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THE END OF CAPITALISM

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2008 Journal Staff

Dear Readers,

The process of putting together this year's Journal was overtaken by events in the international financial markets. In the year which marks the anniversary of the fall of the Berlin Wall, our attention was directed away from an analysis of the events of the last two decades and to the carnage which unfolded on trading floors and quickly spread to high streets and homes around the world. We felt that this crisis raised powerful questions which we have sought to address in this twelfth issue of the *Bologna Center Journal of International Affairs*. With government intervention on the rise, we wondered whether events would herald a move away from laissez-faire capitalism. We wanted to see whether there was consensus around the question of where the system which was assumed victorious twenty short years ago would turn. Would the system now move towards a more ethical variant? Or is capitalism now finished and discredited?

This edition of the Journal brings together a series of articles that seek to examine these issues. Starting with a piece by SAIS professor and former US National Security Adviser Zbigniew Brzezinski on the opportunities offered by the election of Barack Obama, we follow with a European perspective on the systemic roots of the financial crisis in an interview with former French Prime Minister Michel Rocard. We then move to an examination of the question of the capitalist system itself, with a pair of articles which look at the potential for a re-fashioning of the financial services sector and the concepts of laissez-faire and globalization. Looking to specific instances, we have three articles in which the impact of the crisis is examined in the regional contexts of the European Union, Eastern Europe and Latin America. The role of government intervention in halting the growth of democracy is next explored, before the Journal closes with a paper that looks at the way in which comparative cultural economics can be harnessed to explore the development of path dependencies and anti-capitalist behavior.

Given the speed with which events have unfolded, and the directions in which international policy seems to be moving, we are more convinced of the need for the exploration of the arguments contained within this Journal. I would like to thank the Journal staff, the Bologna Center faculty, and the authors for making this possible.

Ben Welch
Editor-in-Chief
April 2009

In his introduction to "Science and Human Values" Jacob Bronowski tells of standing near the harbor in Nagasaki shortly after the end of World War II, taking in the devastation of the city before him while, from a US Navy ship behind him, he heard the strains of a then-popular song, "Is you is or is you ain't my baby?" The metaphorical connection was, of course, obvious: how much was science and its uses (or abuses) to blame for the destruction he saw? Was it time to end his (our) love affair with it? His little book is his answer to the question.

We are at a different time now, and comparing the scope of disasters is not only difficult but also pointless. Nevertheless, the financial crisis quite naturally raises a similar question with respect to capitalism and this issue of the Bologna Center Journal of International Affairs has confronted it with a series of papers on the theme, "The End of Capitalism." In the spirit of the other "End of . . . " publications, from the famous first, Frank Fukuyama's "End of History," through this very journal's previous issue, "The End of the Enlightenment?" to this excellent set of contributions, the intention is not to note, to assert, or to deny the end of capitalism. It is to advance the conversation by examining capitalism itself; by looking at its various manifestations, its relations to the political order, its failures, its possible course corrections, perhaps its inevitability.

The articles in this issue present the work of a mix of graduate students and established scholars; critics as well as defenders of capitalism, whether viewed as goal, institution, or natural state; those who have "been there" as well as those trying to decide whether to go there. As is appropriate for a journal of this sort, the articles focus on capitalism in an international context and on its linkages to globalization. And, reinforcing the underlying premise of a SAIS education, the perspective in most of the articles is a multidisciplinary one, both in analytical approach and in the recognition that the success or failure of capitalism, however defined or described, is, perforce, measured by its effects on the political and social order as well as the economic system itself.

The Bologna Center Journal of International Affairs is entirely a student enterprise. The editorial staff selects the theme, issues the call to authors, selects the papers, and edits and assembles the final product. In the process, they engage the Center's students and faculty in thinking about the topic they focus upon, enriching the educational experience for all of us. And, as will be evident to the reader, they produce a volume that is a useful and significant contribution to the literature. The annual production of the Journal has become a tradition at the Center, and a source of pride to all of us. It is a personal pleasure for me to introduce you to this year's volume, which I hope and fully expect you will find enlightening and engaging.

Kenneth H. Keller
Director and Professor
April 2009

The Global Political Awakening

Zbigniew Brzezinski

A new president is assuming office in the midst of a widespread crisis of confidence in America's capacity to exercise effective leadership in world affairs. That may be a stark thought, but it is a fact.

Though US leadership has been essential to global stability and development, the cumulative effects of national self indulgence, financial irresponsibility, an unnecessary war and ethical transgressions have discredited that leadership. Making matters worse is the global economic crisis.

The resulting challenge is compounded by issues such as climate, health and social inequality—issues that are becoming more contentious because they have surfaced in the context of what I call "the global political awakening."

For the first time in history almost all of humanity is politically activated, politically conscious and politically interactive. Global activism is generating a surge in the quest for cultural respect and economic opportunity in a world scarred by memories of colonial or imperial domination.

This pertains to yet another fundamental change: The 500-year global domination by the Atlantic powers is coming to an end, with the new pre-eminence of China and Japan. Waiting in the wings are India and perhaps a recovered Russia, though the latter is very insecure about its place in the world.

In this dynamically changing world, the crisis of American leadership could become the crisis of global stability. Yet in the foreseeable future no state or

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Zbigniew Brzezinski, President Jimmy Carter's national security adviser, is trustee and counsellor at the Center for Strategic and International Studies (CSIS). This article is based on his 2008 John Whitehead lecture at Chatham House, London. This article was first published in the International Herald Tribune on 16th December 2008 and is being reprinted with permission.

combination of states can replace the linchpin role America plays in the international system. Without a US recovery, there will be no global recovery. The only alternative to a constructive American role is global chaos.

It follows that the monumental task facing the new president is to regain US global legitimacy by spearheading a collective effort for a more inclusive system of global management. Four strategically pregnant words define the essence of the needed response: unify, enlarge, engage and pacify.

To unify pertains to the effort to re-establish a shared sense of purpose between America and Europe. To that end, informal but frequent top-level consultations are badly needed, even though we are all aware that there that there is no such thing yet as a politically unified Europe. The only practical solution is to cultivate a more deliberate dialogue among the United States and the three European countries that have a global orientation: Britain, France and Germany.

For many years, Europeans have complained they are excluded from decision-making, yet they are perfectly willing to let the United States assume the burdens of implementation. Differences over Afghanistan are but the latest example of that dilemma. It is to be hoped that the new US president will make a deliberate effort to revitalize the US-European dialogue.

To enlarge entails a deliberate effort to nurture a wider coalition committed to the principle of interdependence and prepared to play a significant role in promoting more effective global management. It is evident, for example, that the G-8 has outlived its function. Accordingly, some formula for regular consultations ranging in composition from G-14 to G-16 should be devised to bring together countries with geopolitical significance as well as economic weight.

To engage means the cultivation of top officials through informal talks among key powers, specifically the US, the European Triad, China, Japan, Russia and possibly India. A regular personal dialogue, for example, between the US president and the Chinese leader would be especially beneficial to the development of a shared sense of responsibility between the only superpower and the most likely next global power. Without China, many of the problems we face collectively cannot be laid to rest.

Admittedly, China is economically nationalist, but it is also a fundamentally cautious power. It was Deng Xiaoping who best articulated how China defines its international approach: “Observe calmly; secure our position; cope with affairs calmly; hide our capacities and bide our time; be good at maintaining a low profile; and never claim leadership.”

This underlines a significant distinction with Russia. Like Beijing, Moscow wishes to revise international patterns, but it tends to be impatient, frustrated and sometimes even threatening. Nonetheless, it is in the interest of the United States and of Europe to engage Russia. In so doing, America should seek agreements that enhance global stability, promote nuclear weapons reduction and deal with such regional problems as Iran.

America and Europe will have to find a way of reaffirming their commitment to the integrity of Ukraine and Georgia while conveying to Russia that their interest in these two states relates to the gradual construction of a larger democratic Europe and is not designed to threaten Russia itself.

To pacify requires a deliberate US effort to avoid becoming bogged down in the vast area ranging from Suez to India. Urgent decisions need to be made, with Europe's help, on several potentially interactive issues.

The Israeli-Palestinian peace process needs to be a priority. The new president should state on the record that a peaceful accommodation between the two parties must: first, involve a demilitarized Palestinian state, perhaps with a NATO presence to enhance Israel's sense of security; second, the territorial settlement has to be based on the 1967 lines with equitable exchanges permitting Israel to incorporate the more heavily urbanized settlements on the fringes of the '67 lines; third, both parties have to accept the fact that Palestinian refugees cannot return to what is now Israel, though they should be provided with some compensation and assistance for settling preferably in the independent Palestinian state; and last, the Israelis will have to accept the fact that a durable peace will require the genuine sharing of Jerusalem as the capital of two states.

The United States will also have to undertake seriously reciprocal negotiations with Iran. That means abandoning the current US posture that Tehran make a one-sided concession as a precondition to talks.

Finally, America's strategy regarding Afghanistan and Pakistan needs a basic reassessment. The emphasis should be shifted from military engagement to a more subtle effort to seek a decentralized political accommodation with those portions of the Taliban who are prepared to negotiate. A mutual accommodation should involve Taliban willingness to eliminate any Al Qaeda presence in return for Western military disengagement from the pertinent territory. The process should be accompanied by intensified reconstruction.

Let me conclude on a parochial note: Unfortunately, the American public is woefully undereducated about the wider world. Barack Obama will have to strive to make Americans understand the novel dimensions of global realities. Without sounding overly partisan, I believe that he has unique intellectual and rhetorical gifts for doing just that.

So let me end my remarks by asserting simply, "Yes, we can."

Capitalism, Crisis, & Ethics: An Interview with Michel Rocard

Caroline Meledo

Michel Rocard was Prime Minister of France from 1988 to 1991, under President Françoise Mitterrand. Previously, he was French Minister of Planning, of Town and Country Planning and of Agriculture. He was First Secretary of the French Socialist Party (1993–1994), then Socialist deputy to the European Parliament from 1994–2009. He currently chairs the Scientific Committee of Terra Nova, a think tank for the intellectual revival of the Left. In March 2009, President Nicolas Sarkozy nominated him French ambassador for international negotiations relating to the Artic and Antarctic poles. This interview was conducted in Paris in February 2008. In the course of the discussion, Michel Rocard identifies three phenomena at the heart of this transformation: the drift away from the capitalism of "les Trente Glorieuses" that has been brought about by deregulation, the replacement of traditional values of work and thrift with those of profit and fortune, and, finally, the potentially criminal practices of the banking and financial sectors.

That which we casually call a "crisis" is not only a crisis; it is more of a transformation. The word "crisis" is one that comes from the medical lexicon and characterizes the peak of a sickness after which the patient dies or improves. The implicit hypothesis underlying this is that there exists a state of normalcy that one

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calls "health." A crisis occurs when we have left this state of health and are trying to return to it. We are obviously headed toward something else that I would rather call a transformation, that is to say, a profound change rendered necessary by the unsustainable character of certain "inherited situations" which are bound to change. Moreover, what we are currently experiencing is actually an overlapping of three phenomena that offer profoundly different answers to the question of ethical capitalism. I will discuss these phenomena in turn.

1. The Financial and Banking Crisis

I will begin with the last phenomenon that emerged, but also that one which is the most visible and which concerns the entire world: the financial and banking crisis. This crisis has two elements.

The first is endogenous to the American economy. It all began with a change in the behavior of American mortgage lenders who, since the beginning of the 21st century, had adopted an attitude, implicitly encouraged by the public sector, that everyone needed to be a homeowner, everyone needed to be a shareholder, everyone needed to play the stock market, and we needed to rid ourselves of class antagonisms and eliminate wage-earners. This philosophy, explicitly backed by the Bush Administration, led the banking system to renounce its prudent customs in the domain of mortgage credit. Instead of lending 75–80% of the value of what was purchased, the banks began to accept, simply on demand, loans for 100%, 110%, and even 120% of the value of the purchase. These same banks ceased to give employees the time and money to question borrowers on their capacity to repay their loans. They lent to anyone who asked. For the banks, this seemed to make sound business sense, since there was "double-remuneration"; as soon as a loan was made, banks earned a commission, and then they would earn money again on the interest paid. The bankers no longer held a vision of loans guaranteed by the ability of borrowers to pay back their debts and collateralized by the value of their houses. Instead, they were dependent on continued and increased speculation in the housing market. This is supposed to work well, since in the long term, land prices are always increasing a little faster than the average prices in the rest of society.

Since they realized, all the same, that at times they had lent to people of less solvency than would usually be the case, they imposed a standard of "sub-prime." Now, recall that we are not analyzing the crisis but rather discussing its relationship with ethics. We are not yet talking about a crime; we are simply describing the "horror of human brutalization" of the processes accepted by the entire system. The banks offered sub-prime mortgages that allowed borrowers up to three years without payment and at variable interest rates, and in doing so enticed people into impossible situations. The banks effectively asked their clients to commit themselves to their financial instruments, knowing clearly that the massacre would come, while also knowing that their clients wouldn't realize it until it was far too late. The crisis appeared around 2007. That year, the numbers showed that 1.7 million American families were evicted in the US. The assessment of the accounting situation shows that it was not, by a long shot, sufficient to make up for the defaulted payments—they would have had to evict 3 or even 3.5 million people. Even so, at this stage we are still discussing "banking brutality," and are not yet at a stage of "grand larceny."

There was a second element, closely linked to this, which created further crisis in the American financial world. The perception of defaults on payments and that there are large amounts of increasingly uncertain debt concerns bank managers. They could have, and should have, evaluated risk and submitted these evaluations to the oversight authorities of the banking system. Having done so they should have asked the oversight authorities to ensure that they would have sufficient provisions to guarantee solvency and therefore the confidence the banks deserve. They carefully avoided this. Here is where the second element comes in: all or almost all the American banks embarked on operations characterized by the words "packages" and "securitization." The process of "securitization" corresponds to taking out a loan from the balance of the bank, with the name of the client, in order to make a financial investment, that is to say, an anonymous and sellable security (hence the "securitization"). In addition, financial science encouraged them to develop a second practice; one entirely intertwined with the first, which was grouping five, six, or eight individual loans into one sole financial security—which is adequate as long as it is of sound credit. The behavior that spread into the American banking system around 2008 was to mix bad credits and debts in unknown proportions, and without telling anyone, into these securities. Since the banks are all in constant interaction with one another, the packaged credit securities invaded the entire world and spread to all the banks of the developed countries. With this second technique, we switched to something that must be brought to justice. This is where the words hurt. For the bankers, it was a matter of the dilution of risk. Their idea was to dilute the risk in terms consistent with the probability ratios of bad debt, so that the perceived risk increased only slightly. For ordinary mortals, I call it "grand larceny" and I look forward to hearing the courts define it as such. Selling debt reputed to be good and mixing it with bad debt without saying so is robbery. This robbery amounts to tens or possibly even hundreds of billions of dollars, and now the world is infested. In the second half of 2008, the banks found out that their portfolios were infested with bad debt, knowing neither the probability of default nor the overall volume, while each bank believes that the same could be true of any other bank in the system. Each global bank is thus in a position of not being able to trust its colleague. In this way, we had a blockage of inter-bank credit activity caused by mistrust. Lehman Brothers are the main example, but it wasn't just them: all the major American investment banks collapsed in some form in 2008. Returning to the question of the place of ethics in this situation, we face this question: How is it that a profession, recognized honorably until now, let itself drift into behavior which borders on crime, on robbery, without being careful and without paying any attention? This is the first problem with the banking crisis.

2. The Decadence of Original Capitalism

The bad health of our economy was, however, established earlier and is due to something else. In this context, there are two classifications—one large and one small. The small classification is the following: since 2002 or 2003 we have experienced an incredible increase in the price of oil, of certain metals, and especially of wheat, corn, and soybeans. In 2008, we had famine riots in Africa, as people could no longer buy the wheat they had been eating. I had the opportunity to ask an expert in the wheat market about these famine riots, and received this answer: there had not, at any time, been any shortage of physical supply to meet physical demand on any given day. This is the same case with oil. Thus, this is not a sudden, massive insufficiency of supply that made prices increase so dramatically; it was the result of derivatives. Now we are opening a special subcategory: an incrimination of capitalism on account of these derivatives, and why this happened.

In 1944, the world was anxious to restart a suitable economy and to give it a stable base. Hence, a world monetary conference at Bretton Woods at the end of 1944 that laid the foundations of the system, creating the World Bank, the International Monetary Fund, and the Secretary General of GATT. At the same time we witnessed a titanic struggle, lost by John Maynard Keynes, who spoke in the name of Great Britain but also in the name of a pre-nascent Europe. It was won by Harry Dexter White, US Minister of Finance and a monetary theoretician, who wanted to impose the imperialism of the dollar on the international system. Instead of having what Keynes dreamt about, a monetary arrangement between several currencies trading their parity, we created quite a different system called the gold exchange standard, which had the great virtue of allowing fixed exchange rates, and so for traders, stable prices. This was formed under the condition that each power, trading with each other, agreed to only pay in the three currencies accepted by the system: gold, the dollar, and the pound sterling. The stability of the system was conditioned on the parities between gold, the dollar, and the pound remaining stable. Quickly enough, the pound sterling was abandoned because it was not strong enough: the volume of commerce that it covers was just too small. Thus, the standard system of exchange was based on the fixed gold price in dollars, at $35 an ounce. It was not always a smooth ride but all the same it worked fine until 1971. This mechanism allowed the beginning of the globalization of economic activities and commerce, along with the global circulation of capital in which, for a commercial dollar paid for products and services, there also circulated a financial dollar, to be used in loans, borrowing, bonds, shares, and financial accounts.

In so doing, America soon discovered that, since their dollar is the currency of the world, they themselves no longer had the need to balance their accounts. Therefore, the Americans began a policy that they have kept ever since—one of giant deficits that the entire world gladly accommodated, since the entire world demanded its dollars. In addition to this, as the costs of the Vietnam War became unbearable for the American budget, doubt was introduced into the reliability of the system. The Americans could not accept $35 per ounce of gold. Around 1969–70, Germany asked for a reimbursement of its reserves of dollars in gold, something the Americans were unable to do at the time. So a huge debate occurred inside the American administration: Do we suppress the Vietnam War? Do we suppress social programs? How do we balance the budget? Or do we extricate ourselves from this system? Richard Nixon was President in 1971, while it was Dick Cheney who led and won the battle for dropping the dollar from gold. The Americans, therefore drop the dollar from gold. Immediate results: all exchange rates become volatile, as they are floating. The floating exchanges include, of course, regular exchange rate movements due to slow structural movements. But market by market and product by product, a momentous disequilibrium of supply and demand can be added up, which implies immense variations of prices, even with small quantities. Therefore, we enter into a completely chaotic system with breathtaking extremes, prices that double and triple. This worsens after 1971; it creates panic for everyone involved in international commerce because there is no longer a forecasted price, and without forecasting, one cannot work.

Hence, the whole world of international commerce poses a question to the banks and especially to the insurance industry: can you invent insurance for us against these crazy peaks and troughs? They invented it, calling it derivatives. These are contracts of purchase or payment of longer or shorter terms—one pays differently depending on the length of the periods, but it has a stabilizing effect. The supplier's reasoning for such services is that, as long as the long-term business trend is increasing, even if only by a little, we can amortize the costs of offering derivatives and therefore pay the insurance on the excessive economic spikes in one direction or another. That's how we gradually invented derivatives. Then, a second discovery: there is no reason to limit derivatives to the accompaniment of every physical transaction of product or service. These promises to buy or to sell can be exchanged regardless of the actual trade: I have provided an offer to purchase 300 tons of wheat or oil on a certain date, I will sell, you will buy it, and so on. During 2007, the final year of the launch of derivatives, we moved from a world where one dollar traded for one "financial" dollar to a world where, for every one commercial dollar in the system, there circulated between 60 and 80 "financial" dollars.

Returning now to the question of ethics, is it immoral to trade promises of transactions? I do not know. But what I see is that it is not morality that answers this question, but efficiency, because we do not know if it is immoral, but we know it is dangerous, evidenced by this crisis.

