirically observed, this is only for a short period of time and only for a limited group of people. Financial innovation has not contributed meaningfully to improving conditions for investment and has certainly not contributed to the higher socio economic welfare of the major developed nations overall. Indeed, the gains of some people in the financial sector, accrued prior to the onset of subprime and the GFC, have subsequently had to be covered by taxpayers with absolute negative implications for welfare.

Second, the increase of cross-border capital flows since the late 1990s has not contributed to a more sustainable financial system, but has instead opened new avenues for the transmission of financial shocks from one country to another. Compare, say, the Savings & Loans crisis in the 1980s

with subprime. Both were the result of ill-constructed financial regulation in the USA, but the effects were extremely different. The S &L crisis was a domestic affair that did not affect the rest of the world in a significant way. Subprime, however, did. The key transmission mechanism was the capital inflows into the USA prior to the 2007/2008 crisis.

Third, attempts to regulate more prudently will always be exposed to powerful blocking campaigns from key sections of the financial sector, sadly all too often supported by academic economists who benefit in a range of ways from the policy advice they give. History is replete with crusades against proposals for tighter regulation of the financial sector. This past experience suggests that today's world is unlikely to be different.

So what are the benefits from a greater segmentation of financial markets we suggest? Firstly, financial innovation that needed to be explained to a domestic audience would most probably receive less political support. Financial institutions that have to explain to a domestic regulator what the benefits of a one billion page CDO^2 would likely as not see their argument lost in translation. Using developments in global finance as a means of reinforcing the importance of financial innovation worked in the past, but departing from a global approach would enable regulators to investigate pros and cons more thoroughly and make them more accountable.

We are suggesting that the regulation of finance ought to be put back into the national polity and addressed more substantively and substantially within the national policy debate. Since it is domestic societies that bear the consequences of failed regulation of the financial sector, it is they should who should own and control the regulatory process. In such a context, attempts by the financial sector, or parts of it, to lower regulatory standards would prove more difficult in a national context than in a more opaque and politically remote global one. National decision makers, confronted with the potential fallout of lax regulation in the domestic political domain, would approach liberalisation more cautiously.

Secondly, the segmentation of markets would help contain (although not eliminate) the contagion effects of national financial crises. A crisis in one country would not have the same magnitude of adverse impact on other economies, apart from slowing demand from the affected economy. Crisis

would of course still occur, but more in isolation. In essence, we endorse the recommendations of the 2009 Warwick Commission to switch from home-country regulation to host-country regulation (but see also Levinson 2010: 87). In essence, this would enable regulators to require both national and international banks to provide local minimum capital requirements for local risks (Warwick Commission 2009: 8).

A shift to national regulation would make the activities of big international financial firms more difficult and would favour the development of national financial systems. In this regard, John Maynard Keynes' observation that 'finance be primarily national' remains pertinent (Keynes 1933: 758). As long as business cycles are structurally diverging between economies, national approaches to regulation would provide more stability than uniform, global approaches.

4.3. A step further: Is a tax on cross-border flows essential?

But we are of course aware that any attempt by regulators to implement a host country approach will also be subject to the financial sector attempting to circumvent it. Thus, the proposal for host country regulation has to answer the following question: What response are regulators willing to implement if their rules are by-passed? Assume, for example, that in a country the authorities notice a steep increase in real estate prices as well as lending for real estate. If they tighten regulatory standards, this will make borrowing at home less attractive and will entice borrowers to turn to foreign lenders. In such a situation, authorities ought to be willing to implement temporary taxes on capital flows, maybe at the one percentage point envisaged by James Tobin. Whilst taxation of cross-border flows may not be necessary other than in times of credit boom, they can if appropriately used surely help ensure the stability of the domestic financial system.

True, Tobin's aim, unlike ours, was not the creation of regulatory divergence, but rather the stabilization of exchange rates (Tobin 1978). Our goal is somewhat different. Whilst a tax on cross-border flows could potentially stabilize exchange rates, partly because a significant tax would constitute a *de-facto* restriction on capital flows, our main goal is to enhance a state's ability to restore regulatory sovereignty—to give back to the state some of its policy influence lost since the time of the neo-liberal revolutions of the 1980s.