3. They Have Changed Capitalism without Telling Us

We have already covered a good deal, but not the principal thing. The third, principal phenomenon is that they changed capitalism without telling us, and that the amazing and beautiful features of capitalism, which we call *les Trente Glorieuses* (from 1945 to 1975), have disappeared. Here are the features for the developed countries:

- Rapid growth;
- Steady growth – all around 4.5 or 5% growth per year;
- Absence of financial crisis—any national bankruptcy (as in Turkey, Brazil, Mexico, and Argentina) remains local and is immediately treated, cauterized nationally, it is not contagious;
- Full employment everywhere—30 years of full employment in France, everyone seems to have forgotten; in Japan, they were proud to never have layoffs; the United States had 2.5% unemployment.

Forty years later, growth is only half of what it was before. There are financial crises every five years: Latin America, crisis of the European Monetary System (EMS), Asian crisis and the crisis of the e-economy to name but a few. The new capitalism is the problem here. Its main feature is a lack of growth because of low levels of consumption.

How did we go from full employment to a generalized situation of unstable employment? Oddly enough, a lot of economists wanted us to enter into the despicable debate—I hold to that word—on the question of whether it would be preferable to have workers in insecure jobs than workers completely unemployed, because it seems work has its own virtues. However, when the salary of a precarious worker is less than the legal level of poverty, it is really unacceptable. It is stupid. Indeed, it is true that France and Germany have much more unemployment but less permanent precarious employment than Britain or the United States. Interestingly, what no one stresses and what still strikes me often is that the sum of precarious workers, the unemployed, and the poor, that is to say those who are in the worst situation in that they are thrown out of the labor market, make up everywhere a quarter of the population. And it is this quarter of the population who starts to vote "No" for all referendums that are presented—something that happened in Denmark, the Netherlands, Ireland and France, and, if the Germans had to vote on the Treaty establishing a Constitution for Europe, I have little doubt that they would have rejected it as well. Europe has nothing to do with it, as the poor thing is not capable of doing anything. This is a rejection of the system. The main reason for this rejection is instability in the labor market and the loss of familiar landmarks. That's what makes the political behavior frightening, because it is populist, marked by absenteeism, and is on the margins of society.

This change in behavior is linked to two things. First, the gradual doctrinal abandonment of any reference to the fact that wages are the crux of the economic balance, because they are the medium of consumption. In the modern view of Milton Friedman, this reference disappears. There is nothing important but profit, and therefore it must be made. Bringing together the shareholders enabled this to happen. The shareholder was the great vanquished of the *les Trente Glorieuses*, when we paid workers rather than shareholders. For the regulators (shapers of the system), such as Henry Ford as well as John Maynard Keynes, social security and high-wage policy were paramount. Later, shareholders took the form of pension funds, investment funds, and eventually hedge funds. The large package of investment funds, and the two small packages of pension funds and hedge funds started to demand higher dividends, as members of the boards of companies. It resulted, in the 1990s, in "the waltz of CEOs"—the word has almost disappeared because we are well beyond this, which simply. This meant that CEOs would be threatened with dismissal if dividends were not large enough. This led companies to outsource tasks and allocate as much as possible of what was done in their firms to SMEs (Small and Medium-Sized Enterprises) on the outside, in order to make the companies first, less unionized; second, not dependent on the pay scales of traditional enterprises—upon which they pin their dignity—and finally, because the outsourced supply contract could be changed every year by playing the competition off one another, thus crushing subcontractors and reducing overhead costs. That is how we have moved from full employment to unemployment, which is now 8–10% in France and Germany and 5% in the United States (where, nonetheless, employment is far more precarious).

The result is weakened purchasing power and therefore the collapse of the strength of demand. Is a mechanism that weakens demand morally wrong? I am not yet sure. However, this pressure leads to a slowdown of growth in all developed countries at different speeds and on different dates. So where did the money go? It did not go into taxes; it went into the general, vague category that is known as profits. In profits you find rent, interest revenue, fees and so on. But you find that it also hides the salaries of the big-company bosses. At the time of *les Trente Glorieuses*, these earnings were about forty times the average real wage; starting from the 1990s they rose to 300 or 400 times the average real wage. This is true for large businesses as well as for banks. But as long as his retirement savings are in a pension fund, the small-salaried American, Canadian, or English employee likes that the representatives of his pension fund put upward pressure on shareholders' compensation. He trusts a system that brings enrichment and bigger pensions via sudden capital gains. It is as if, in the upper-middle classes (a few hundred million people in the developed world) the hope of achieving affluence through labor was replaced by the hope of access to fortune thanks to instant profit. This has been substantiated by deregulation and the tax exemptions—which go in the same direction—and the worship of profit at the heart of the system, as verification of its effectiveness.

The results that I draw are as follows. First, the resilience of the system to economic hiccups is linked precisely with the purchasing power of employees, therefore attempts to get rid of employees and make "everyone an owner" completely fail. It should probably be that economic science recognizes and authenticates this. Secondly, we should note that behavior oriented towards capital gain is not compatible with the generally smooth operation of the system.

Did capitalism need all this? My thesis is that in the post-war period, capitalism worked remarkably well. Its stabilizers were based on Keynesian policies according to which each isolated national power used its monetary and fiscal policy to counterbalance exogenous jolts. The revolution that Keynes brought protected against any world crisis for twenty years, and that's not bad. These idiots have broken it all. But there is more. There is the fact that we need to maintain a balance between social protection and compensation pay. If we fall below this equilibrium, it weakens demand, and we break the system itself. Could the quest for that equilibrium be entrusted to moral maxims, like "Be fair with your employees?" I don't believe in anything like that. The effectiveness of the system tells us that we must maintain a decent—not minimal, but decent—level of purchasing power so that there is enough consumption for an ingenious system of mass production to continue working. This coincides pretty well with ethics.

However, take the official public discourse: isn't it trying to pull us out of this crisis only through finance? It is only talking about banking and finance. I have a hypothesis: as the banking crisis is explicable by the immorality of the financial system—a clear and convincing argument—it has the enormous advantage of not putting into question the general organization of the economic system. Here's a great debate: do we still need rules and sanctions? Will we return to more morality in economics by simple persuasion? On the macroeconomic level, deregulation is related to the fact that optimization of market equilibria allowed people to do whatever they wanted, and thus to get rid of any reference to a balance that would need to be preserved by regulations. Here, the formulation of a diagnosis opens a sensational debate in economic science. For thirty years it has been the case that, in order to be appointed a professor of economics in the developed world, it has been necessary to conform to the vision of Milton Friedman. Economic advising to governments is in line with the monetarist thinking of Milton Friedman. It would be very difficult to expect that failure of Friedman's system speaks louder than deeply rooted convictions; that the assessment of the situation contradicts the paradigm of the organization, that is to say market optimality: "*Laissez faire*, *laissez passer*, don't regulate anything, we will be even better." Acknowledging the failure of the market would wreck the theoretical discourse of this scientific era. You can imagine, for example, what it would be like if some in the medical field started saying that everything that comes from Louis Pasteur is wrong. This is what economists are going through. They have developed a science for themselves without worrying about the connection with sociology, history, political habits, modes of regulation of governance, etc.; they are left stuck in internal dogmatism.

But does this still mean that it is necessary and/or likely that this is the end of capitalism? Of course not. The market is like "sedentary agriculture" or "writing," we do not know who invented it three or four thousand years ago. We should absolutely not get rid of the market. Nothing else has worked so far and it ensures a basic level of freedom. If there is no market, it is unlikely that there will be basic freedoms like freedom of expression.

We have therefore been brought back to the fact that capitalism is a variable entity that can take many forms. The form we had from 1945 to 1971 provided us with thirty unprecedented years, while the form we had in 1990–2000 was abominable and put us in the hole. Capitalism should aim to preserve the grand equilibrium. At the moment, the big problem is the world's inability to agree on the diagnosis of the overall system, beyond what is happening in finance. Will we have enough political willpower to impose a change? I am not sure because there are still a bunch of fanatics who continue to make money regardless.

Are We Learning the Wrong Lessons?

Jonathan C. Vogan

In handling the current financial crisis, policymakers are seemingly blind to the opportunity to re-fashion the financial sector into a more efficient and competitive form. This failing is due to three major erroneous lessons: that it is better for banks to be big than to be bust; that securitization is without social value; and that investment banking is dead. Large commercial banks pose both a systemic risk and a risk to competition. Securitization is necessary to reduce the concentration of risk in smaller banks. Investment banking is a necessary activity, and should be made up of smaller market participants.

The current financial crisis has left many formerly private financial institutions under either the partial or complete control of the public sector. This has happened in both the Anglo-Saxon world of the US and the UK, and in continental Europe. It is reasonable to expect that this trend towards nationalization will continue in the months ahead as banks are forced to acknowledge more loan losses and even question their viability as going concerns. This trend presents government an opportunity unprecedented in the post-WWII era to determine the structure of the financial sector. It is of critical importance that we learn the correct lessons from this and past crises and that the solutions we enact be thoroughly thought through.

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Unfortunately, on current evidence, it would appear that we are learning the wrong lessons.

Take three lessons that are gaining in prominence in the current debate: that it is better to let banks get bigger than to allow them to go bankrupt; that securitization is inherently flawed and serves no socially useful purpose; and that investment banking is dead. These lessons have all been much discussed, although it should be noted that the seriousness with which they are taken by policymakers and the more informed segments of the press is probably rising as one goes backwards through the list. All three of these lessons are wrong. Letting banks get bigger is only an invitation to reduce competition and facilitate continued abuse of moral hazard at broader societal cost. Securitization can still serve a very useful risk diversification purpose, especially for smaller banks, which tend to be more geographically focused. Investment banking as an activity is in no long-term danger, but policymakers should end its domination by firms with trillion dollar balance sheets and usher in a return to an industry made up of much smaller and more numerous firms. More broadly, this crisis is not the end of capitalism, but it would be good if policymakers used this opportunity to end the dominance by capital.

Better to be big than bust?

There is a seemingly endless willingness on the part of regulators in multiple countries to ensure that no big bank goes bust: the US government's efforts to ensure the continued viability of both Citigroup[1] and Bank of America[2] (which together with the Troubled Assets Relief Program (TARP) and the AIG bailout has been estimated by the Congressional Budget Office to have already cost the taxpayers a subsidy amount of 58B USD);[3] the British government's effective nationalization of RBS; and the repeated capital injections given to Commerzbank by Germany's government, the second injection for the explicit purpose of keeping Commerzbank's purchase of Dresdner Bank from failing, which would have resulted in Dresdner's failure.[4] This is to say nothing of earlier efforts to save smaller institutions by forcing them down the altar to relatively more stable competitors, Bear Stearns to JP Morgan, HBOS to Lloyds and Merrill Lynch to Bank of America, as opposed to having simply nationalized the defunct institutions.

The political imperative behind these actions is easy to decipher. After Lehman Brothers' bankruptcy, no government wants to be seen as letting another failure happen on its watch. This is fine, but it comes at a not-inconsiderable long-term price to banking competition, to say nothing of financial stability. The public is made to pay twice, first to bail out the bankrupt institutions and then insidiously by being subject to inadequate competition for the provision of banking services.

If big banks cannot but help to exploit the moral hazard that their systemic risk creates to their private benefit and exploit the market power from excessive concentration, regulating banks more rigorously is not the only solution; banks could simply not be allowed to be big. Current policymakers, including at the US Treasury and the US Federal Reserve, are not considering this option, as they continue to search for ways to change the regulatory system to "address effectively at an early stage the potential failure of any systemically critical financial institution."[5] Such a position assumes that such large and systemically critical institutions will continue to exist, which doesn't have to be the case. Bank size could be reduced by changing the formula for deposit insurance to make the percentage charge an increasing function of risk-weighted assets. This would have recurring benefits to the real economy by increasing competition, which is not likely to be offset by reduced economies of scale (which I discuss below), while significantly lessening the risk and severity of future financial crises. A further benefit would be the greater diversity of opinion that exists in a banking sector with less concentration. This helps new firms gain access to capital.[6]

A recent G-30 report, chaired by Paul Volcker, recommended limiting the concentration of the banking industry.[7] Government actions, principally in the US and the UK, have so far gone against this piece of advice. The last minute JP Morgan purchase of Washington Mutual only avoided the rule against a bank merger resulting in a single entity having more than 10% of total US bank deposits because Washington Mutual is legally incorporated as a thrift and not as a bank.[8] The UK government ignored competition law to allow Lloyds to take over HBOS and so to prevent HBOS from failing.[9] This occurred in a market that already had a very significant degree of concentration and was described as "making excessive profits" by a competition authority report.[10] In the short-term, strong government involvement in the management of the UK banking sector (having taken major stakes in every clearing bank except HSBC) is likely to block anti-consumer behavior, but eventually the government plans to sell these shares and then the UK will be left with a banking sector that is even more concentrated.

A further concern with the state of banking sector competition comes from the financial incentives now faced by the state as both the regulator and as a major shareholder. Both the US and UK governments have firmly communicated a desire for these investments to produce a positive financial return for their respective treasuries.[11] This creates an incentive for the governments to alter their regulatory practice so as to enhance the market power, and resulting shareholder value, of the banks. The UK government's action to ease the effects of Basel II regulations could be only the first example of such behavior.[12] That governments would disadvantage the wider economy to achieve such a "success" is not very difficult to fathom. Examples of governments sacrificing diffuse cost to the cause of concentrated benefit are not difficult to find, the 2002 US steel tariffs being just one such example.

If these damaged titans of the banking industry are not to be resuscitated in their current form to the specious enrichment of the taxpayer, what is to be done with them? They could be broken up. The competitive landscape of the industry would be enhanced if these large institutions were broken up into much smaller pieces and sold back to the private sector in bite-size pieces. This would certainly result in the government treasuries showing a loss for the recapitalization/nationalization exercise, as the loss of future excessive profits was removed from the market value of the firms, but this would be more than offset by the increased societal benefit from greater competition.

That greater competition would result from such action is not certain. Since some large banks have escaped the nationalization path up until now, it is possible that breaking up those under the control of the state would simply result in a more concentrated banking sector. The long-term solution to this is to do away with those concentrations of banking activity as well. In the short-term, the deposit insurance charges for such large banks should be significantly increased to reflect their greater systemic risk and the resulting moral hazard that results from their larger size. This would be accomplished by adding a size variable to the calculations for deposit insurance that currently only reflect individual bank solvency.[13] Such a structure would provide a non-arbitrary and non-rigid but real and consequential limit on the re-emergence of large banks in the future. This could even result in the nationalization of such banks as the higher deposit insurance charges could undermine their financial sustainability. Competition authorities should also greatly increase their focus on financial institutions—both those remaining under private control and those now operating as wards of the state.

Large private banks would argue that they do not pose this higher systemic risk. However, during the 1980s sovereign debt crisis, in response to the US Comptroller of the Currency stating that some banks were "too big to fail," research has shown that the shareholders of these banks subsequently earned excessive returns.[14] The resulting behavior that this induces in bank owners is logical if we take a simple model of a private bank. Assume that the bank has a unitary owner-manager, who stands to lose the bank's market capitalization in the event of bankruptcy. Next assume that market capitalization is proportional to asset base and that the likelihood of state bailout, defined as making whole all deposits, not just those below the statutory levels, increases with asset size. If depositors know that they are more likely to get their money back in the event of bankruptcy from a larger bank (one more likely to be "too big to fail"), then these depositors will accept lower interest rates on their deposits. This increases the profitability of the bank, all other things being equal, so the owner-manager will strive to increase the bank's assets without limit. In addition to this, the owner-manager is likely to increase the risk profile of the bank, as the possibility of state bail-out represents an implicit put option that has been sold to the bank by the state, whose value rises with the bank's volatility.

The standard industry response to this claim of the costs of size, is to point to the economies of scale that exist in banking. There is much to support this, particularly in the US's experience with intra- and inter-state banking deregulation in the 1970s and 1980s.[15] These benefits can be summarized as being made up of operational efficiencies and risk diversification advantages, in addition to the general benefits that result from introducing greater competition into a market. The operational advantages of multi-branch banking cannot be denied. The costs imposed, for example, by Illinois's rule that all bank activities take place under one roof, included some bizarre structures covering multiple buildings in downtown Chicago, but also real increases in operating costs in the form of foregone productivity growth.[16] However, that a bank needs thousands of branches to fully benefit from the available operational efficiencies is dubious. The market for third-party providers of banking software, the center of most bank "processes" these days, and even for physical services such as check issuance and retail lockbox, among others, is active. Drawing from the experience of the automobile industry's use of part suppliers,[17] it is entirely conceivable that greater use of outside suppliers in the banking industry could improve operational efficiency by making it easier for innovations to spread throughout the industry. This is particularly true as the benefits of outsourcing increase with greater product standardization. Avoiding the pointless race for greater complexity in product structuring that characterized finance in recent years would mean that outsourcing would be beneficial.[18] Today, the largest banks all replicate, on their own, much of their IT infrastructure and software. If these banks were broken up and their progeny became active clients of the banking services industry, operational efficiencies could actually improve by making more banking processes subject to broader market competition.

The issue of risk diversification is different. It has been shown that during the Great Depression, it was not the large national banks, but the smaller regional or local banks that failed more often, in the face of geographically concentrated and correlated loan losses.[19] It should be noted that recent scholarship has brought this explanation into question,[20] but the final conclusion with regards to the benefits of lesser concentration remain.[21] Breaking up today's very large national banks would seem to move in the direction of a return of diversification problems, but this overlooks a significant advance in finance: securitization. Securitization is not held in very high regard at the present moment (more on that below) but it does make it possible for a smaller bank to avoid a geographically-concentrated loan portfolio by selling on a significant portion of its loan book and buying securities backed by the loans of similar banks from other regions. This would most likely require intermediation to pool assets from different banks and so produce diversified securities.

Securitization, the root of all evil?

It has become commonplace in certain circles to blame the current financial crisis on securitization.[22] Specifically, the securitization of mortgages, especially sub-prime mortgages in the US, is seen as an inherently de-stabilizing phenomenon. It is undeniable that the rapid fall in market value of many mortgage-backed securities (MBS) was a precipitating event of this crisis. However, the extent to which this is a result of the process of securitization has been over-stated, and where securitization did have procedural failings, these have, in some corners, been exaggeratedly portrayed as something akin to original sin from which there is no possible redemption.[23]

The most important point about securitization is that, while it can move risk around and obfuscate that risk, it does not alter the underlying reality, and consequent risk, of the assets that have been securitized. In the case of MBS, the loss in value, was fundamentally a result, not of the process of securitization, but of the delayed recognition of the poor repayment prospects of the underlying mortgages. In a world where people could get a mortgage with no down payment, or without any proof of income, employment, or other assets, it was inevitable that financial value was going to be destroyed.[24] Securitization just shifted the loss to investors other than the originator of the loan.

It has been argued that securitization's value is more theoretical than actual and that the profits made in recent years have mainly been at the expense of investors.[25] This argument rests on the idea that valuation of securitized loans is very complicated and liable to error by the purchasing investor. It is certainly true that the valuation of such structures is not easy, but some entity must own the underlying assets and that entity is almost certainly likely to own portfolios of them (it is possible for individuals to own a particular mortgage but this is rare and exposes the owner of the mortgage to a very concentrated credit risk) and so has to consider valuation of large groups of mortgages, just as he or she would if the loans were securitized. So the problem, while difficult, is not avoidable.

However, it has further been argued that securitization, by separating the originator from the credit risk of the mortgage, encourages reckless lending. This would undoubtedly be true if the originator could always be sure of finding a greater fool to whom to sell the mortgage. This is not an inaccurate description of many of the MBS transactions in the last several years. Yet, the responsibility of the buyer of the MBS should also be acknowledged and considered. The reality of these assets, where borrowers were practically being told to lie about their financial circumstances, were known at the time, but MBS investors knowingly chose to ignore these risks in the hope of finding a greater fool to sell the MBS to before the price collapsed. This market failure logic is well known, and should be recognized.[26] However, it must also be recognized that these types of mistakes are not indefinitely repeated in static environments.[27] Therefore, we can expect that the future of the MBS market will be a lot more like it was before the most recent past, when the underlying mortgages were required to be of a higher quality and the resulting MBS were less risky. Also, originators could reduce the perceived risk of reckless lending by maintaining exposure to early losses on the securitized portfolio of mortgages. This is the norm in other securitization markets, such as those for credit cards, auto loans, and commercial mortgages.

So, having established that the recent collapse in value of entire sections of the MBS market was due in large part to the delayed recognition of the shoddiness of the underlying mortgages, we can then ask the question if there are elements of the existing MBS process that destroy value. Specifically, attention has been drawn recently to the fact that it is almost impossible to restructure a mortgage once it is in an MBS pool. This is because such securities contain terms requiring the processor to obtain the permission of a large majority of the MBS-holders before re-negotiating the terms of an underlying mortgage, even when such an action is beneficial to both sides as the only alternative to foreclosure. Such a problem is easily remedied for future MBS by changing such terms, and therefore should not be considered as an inescapable failing of securitization.

Is investment banking really dead?

With the acquisitions-under-duress of Merrill Lynch and Bear Stearns by Bank of America and JPMorganChase, respectively, the bankruptcy of Lehman Brothers and the application to be regulated as bank holding companies by Goldman Sachs and Morgan Stanley, many commentators spoke of the end of the independent investment banking. Such talk, more common in the popular press than in the financial press, reflects a confusion of form for function. The bulge bracket US investment bank, regulated exclusively by the SEC, is clearly not going to return, but sophisticated professionals who issue securities, provide advisory services, and do market-making are not going anywhere for the simple reason that these activities remain central to the financial market in the US and other developed markets.[28] Actually, the current prognosis for the industry is perhaps relatively upbeat as the number of competitors has thinned out with the withdrawal of several second-tier players, an outcome that should be avoided for its dampening effects on competition. However, it should be remembered that the large increase in the capital deployed and the concentration of said capital in the investment banking industry was largely driven by the entrance into the business by large commercial banks with large balance sheets. These were used to gain access to what previously had been a relatively financial capital-lite and profit-rich business. It could be that investment banking as we know it is dead, but that the investment banker is likely to be reborn, in a form much like that of a previous era, although a better competitive oversight process would be needed this time around to avoid the clubby behavior of the past.

What do investment banks do with their capital? There are three broad categories of activity into which capital has been deployed. The bread and butter of investment banking, taking new securities to market, both equity and fixed-income, requires capital to allow the investment bank to actually underwrite the issuance of the security. This basically hands over the risk of not finding enough buyers at the offer price from the company whose security is being issued to the investment bank. This has obvious advantages for the company but is not a fundamental necessity of the process. Instead of underwriting a security, an investment bank can also issue it on a "best efforts basis." This means that anything they can't sell is returned to the company. The "best efforts" model has been used less frequently in recent years, but if there were less capital available, it could return. It might even address a conflict of interest between the company whose issue is being taken to market and the investment bank doing the underwriting. The investment bank has an incentive to under-price the security to guarantee that it is not left holding any at the end of the day. Given that the investment banks are traditionally paid on a percentage basis for this work, the interests of the two parties could even be more closely aligned in a world with much more frequent use of "best efforts" issuance and less reliance on balance sheet heft.

The second traditional usage of capital is to make markets in securities, to serve as broker-dealers. As this business requires owning the security for at least a certain amount of time, it is inevitable that capital will be required. While this business can be dis-intermediated for heavily traded securities such as large-cap equities, there will always be securities that require a broker-dealer intermediary due to the relative lack of liquidity and as such a need for capital to be deployed in this line of business. However, the amount of capital deployed in this area has in recent years grown significantly. This has largely been due to the emergence of prime brokerage as a new revenue stream for the investment banks.[29] Prime brokerage involves a series of services sold to high volume trading clients, principally hedge funds. Included in this is lending securities for short-selling and providing leverage, i.e., lending money. This is consequently a capital-intensive line of business. But the lending need not be done by the investment bank in its role as broker. It is entirely possible for the brokering and lending to be separated. This would require the development of new standards for inter-firm operability to allow the lender complete visibility and blocking control over the loan recipients' trading, but this is in no way an insurmountable problem. Of course, the entire business of lending to hedge funds is already in severe contraction, but that doesn't do away with the need to change form as well as size.

The amount of capital deployed in market-making activities is normally joined together with the third category, proprietary trading, under the generic label of trading. This obfuscation hides from investors the extent to which revenue is based on client-flow trading, serving as a broker-dealer, which is good, as opposed to proprietary trading, which is bad, because it is always at risk of reversal if the bank makes a bad bet, as many did in the recent period. Proprietary trading has grown in prominence among investment banks in the last several decades, reaching the point in the last several years where some banks seemed to be closer in nature to hedge funds than banks of earlier years. This deployment of capital does not have a necessary purpose within an investment bank. It is true that it can be very profitable, but to the extent that this is true then it should be done in a stand-alone hedge fund with complete transparency to outside shareholders. Investors seeking such an exposure—and they are fewer in number these days—could invest directly in the hedge fund.

Does an investment bank have an advantage in proprietary trading over a stand-alone hedge fund? It does, but it shouldn't. The advantage that proprietary trading has within the umbrella of a larger investment bank with its client-based, market-making activities is to benefit from the informational advantage that comes from such activities. Put simply, it helps to make money in the markets, if one sees the orders coming into the market before they are executed. Exploiting informational advantages is a recurring phenomenon. The outsized profits that come from this are at the expense of the wider market. As such, ending this business would have general benefits.

Where would this leave the investment bank? The investment banking model would require less capital, would focus on issuance, consulting, and market-making, and consequently would have much lower barriers to entry. One can already see this re-alignment taking shape. Many boutique investment banks, such as Jeffries Group and Amherst Securities Group, that are already built along such lines have been quietly expanding their staffing and preparing for the eventual day when they can fight for business based on the quality of their ideas and prior execution and not on the size of the balance sheet they can deploy. In short, the days of the trillion-dollar investment bank may be over but the investment banker is not likely to disappear anytime soon. This transition should be welcomed by government, not subverted as has been done by giving large capital infusions to Goldman Sachs and Morgan Stanley under the Capital Purchase Program,[30] as well as the large transfers to these same institutions that happened indirectly through the AIG bailout.[31]

Conclusions

As the less-than-proud new owners of their bankrupt financial sectors, governments have to decide what they are going to do with them. Proposals that would rehabilitate the existing institutions, such as "good bank/bad bank" (or more appealingly "aggregator bank") fail to capitalize on the unique opportunity presented by such a situation. Much as Dean Acheson, writing of a different time and place, implied in the title of his memoirs *Present at the Creation*, today's policymakers have before them the real chance to refashion the financial sector in such a way as to not just revive it, but to create something inherently more stable. By changing the rules in such a way as to prevent the re-emergence of great concentrations in the banking sector, ensuring the revival of the securitization market and removing the incentives for investment banks to require large amounts of capital, today's policymakers can ensure not only that the economy will recover, but that competitive capitalism returns to finance, to the benefit of us all. This benefit would be in the form of a more robust, competitive, innovative, and open to innovation financial sector. In simpler terms, such a sector would be better than that which we have today.

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Bound at Last? Laissez-faire Capitalism and Globalization

Henrique Schneider

Often, an unrestrained capitalism in association with globalization is blamed for causing the actual financial crisis. In this article, after a historical overview on the emergence and development of the term "Laissez-faire Capitalism," the question of the truthfulness of the above assertion is examined. Although laissez-faire capitalism does not oppose globalization, it does not endorse the process of the last two decades. While laissez-faire capitalism champions economic freedoms and deregulated markets, it also stresses the aspect of accountability: the possibility of failure itself is essential for assessing risks. Globalization on the other hand made not only markets and players global, but also regulations and regulators, and thus constrained economic freedom. In particular, globalization played a significant role in diminishing accountability for the decisions of actors in the market.

As newspapers, politicians and economists write obituaries for laissez-faire capitalism, globalization is being buried with it. Many blame the actual financial and economic crisis on an "unconstrained" globalization of free markets. At the same time, these critics link the global integration to laissez-faire capitalism. Their conclusion seems clear: the current crisis has allegedly proved globalization bad, thereby also proving laissez-faire capitalism wrong and morally unacceptable.

The main intention here is not to proclaim capitalism's death, but rather to cast doubt on two commonly held notions: that laissez-faire capitalism and

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globalization are actually linked, and that laissez-faire capitalism lies at the root of the current financial crisis.

Surveying the development of laissez-faire capitalism and how its definition has been adopted and modernized over time could provide essential insights in order to answer the first question. The second will be analyzed by exploring if a basic claim is true: that laissez-faire capitalism is to blame for exploiting (rationally, perhaps) flaws in the global system, but it bears no responsibility for bringing about the crisis to begin with. The World Trade Organization (WTO) and the current financial crisis will exemplify the validity of this claim.

Without giving any definite answers, the following article hints that although globalization is intertwined with capitalism, its specific and actual form lacks some crucial characteristics of laissez-faire. As governments and regulating institutions joined the global integration to become big players, globalization expanded at least the scale, if not the scope, of possible mistakes that gubernatorial agents could make, thus working as a catalyst for the market turmoil of the past years.

1. Laissez-faire, from Marginalization to Dominance

1.1 Laissez-faire, Morbleu! Laissez-faire!

"Laissez faire, telle devrait être la devise de toute puissance publique, depuis que le monde est civilisé.... Détestable principe que celui de ne vouloir grandir que par l'abaissement de nos voisins! Il n'y a que la méchanceté et la malignité du cœur de satisfaites dans ce principe, et l'intérêt y est opposé. Laissez faire, morbleu! Laissez faire!"[1]

["Let they do, that should be the motto of every public authority, according to which the world is civilized. . . . A detestable principle that which would not wish us to grow except by lowering our neighbors! There is nothing but mischief and malignity of heart in those satisfied with that principle, and interest is opposed to it. Let them do, damn it! Let them do!"]

The exact origin of the term laissez-faire as a slogan for economic liberalism (or a certain shape of capitalism) is uncertain. The first recorded use of the laissez-faire maxim was by the French foreign minister René de Voyer, who championed free trade, in the abovementioned statement. The term "laissez-faire" can be traced back to 1680, when the French finance minister Jean-Baptiste Colbert held a meeting with French business representatives, led by a Mr. Christophe de Le Gendre. The minister, who himself developed theories on monopolies and oligopolies, asked the merchants what he could do in order to ease their ado. Mr. Le Gendre then replied "*Laissez-nous faire*" (Let us do). Later on, around 1760, a French inspector of trade, Vincent de Gounrnay, appropriated the motto and made it part of his doctrine.

Let us not forget however, that even mercantilists were—by some standards—proto-state-capitalists. Of course, it was not until the works of Adam Smith, David Ricardo, John Stuart Mill, and Jean-Baptiste Say that capitalism emerged as a set of new theories about actions, ownership and markets. Capitalism refers to an economic system characterized by private or corporate ownership of capital and goods. Investment is determined by private decisions while prices, production and the distribution of goods are caused mainly by competition in a free market.

These were mainly technical aspects on how to organize economies, but political aspects soon joined the science. Capitalism (or classical political economy), as other doctrines concerning the organization of markets, is not free from values or moral views. As much as it proposes the freedom of markets and individual actions therein, it rapidly associated itself with political liberalism, which advocates the broader freedom of individuals in society. Both classical political economy and political liberalism were in favor of constraining the role played by the government. On the other hand neither aimed at totally expelling government of all realms of social relations.[2] On the contrary, classical economic and liberal thinkers assigned the government pro-active tasks, like encouraging innovation, guaranteeing patents and intellectual property and providing basic goods such as building roads and schools, as well as administering education. Of course, the discourse went on as to how to pay for these services (tolls, progressively to the income, free provision, etc.), but there seemed to be no doubt on the government's role.

Two main questions remained at the centre of the free-market advocates' discourse: to what extent were markets able to regulate themselves? Moreover, who should be allowed to participate in the system? Stable markets were considered the aim of all economic development; any kind of instability, such as unemployment or capital overflows, ought to be dealt with immediately. Classical capitalism took it more or less for granted that the state would be able to participate in markets and also, if needed, to leverage them. The reason for these assumptions was twofold: First, it was quite clear that the state would not retreat from its influence over its society. Second, the classical economist, influenced by enlightened ideas, thought the state to be an impartial agent caring for the overall wellbeing of the society.

Early laissez-faire capitalism, on the other hand, dismissed this belief. Recognizing the state to be as partial as every other agent, laissez-faire thinkers advocated for as little regulation as possible, claiming that markets are always able to leverage and stabilize themselves on their own. As the idea of capitalism merged with the political system of liberalism, the inner-systemic debate about what laissez-faire capitalism is, or how far it is able to go, coined a discourse of its own. Laissez-faire capitalism henceforth not only criticized mercantilism, but also classical capitalism, adventuring beyond the scope of the original ideas of Adam Smith and David Ricardo.

The laissez-faire claim of intrinsic stability of markets grounds on two models: first, in a long-run analysis of the amounts of supplied and demanded goods, which are the same at a given price; and second, in the direct abstraction from the micro level (small scale markets) to a macro level (encompassing all markets). As a baker only makes the amount of bread being sold in one day at a given price, all markets do the same—at least in the long run. Since all agents can be said to act on average in a rational way, markets always settle in equilibrium.

Throughout the history of capitalistic thinking, proponents of laissez-faire were often marginalized in the political debate. Indeed, until after World War II it played a secondary role in politics and was championed only by the Vienna Circle (Friedrich Hayek and Ludwig von Mises). Although this marginalization came to a sudden end, the question concerning the inherent stability of markets has remained unsolved.[3]

1.2 Rebirth and Rise

A much more pressing matter however, seems to be what laissez-faire capitalism is today. The answer is more complicated than what one might expect. In the 1980's, the rise of Ronald Reagan and Margaret Thatcher was tantamount to the rebirth of laissez-faire. Both "tried to overthrow the big government interventionist Capitalism that they inherited."[4] The government was now to play a minimal role in the market economy, and development left to the "natural laws of the market."

Note that the last assertion is in itself a twofold claim—being both a political as well as a scientific one. Nevertheless, the political point can only be true with the scientific foundation at its heart. The term "natural laws of the market" stems in fact from a different context altogether. This type of expression relies on a physical conception of the world, and was shared by the Vienna Circle, a group of positivistic philosophers believing only in mathematical-physical truths. For them, science was a quest for the natural laws governing the world. It was through this group that the physical ideas spread on to the economics of the Austrian School and laissez-faire capitalism. As time went by, these "laws" were adapted and modified, acquiring certain robustness until they reached the form of social-scientific models as we see them today.[5]

Personal interest and competition are here the fundamental forces driving rational individuals to achieve social welfare while at the same time pursuing their own interests. Private property and freedom are the institutional prerequisites safeguarding the development of these personal interests and therefore, the role of the government has to be limited to the protection and reinforcement of private property and market freedom. Rational individuals seeking their own interests and competing against one another will thus ultimately lead to stability in the economy.

Any absence of this stability is a result of the government's failure in providing or ensuring private property and market freedom. This is a two-way argument, as the government can fail in not doing enough, but fail if it does too much. Many of the problems of the so-called welfare state arise from the over-activity of the gubernatorial body, thus constraining freedom or diminishing its utility.

Unemployment serves as an example. Under laissez-faire theories, unemployment is voluntary, because rational individuals prefer leisure to the "disutility" of work. By providing social security, the state is instigating individuals to work less. As governments pay people not to work, rational agents will try to use the incentive of leisure as long as they can. By constraining the freedom to decide, states urge individuals to pursue their interests at the expense of the common body.

There is still a missing step however, in the development from Vienna's laissez-faire capitalism to Thatcher and Reagan's version. This link is the work of Milton Friedman and the foundation of modern laissez-faire. Milton Friedman effectively took many of the basic principles set forth by Adam Smith and the classical economists, and modernized them in his own peculiar way. One example is an article he wrote for the September 1970 issue of The New York Times Magazine where he claimed that the social responsibility of businesses is "to use its resources and engage in activities designed to increase its profit [… through] open and free competition without deception or fraud."[6] This is equivalent to Smith's argument that self-interest in turn benefits the whole of society. Yet in sharp contrast to Smith, Milton based his claim on microeconomic principles as advocated by the Vienna Circle.[7]

Friedman's academic work, coupled with its implementation by Reagan, Thatcher and Clinton, led to the new ascension of laissez-faire capitalism. According to this "modern" laissez-faire capitalism, markets are inherently stable if left to themselves. Depressions, recessions and other challenges result only from government intervention. The laissez-faire economists see capitalists as earning profits by forgoing current consumption, taking risks, and organizing production. On this account, capitalists need market freedom to operate. And as they act according to their own best judgment, they become responsible for the outcome of their actions. Only then will markets be able to provide stability.

Freedom—market freedom—longs to be absolute, even worldwide. Along this logic, free-marketers want to expand their ideas beyond the boundaries of nations. They engage in the dissemination of global laissez-faire, with globalization perceived as the adequate vehicle to do so. However, is it really so?

2. Globalization: Its Friends And Its Enemies

Globalization is widely attributed to laissez-faire capitalism. This is because its implementation occurred simultaneously with the enormous growth in international exchange markets and, correspondingly, of international corporations, which sometimes have greater resources at their command than nation states.

Globalization is certainly a process no laissez-faire economist will oppose. However, he will have strong objections concerning some of the actual features of globalization. Among the criticism, two pole-positions emerge: First, globalization itself should be a process in which free-willed agents act upon their best judgment. This implies that there is no need to impose globalization. If the process of freeing worldwide markets is desirable, the markets themselves will adhere to it. Second, if rules are needed at all, they will be made by the market and should not be stated ex-ante. Globalization as we find it today can be criticized along these lines, because it is not based on such freedom and because it is foremost a worldwide integration of regulations and regulators. While it may be capitalistic, it certainly is not a free market approach.

2.1 The Laissez-faire Critique

From a laissez-faire perspective, there are some additional critiques of globalization based on the general logic of the last paragraph. They address primarily international treaties, the so-called intellectual property rights, and the functioning of international agencies and organizations.

To start with, several international treaties seem to serve mainly as insurance policies for specific interests of multinational corporations and other worldwide oligopolies. The WTO, among other organizations, may open segments of certain markets, but at the same time it closes others. In addition, different national regulations still impose considerable barriers to free markets. For example, access to agriculture in Europe or investments in infrastructure in the US still remain restricted. In China and Israel, pharmaceutical, chemical and energy industries, as well as telecommunications remain state run or state planned areas. These barriers are often sustained by WTO regulations.

Consider the beginning of the WTO, such as the Cancun and Doha conferences, where highly developed countries advocated an aggressive, three-pronged agenda: to foist a stricter system of investment rules on developing nations (including patent and copyright enforcements), to extend European-style environmental and labor regulations to poorer nations (the so-called welfare state), and to reduce restrictions on exports and foreign investment to poorer nations. What was missing was the good will of countries to make a change in their own policies, which—especially for Europe—are more or less openly protectionist.[8]

Trade is invariably part of the WTO agenda, but completely *free* trade, as understood by laissez-faire, is not part of it. A claim could be made that from the start, the WTO was based on the urgency of industrialized nations to find markets for their products. This would allow for the reverse conclusion: if the developed regions of the world were searching for markets, globalization was a tool to find them, *and not one for freeing them*. Deregulating presupposes that poorer and emerging nations might have something to sell that consumers in rich nations might want to buy. Nonetheless, there was no deregulation on the horizon.

Again, the WTO was from the start overly concerned about regulating intellectual property rights and tracking countries, which did not respect these laws. This became a high priority, whereas free trade in agricultural goods was pushed off the table completely. Even as some ministers and experts from emerging and developing countries tried to usher their demands, ministers from Europe and the US responded by telling poorer nations that they should regulate their economies more heavily.

Furthermore, liberalized markets in the developed world cracked down on alleged copyright and patent abuses in developing countries, raised wages so that workers could not "unfairly" compete with those from industrialized nations, and started enforcing stricter environmental laws.

From a laissez-faire point of view, this is extremely problematic. According to classical microeconomics, poor or emerging countries will only be able to succeed in free trade if they are free to use their comparative advantage. Agents usually offer what they do best when compared to the other choices they have (and not compared to all other agents).

The comparative advantage that poor nations have in attracting investment and producing their own goods for export is precisely their unregulated labor and environmental regimes. Given that their objective is to become more competitive, it would make little sense to legislate higher wages. This would only drive out capital and lead to more unemployment. If they stand a chance for development, what is needed is an open marketplace where they are free to compete by using their comparative advantage.

This shows quite clearly how laissez-faire capitalism approaches globalization. Based on market freedom, it locates individual property rights to the micro level. The WTO—as an example of globalization—disrespects the first and infringes the second. There is however, another problem with globalization, discussed in the following section.