Critics will correctly argue that taxes on cross-border flows will make borrowing more expensive. But is this a bad thing? Given the numerous credit booms that went unchecked since the liberalisation of finance, we do think it is not necessary to prove the efficacy of more restricted lending practices. After all, credit booms foreshadow quite precisely the subsequent advent of financial crises (Schularick/Taylor 2009: 26). As Bhagwati suggested a decade before the GFC, unrestricted capital flows contribute to crises.

> '... only an untutored economist will argue that … free trade in widgets and life insurance policies is the same as free capital mobility. Capital flows are characterized, as the economic historian Charles Kindleberger … has famously noted, by panics and manias' (Bhagwati 1998: 8).

And there is historic-empirical evidence that restrictions on capital flows at least correlate with greater financial stability? Bordo *et al.* examining 21 countries over a 120-year period found interesting results.[3] The only period that was characterized by a co-operative international climate (if one ignores the economies of the Warsaw Pact) and restrictions on capital flows, is the era of Bretton Woods, when banking crises were almost non-existent. From 1945 to 1971, not a single banking crisis was recorded in any of the 21 countries in the sample (Bordo et al. 2001: 59). Currency crisis continued to occur, which is not surprising since fixed exchange rates tend to require adjustment in regular intervals, but the absence of banking crises in the era of Bretton Woods is a feature of finance we should not dismiss lightly.

A recent quantitative study by Schularick and Taylor supports further our plea for national regulation. They analysed data of 14 developed economies over 140 years. They test whether the financial system is prone to crisis due to endogenous credit bubbles The result of their analysis is clear: credit booms matter, and they usually precede financial crises: 'the model show(s) that a credit boom over the previous five years is indicative of a heightened risk of a

[3] The countries in the sample are Argentina, Australia, Belgium, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Great Britain, Greece, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the USA, i.e. the leading economies in that 120 years time span.

financial crisis (Schularick/Taylor 2009: 20). Phases of greed and euphoria alternate with periods of anxiety and panic. And as we have shown from the case of Spain, many credit booms would not have occurred without substantial unregulated capital inflows.

These findings have severe repercussions for the evaluation of monetary policy. The mainstream school of thought prior to the GFC, primarily, championed by Alan Greenspan and the American Federal Reserve Bank, was that monetary policy's exclusive focus should be on price stability and the promotion of economic growth. Financial stability, defined as the absence of unsustainable asset price inflations, was not an issue for the Fed. In the early years of the 21st century, Greenspan defended his deliberate ignorance of asset price inflations in a debate with the European Central Bank's then Chief Economist Otmar Issing. Greenspan's position, shared by prominent American economists Alan Blinder and Frederic Mishkin, named after the annual gathering of central bankers and academic economist in Wyoming's, was labelled the “Jackson Hole Consensus” (Issing 2008: 3).

Like the dismantling of capital controls, this mainstream position was based on the assumptions of the neo-classical efficient market hypothesis that markets correctly reflect all available information at the time of pricing assets, and asset price inflations essentially either do not occur at all (the radical position) or cannot be addressed by monetary policy at reasonable cost (the more nuanced position). Consequently, a coherent monetary policy would then have to ignore asset markets all together.

However, following the collapse of Lehman Brothers, Issing identified the asymmetry in this approach and the manner in which it contributed to weakening risk management in the market. He noted numerous empirical studies that demonstrated how most price bubbles had been accompanied by, if not preceded, dramatic growth of credit and/or money (Issing, 2008: 4-6). Prior to the bursting of the US bubble, the then Chief Economist of the Bank for International Settlements, identified the same trend in a 2006 BIS working paper (source citation here).

Assuming these various findings are correct, credit booms and asset price inflations are indeed a second key factor to which central banks should pay attention. As Schularick and Taylor affirm (2009: 26) monetary policymaking

should consider price stability *and* financial stability. Central banks should no longer pretend that credit booms are a private sector phenomenon that they can ignore. But what are the implications and consequences for our proposal for a return to national rules in finance? The answer is that central banks and national bank supervisors can control credit booms and unsustainable asset price inflations at home, but it cannot be assumed that they can undertake the same task beyond their sovereign borders.