2.2 Globalization of International Regulations

Laissez-faire capitalism is not just about the global expansion of markets, but also advocates the deregulation of them. The true aim of laissez-faire is to enforce economic freedom for all agents in the market.[9] Note specifically that "deregulation" is used in a positive sense. Whatever results from the *market-ing* process, it is at that certain point of time the optimal output of regulation under the constraint of the involved agents. There is no normative claim to this. Laissez-faire capitalism, at least at this stage, remains agnostic of the equilibrium's moral qualities.

Of course, this model only works if private property is respected and market freedom ensured. Globalization through the last two decades did not advance accordingly. National and international agencies or governments took over the responsibility for regulating world markets rather than freeing them up.

Regarding the current financial crisis, laissez-faire capitalists will point out that market failures occurred because of government regulations and not the contrary; in the aftermath, fiscal packages, bailouts and stimuli only helped to aggravate the scope and intensity of the turmoil. Why was this so? The regulation of part rather than all aspects of the financial markets caused an increase in the demand for unregulated, adventurous instruments, because investors had the—correct—impression that regulation diminishes revenues.

This phenomenon is explicably due to the socialization of the investor as taxpayers. As taxes have to be paid because of laws, diminishing the investor's wealth and profit, law and loss become associated with one another. Surely, the supply side offered what demand wanted, losing itself in extremely complicated financial products. Note however, that the products themselves took advantage of often misled central bank policies throughout the world. As central banks printed money, adapted modified the interest rates, or changed the reserve policies, the financial markets adapted to them.

Furthermore, since investors and suppliers of financial products are used to regulations, many attached the character of regulating actors to the rating agencies. As long as investment products were positively rated, the market thought they would remain secure. Because the state institutions kept silent about their relationship to rating agencies, many then interpreted this as an implicit endorsement of their judgments.

The most important mistake of the state institutions however, was to try to "save the world" from a financial crisis. In the best of intents, interest rates were lowered, fiscal stimuli were granted, tax rebates were given, and bailouts were pursued. But these measures are nothing but pure poison to markets, since all the instruments used merely rewarded the investors who had been assessing their risks poorly. They infringed the models of interest and competence because they socialized risk and dictated who should be saved and who should not.

Implementing aggressive stimuli-oriented policies also led to extreme long-run risks. For example, the risk of inflation due to drastic interest-rate cuts; a loss of efficiency and profitability in global banking due to new regulations, a possible bond bubble, the jeopardizing of budgets because of overspending and future interests having to be paid, the creation of a liquidity trap in worldwide markets, and the crowding out of private investment.

Not only the risks but also the failures are then socialized. This caused investors to assess their risks even more poorly through relying on the distribution of burden to all other agents. By rewarding the losers through socialization of their failures, the state educated them to become greedy—or even greedier than they were. Once again, the state proved that it lacks the capability of preventing economic crisis, let alone the capacity to remediate them.

Laissez-faire capitalism claims that the state is neither the benevolent dictator nor the impartial umpire. The state itself acts as self-interested and self-centered as the other market players, dealing with the same constraints, the same imperfect information and the same risks as all the others. Nevertheless, the state has two peculiar traits that make it a much worse agent compared to the others: it sets the law and cannot fail, thus escaping the limiting market forces.

Failing means being punished by customers or by suppliers, or worse still, by going bankrupt. The state however is not accountable for its mistakes. This causes it to become much more eager to commit mistakes, take oversized risks, and act without measuring the means and the ends of its actions. Lack of accountability is the primary error in state-driven capitalism. It is also the primary error of reasoning for all who think that regulation or legislation will ease the development of the worldwide markets. On the other hand, since international regulators are not accountable—in market terms—they just add to, or perhaps aggravate, the problems of the national bodies. Concerning those who urge for new and heavier regulation, two insights seem interesting. Firstly, more regulation is not a self-evident cure to the disease, and second, after each single crisis, when more regulation was enforced, this did not prevent new turmoil to occur nor did it soften the bad consequences.

The reasoning suggests a conclusion: international regulation, subdued competition and distortion of market forces are chiefly responsible for the actual economic crisis. It was not too much laissez-faire or globalization that caused the financial crisis. On the contrary, it was caused by worldwide regulation without market freedom. Is laissez-faire then free from all sins? Many of the self-proclaimed advocates of free trade use regulated globalization in order to pursue their own interests. The thinking is simple: according to the microeconomic "laws" that laissez-faire capitalism bases itself upon, free-traders endorsing worldwide regulation act perfectly rationally. In the name of their personal interests, they see their chance in constrained markets. Unfortunately, the voice for competition is then kept silent.

3. Bound at Last?

In this article, two questions have been pondered. The first one asks if laissez-faire capitalism and globalization are linked, while the second questions if laissez-faire and globalization necessarily lie at the root of the actual economic crisis.

In order to discuss these questions, the article first tried to show through a historical perspective that most common held notions of what laissez-faire capitalism actually is may be misguided. Laissez-faire capitalism certainly favors the worldwide expansion of markets. But it also believes that markets should be able to operate freely throughout the world, opposing thus a certain type of regulated globalization. This again means that the different market players should have the possibility to decide on their own if they want to open their markets. Second, every agent should be able to play by the same rules. All protectionist regulations will impose unacceptable barriers to free trade. Third, according to laissez-faire capitalism, free markets—not regulating bodies—should be globalized. As a conclusion to the first question then, the answer is yes; laissez-faire capitalism advocates globalization, but not the one the world is confronted with.

Concerning the second question, globalization is perhaps the catalyst of today's crisis, but it was the lack of market freedoms that caused the actual crisis. The globalization of regulating systems is one major driver of global downturn. Moreover, supposing governmental agencies, national or international, are more suitable, informed agents is a crucial mistake. Laissez-faire economists can be blamed for adapting too quickly to the international system of state-capitalism, for calling on central bank intervention and for speculating on the system. In sum, they can be blamed for forgetting a most important feature of laissez-faire: to always be responsible for one's mistakes.

Is there a future for laissez-faire? Or are we bound to the new surge of state-capitalism? Economic nationalism—the urge to keep jobs and capital at home—is the ugly face of sate-capitalism and is not resurrecting; it is alive and *en vogue*. It is both turning the economic crisis into a political one and threatening the world with depression. Its consequences may be dire.

Most measures implemented in order to stem the crisis may actually worsen the crisis by creating more government intervention (which sparked it to begin with) and removing the accountability of those who over-played their risks by socializing the burden. Furthermore, these stimuli packages are instigating market players to enter even bigger risks, because they can count on guaranteed protection.

Perhaps world politics is marching in the direction of state-capitalism and economic nationalism. When individuals and enterprises called for more government oversight on financial markets, looming in the dark, some agents hoped for market restrictions in imports, and subsidies for exports.

Is there a way out of the crisis? Laissez-faire capitalism would suggest that there is only one way: state governments must guarantee free markets and private property, including the possibility of losing out to the markets. This has to be done in order to ease the decision making process of self-interested agents in healthy competition with each other. Is it this simple though? Yes. However, it seems to be simpler to regulate than to stand the temptation of state capitalism. Laissez-faire makes the case for individual responsibility in worldwide markets that are free at last.

Notes

1 Peter Saunders, *Capitalism* (Minneapolis: University of Minnesota Press, 1995) p. 17.

2 Friedrich Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960) pp. 43–56.

3 The controversial discussion of Laissez-faire's assumptions and undermining principles is still ongoing. For its defence refer to Arthus Sullivan and Steven Sheffrin, *Economics: principles in action* (Upper Saddle River: Pearson Prentince Hall, 2003); for its criticism to Carin Lee Holroyd, *Government, International Trade, and Laissez-faire Capitalism* (New York: McGill Queens University Press, 2002).

4 Hymam Minsky, "Finance and Stability: The Limits of Capitalism," The Jerome Levy Economics Institute of Bard College, Working Paper No. 93 (May 1999): p. 7.

5 Today, instead this physicalist terminology, social science prefers models with law-likeliness. David Kreps, *A Course in Microeconomic Theory* (Princeton: Princeton University Press, 1990) pp. 1–5.

6 Milton Friedman, "The Social Responsibility of Business is to Increase its Profits" *The New York Times Magazine* 13 September 13, 1970 retrieved 18 February 18 2009 <http://www.colorado.edu/

studentgroups/libertarians/issues/friedman-soc-resp-business.html>.

7 Ibid.

8 Jagdish Bhagwati, *In Defense of Globalization*. (Oxford: Oxford University Press, 2005) p. 98. Jagdish Bhagwati, “Reshaping the WTO”, *Far Eastern Economic Review* 162 No. 22 (January 2005): pp. 25–30.

9 This does not necessarily entail political freedom. There are countries like South Korea and Taiwan, which started as a capitalistic economy under political dictatorship and developed towards Capitalism and Democracy. Others are free markets without democratic structures, like Singapore, Hong Kong and Malaysia with *de jure* capitalism, and China with de facto free markets. However, some profoundly democratic societies, like the Bolivarian Republic of Venezuela and Anarchist Catalonia have been expressly anti-capitalist.

The 2007–2008 Financial Crisis: Does the EU Matter?

Greg Fuller

Both realists and institutionalists agree that more empirical research is needed to determine the explanatory value of institutions. This paper looks at the EU's reaction to the 2007–2008 financial crisis for evidence that the EU mattered in shaping the behavior of its member states. Three responses at the EU level—attempts to reform EU banking supervision, the creation of European Economic Recovery Plan, and the push for the November 2008 G20 summit—are examined for evidence of the EU altering member states' interests, calculations of interests, power, and resources. It concludes that the EU mattered only when member states were not motivated by relative-gains concerns to restrain collective action.

The global financial crisis has provided a unique opportunity to assess the impact of institutions on state behavior. In the debate over whether institutions affect behavior at all, realists and liberal institutionalists have come to one shared conclusion: more empirical study is needed.[1] The problem with carrying out such research, as Robert O. Keohane and Lisa L. Martin[2] point out, is that "rarely, if ever, will institutions vary while the 'rest of the world' is held constant." They suggest that one solution to this problem is to examine situations where the opposite is true—where circumstances shift rapidly but institutions remain relatively unchanged.

The worldwide financial meltdown has provided exactly that set of conditions. From the emergence of the tip of the financial iceberg in September 2007 to the

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radical acceleration of the crisis in September 2008 the European Union has been faced with a rapidly changing situation commonly characterized as the greatest challenge to world economic order since the creation of the Bretton Woods system.[3]

The intent of this paper is to determine whether there is empirical support for the argument that the EU has mattered during the financial crisis. The first section will establish some definitions to be used throughout the analysis—particularly what it means to "matter." The following sections will examine three EU responses to the crisis for evidence of the EU mattering. The first two responses, cross-border financial oversight reform and the development of the European Economic Recovery Plan, reveal the EU as having only a minimal impact on policy outputs. In the third response, the successful push for the November 2008 G20 summit in Washington, the EU did play a significant role in shaping the outcome. The final section considers the influence of relative and absolute gains in explaining why the EU matters in some situations and not others and attaches some caveats to an analysis focused solely on observable outcomes.

What It Means to "Matter"

First, it is necessary to establish some semantic ground-rules. I will treat the terms "institution" and "regime" as synonymous (borrowing the reasoning from Mearsheimer[4]) and defined as "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge."[5] I prefer to use "institutions" in deference to the linguistic objections Susan Strange raises concerning the word "regime".[6] Within this definition, I will employ "the EU" in a fairly broad sense, encompassing the principles, norms, rules, and decision-making procedures of the union as a whole and of its constituent parts, from the European Commission down to the Committee of European Banking Supervisors (CEBS). For example, this means that while the European Parliament is governed by one set of decision-making procedures, the European Commission by a second, and the relationship between the Parliament and the Commission by a third, the "EU" label is meant to encompass all three. With that said, this paper is primarily concerned with the European Commission, the European Parliament, and the Council of the European Union.

Although defining what it means to "matter" may be more nuanced, there is some agreement between the realist and institutionalist camps. Mearsheimer[7] argues that "what is needed is evidence of cooperation that would not have occurred in the absence of institutions." Similarly, Keohane and Martin[8] set the bar at demonstrating "that institutions are sometimes significant for political outcomes." Both formulations agree that, in order to matter, an institution must act as an independent variable in determining states' behavior.

Stephen D. Krasner[9] provides an explanation for how this can happen through his notion of "feedback." He outlines four mechanisms by which institutions can alter member states' behavior through influencing the basic causal variables behind that behavior. Those mechanisms are defined as institutions changing member states' (1) calculations of interests, (2) interests, (3) power, and (4) resources and capabilities. The remaining sections of this paper will examine the EU's responses to the global financial crisis for evidence of Krasner's four mechanisms in use. Where such evidence is found, it indicates that the EU has independently affected member states' actions and therefore matters. Where such evidence is not found and the EU's activities are seen to be solely dependent on national interests such as relative-gains calculations, the EU has not mattered.[10]

It is worth noting that the body of this paper is focused on searching for *outcomes* not *processes* that show evidence of the EU's explanatory effects on member state behavior. An argument can be made that an "automatic reflex of coordination"[11]—an instinctive desire on the part of member states to seek consensus—demonstrates that the EU is affecting national interest calculations and behavior. However, the analytical usefulness of this approach is limited. Much of the research in the area focuses on sociological questions of identity and social roles[12] which are difficult to apply to an empirical study such as this one. This is not disputed by the proponents of constructivist approaches, who criticize analyses "hampered by an excessively tight causal epistemology."[13]

Furthermore, many of the processes within EU institutions are simply unknown. The secrecy of the European Council, in particular, hampers thorough investigations of its decision-making processes.[14] This lack of transparency risks making process-oriented studies too dependent on the public statements of participants, entailing the assumption that rhetoric for public consumption accurately reflects what is happening behind closed doors. Despite these criticisms, the process-oriented perspective is not without value and some specific applications for it will be addressed in the conclusion.

I. Financial Oversight Reform

The response to calls for enhanced supervision of multinational European banks is perhaps best described as schizophrenic. In the year between the onset of the financial crisis in Europe and the decision by the Commission to postpone handling reform for several months, significant conflicts arose between those who wanted the EU to wrest control of cross-border financial supervision away from member states and those who aimed to keep that power in national hands.

Nicolas Véron, authoring a policy brief for European think tank Bruegel in August of 2007, forecast that if a large-scale banking crisis struck Europe, the authorities would be caught unprepared. Under the Lamfalussy process for dealing with financial legislation, Level 3 Committees such as CEBS hold responsibility for coordinating financial regulations across borders. However, despite the proliferation of large banks operating in countries across the EU, these committees serve in an advisory capacity and do not have the mandate to force national agencies to take action.[15] Véron warned that because real supervisory power over banks remained at the national level, member states would protect their own citizens at the expense of their neighbors if a pan-European bank's solvency was threatened in a crisis.[16] To mitigate this risk, he called for regulation of pan-European banks to be carried out at the EU level with the aim of minimizing the collective European cost of a crisis.[17] As this would weaken a nation's ability to regulate its own industries, pursuing such a recommendation would represent the EU reducing member states' resources and capabilities—the fourth of Krasner's mechanisms of feedback. Additionally, if states were willing to accept this loss of resources in the interest of the collective good, that would have constituted Krasner's first mechanism by demonstrating a fundamental change in interest calculations. As the ensuing year proved, this was not to be.

When Northern Rock applied to the Bank of England for emergency liquidity on 13 September 2007 it sparked a bank run and signaled that Europe was indeed going to suffer from the subprime crisis in the US.[18] The Ecofin Council was quick to announce a response, adopting a roadmap of measures to enhance "cooperation and preparedness" at the EU and national levels.[19] This commitment proved more rhetorical than substantive.[20] Many, such as Italian Finance Minister Tommaso Padoa-Schioppa called for a radical overhaul of the EU's financial supervisory institutions, pushing for Level 3 Committees to become agencies with the power to make binding decisions. However, in December 2007, the Ecofin Council rejected the notion of a supranational financial market supervisor under pressure from the UK and Germany.[21][22] Instead, it decided to "strengthen" the Level 3 Committees without "unbalancing the current institutional structure" or "changing their legally non-binding nature."[23]

The Ecofin Council in May did assign additional tasks to the Level 3 Committees but handed responsibility for cross-border banking supervision to colleges of supervisors drawn from willing supervisory authorities, central banks, and finance ministries.[24] This arrangement has been criticized as being weak and convoluted, particularly by the European Parliament, which took the lead in pressing for more powerful EU-level oversight.[25] On 9 October 2008, the Parliament voted 565–74 (with 18 abstentions) to adopt a report calling for the Level 3 Committees to be given a legal mandate to "break deadlocks and solve conflicts" and for the colleges of supervisors to have streamlined decision-making procedures including qualified majority voting (QMV). The report also stipulated that participation in the colleges of supervisors should be mandatory.[2627]

Following the Parliament's vote, the debate reached a stalemate and the Commission handed the issue off to a team of experts headed by former International Monetary Fund (IMF) President Jacques de Larosiere. That high level group is due to present its recommendations in the spring of 2009.[28]

The desire by some at the Commission and especially in the Parliament for supranational financial supervision was stymied by member state opposition in the Council—particularly from the UK and Germany. [29] The UK, which claims three of the most valuable ten pan-European banks (including the largest and second largest) would stand to lose a great deal from increased EU-level control.[30] The stumbling block to coordinated action thus becomes the UK's relative-gains concerns.[31] It is possible that the UK would realize an absolute gain by having better cross-border financial supervision and, therefore, a more financially secure EU. However, because it must give up more than other EU member states to implement such a system, it would *lose* relative to the rest of the EU. Mearsheimer's point that this is a significant barrier to cooperation is confirmed to be the case. As long as the UK calculates their interests with more emphasis placed on its relative loss than on the whole EU's absolute gain, it will resist calls for reform. The success of member state blocking efforts means that the EU has not mattered on this subject thus far. Furthermore, the fact that the Parliament has already raised objections to the composition of the high level group, which includes the former managing director of Lehman Brothers, does not bode well for the supranational side.[32]

II. The European Economic Recovery Plan

In November 2008, anticipating the Commission's forthcoming announcement of a European Recovery Plan, Bruegel produced another policy brief laying out a recommended course of action. It suggested a harmonized stimulus of 1% of GDP to be enacted through VAT cuts and a more coordinated system of economic governance, including a strengthened Excessive Deficit Procedure (EDP) within the Stability and Growth Pact (SGP).[33] If enacted, such a program may have constituted a realignment of interest calculations towards an EU rather than national center by putting the economic health of the bloc first—Krasner's first mechanism. The plan proposed by the Commission on 26 November 2008 fell short of this target and has been watered down by the Council since. There was very little in the Recovery Plan to indicate that the EU mattered.

It is important to note that there was not much the EU could do in terms of direct fiscal action aside from accelerating structural funds payments and prompting further investment by the European Investment Bank (EIB). The EU does not possess the power to raise funds via taxation and the entire EU budget only amounts to around 1% of the EU's GDP.[34] The EU's contribution to the crisis would necessarily be one of guiding and coordinating member state action.

Even the most basic aim of the announced plan—coordinating a stimulus of some amount—has not yet been achieved. A cut in the VAT proved to be controversial. Although the UK did reduce VAT from 17.5% to 15% it did not harmonize the move with other EU countries and France and Germany both rejected VAT cuts outright. [35] The text of the Recovery Plan as released by the Commission eliminated any reference to VAT and simply called for fiscal stimulus of 1.2% of EU GDP to come from member states with an additional 0.3% of EU GDP to be provided at the EU level, coming to a total of €200 billion.[36] Ministers then failed to agree on those percentages at the 2 December 2008 meeting of the Ecofin Council; France asserted that there was agreement on a total figure of 1.5% and Germany complained that other countries were "not registering" their 1.25% figure. The Council also opted to omit the €200 billion number altogether.[37]

Much of the problem lies with the accounting of various national stimulus plans. Germany says that its package is worth 1.25% of GDP but others claim that it is merely previously announced plans repackaged as something new and amounts to far less.[38] The Bruegel proposal attempted to circumvent this problem by having financial reforms—both the stimulus and the subsequent plans to restore fiscal stability—submitted to the Commission for an even-handed evaluation. This would be combined with an accelerated EDP to bring deficits back under the 3% of GDP threshold by 2010 rather than by 2012.[39] The combination of these two policies echoes the sort of centralized economic governance that France has sought in vain since the crisis began.[40]

However, nearly every effort to coordinate a fiscal response—first a European bank rescue fund, then calls for more EU-level economic governance, and finally an EU-directed stimulus—fell at the relative gains hurdle. For this, Germany bears the most responsibility.[41] The Germans' lack of structural deficits allows the country more room than most EU governments to spend on stimulating the economy.[42] However, Germany has not been aggressive with its efforts and has been criticized for pursuing a passive "beggar-thy-neighbor" approach.[43] While there are absolute gains to be realized by Germany if the EU's economic health improves as a result of a robust stimulus package, Germany would be on the wrong side of the relative gains equation. Instead, by essentially free-riding on other nations' spending, Germany is choosing to maximize relative gains.[44] Through not allowing the EU's communal interests to alter their own, the Germans are showing that the EU has not yet mattered in the stimulus debate.

Bearing in mind the fast-changing nature of the crisis and the tremendous pressure on Germany to take a more active leadership role,[45] it is possible that this will change. If it does, it would have tremendous ramifications for the conclusions of this paper.

III. The G20 Summit

Two features of the 15–16 November 2008 G20 summit are relevant to the question of whether the EU matters—the assertiveness that the EU demonstrated in securing the cooperation of the US and the extra representation that EU member states obtained.

The existence of the summit was a coup for the EU in general and Nicolas Sarkozy in particular. Sarkozy had advocated some kind of summit as far back as his 23 September 2008 speech to the UN General Assembly.[46] Support came quickly from European leaders, with UK Prime Minister Gordon Brown also calling for a "new Bretton-Woods."[47] It was clear from the outset that George W. Bush was lukewarm to the idea but Sarkozy was adamant, declaring: "Europe wants this summit before the end of this year. Europe wants it, Europe requests it, Europe will obtain it."[48] By pressing Bush at an October 18 visit to Camp David with Sarkozy and Commission President José Manuel Barroso, Europe did obtain it.[4950] The EU's success in forcing Bush to follow its lead pushed European leaders' confidence to new heights with Brown proclaiming that he would "send a message to the world" and Sarkozy announcing that the dollar "can no longer claim to be the only currency in the world."[51]

Would things have unfolded this way without the presence of the EU? Without Barroso and the added heft of the EU, would France alone (or France and the UK together) have been able to bring such pressure to bear on their more powerful ally? My answer to both questions is 'no.' The fact that Sarkozy and Barroso were able to leave Washington with a commitment to a summit that the US President didn't really want demonstrates evidence of Krasner's third feedback mechanism—that the EU has increased the power of its member states.

The Spanish and Dutch efforts to secure representation are also significant in examining the EU's value as an independent variable. Despite their respective positions as the 8th and 16th largest economies in the world neither was allotted a seat at the summit.[52] The US refused to expand the guest list, turning down a direct Polish appeal as well; however, both Spain and the Netherlands were able to attend by working through the EU. France, as an invitee both in their own right and as holders of the EU presidency, had seats to spare. [53] In a symbolic show of solidarity, the French, Dutch, and Spanish representatives were all seated behind the flag of the EU.[54] While one could argue that these arrangements were essentially bilateral deals struck between Spain, the Netherlands, and France, the fact remains that France would not have had extra seats to give up if not for the EU. Furthermore, the fact that France would choose to surrender any representation is difficult to explain from a strictly realist perspective (without being privy to any *quid pro quo* that may have gone on behind closed doors). A donation in exchange for nothing would indicate that shared EU membership, through Krasner's first mechanism, led the French to calculate their interests as encompassing their neighbors' interests. At the very least, the EU had an impact through enhancing the diplomatic power of both Spain and the Netherlands.

Here, relative gains issues were less relevant than absolute gains. The EU and all members stood to profit in absolute terms by forcing the summit and gaining extra representation. The relative gains issues at stake were limited—France did not experience much relative loss by surrendering its extra seats.

Conclusions

In the one external issue examined above—the G20 summit—the absolute gains at stake outweighed the relative gains at stake. The opposite was found to be true in two internal issues—financial market supervision reform and the European Economic Recovery Plan. In these two cases, the relative loss to some members (chiefly the UK and Germany), led them to block action that may have improved the absolute position of the whole.

The question of whether the EU matters is intimately linked to the notion of how much weight nations place on absolute versus relative gains. In terms of Krasner's mechanisms, the more emphasis nations place on absolute gains, the more member state interest calculations will have shifted towards the collective center. This would represent the EU mattering. The lesson from the three EU responses considered in this paper, however, is that member states still put more weight in relative-gains considerations. Has the EU mattered within the context of the financial crisis? Yes, but less than concerns over relative gains. Empirical evidence for the EU mattering in the form of a tangible outcome can only be found in the example of the G20 summit where relative-gains considerations were minimal.

Returning to a broader theoretical perspective, this conclusion does warrant one caveat: it only reflects the degree to which the EU matters at this particular moment in time. Although the EU does not yet have centralized banking supervision reform or a coordinated fiscal response to the crisis, it is clear that there are forces inside and outside the EU still working to achieve those aims. The fact that the EU has not mattered *enough* to produce an output like Germany sacrificing fiscal responsibility for the good of Latvian manufacturers does not necessarily mean that the EU has not mattered *at all*. That member states continue to invest significant time and effort in trying to come to a consensus testifies to the strength of the idea that the EU does and should matter. If, as some argue, these ideas matter,[55] then the balance between the EU as a dependent variable and the EU as an independent variable may indeed shift towards the latter over time. These more process-oriented topics warrant further research.

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The Impact of the Financial Crisis on Euro-Adoption Strategies in Central Europe

Zuzana Svetlosakova

The global financial crisis has a significant impact on euro adoption strategies in the Czech Republic, Hungary, Poland and Slovakia, as national governments use the crisis strategically in national debates about economic policies and future choices. The turmoil in Hungary was a wake-up call exposing the vulnerabilities of emerging economies as Central Europe did not prove resistant to liquidity deterioration, exchange rate volatility and direct and indirect effects of the crisis. The policy implications of the crisis on the euro adoption strategies reveal that these developments only intensified the already existing position on the euro rather than dramatically changed the attitude of the governments currently in power. Analyzing the effects of the financial crisis on Central Europe, exemplified in the issue of euro adoption, helps us to understand policy choices that politicians make and the extent to which these are being influenced by international organizations.

The global financial crisis has had a significant impact on euro adoption strategies in Central Europe, as governments in the Czech Republic, Hungary, Poland and Slovakia use the crisis strategically in national debates to determine economic policies and future paths of their respective countries.

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The euro has traditionally been linked to the question of timing for a country's entry into the euro area and its commitment to the convergence criteria set by the European Union (EU) in the Maastricht Treaty. With the next European parliamentary elections set for 2010 in all four of the countries mentioned above, euro area membership is hotly debated because it represents the governments' strategies in fighting the effects of the crisis as well as the countries' economic and political priorities.

Over the last few months financial turmoil has led to various political outcomes.[1] In Hungary, the crisis has pressured the minority government to adopt necessary economic changes that move the country closer to the fulfillment of the convergence criteria. In Poland, the crisis and the government's recently announced euro adoption plan have become powerful weapons in domestic political battles, while in the Czech and Slovak Republics, these two issues have provided justifications for the respective governments' pre-existing euro-skeptic or euro-friendly positions.

This analysis seeks to explain the current euro area attitudes of the Visegrad countries[2] in two steps by considering the impact of the crisis and the response from politicians and central bankers. The fact that the economic and financial impact of the crisis is still unfolding naturally creates methodological problems. However, although the full scope of the crisis cannot yet be assessed, general trends and patterns in domestic politics evolving from the crisis can be identified. Our knowledge of the trends and patterns allows us to consider the way governments in Central Europe perceive the limitations and opportunities derived from the current economic situation.

Financial Crisis Hits Central Europe

The international financial crisis hit Central Europe in October 2008, with Hungary being the first and the worst affected.[3] As the bond market froze, the Hungarian forint depreciated sharply in October and the stock market plunged. Consequently, the Hungarian National Bank (NBH) had to respond with a 3% 'panic interest rate hike'[4] in order to defend the currency from speculation. Only a few weeks later, an international US$16bn loan from the IMF, the EU and the World Bank was negotiated.[5]

At the same time, the Polish zloty and stock market plummeted, and liquidity dried up in the inter-bank market.[6] Meanwhile, in Prague, the Czech National Bank (NBC) cut rates to 2.75%, at that time the lowest in the EU,[7] and created a new facility 'aimed at providing more liquidity by extending two-week loans in exchange for state bonds as collateral.'[8] As the crisis spilled over into the region, Slovakia was the only Visegrad country which experienced only a "limited" direct impact of the crisis throughout October and November. With the crown-euro convergence rate firmly set in July 2008, Slovakia was able to avoid the exchange rate fluctuations that plagued the national currencies of all its neighbors.

Past policy choices and a vulnerable banking sector explain the speed and force with which the crisis affected Hungary.[9] Outsized government debt, which in 2007 increased to 66% of Hungary's GDP, more than double the debt of the Czech and Slovak Republics,[10] together with a 'maturity and currency mismatch in the banking sector'[11] meant that with the global liquidity shortage, investors started to worry. Liquidity dried up in the bonds market and the forint depreciated some 13% against the euro. Because of high domestic inflation levels, loans in forint were charged at a higher rate. This encouraged Hungarian consumers and businesses to take loans denominated in foreign currencies, particularly in the Swiss Franc.[12] Whereas in the Czech and Slovak Republics only 2% of new mortgage loans are made in foreign currency, in Hungary, foreign loans account for 90% of the total.

In comparison to Hungary, the Czech and Slovak money and currency markets were 'barely affected by the crisis.'[13] As risk aversion to the region intensified,[14] yields increased and the bond markets in the Czech Republic and Poland experienced some liquidity problems. The NBC repeatedly claimed that the Czech financial system was less vulnerable than that of Poland or Hungary;[15] however interest rates were cut drastically.

Although the Polish economy is regarded as being in better shape than Hungary's,[16] it faces many similar problems. The government net external debt is 40%,[17] and much of its domestic mortgage lending is denominated in Swiss Francs.[18] Instability in the Hungarian financial and banking markets has caused foreign withdrawals from Poland, affecting the value of its national currency, which has dropped some 30% against the dollar and slightly less against the euro.[19] The Polish National Bank (NBP) did not hike interest rates to save the currency, although this could happen given further speculation.

In Slovakia, the fixed exchange rate between the crown and the euro protected the national currency from exchange rate volatility.[20] The banking system was cushioned from a shortage of capital by the "over-liquidity"[21] resulting from a January currency swap. However, the banking sector was not spared completely; for example, insurance sector profits shrank by 27%.[22] Most worrying is the dramatic fall of Slovakia's industrial output from 5.4% in mid-2008 to practically zero in October of the same year, which was the most dramatic change amongst the Visegrad countries.[23]

Despite differences in the way the global crisis affected these countries, all four countries experienced similar indirect effects. Integration into the global market, strong links with the eurozone, dependency on exports, and foreign bank ownership are all likely channels of instability.

As demand from the EU declines, exports will fall and the trade deficit in these four countries will increase. The decline in external demand will also coincide with a domestic decline in consumption that could depress wages and production and increase unemployment. Such increased unemployment may lead to depreciation and will generally cause slower economic growth.[24] In terms of industrial output, the industry affected most could be one of Central Europe's champions—the automobile industry—especially in the Czech and Slovak Republics.[25] Slovakia might be better off, however, since its car production focuses on ecologically friendly cars for which demand is still strong. In addition, its marginal costs are lower than those of its neighbors, so that further optimization and cost-cutting in Western Europe might actually create new investment opportunities.[26]

Similarly worrying is foreign bank funding and ownership. Traditionally, Central European economies, Hungary and Poland in particular,[27] have funded a growing current account deficit with high FDI inflows. While in good times this funding method is not a problem, when liquidity abroad dries up in times of crisis, this dependence becomes unsustainable and increases the risk potential in emerging economies.[28] Although the loan from the IMF was certainly necessary, it has also aggravated Hungary's reliance on foreign funding.

Finally, regarding foreign bank ownership, there are both advantages and disadvantages. The banking sector in Central Europe is mostly composed of universal banks with some specialized banks.[29] Foreign presence is high at 96% in the Czech Republic, 83% in Hungary, and 96% in Slovakia.[30] On the one hand, the foreign element provides the domestic sector with valuable knowledge and management skills. On the other hand, even though the domestic branches function as separate subsidiaries, there is the risk that, given liquidity problems in the parent banks, foreign interests might influence the choices of domestic banks.[31] Although this risk channel is far from negligible, for now there is no evidence of foreign banks withdrawing from Central Europe during either the financial crisis or an economic downturn, so that the impact of foreign bank ownership remains to be assessed.[32]

Overall, the impact of the financial and economic crisis on Central Europe is sizeable. Hungary will most certainly slip into recession, with GDP growth for 2009 predicted to contract by 1.5%;[33] some forecasts also predict that the Czech

Republic might see a recession,[34] while the Polish GDP growth will slow down from 5.8% in the Q2 of 2008 to 3.7% in 2009,[35] while in Slovakia, the GDP growth predicted from December 2009 lies at 4.7%, down from 10.7% in 2007.[36]

Political Response and Euro Adoption Strategies

In November and December, the Visegrad governments presented packages aimed at stabilizing the banking sector and stimulating the real economy. As in other European countries, the response to the financial crisis focused on liquidity, recapitalization of the market, greater international cooperation and domestic deposits guarantees. However, in addition to these points, countries' responses were very much shaped by a re-evaluation of euro area entry, and attempts of national governments to use the crisis in bargaining with the opposition and justifying their euro position regarding the wider public.

Upon the fulfillment of the four convergence criteria laid down in the Maastricht Treaty, all EU members (except for Denmark and the UK) are obliged to adopt the euro. The convergence criteria require low inflation, a stable exchange rate within the Exchange Rate Mechanism (ERM 2) band, a sustainable budget position, and a low long-term interest rate.[37] For the price of independent monetary policy, the euro can provide a shelter from external shocks. The substitution of the euro for national currency eradicates exchange rate volatility and speculation, which means that a banking crisis is less likely to turn into an exchange rate crisis.[38] The euro eliminates exchange costs for businesses and households, fosters trade and integrates financial markets. In the long-term, use of the euro secures steady economic growth,[39] as adherence to the convergence criteria is instrumental in the implementation of economic, structural and banking reforms.

In Hungary, the crisis seems to have strengthened the minority government run by the Hungarian Socialist Party (MSZP) with external support from the SZDSZ-Hungarian Liberal Party (SZDSZ).[40] The MSZP was previously criticised by its ex-coalition partner SZDSZ, as well as by the opposition led by the Fidesz-Hungarian Civic Union, for not implementing reforms promised in the April 2006 elections. Thanks to the rapid management of the IMF loan and equally quick drafting of stimulus packages that hope to provide more funds to business, create new jobs, save some 100.000 current ones and boost the construction industry,[41] the popularity of the Prime Minister, Ferenc Gyurcsány of the MSZP, has increased over the last two months.

The ascendancy of Gyurcsány could change however, as the government is under pressure from the IMF loan to adopt long-delayed unpopular policies. The IMF loan, which exceeds the country quota by a factor of ten, requires Hungary to decrease government deficit (currently the largest in the EU[42]) to 2.6% in 2009 and cut down public expenditure. In November, the Hungarian parliament passed legislation imposing a cap on budget spending and establishing 'a three-person budgetary council to oversee budget performance.'[43] The announced cancellation of the 2009 bonuses for public sector employees faced severe criticism from trade unions, which are said to be planning a large-scale strike for January. Furthermore, none of the commercial banks have yet accepted help from the proposed bank rescue package.[44] With approaching parliamentary elections in 2010, the government will be careful about pushing through drastic reforms. The elections for the European Parliament in summer 2009 will, in this way, be a test round for MSZP and a sign as to whether or not Gyurcsány will remain as the head of the party.

In this way, the euro and the fulfillment of the euro-convergence criteria, which coincide with the conditions set out by the IMF loan, could prove to be a useful tool for the government to justify unpopular policy choices. While Hungary was at no point openly against euro adoption, and prior to October 2008 actually aimed to draw up a euro adoption plan, the government never committed itself sufficiently to the necessary changes. With the IMF loan, there is a chance that Hungary could meet the Maastricht conditions sooner than originally intended.[45] In this light, it is not surprising that Gyurcsány confirmed in December 2008 that Hungary intends to join ERM-2 in 2010 so as to allow for a possible 2012 adoption of the euro.[46]

Regarding the dynamics of Polish domestic politics, there is much evidence that the government, especially the leading party Civic Platform (PO) has every intention of using 'the global economic crisis to build up momentum for [...] Poland to join the euro in 2012.'[47] Already in September 2008, Donald Tusk, Poland's PM since 2007, unexpectedly announced 'the government would try to ensure that Poland became a member of the eurozone in 2011.'[48] As the financial crisis unfolded, the government and the NBP were busy not only with handling the currency and stock market, but also with creating a timetable for Polish adoption of the euro.[49] Having seen the effects of exchange rate speculation in Hungary and given that the zloty has been considered as one of the most vulnerable currencies in the region, Polish policy makers were re-reading the positive PNB recommendation for a fast-track euro-entry from 2004.[50] In fact, by the end of October the government published a "road map" 'setting out the measures needed to allow adoption of the euro in Poland in January 2012.'[51]

Tusk's euro-friendly stance is a powerful weapon in the domestic battle against the Kaczynski brothers and the conservative Law and Justice (PiS) party. As in Hungary, in the face of an upcoming presidential election in 2010, in which Tusk hopes to defeat the current President Lech Kaczynski, the government has had to take care to avoid alienating public support while carrying out drastic reforms. The euro offers a good opportunity to rally against the euro-skeptic Law and Justice by brightening up Poland's economic path (EIU 2000d:9–10). The "EU-credentials" were a useful force in electoral victories in Slovakia in the 1998 and 2002 parliamentary elections. However, the current political battle in Poland will not be easy. Adoption of the European currency requires a change in the constitution, but the government currently does hold enough seats and has to rely on defecting opposition votes.

Political struggle is also characteristic of the Czech political scene. After the electoral fiasco in regional and Senate elections for the governing right-wing Civic Democratic Party (ODS), in which the ODS lost seats to the opposition Czech Social Democratic Party (CSSD), the Czech Republic had to face a financial and economic crisis at a time of political instability.[52] A general attitude towards the EU as well as the euro is an important issue in domestic politics, as both President Klaus and the PM Topolánek of the ODS are euro-skeptic while the opposition CSSD chairman Paroubek is in favor of better relations with the EU and of euro adoption. With general elections due in 2010, these views are becoming increasingly more explicit in political debates.

Together with the NBC, headed by pragmatic Governor Tůma, President Klaus and PM Topolánek have repeatedly advocated the benefits of staying out of the euro area.[53] As mentioned earlier, the Czech 'banking sector appears sounder than other countries in the region.'[54] The Czechs were not as badly hit as Hungary, which means that so far the government has not had to resort to "emergency responses" such as a bank bail-out or a business stimulus package. Therefore, the relatively moderate direct impact of the financial crises has thus far allowed the Czech government to justify its anti-euro position by juxtaposing the flexibility of the NBC with the restrictive nature of the convergence criteria.

However, while a temporarily weaker Czech crown is certainly useful for exports, exchange rate volatility has negative connotations for foreign investors. The Czech 'currency has a strengthening tendency against the euro, growing by 6% in nominal terms from January to May.'[55] Despite recent depreciation the Czech crown is expected to strengthen again by a further 10% in 2008.[56] The ODS government is increasingly under pressure by business to adopt the euro, as in 2008, when Czech Škoda VW saw its profit decline by 24.7% even though in the last nine months Škoda sold 11.3% more cars.[57]

The Czech Republic has traditionally been viewed as an apt candidate for euro adoption and it seems it is only a matter political commitment that is problematic.

Nowadays, the NBC's intervention of cutting down interest rates fully agrees with the ECB's monetary policy. Also, considering the planned expenditure cuts and tight budget deficit,[58] the Czechs seem to be in fact pursuing policies similar to those outlined by the EU convergence criteria. Depending on the results of the next EU convergence report, and supposing that Poland and Hungary seriously commit themselves to adopting the euro in January 2012, the current Czech government, which is most probably not going to remain in power much longer, may have to reconsider the costs and benefits of the euro.