Consider a hypothetical proposition: would OECD central bankers and banking supervisors be capable of deciding at the end of 2011 whether lending for real estate investment in China would constitute lending into an asset price bubble? China, of course, does not permit borrowing abroad. Evidence suggests that 34 million dwellings are unoccupied in China and this surely constitutes a real estate bubble. But an assessment of the sustainability of a boom, say from London and Frankfurt, will always be more difficult than for domestic central bankers and supervisors. Almost inevitably, central bankers and national supervisors will be put under pressure by the domestic financial sector to be more generous with international lending operations. Since this could easily lead to future cases of Icelandic style crises, we suggest that the segmentation of financial markets is a radical, but more sustainable policy choice.

5. The utility of global rules in trade

Our proposal to abandon the endeavour to develop global rules for finance should not be interpreted as anti-liberal and anti-multilateral. It is not. Not only are we committed multilateralists, we actually believe that in a whole range of policy areas ‘Problems will be Global and Solutions will be too’—to borrow the title of Anne Marie Slaughter’s (2011) article in *Foreign Policy*. So we juxtapose our argument about the regulation of global finance with a short counter factual discussion of the global trade regime. We suggest that there are sufficient reasons for a sharp distinction between global rules in trade and those in finance. We are staunch advocates of the continuing liberalisation of trade. We reiterate Bhagwati’s suggestion that trade in widgets and trade in dollars differ and we differ from Keynes view that ‘... goods should be homespun whenever it is reasonably and conveniently possible’ (1993: 758).

In contrast to the ambiguous (at best) effects of unrestricted capital flows, both economic theory and historical practice have shown time and again the welfare enhancing benefits of fewer restrictions in trade. For any country, the overall welfare benefits of trade far outweigh possible negative dimensions for a specific sector. In the most recent era, the liberalisation of trade has enabled countries like China, India and Vietnam to contribute to and benefit from a deeper international division of labour. Hundreds of millions of workers in developing economies have worked their way out of poverty by producing for global markets. We still observe the worst cases of poverty in countries that continue to try to protect their citizens from a more liberal approach to trade. And of course the industrialised societies have benefitted over time as well. Consumers would not enjoy the same range of goods and services if there were significantly less trade. Central bankers would have had a much harder job in controlling inflation if China and other emerging economies would not have provided cheap manufactured products. All these are tangible benefits of the global historical trend towards freer trade.

Thus, we would argue that in the other domain of global economic relations—as both economic theory and the history of the trade regime tell us—global rules are appropriate and do indeed provide additional benefits to the global economy. Indeed, as Rodrik (2011) notes, global rules are essential under conditions of globalisation. It is thus ironic and regrettable that we have observed a declining commitment to the norms and practices of the multilateral trading system and a proliferation of bilateral and regional preferential trading arrangements (PTAs) such as the now much hyped Trans Pacific Partnership. The World Trade Organisation is currently challenged by the unwillingness of the United States of America and other key players to support the conclusion of the Doha Round. Whilst the WTO continues to fulfil a range of important functions—and the Russian Federation becomes the 154th member in early 2012—the organisation has lost support from its previous core constituency. All OECD-countries are defecting to alternative strategies, especially PTAs. These agreements are making international trade

more complex and are unlikely to facilitate a deeper international division of labour.[4]

Notwithstanding derogations, the vast majority of scholars and practitioners continue to acknowledge that global rules for trade continue to be the first-best of approaches to trade governance. This case can be stated with much less equivocation both historically and contemporaneously in the domain of financial governance where, as we have tried to argue, diversity in regulation stakes a stronger claim to optimality.

Conclusions

At one level the paper is substantively empirical in its discussion of key elements of the contemporary global financial crisis. At another level there are important normative consequences and implications that we have tried to draw from the empirical analysis. At an applied policy level we are suggesting a radical departure in current thinking about the optimal venue for global financial regulation. At the normative level we are suggesting a need to revisit the impact of the dilution of sovereignty of financial governance for the health of the contemporary social bond in developed societies. Let us take each issue in turn.