Of all the Visegrad countries, Slovakia has felt the direct effects of the economic crisis the least. Given the set date for euro adoption, for which Slovakia has been preparing meticulously throughout 2008, Slovakia's response was the most predictable and path-dependent. The National Bank of Slovakia (NBS) has been closely following the interest rate policy of the European Central Bank (ECB), with rates in December at 2.5%. As in the Czech Republic and Poland, there has been no bank bailout. In fact, similar to the Czech banks, the Slovak banking sector has, in the last ten months, made net profits and a 14% increase relative to 2007. [59]

In Slovakia, although the euro is no longer a political issue, governmental policies are closely followed. After the 2006 elections when SMER, headed by Robert Fico, formed a government with Mečiar's Hnutie za Demokratické Slovensko (HZDS) and Slota's Slovenská Národná Strana (SNS), the government's firm commitment to euro adoption in 2004 came as a positive surprise given its populist electoral rhetoric. Prime Minister Fico has frequently voiced his wish to adapt Slovakia's laissez-faire economic legislature to SMER's social democratic electoral promises. The PM also frequently threatened to nationalize uncooperative energy companies or force them to curb their profits.

However, the convergence criteria and special interests of businesses have imposed a limit on PM Fico's government's plans. In the last three months, the government has promised to keep strict fiscal policies and cut expenditure if necessary. The government also seems determined to sustain Slovakia's competitive conditions by encouraging investment in infrastructure and nuclear energy. Considering daily news about job and production cuts, this could indeed prove to be the most challenging credibility test for the government in the coming months.

The current crisis has greatly strengthened PM Fico's and his party's position. The opposition, represented by three main parties (the Slovak Democratic and Christian Union-Democratic Party (SDKU-DS), the Christian Democratic Movement (KDH) and the Hungarian Coalition Party (SMK), have not been able to cash in on the economic crisis. Although it was the government formed by these opposition parties between 1998 and 2007 that made all the necessary changes to enable Slovakia's euro adoption, criticism of the euro during 2008 from the KDH severely damaged the opposition's political credibility and weakened their chances in the 2010 elections. According to monthly opinion polls, the coming parliamentary elections should secure a landslide victory for SMER and allow Fico to abandon his clumsy HZDS coalition partner. The upcoming presidential elections in March will test the population's satisfaction with the government's handling of the impact of the financial crisis.

Conclusion

The turmoil in Hungary was in many ways a wake-up call for Europe and the world, exposing the vulnerabilities of emerging economies.[60] Countries in Central Europe did not prove resistant to liquidity deterioration, exchange rate volatility or to other direct and indirect effects of the global financial crisis. The region's potential risk grew in the eyes of foreign investors, and this risk has already had and will continue to have a negative impact on their trade-dependent economies.[61]

At the moment, it is difficult to measure the full impact of the crisis as new data is being re-evaluated on a daily-basis. However, certain trends are clearly identifiable. The policy implication of the crisis on euro adoption strategies in Hungary, Poland, the Czech Republic and Slovakia reveal that these developments only served to intensify pre-existing positions on the euro rather than dramatically change the attitude of the governments currently in power. In each of the Visegrad countries, the government has tried to exploit the situation to its advantage.

In Slovakia, SMER has so far been able to increase its economic credibility, although it is questionable to what extent the government really could have shaped the events given the path-dependency of the January euro adoption. Throughout October and November, Slovakia found itself in a relatively lucky position in contrast to its neighbors. Despite growing concerns about the indirect effects of the crisis, especially in industrial production and exports, the euro area entry should place Slovakia in a good position in Europe's post-crisis economic recovery.

The Hungarian government also seems to have successfully enhanced its position, showing that a minority government can handle a financial crisis. With parliamentary elections coming up in 2010, it remains however unclear how willing Gyurcsány will be to implement the IMF conditions. Whether fully or only partly implemented, the reform policies will move Hungary closer to fulfilling the Maastricht criteria. Joining the ERM-2 before 2010 could bring the euro to Hungary by 2013.[62]

In Poland, the Tusk government has been flirting with the idea of joining the euro ever since the 2007 parliamentary elections. The crisis has become a strategic tool to push through with fiscal and monetary policies that have long been on the Civic Platform's economic agenda. While the euro adoption and Slovakia's example might prove to be a powerful weapon against the euro-skeptic President and the conservative Law and Justice party, the fight over economic choices will be eventful. Only once the constitution is changed and Poland joins the ERM-2, can we say that euro adoption in 2012 seems viable.

Likewise, the Czech Republic gives an excellent example of how a previously held attitude strongly dominates the debates on the financial crisis and euro adoption. Despite the fact that the country shares many economic characteristics with Slovakia, being a small, relatively open economy with significant EU-trade, the Czechs seem to have a much more pragmatic attitude towards the euro. Once the turmoil is over and European economies start to recover, and given a very likely change of government, it is possible that the Czechs will join the ERM-2 in 2010 in order to coordinate timing with Poland and Hungary. If Poland and Hungary are in a position to adopt the euro simultaneously, the Czech government will have to seriously re-evaluate the costs and benefits of remaining the only Visegrad country without the single currency.

Analyzing the effects of the financial crisis on Central Europe, exemplified in the issue of euro adoption, helps us to understand policy choices that politicians make and the extent to which these are being influenced by international organizations. This paper sought to demonstrate that euro adoption is not just a matter of cost-benefit analysis and optimal timing determination but is directly linked to the adoption of an EU-specific package of economic and political reforms such as sound public finance and structural reforms. The European single currency offers good soil for further research into the power of supranational organizations to influence domestic politics, analyzing how the euro becomes part of the strategic bargaining and calculations of domestic actors.

This analysis furthermore implies that policy choices matter and that there is no easy way to a successful transition from a socialist to a market economy.[63] The impact of the crisis has shown that slow reformers, like Hungary, were severely punished[64] while some, like Slovakia, have found themselves (so far) in a relatively lucky position. However, the impact of the global financial crisis on Central Europe also highlights the necessity of scrutiny of the way capitalist markets function, the rules and regulations (or their lack) that guide them as well as the political intentions that come along with them. In this way, a close analysis of the interaction between the world of politics and economics is a useful starting point.

Notes:

1 This article was written in the first two weeks of December 2008.

2 The term Visegrad countries refers to the Visegrad Group (or V4) formed in 1991 by Czechoslovakia, Hungary and Poland with the purpose to coordinate efforts to join the process of European integration. Since the 2004 EU accession, the Visegrad Group has been meeting regularly to coordinate positions vis-à-vis EU legislation and politics.

3 This went against the expectations raised in the September 2008 ZEW Financial Market Report CEE.and the December 2008 ZEW Financial Market Report CEE.,, also the "EU10 Regular Economic Report," *The World Bank*, October 2008, http://www.worldbank.org, 5.

4 "Hungary: A Panic Rate Hike and a Potential Contagion Effect," *Stratfor,* 22 October 2008..

5 "Hungary," *The Economist Intelligence Unit,* December 2008, http://www.eiu.com, 4.

6 "Poland," *The Economist Intelligence Unit,* November 2008, http://www.eiu.com, 2.

7 "Czech Republic," *The Economist Intelligence Unit,* December 2008, http://www.eiu.com, 5.

8 Ibid.

9 Lázsló Andor, 'Hungary's boomerang effect,' 29 October 2008, http://*guardian.co.uk*.

10 In the Q1 of 2008, Hungary's gross debt was 100% of GDP and net debt was 54% of GDP—see World Bank, 6.

11 World Bank, 7.

12 EIU Hungary Report, 11. World Bank, 7. 40% of Hungarian mortgages were affected by the Swiss currency trade along with 40% of consumer debt.

13 Zsolt Darvas, "Should the crisis be the trigger for a reshaping of euro-area entry rules?" *VOX*, 11 November 2008, http://www.voxeu.org/index.php?q=node/2547.

14 World Bank, 7.

15 Czech National Bank,'The CNB's statement regarding the global market crisis,' 30 September 2008.

16 Nicholas Kulish 'Credit Crisis Slows Economy in Once-Hot Poland,' *The New York Times* 27 October 2008.

17 According to Darvas, 45%.

18 EIU Hungary Report, 11.

19 Ibid.

20 Darvas.

21 National Bank of Slovakia. 'Comparison of the current performance of NBS monetary policy with the performance after the euro adoption in Slovakia.' *Biatec* 16:9, 2008, 17.

22 "Slovakia," *The Economist Intelligence Unit,* November 2008, http://www.eiu.com, 11.

23 Ibid., 13.

24 World Bank, 7, 9.

25 Beata Balogová, 'Slovakia braces for the storm. Politicians and economists are debating what steps the country should take,' *Slovak Spectator,* 3 November 2008. and Radoslav Tomek, 'Slovak Economy Is Vulnerable to Car Industry, Moody's Says.' *Bloomberg* , 27 November 2008.

26 'Zahraniční investori sú čoraz opatrnejší,' *Hospodárske Noviny HNOnline*, 30 October 2008, and 'Kríza potápa európske automobilky,' *Hospodárske Noviny HNOnline,* 31 October 2008.

27 World Bank, 10.

28 EIU Poland Report, 15.

29 "Banking structures in the new EU Member States," *European Central Bank*, January 2005, http://www.ecb.int, 5.

30 Ibid., 15.

31 European Central Bank, 6 and 'Who's next?' *The Economist*, 23 October 2008.

32 De Hass R.T.A, Van Lelyveld I.P.P., 'Foreign Bank Penetration and Private Sector Credit in Central and Eastern Europe,' July 2002.

33 See Darvas, and his article 'The rise and fall of Hungary', 29 October 2008, http://*guardian.co.uk*; EIU Hungary Report, 7.

34 'Česká a pol'ská ekonomika by mala rást' pomalšie,' *SME*, 28 November 2008.

35 EIU Poland Report, 13.

36 "NBS výrazne znížila odhad rastu ekonomiky na 4,7 %," *SME,* 7 December 2008.

37 Note that that advantages and disadvantages of the euro and of the ERM 2 in relation to transition economies will not be fully discussed in this essay. For criticism of the ERM 2, see for example, Anne-Marie 'The challenges of EMU accession faced by catching-up countries: A Slovak Republic Case Study,' *OECD ECO/WKP* 31:44, or Charles Wyplosz, 'Who's afraid of the Eurozone?' *VOX,* 10 June 2004.

38 Goldman Sachs, 'The Euro at Ten: Performances and Challenges for the next decade,' June 2008, 77. Darvas: A common monetary policy also allows commercial banks to turn directly to the ECB for extra liquidity.

39 Elena Kohútiková, 'Dva názory na euro a krízu. V poslednej chvíli,' *SME,* 23 October 2008.

40 EIU Poland Report, 3.

41 EIU Hungary Report, 12.

42 Darvas, "Should the crisis be the trigger for a reshaping of euro-area entry rules?"

43 EIU Hungary Report, 2.

44 EIU Hungary Report, 11.

45 See the articles by Darvas, and 'Support package, gov't measures bring Hungary closer to Eurozone—Finnish finance minister,' *MTI Econews*, 31 October 2008.

46 'PM tells Financial Times that Hungary intends to join ERM-2 in 2010,' *MTI Econews,*16 October 2008.

47 EIU Poland Report, 10 , also see "Euro For Zloty; Why Poland Needs the European Currency" *Polish News Bulletin*, 1 October 2008.

48 "Poland," *The Economist Intelligence Unit,* September 2008, http://www.eiu.com, 2.

49 "Poland," *The Economist Intelligence Unit,* October 2008, http://www.eiu.com, 2.

50 National Bank of Poland. 'A report on the costs and benefits of Poland's adoption of the Euro,' July 2004.

51 EIU Poland Report, 12.

52 EIU Czech Republic Report, 3.

53 Ibid., 11.

54 Ibid., 12.

55 Ibid., 7.

56 Ibid., 8.

57 "Kríza potápa európske automobilky,"*Hospodárske Noviny HNOnline,* 31 October 2008.

58 EIU Czech Republic Report, 10–11.

59 "Banky v SR dosiahli za desat' mesiacov zisk 17,8 miliardy korún," SME, 30 November 2008.

60 European Central Bank, 7, and.'Financial crisis takes harsh toll on Europe,' *IMF Survey Magazine,* 21 October 2008.

61 'Zahraniční investori sú čoraz opatrnejší,'*Hospodárske Noviny HNOnline,* 30 October 2008.

62 'Goldman Sachs sees Hungary joining neighbours in eurozone by 2013,'*MTI Econews,* 19 September 2008.

63 The author agrees with the articles by Darvas, and with Deutsche Bank Research's 'EMU entrant Slovakia: Well positioned due to sound policies,' *Talking Point* 8 August 2008.

64 European Central Bank, 8.

Remittances and the New Diaspora Consensus

Roberto G. Peña

Through analyzing the Mexican and Salvadoran migrant communities living in the US and their remittance flows back to Latin America, this paper attempts to examine the political implications of economically empowered diasporas and how home country governments are responding and becoming more accountable. This paper explores this phenomenon's implications on political processes through remittance delivery collaboration and reviews recent developments in Mexico and El Salvador in light of the current global economic crisis.

The close of the 20th Century brought major changes to governments in Mexico and El Salvador. While the political dynamics of each country differ, Mexico saw a peaceful shift in power ending the Institutional Revolutionary Party (PRI) dominance over the country in 2000, while El Salvador saw a peaceful end to a bloody civil war with the revolutionary forces laying down arms to participate in the political process in 1992. These are two young democracies inextricably linked to the United States by a continual flow of remittances from native workers who migrated to the "land of opportunity."

Curiously, the dawning of democracy in Mexico and El Salvador was accompanied by a spike in migration that left the two governments politically accountable to their burgeoning diasporas. Through remittances and binational lobbying of

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US foreign policy, these flourishing émigrés built strong ties to their home governments—ties that will likely strengthen institutions and consolidate their democracies. This new "Diaspora Consensus" will seek to evoke changes in home country governments by promoting transparency, encouraging moderation and leveraging remittances, much like the Washington Consensus influenced Latin American public policy through conditionality in foreign aid and development loans. Mexico, having a longer experience with migration to the US and far more developed external civil society and tangible political influence, may serve as a model for the Salvadoran democracy and its migrants in the US. How these diasporas develop and influence their countries will also be a demonstration of what is possible for other diasporas to follow.

These two diasporas are gaining and have gained significant influence in their home country governments through remittances and their increasing clout in US politics. El Salvador and Mexico need their respective diasporas to provide legitimacy and economic stability and must therefore be accountable to them. The relationship between home country governments and the diasporas has been established and the economic impact is acknowledged. What the relationships currently lack, however, is full political accountability of home country governments and public policy influence. Given the evolving nature of the relationship and dependency, this accountability may be the final step of consolidating country democracies by extending rights to bi-national citizens.

The current global financial crisis will only deepen this accountability. While projections from the Inter-American Development Bank predict a fall in remittance levels in the coming year, they are expected to "decline less than export revenues, tourism, FDI or speculative flows."[1]

What's more, Mexican and Salvadoran governments have been working with US authorities to shift remittance flows away from the informal sector to lower transaction costs, maximize capital mobility and better track remittance data. As the economic slowdown takes hold on the Mexican and Salvadoran economies, pressure will mount to improve government accountability in order to increase remittances through official channels. Furthermore, shifting remittances to more formal channels will weaken a regional undercurrent of narco-terrorism.

Through an extended stay in the US, diasporas begin to understand contrasts in government services and political accountability, thereby raising their expectations of performance and lowering their tolerance for failure of the governments in their native countries. The additional discovery that their remittances are keeping their native countries afloat adds to their desire to ensure that their funds are not lost by hyperinflation or government corruption.

Role of Remittances in Mexico and El Salvador

Mexico and El Salvador are relevant remittance case studies because Mexico is among the top five gross remittance recipients in the world (pairing it with countries like China, India and the Philippines) and El Salvador is among the world's top recipients of remittances as a percentage of their GDP.[2] A surprising development has been how both Mexico and El Salvador's remittance-to-GDP ratios have risen over the last 20 years, peaking in 2006.[3] This demonstrates how over time, remittance flows grow at faster rates than output and comprise of a larger share of country output.

Mexico's remittance flows have been growing, but their remittance-to-GDP ratio is much smaller given that its economy has joined the trillion-dollar club. However, this lower ratio should not be misinterpreted as Mexico having less dependency on remittances. Remittance flows in Mexico exceed the value of agricultural exports and tourism receipts.[4] Furthermore, official remittance flows fail to capture the full scope of cash transfers through the informal sector. Another distinction of Mexican remittances is that remittances provide a substantial form of social protection and income transfers, at times even surpassing the state's capacity to alleviate poverty or to develop rural infrastructure.[5]

Notwithstanding the impact of economic crises, remittance flows are generally regarded as more stable than alternative capital flows.[6] The steady increase in growth rates even prompted El Salvador and Mexico governments to leverage them to obtain sovereign debt by securitizing remittance flows and even receiving investment grade ratings for these "diaspora bonds."[7] A major slowdown in remittances in Mexico and El Salvador could affect each government's credit rating and further hurt their ability to issue sovereign debt in private capital markets. Given the possible decrease in remittance flows as a result of the economic crisis, the Mexican and Salvadoran governments face pressure to ensure that their diasporas continue to send remittances through official channels. Much discussion is taking place on the future of remittance flows, but the how governments respond politically will demonstrate how much leverage that diasporas hold.

Devesh Kapur of the Center for Global Development writes:

> Rather than simply react to state policies, international migration and remittances have forced states to accommodate new realities. In lieu of political voice, migration becomes an exit strategy, and remittances either fuel further exit or empower political voice by making resources available to new groups.[8]

The policy concessions that the Mexican and Salvadoran governments grant to their diasporas and the increased accountability that will result is the new conditionality that will constrain governments. This "Diaspora Consensus" will demand greater transparency in government activities and the policy making process. An immediate condition that will be sought out by the Salvadoran diaspora will be the external vote, or right to vote abroad. This development is significant because it further strengthens the diaspora's voice in the political process. Mexico already grants this right to its citizens living abroad. So influential is their diaspora that the Mexican legislative assembly has even considered making the Mexican population in the US a congressional district with full representation. US-based Mexican immigrants have even won political office in Mexico from abroad.[9]

HTAs as Institutionalization Mechanisms for Diaspora-Home Government Relations

Both the Mexican and Salvadoran diasporas have been able to organize and target their remittances for infrastructure projects in their countries and wield significant collaboration from the home governments through Hometown Associations (HTAs). HTAs are US-based immigrant organizations of various sizes and fundraising potential that send remittances for specific projects or regions in their home country. The remittance explosion came at a time of the implementation of the North American Free Trade Agreement (NAFTA), which encouraged deregulation and increased immigration, effectively enhancing public accountability in Mexico. El Salvador, now part of the Central American Free Trade Agreement (CAFTA), has followed a similar process. But just as NAFTA preceded CAFTA, Mexico's more developed HTA programs have brought greater accountability and responsiveness from government. This institutionalization of the development process has brought calls for increasing transparency and a more involved decision making role for migrants abroad.

Collaboration between HTAs and home country governments suffers from persistent bureaucratic problems, but given the small level of immigrant participation in HTAs, the onus falls on governments to accommodate diasporas, to increase transparency and to improve levels of diaspora involvement in order to increase participation and trust in the programs. Governments have an incentive to be more responsive as HTAs offer the ability to target remittance flows towards infrastructure. According to Orozco, although 60% of Mexicans in the US send remittances, only 4% participate in HTAs.[10] Many Immigrants are discouraged by perceived bureaucratic problems with HTAs and simply and direct their remittances elsewhere. In order to increase participation in HTAs, governments must attempt to remedy complaints, leaving them accountable to this external population.

With over 700 HTAs registered with Mexican consulates, established outreach efforts and the allowance of an external vote, the Mexican government is well aware of the potential of HTAs. Another concern for the government may be HTAs highlighting the failures of rural development in parts of Mexico. In Mexican municipalities with less than 1,000 people, remittances can comprise of up to 70% of infrastructure spending. HTAs also offer a much more streamlined distribution process, forcing governments into more expedient action. [11]

In El Salvador, the government has established a vice-ministry for the diaspora. On a smaller scale, it has also created remittance-matching plans similar to the Mexican government's "Three-for-one" program called "United for Solidarity," implying a partnership, at least symbolically. As Orozco notes, "an outreach policy to the community residing abroad is key to any migrant-sending country's economic strategy."[12] Remittances, and more formally HTAs, are an immigrant's execution of a desire to participate in their home country's development process. HTAs institutionalize this process, and, "the economic activities that immigrants engage in with their home countries reposition their roles in more concrete ways, while simultaneously helping their home country stay afloat."[13]

What has developed among Salvadoran HTAs is a rivalry for control over infrastructure projects. First, HTAs submit proposals to the government development agency. Then, the government can choose to take a majority stake in the program thereby controlling implementation. By contrast, the Mexican process gives HTAs a larger role in the decision-making process, depending upon the municipality. In Mexico, the federal government seems to feel excluded from the process, especially where local municipalities have started "two-for-one" remittance-matching programs that generally capture controlling shares of projects. With El Salvador's "United for Solidarity" program, approval and control rests more with the state, which selects preferred projects to match funding. With around 200 registered Salvadoran HTAs in the US, it is unclear whether this arrangement is satisfactory to the diaspora. Wielding such collective economic power, albeit less formalized due to lacking external civil society, the Salvadoran diaspora is in a position to leverage concessions from the government for a greater participatory role in remittance programs and possibly the political arena.