At the immediate policy level, drawing on the empirical analysis we have presented, and in contrast to the current orthodoxies and trends reflected in the agenda of the G20, we advocate the privileging of national or regional rules for finance regulation. To achieve this goal, we are also suggesting the taxation of capital flows in order to provide polities with the necessary ability to develop tailor-made responses to specific circumstances if and when required. Needless to say the financial sector, supported by strong residual neo-classical economic argument, will continue to argue that taxing cross-border flows is improper government intrusion into the market place. But our basic argument is neither new nor radical. Rather it is one that simply failed to find voice in the heyday of the neo-liberal ascendancy of the 30 years prior to the global financial crises of 2008. Yet, as Bhagwati noted long before the subprime crises and the various crises in Europe, the assertion that free

[4] Our position on the positive benefits of a rules based global trade regime and a description of the motives for, and the disadvantages of preferential agreements, find full expression in the report of the Warwick Commission (2007: 45-53) of which we were both members.

capital flows represented the ideal option was always an essentially ideologically driven, self-serving assumption. If it was appropriate, as he argued over a decade ago (1998: 12) that the burden of proof should be imposed on those advocating it rather than those opposing it, then it is doubly appropriate in 2012. Moreover, let us not forget that capital controls are a legal and legitimate instrument of policy for sovereign states should they so choose to use them. That governments may not have used these instruments where arguably they should have done is explained by politics (and especially the power or organised money) not because, in contrast to trade liberalisation, it is incontrovertibly good economic theory.

But we are not naive. We are under no illusion as to the limitations of this approach. Tougher regulation at the national or regional level will continue to be exposed to intensive lobbying. Players will relocate to (or threaten to relocate to) less restrictive market places. It was ever thus. And it is indeed capital's choice to do so should it wish; just as it is the sovereign right of governments to ignore these threats and regulate should they so wish. But we have demonstrated that the benefits of a soundly regulated national financial sector outstrip the costs. And surely, at the very least, global rules should not discourage the introduction of additional regulatory measures at the national level if it is governmental choice to do so.

At the broader level, this paper has reflected an attempt to combine some political theory with international economics—an unusual combination but one we argue is essential to capture the complexity of the contemporary dilemmas that led us into the global financial crises. Implicit in our discussion is the view that if scholars are to assist in taking us beyond these crises then we must avoid the neo-classical economic monoculture that dominated the economics discipline over the last several decades (see McNamara, 2009, Wade, 2009). For it was in this context, emboldened by the ideological support of the 'science of economics', that the Anglo-American financial sector was able to practice the financial engineering that became hegemonic in the 20 years from the end of the Cold War to the GFC was

There was no counter-veiling power. Public regulators became timid, subordinated and the hand-maidens of organized money. In the struggle between market power and rules based behavior the intellectual ammunition

that the economist supplied to the financial sector was not provided to the regulators in equal measure by either the lawyer or the political philosopher. Observation was suboardinated to algebra. This imbalance was not without consequence. It left an intellectual, some would say moral, void that permitted the ascendency of Packer's 'organised money', Norman's 'crony capitalism', and Hacker and Pierson's 'winner take all' society with the subsequent weakening of the social bond between the modern state and its citizenry in countries such as the USA and the UK.

As a consequence, the struggle between financial power and rules based behaviour will continue to be a hallmark of the present system. It will not be overcome by any substantive developments in global governance writ large—these remain the pietistic chimera of the cosmopolitan theorist. Even on the smaller, more practical canvas of 21st century *economic institutional multilateralism*, cooperative collective action problem solving will remain constrained by both *national and international politics* (see Higgott, 2012). The G20 may have acted as something of a crisis buster at the height of the GFC and it will continue to be a forum for setting an agenda for serious discussion of how best to manage the global economy. It is part of the plurality of the arenas of regulatory discourse. But it is not in this forum, we argue, that the ultimate regulation of risk in the global economy can and will be determined. That role will, and indeed must, for the reasons of sovereign primacy that we have adumbrated, remain primarily the preserve of sovereign states. Co-ordinaton in the global financial system is to be encouraged but responsibility for regulation, reflecting Rodrik's 'paradox of globalisation', should remain largely a 'host country' activity if we are to re-democratize regulation.

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