Mexican Migrant Community in the US during the late 20th Century

While there is evidence that Mexican political campaigning in the US may have begun over a century ago,[14] the recent spike in immigration to the US and the subsequent realization of mutual interests between the diaspora and Mexican government provides the opportunity to view the dynamic of this relationship as it has evolved in ultimately providing an additional pillar of accountability for the Mexican government and may be the final step in fully consolidating its democracy. Mexico's binational migrant influence works both ways: migrants send remittances to Mexico for relatives; the Mexican government depends upon these remittances and must now factor in this community in their governing decisions, as evidenced by HTA collaboration. Also, the Mexican government seeks to influence US policy in the US to help its diaspora and relies on their diaspora for influencing US policy towards Mexico.

Some might have viewed Vicente Fox handing out phone cards while campaigning in the US during the 2000 elections as a publicity stunt,[15] but upon taking office, he acknowledged the constituency's influence by appointing foreign-born officials to his cabinet and creating a special office to promote the interests of Mexicans abroad, " . . . headed by a Chicano son of immigrants to the United States."[16] With the Fox Administration appointments, the diaspora had a voice within the policy-making mechanism of its home country. This political infiltration may also be possible in El Salvador soon.

It is this Mexican political outreach in the US that may have sparked diaspora empowerment. The initial objective may have been to encourage migrants to contact relatives in Mexico, but allowing Mexicans in the US the right to vote, may have opened a Pandora's box of accountability. While Mexican politicians have tried to keep the diaspora at arm's length, the diaspora has come to expect a closer relationship. The 2005 decision to allow Mexicans abroad to vote by mail has only enhanced the political power of the diaspora.

A survey of diaspora voter registration in the 2006 Mexico Presidential election showed extremely low participation. Out of an estimated 3 million eligible voters in the US, only 56 thousand submitted ballots, and only about 40 thousand counted. While over three-quarters were aware Mexicans abroad would be allowed to vote, only one-fifth were aware of registration deadlines. Significant obstacles and lack of information provided by the Mexican government and the independent electoral commission might also be to blame. The survey also cites the law disproportionately favoring eligibility for younger emigrants.[17]

While the 2006 diaspora voter turnout may indicate the diaspora is not a potent political force yet, it still requires a re-calibration on the part of the government and campaigning candidates. As Fitzgerald notes, "The fact that Mexicans abroad won their political rights, even if only in principle, has permanently redrawn the boundaries of the Mexican immigrant civic arena, with quite open-ended consequences."[18] A month after voting registration began, the Director of the Institute of Mexicans Abroad (a governmental body) preemptively requested that the independent electoral commission launch a media campaign to inform the diaspora of registration deadlines signaling the government's responsiveness to the diaspora.

The Mexican government has also been proactive in reaching out to the diaspora in the US through consular outreach. The government's response to this emigrant community throughout the US involves political, economic and foreign policy objectives. This high level of engagement places the Mexican diaspora model in a different category than the Salvadoran model.

Remittances on the Salvadoran Campaign Trail

Following the Civil War, the Nationalist Republican Alliance (ARENA) party was the dominant force in presidential politics. However, the Farabundo Marti National Liberation Front (FMLN), the political party established by the guerrilla movement after the peace agreement, has since met with notable successes in local and departmental elections and recently won the presidential elections. The level of competition between the two main parties provides a scope by which to view the current diaspora's influence. The diaspora and remittances have become a campaign issue at several key moments, and the recent presidential election in March of 2009 is a real test for the diaspora's power and influence on Salvadoran politics.

El Salvador is so heavily reliant on remittances that it dollarized its economy to prevent an inflationary degradation of purchasing power. The influx of remittance in US dollars entering the country also provides its central bank with the necessary dollar reserves. As a percentage of its GDP, El Salvador has one of the highest remittance levels in the world.[19]

Remittances even became a major campaign issue in 2004, with ARENA candidate Tony Saca declaring that an FMLN victory, might prompt the US to cut off remittances and increase deportation of Salvadorans living in the US.[20] This threat may have helped ensure a Saca victory. The same tactic was used by ARENA to describe a potential victory of the FMLN 2009 candidate and election winner, Mauricio Funes. Much like in Mexico, Salvadoran candidates have traveled to the US to gain political support. Funes traveled to the US as early as December of 2007 to court expatriates. He asserted that an FMLN victory would have no repercussions on remittance flows. This accusation proved to be so damaging for the FMLN in 2004 that Funes sought to address it as early as possible. It is quite telling that Funes was able to demonstrate his position as a moderate throughout the remittance debate, which illustrates not only the importance of remittances to the country, but also the diaspora's influence.

With the transition of power, the debate now shifts towards the quality of democracy and the characteristics of representation. This external population, with its economic contribution and possibility of eventual return to the home country, deserves a stakeholder's role in the future of the country. Representing nearly 20% of El Salvador's population, the diaspora in the US could represent a significant voting block if given the external vote (compared to the Mexican diaspora comprising of less than 10% and already wielding significant influence).[21]

The omission of such a sizable actor that still exerts significant cultural, economic and familial ties, should not be ignored given the rising presence of Latinos in the US and the possibility of establishing a diaspora like the Cuban lobby, which seeks to influence changes in Cuba through US foreign policy lobbying. Just as Fox went from handing out phone cards in the US to formalizing the diaspora clout with cabinet appointments and ultimately the external vote, there will come a time when the Salvadoran government may have to grant similar concessions. As Orozco also notes, "Just as the economic contributions of migrants to their home countries are significant, their participation in the policy debate should make them development stakeholders with voice and authority."[22] Were the Salvadoran and Mexican diasporas denied this role, they might have instead focused their efforts upon directing policy changes by lobbying in the US. A 2005 Los Angeles Times article on the Mexican external vote issue quotes a Mexican HTA project director, "If the [Mexican] Congress wouldn't have approved this, the immigrants would have made them pay a huge price."[23]

The Cuban and American-Israel lobbies offer contrasts for the Mexican and Salvadoran contemporary models in terms of objectives and evolution. Fitzgerald notes that Mexican political leaders have intermittently attempted to create a 'Mexican American lobby,' often explicitly modeled on the American Jewish or Cuban lobbies.[24] As a younger diaspora, the Salvadoran diaspora is drawing lessons from these models as well as the foundations laid by the Mexican diaspora. Home country governments may want a diaspora lobby to form in the US to legitimize their actions, but if diasporas are not given a stakeholder role in policy making, an issue to consider is whether Mexican and Salvadoran communities in the US will decide to abandon the home country political process and exert their influence in the US to reach their desired outcomes and circumventing their home country governments.

Accountability Gaps in Mexico and El Salvador

The FMLN victory in El Salvador may result in an acknowledgement of the diaspora with political appointments and expanded consular outreach, much like what took place in Mexico after the Fox victory. This would signal a diaspora development pattern much like that of Mexicans living in the US. Salvadorans in the US are already asking for the external vote, after gaining the right to return and vote. The new Funes government may prefer to keep Pandora's box closed, but with an upwardly mobile population in the US anxious to participate in the political process, it may have no choice but to expand collaboration and political rights to its diaspora, and ultimately acquiesce to this new pillar of accountability. With several news sources focusing on immigrants returning to El Salvador to vote, the election outcome signals a victory in empowering Salvadorans living in the US. Government figures estimate approximately 40,000 US-based immigrants returned to vote in the elections.[25] With around 4,000,000 registered voters, Funes' margin of victory of 51.3% (2,052,000 votes) gave him an edge of about 100,000 votes. If government estimates of 40,000 diaspora voters are correct, the returning diaspora could have tilted the outcome of the election with an additional 10,000 voters, without even having the external vote.[26] The FMLN's narrow margin of victory in the election only intensifies this diaspora political empowerment.

In Mexico's 2006 presidential elections, Mexicans voters in the US were less than one-half of one percent of the 10 million eligible voters,[27] yet Calderon's small margin of victory will only strengthen campaign efforts to reach the diaspora in the US in future elections. With only a slight improvement in voter turnout, the diaspora could have determined the outcome of the 2006 election. Fox showed foresight in campaigning in the US, but he may have also been a catalyst with his subsequent overtures to Mexicans living in the US. Similarly, as campaigning in the US by Salvadoran candidates intensifies, suggesting this cycle may have also begun in El Salvador. With Funes ensuring remittances flows would not stop, he may have made his first concession to the diaspora.

In El Salvador and Mexico, where migration to the US is an alternative development mechanism, home country governments have a respective need to ensure these capital flows continue and that migrants continue to have an incentive to send remittances for reasons other than altruism. Mexico has already created remittance fund-matching programs and expanded political rights and outreach to its diaspora. The government of El Salvador has not yet reached the same level of involvement with its diaspora, but through alternative channels in the US (think tanks, media, word-of-mouth), its diaspora is fully aware of the incentives and political accountability that can be achieved. The Salvadoran diaspora will continue to attempt to expand its political influence and will ultimately seek a policy making role in its native country.

With such large populations relative to home country populations living abroad and the significant percentage of country GDP reliant on remittances, the lack of access to the political process leaves an accountability gap of an otherwise influential political and economic partner. But in Mexico, where the migrant population in the US enjoys considerable influence, it becomes a matter of what degree of influence and accountability exist and whether the external vote is the ultimate measure to ensure desired outcomes. For the Salvadoran diaspora, there is no mechanism by which to exert direct influence on country governments short of withholding remittances or urging relatives to vote for the opposition. Only until there is a demonstration of this political will, measuring migrant voting patterns or US conditionality based on diaspora lobbying in the US, can home country governments even qualify or quantify the extent of their accountability to their respective diasporas.

The Global Economic Crisis and Remittances

With the recent economic slowdown, developing countries are bracing themselves for the perfect storm of falling foreign aid, export market demand, and declining remittances. Historically, remittances to Mexico and El Salvador have proven resilient in the face of economic slowdown. What distinguishes this economic crisis from others is that it is rooted in developed country integrated financial systems, and marks a parallel slowdown of both developed and developing countries, whereas prior crises, like the Mexican Tequila crisis in 1994, the Asian crisis in 1997 and Russian crisis in 1998 were isolated and expediently resolved in order to prevent contagion. The current economic crisis has originated in the US, and thus affects both remittance-sending immigrant workers and developing world export markets, a double-blow for Mexico and El Salvador given their increased trade with the US due to NAFTA and CAFTA.

Discussions are taking place over the effects of the financial crisis on remittance flows to Mexico and El Salvador, including exchange rate and migration considerations. Recent Mexico data for January 2009 shows a 12% decline in remittance flows from a year prior, suggesting the possibility of a double-digit decrease for 2009.[28] In El Salvador, remittance projections range from a drop of 5% from Manuel Orozco of the Inter-American Dialogue, to 8% fall by the country's outgoing Finance Minister, William Handal. [29] Predicting remittances is an incredibly difficult exercise; one must consider the large numbers of undocumented immigrants and large capital flows in the informal sector, and also look at how diaspora remittances have responded in prior crises and recessions to get an adequate indication.

A 2009 Inter-American Development Bank and the Multilateral Investment Fund report on how the financial crisis will affect remittance flows, explains how migrant workers tend to be more mobile and are more willing to shift to different sectors with higher labor demand during recessions. Migrant worker strategies for coping with a difficult climate to maintain remittance levels can include: "[. . .]reducing the amount of money they spend on themselves, working longer hours or multiple jobs in the face of decreasing wages, shifting sectors because of declines in sectors such as manufacturing and construction, moving to areas with higher labor demand, or even dipping into their savings."[30]

The IDB report also makes an important distinction regarding the role of immigration on remittances by considering migrants in terms of 'stocks' and 'flows.' The stock refers to the diaspora groups living and working in the US, while the flow refers to how migration patterns adjust to economic conditions. Both stocks and flows impact remittance levels, however the stock is what home country governments can gauge to determine sustainable remittance levels. The declining flow of immigration into the US is relevant to remittances, but the established stock of migrants already living and working and how they are affected by the downturn is the more relevant measure in trying to predict remittance flows. If one considers the stock more relevant to remittances than the flow, there is reason to believe the impact on overall remittances may not be as excessive as anticipated.

Another consideration that may lessen some of the negative impact on Mexican remittance is the declining value of the peso against the dollar. Remittance senders tend to respond to exchange rates and increase flows when dollar purchasing power increases.[31] El Salvador cannot benefit from this phenomenon as its economy is dollarized. Another factor that may soften the dual blows is that remittance flows tend to be more stable than other capital flows. But the ultimate indicator for gauging remittance flows will be the performance of the US economy and the length and depth of the current financial crisis, two factors that are largely out of the control of Mexican and Salvadoran governments.

For home country governments this means trying to ensure a steady, reliable flow of remittances, which translates into increased collaboration with their external populations. The establishment of remittance matching programs and working with HTAs in Mexico and El Salvador is very much an attempt to maintain and increase remittance flows. The global economic crisis will make strengthening and increasing immigrant participation in remittance-matching programs a top priority for Mexico and El Salvador. It is in increased collaboration and incentives that the policy-making empowerment of the diaspora will manifest itself.

Home country governments will no doubt be watching their external populations and work to strengthen their organization and collaboration efforts. Whether diasporas are able to mobilize their collective economic efforts is yet to be seen, but Mexico and El Salvador offer examples of how diasporas can translate remittances to the political arena. The economic slowdown will only increase pressure on governments to preserve remittance levels and voluntarily strengthen their diasporas. In countries that lack full political accountability, this is particularly significant, as their institutions are measured against the developed world's institutional apparatus. The pressure to catch up economically will lead to a pressure to converge at the institutional and political level. Mexico and El Salvador are already showing signs of change, with more to undoubtedly follow.

Mexico and El Salvador's diasporas are at an advanced stage of transnational engagement with their governments, but the global economic crisis may prove to be the catalyst that ultimately legitimizes their role as stakeholders in a new Diaspora Consensus. Given that many immigrants from Mexico and El Salvador were driven from their homelands due to conditions of poverty and civil strife, the fact that they now wield such influence, and are gaining more power in their home countries, shows a globalized expansion of the traditional meaning of self-determination as a result of an increasingly globalized world economy.

The following data is based on World Bank Remittance Data and IMF country data.
http://peoplemove.worldbank.org/en/content/remittance-flows-to-developing-countries

Mexico and El Salvador Remittance Levels

Mexico	Remittances (Millions)	GDP (Billions)	Remittances/ GDP (Percent)	GDP Yearly Growth (Percent)	Population
1990	3,098	262710	1.18%	5.068	83.226
1991	3,030	314507	0.96%	4.222	84.793
1992	3,700	363661	1.02%	3.629	86.369
1993	3,979	441777	0.90%	1.951	87.954
1994	4,122	462023	0.89%	4.415	89.546
1995	4,368	314115	1.39%	-6.167	91.145
1996	4,949	364720	1.36%	5.153	92.571
1997	5,546	434230	1.28%	6.772	93.926
1998	6,501	455589	1.43%	4.907	95.251
1999	6,649	520445	1.28%	3.873	96.584
2000	7,525	628854	1.20%	6.602	97.966
2001	10,146	672823	1.51%	-0.157	98.994
2002	11,029	702022	1.57%	0.827	100.002
2003	16,556	700324	2.36%	1.684	101.021
2004	19,861	759422	2.62%	3.996	102.05
2005	23,062	846990	2.72%	3.13	103.089
2006	26,877	948861	2.83%	4.906	104.221
2007	27,144	1,022,816.00	2.65%	3.199	105.264
2008	26,212	1,142,629.00	2.29%	2.051	106.316

El Salvador	Remittances (Millions)	GDP (Millions)	Remittances/ GDP (Percent)	GDP Yearly Growth (Percent)	Population
1990	366	4,801	7.62%	4.83	5.11
1991	475	5,311	8.94%	3.58	5.207
1992	694	5955	11.65%	7.55	5.314
1993	796	6938	11.47%	7.37	5.429
1994	972	8086	12.02%	6.05	5.548
1995	1,064	9500	11.20%	6.40	5.669
1996	1,084	10316	10.51%	1.71	5.787
1997	1,199	11135	10.77%	4.25	5.908
1998	1,340	12008	11.16%	3.75	6.031
1999	1,387	12465	11.13%	3.45	6.154
2000	1,765	13134	13.44%	2.15	6.276
2001	1,926	13813	13.94%	1.71	6.397
2002	1,953	14307	13.65%	2.34	6.518
2003	2,122	15047	14.10%	2.30	6.639
2004	2,564	15798	16.23%	1.85	6.765
2005	3,030	17070	17.75%	3.09	6.887
2006	3,485	18654	18.68%	4.18	7.011
2007	3,711	20373	18.22%	4.65	7.13
2008	3,804	22284	17.07%	3.00	7.251

NOTES

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25 "Tense El Salvador Election Evokes War Memories" *Reuters* March 15, 2009.

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Increased Government Intervention and Halted Democracies

Tomoyuki Hashimoto

It has become a cliché to say that there are many forms of democracies: instead, we ask if a policy is "democratic." With the onset of increasing economic difficulty, governments intervene in otherwise free markets. Voters tolerate corruption when rural development is secured through it. Civil rights have been restricted due to possible harm of the national economy. This essay temporarily defends such incidents from the accusation of being "undemocratic," for such policies are often believed to be necessary to strengthen a democracy in the long run. After all, our model of democracy is not the only model of democracy, nor is it always the best for them.

It is Economics 101 that the world suffers when the American economy declines, but it requires a bit of imagination to foresee how other governments will react to situations on the ground. Not all governments have hired advanced economists, and even if they have, those economists can politicize financial and economic matters as if they were in a Machiavellian world. If liberal democracy is fated to advance hand in hand with free market capitalism, politicized and neglected macroeconomics will result in the halting of democratization. Today even America, the world's leading democracy in most people's eyes, is increasing government intervention in the private sector, contrary to the principles of free market economics; the same is expected

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in other parts of the world. This short study, therefore, highlights the paradigm of contemporary economics and politics, in which "free market capitalism" and "liberal democracy" are diametrically opposed to "recentralization of the economy" and "corruption" (see the diagram below). In this paradigm, "free market capitalism" is an economic system in which any transactions are based on the mutual consent of economic actors (e.g., buyers and sellers). "Liberal democracy" is often understood as a form of constitutional democracy in which citizens' rights and freedoms are protected from authorities. The term "re-"centralization is preferred in "recentralization of the economy" because this paper mainly deals with countries which have experienced democratization, hence "de-"centralization of the economy. "Corruption" is the dysfunction of any political or economic activities associated with illegitimate personal gains for participants of the action.

Free Market Capitalism	"Democratic"	Liberal Democracy
VS		VS
Recentralization of the Economy	"Undemocratic"	Corruption

[Theoretical paradigm of this paper]

This paper primarily argues against the automatic bipolarization in the paradigm, and defends several incidents in the latter category from the accusation of being "undemocratic." Both "recentralization of the economy" and "corruption" suspend liberal democracy, and thus are inherently "undemocratic" for many of us. Nonetheless, this essay hypothesizes that such "undemocratic" policies can strengthen a "different type of democracy" in the long run, as long as the country-in-question retains popular approval for those policies. In this "different type of democracy," governments may increase control over critical resources in the face of economic crises, contrary to what the International Monetary Fund suggests; or they may tolerate a small degree of corruption so that a corrupt but locally influential politician can be a moderator between the central government and rural voters in conflicts over rural development. Strictly speaking, those characteristics are not characteristics of liberal democracy, and we do not observe them in the US—thus, they are not characteristics of American democracy.

After all, the priority of concerns given to the range of issues are different in each political culture, and thus a democratic government deals with these issues according to the priority indicated by voters. Therefore, while the government-in-question is democratic in principle, the emphasis (or intention) of policies are different from government to government and the values of each policy are not necessarily shared by all democratic societies in the world. In this regard, the following analysis draws examples from Taiwan, South Korea, and Japan, where both free market capitalism and liberal democracy are practiced, and where their values on policies seem to differ from that of the US.

Democracy and priority of issues

If "democracy" only means a political mechanism that reflects peoples' (or more precisely, the majority's) opinions on policies, even a coup d'etat with popular support can be "democratic." Socrates or Henry David Thoreau would emphasize that the majority rule exists not because they are *just* but because they are *strong*. Hence, the question of democracy today is how to mediate the differences in opinion among its citizens, as well as among different societies. In the current democratic system, citizens elect their representatives according to the issues that primarily concern them. Yet, only those supported by the majority have the power to set society's agenda for upcoming policies. Hence, a priority is given to a range of issues unique to each society: an issue that concerns Americans may not be an issue at all in other countries. Are there any issues, then, which all democratic societies *must* be concerned about?

For example, it was not in some dictatorial nation, but in democratic South Korea where civil rights seem to have been suspended with the rhetoric of "economic recovery." According to news reports,[1] a South Korean national who has been commenting on economic issues on the Internet was arrested because his writings damaged the government's "reputation" in the world financial market. His false information regarding the Korean national currency has cost the South Korean government nearly two billion dollars. At the same time, both in and outside of South Korea, media and intellectuals rushed to question Seoul's overreaction.[2] Does the government have the right to infringe upon civil rights in the face of (possible) national economic loss? The US or Europe seems to answer negatively.

Nonetheless, we must acknowledge that the government of South Korea intended to protect the national currency by eliminating false information on the currency market. The arrest was by no means to regulate the freedom to criticize the national economic and financial policies, as no other arrest similar to the case above has occurred (as of March 2009). On the contrary, by protecting the national currency, South Korea remains as a part of the worldwide free market. A free market provides citizens equal opportunities and thus strengthens their political independence from the central government. This independence is an essential factor for democracy. Therefore, South Korea indirectly strengthened democracy through the chain mechanism of "the national currency"—"a free market"—"political independence"—"democracy." How can we call this government "undemocratic" when their policies are believed to strengthen democracy in the long run?

This incident was indeed an "undemocratic" policy, but the government does not seem to be "undemocratic." Voters in South Korea, in fact, have a high degree of concern over their national economy in the face of the current worldwide financial crisis. Economic recovery becomes the highest priority not only in South Korea but also in many other countries, while other issues such as freedom of speech, such as in the previous incident, are temporarily forgotten, so to speak, from the mind of policy makers. Keeping this question of "priority of issues" in mind, the following sections will analyze first "recentralization of the economy," then "corruption."

Recentralization of the economy

A free market economy values efficiency and productivity while it encourages entrepreneurship. Simultaneously, liberal democracy guarantees each citizen fair and equal opportunities with respected civil rights. These two concepts—free market capitalism and liberal democracy—are developed (or designed) to enhance each other, and thus, a *free market liberal democracy* becomes a textbook scenario for developing countries.[3] On the other hand, a recentralized economy loses (at least in this textbook of development) economic efficiency as scarce resources are not well allocated to maximize productivity, and it discourages entrepreneurship through numerous regulations. Furthermore, Machiavellians in the government frequently use such *financial* and *economic* regulations against opposition parties, undermining the democratic political system.

One missing point in the above argument, however, is that entrepreneurship tends to grow in the service and the industrial sectors rather than the agricultural sector. Thus, one of the benefits of a free market economy, the encouragement towards entrepreneurship, is seldom understood in *politically* agricultural societies. In the countries where industries are concentrated in only a few cities, such as South Korea, Taiwan, and Japan, agricultural rural voters have rather disproportional representation in national politics. Such voters seek heavier agricultural subsidies and deeper protectionism, not freedom of entrepreneurship, and hence, recentralization of the economy becomes a reasonable choice. Free market capitalism, therefore, is not necessarily shared among democratic voters in those political cultures.

Furthermore, in those Eastern Asian nations, recentralized economies are believed to be less vulnerable to economic crises. Comparing historically and sociopolitically similar South Korea and Taiwan, Heo and Tan (2003) argue:

> Unlike the South Korean state in the late 1990s, the Taiwanese state's control of critical resources coupled with a political economy characterized by *dispersed and weak interest group structures* allowed the autonomous economic technocracy in Taiwan to adopt tough pre-crisis and post-crisis policies to maintain Taiwan's economic viability. Due to these differences in the institutional capabilities, we saw the effect of the variations in the industrial structure, the pace and nature of market liberalization, and the nature of capital financing in contributing to the differential impact of the financial crisis [emphases added].[4]

The people's tolerance towards recentralization of the economy partly comes from "dispersed and weak interest group structures" which the US will never be able to possess. In the US, where lobbyists influence economic decisions in Washington, strong federal control over critical resources would result in political resistance and disturbance. In Taiwan, however, control over those resources by the central government is believed to have enhanced its immunity against economic and financial crises. Since Taiwan suffered less than other Asian nations during the 1997–8 crisis, then President Lee Teng-Hui obtained continuous popular support for his "economic" leadership. In this regard, recentralization of the economy during crises becomes a norm or a regular procedure, in which a successful result promises political stability. Of course, this stabilized political system can be democratic as long as the leaders are elected through free elections.

Surely, not all citizens are informed of the essence of, and connection between, free market capitalism and liberal democracy. Non-economist voters "underestimate the wisdom of the market mechanism, distrust foreigners, undervalue the benefits of conserving labor, and pessimistically believe the economy is going from bad to worse."[5] In the face of economic crises, voters with these biases seek protectionism and rather centralist fiscal policies. Politicians who share (or who act as if they share) such preferences to centralist policies become popular in elections and only a few of them have tried to inform their voters about these biases. Convincing voters of these biases is particularly hard in East Asia. After all, Asia is full of countries in which centralist economies performed well beyond expectation. The common belief that decentralized political and fiscal systems bring superior economic growth lacks confidence in the face of so-called "catch-up" factors.[6] Any inefficient and unproductive economy can grow without decentralization through more effective and productive micromanagement.

In the case of Taiwan, President Lee himself was also a reason why his recentralization of the economy was not regarded as "undemocratic" by the Taiwanese people. In the late 1990s, Lee advanced Taiwan's democratization by reforming the political system, including the direct election of his position, the president. Prior to this reform, the president was elected by the National Assembly without a popular vote. In fact, Lee himself was elected by the Assembly in 1988 after the death of President Chian Ching-Kuo. A few years after Lee took office, the people of Taiwan, especially the younger generation who were born on the island, started to demand more democratic political structures (the so-called Wild-Lily Student Movement).

Lee responded to such demands for democratization in 1996 with the series of electoral reforms. Simultaneously, the People's Republic of China (PRC) carried out several missile exercises over the Taiwan Strait to pressure the nationalist movement of Taiwan. Helped by the rise of reactionary nationalism, Lee won the presidential election by a simple majority, and the PRC began normalization negotiations with the Lee administration in the following year.[7] Thus, Lee was regarded as a true democratic reformer and the father of the Taiwanese independence movement among the young native Taiwanese. It was this political characterization of Lee that distanced him from the criticism that his economic recentralization was "undemocratic." Therefore, not all forms of economic recentralization can escape criticisms of being "undemocratic" from domestic voters.

Corruption

Of course, not all voter-supported policies will strengthen a democracy. Voters who are concerned primarily with economic recovery during a crisis demand results rather than processes or styles, and preference towards recentralization of the economy is one phenomenon. Hence, public expenditure projects increase productivity (and efficiency to a lesser extent)[8] *in theory*—leaving the door open for corruption. Officials can distribute public expenditure projects in exchange for political support, or vice versa, influential businesses promise political support in exchange for public projects to their companies. Even the "autonomous economic" technocrats mentioned in Heo and Tan (2003) above can be motivated by personal political gains through pre-crisis and post-crisis policies, rather than solve national economic problems. Corruption is any practice against fairness and equality, and thus it is the opposite of liberal democracy.

Nevertheless, the answer to the question whether or not corruption helps political development (towards democracies) is surprisingly optimistic. John Girling summarizes: "that corruption in a number of cases failed to pervert society—even if it perverted politicians—is attributable, rather, to normative strength everywhere: personal moral obligations and effective voluntary associations are examples."[9] Regardless of the risk of impeachment and imprisonment, those who do not share our cost-benefit analysis commit corruption anyways—hence, corruption survives. Yet, in a democratic society, a collective political will restores democracy by electing new uncorrupted leaders. Post-corruption elections are, in this regard, a step towards the moral realm of politics, even though corruption itself is undemocratic.

On the other hand, in many cases, corruption promotes rural economic development, and corrupt politicians are continuously reelected to the parliament as the "voice of the rural area." Joseph Nye visualizes such "positive" elements in economic terms—capital formation in rural areas, including incentives to entrepreneurs. At the same time, however, there is no guarantee that such rural economic developments are *nationally* beneficial, and hidden corrupt fees are on the shoulder of citizens, mainly from urban areas. As the cost of such unbalanced developments spread evenly nation-wide, the *individual* cost is too little to take actions against corruption. Moreover, the entrepreneurs which Nye points out are less likely to appear in recentralized economies. Due to the control over critical resources in a recentralized economy, it is hard to start any businesses, particularly if one opposes the government. Political freedom is therefore undermined as a cost of entrepreneurship in such an economic environment.

Besides those *political* costs, Nye foresees the *economic* costs of corruption in the following three points: capital outflow, unbalanced investment, and wasted resources.[10] First, like former Prime Minister Thaksin of Thailand who purchased the Manchester City Football Club, a large sum of personal capital gains from corruption tends to flow outward to deter domestic investigation. Customer-friendly Swiss banks are also destinations for such dirty capital. Second, due to the ease with which corrupt fees can be hidden, public investments are often concentrated into certain sectors, such as construction. For ordinary citizens, it is hard to estimate the costs of railroads, while it is relatively easier to recognize if an ashtray costs ten times more than usual. Finally, anti-corruption resources, both capital and labor, are wasted as long as corruption is tolerated. A non-independent judicial branch is also part of this category.

Japan, therefore, is a curious case. Japan is undoubtedly democratic by its political structure. Yet corruption is rampant and those accused of corruption are often re-elected after a short period of silence. Under the Kakuei Tanaka administration (1972–74), numerous construction projects were launched throughout Japan. Some enhanced capital endowment and some wasted millions of dollars. A gorgeous marble bridge named after Tanaka in the middle of rice fields is an example of the latter. Tanaka was arrested on corruption charges in 1976 ("Lockheed Bribery Scandal"). Yet, Tanaka won with a wide margin in both the election of 1976 following his arrest, and of 1983 following the court judgment of "guilty." Local voters who supported Tanaka preferred visible local developments to invisible political morality, even though the preference was dissimilar nationwide.

While it is dangerous to generalize, there are at least a few cases where corruption helped a national economy. The Gifu-Hashima station of the Japanese super-express "Shinkansen" railway is one. Among many Japanese, it is believed that an influential politician, Banboku Ono,[11] invited the construction of this station in the middle of rice fields near his house for his own convenience. Allegedly, he cried out to the Japanese National Railway (JNR) representatives: "Where do you want me to get off [from the super-express]?" However, later research revealed a different story.[12] Due to heavy snow in the Gifu region, the JNR was already planning the construction of a station in this area prior to Ono's intervention. At the same time, the governor and the local parliament of the Gifu Province were protesting the JNR because the planned super-express would not go through the provincial capital, Gifu city. The JNR explained that this super-express was intended to connect two megalopolises, Nagoya and Osaka, and thus largely detouring to Gifu city was uneconomical. In response, the governor and locals in Gifu physically prevented further construction and maintenance of the super-express and asked Ono to arbitrate. In the negotiation, Ono acted as if he ordered the construction of a super-express station within the Gifu Prefecture in exchange for a "compromise" not to detour entirely to Gifu city; the JNR accepted. Feeling a sense of superiority over the JNR, Gifu locals calmed down, and the Gifu-Hashima station was built as it was originally planned by the JNR.

In this episode, Ono, who had been viewed as corrupt by many Japanese, actually acted this way to smooth the situation. Ono is likely to have received some amount of money for this arbitration. Yet, because of his effort, the JNR (then a public company) did not unnecessarily spend tax-payers' money on the unproductive project (detouring the super-express line to Gifu city). Locally, the Gifu Prefecture obtained a super-express station which attracts private capital even now. The arbitration fee (or some may call it "the corruption fee") to Ono, if any, would have been a far less amount than what the Japanese government would have lost if the super-express detoured to Gifu city. Moreover, without Ono, the

JNR was unlikely to advance the super-express project. Total economic calculations seem to be positive on the whole, and there is no discrimination in terms of economic gains. Is this "undemocratic"? Is this "corrupt democracy"? As far as Ono is concerned, voters of the Gifu region enthusiastically kept their support until his retirement.

What is "(un)democratic"?

Observing the trends above in Asian nations, while the term "undemocratic" seems to fit in this context, we must keep in mind that there is no such thing as *the* democracy except for a few fundamental elements.[13] Since the time of ancient Greece, mankind has tried to establish the formula for democracy, yet we have never reached the perfect conclusion. This is an inherent problem around the idea of "democracy" because a democratic system always refers to people, and people's preferences and priorities change over time. Yet, if a democracy is a political system whose policies reflect the demands of its citizens, each democracy can take a different form suitable to each political culture. On the other hand, US (and European, to a lesser extent) officials seem to anticipate that liberal democracy *must* be supported by free market economy with less government intervention. Any policies against the above value system are labeled "undemocratic." If the basis of American foreign policy strategy[14] is inheriting such an assumption of *the* democracy, the American-aided effort of democratization in the various parts of the world loses theoretical coherence of "democracy" (i.e., reflecting the local people's opinions), hence legitimacy. Therefore, this essay has argued that increased government intervention halts the American model of democracy (i.e., free market liberal democracy)[15], but it *can* preserve different kinds of democra*cies* (such as political democracy with a recentralized economy in a crisis, and/or with what we call "corruption"), in which local people determine the future of the nation by themselves. Of course, the author has no intention of claiming the fall of "free market democracy," nor generalizing the "undemocratic" local incidents as "democratic" all over the world. Rather, the author argues that the flexibility to adapt voter's demands into policies is the key for preserving *their* democracies, even though contemporary policies are "undemocratic" in *our* eyes.

"Undemocratic" methods of governance, such as recentralization of the economy and corruption, cannot be fully understood by the cost-benefit analysis derived from American politics. Even though those policies halt *our* democracy, many voters in the country-in-question tolerate those policies especially when economic recovery and development are involved. However, change is inevitable. The long-lasting reign of the Liberal Democratic Party in Japan (since 1955) was broken in 1993 by the coalition led by Morihiro Hosokawa. Japanese voters who tolerate corruption in general were finally fed up and hoped for change. Prime Minister Thaksin of Thailand is most likely to be arrested as soon as he returns to Thailand. South Korean as well as Taiwanese high prosecutors' offices have launched a long-lasting anti-corruption campaign against past and even current political leaders. All of those countries, therefore, are "democratic," because the switch of leadership was conducted according to democratic procedures when voters demanded.

Therefore, the automatic bipolarization of "democratic" and "undemocratic" has little to do with the assessment of democratization when people have a disagreement over what "democracy" is. Throughout this paper, the author emphasizes the intentions of policies in addition to their styles and outcomes. Not external observers, but voters within the political system should decide what "democracy" is for them. If outsiders believe that their choice is not acceptable, those outsiders can suggest that insiders should change their political system, but they cannot force it.

NOTES

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2 Pesek, W. (2009) "'LeeMan Brothers' Offer No Panacea for Economy." *Bloomsberg*. [Online] January 26. Available at: http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_pesek&sid=aEx7JaA9KhAs (Accessed: January 27, 2009).

3 Some scholars have been arguing that free market capitalism promotes unequal distribution of wealth along ethnic lines, which causes political instability. See Chua, A. (2003) *World on Fire: How Exporting Free Market Democracy Breeds Ethnic Hatred and Global Instability*. New York: Doubleday.

4 Heo, U. & A. Tan. (2003) "Political Choices and Economic Outcomes: A Perspective on the Differential Impact of the Financial Crisis on South Korea and Taiwan." *Comparative Political Studies*. 36 (6), pp. 679–698.

5 Caplan, B. (2007) *The Myth of the Rational Voter: Why Democracies Choose Bad Policies*. Princeton: Princeton University Press.

6 Castles, F. (2000) "Federalism, fiscal decentralization and economic performance." In Wachendorfer-Schmidt, U. (ed) *Federalism and Political Performance*. London: Routledge.

7 Lin, G. "China's Relations with Taiwan in Retrospect." In J. Cheng. (ed) *China Review 1998*. Hong Kong: Chinese University Press. pp. 187–208.

8 Bealey, F. (2001) *Power in Business and the State: An Historical Analysis of its Concentration*. London: Routledge.

9 Girling, J. (1997) *Corruption, Capitalism and Democracy*. London: Routledge.

10 Nye, J. (2002) "Corruption and Political Development: A Cost-Benefit Analysis." In A. Heiden-

heimer & M. Johnston. (eds) *Political Corruption: Concepts and Contexts*. New Brunswick: Transaction.

11 It is read "Ono" with the long "o" at the beginning, sounding like "Oono."

12 Sankei Shinbun (newspaper). (1999) *Sengo-shi Kaihu (Revealing Post-war History)*. Tokyo: Huso-shya.

13 For theoretical understanding of democracies, see Dahl, A. (2000) *On Democracy*. New Haven: Yale University Press, and Held, D. (2008) *Models of Democracy*. Stanford: Stanford University Press.

14 The author emphasizes on American foreign policy to those with democracy-in-progress.

15 Some may argue that there were the elements of "recentralization of the economy" and "corruption" in Lyndon Johnson's "Great Society" or F. D. Roosevelt's "New Deal." The comparison what the author intends to make in this paper is not the comparison between the *realities* of "democracy" in America and in Asia, but rather between the *ideas* of "democracy" proposed by America and perceived by Asia.

Comparative Cultural Economics Offers Insights into the Current Crisis of Capitalism: Path Dependencies and Anti-Capitalism at Work

Patricia Commun

This paper intends to show how Comparative Cultural Economics help to understand more about the path dependencies that affect economic agents in case of brutal and severe economic downturns such as the current one. Policymakers tend then to get back to former economic models experienced as successful in the past or mainly try to avoid already experienced dangers. The actual spreading of anti-capitalist behavior in the economic and political elite itself and of deeply rooted anti-capitalist violence by the victims of the downturn is one more sign that the current economic downturn also entails a strong psychological and cultural dimension. This thesis is illustrated by short examples from France, Germany, the UK and the USA.

What has recently been referred to as a vast comeback of state regulated capitalism could also be considered a totally uncoordinated panic reaction among various Western countries, each remaining faithful to its past experiences, economic systems and intellectual mainstreams. Experiences and intellectual beliefs constitute a "shared framework of mental models that groups of individuals

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possess that provide both an interpretation of the environment and a prescription as to how the environment should be structured."[1] These are so called "path dependencies." In situations of major stress, such as the current financial turmoil, policymakers are often compelled to act on the basis of intellectual and cultural traditions deeply rooted in history. To illustrate this, it is important to look at comparative examples taken from French, German, British and American crisis management policies over the last few months.

Coming back to former successful economic models might be a serious temptation as well. After the Center on Capitalism and Society's 2009 conference in New York, Nobel Prize Winner Edmund Phelps presented proposals to the British Prime Minister Gordon Brown strongly resembling the neo-liberal and ordo-liberal principles on which the American Free Market Economy and German Social Market Economy based their post-WWII reconstruction.

Refounding Western capitalism might also suppose a better understanding of the anti-capitalistic forces (like risk aversion and lack of confidence) that influence and could partly explain the general decline of Western economies. Cultural Economics can shed a certain amount of light on the extent to which and reasons why these forces have been at work in the very heart of financial capitalism.

Economic policies as path dependencies in Europe

The French government issued guaranteed debt for French banks[2] but did not consider any further financial steps. This seems to reflect a return to the country's traditional interventionist policies though the government remains reluctant to initiative more radical measures like a general rescue plan.[3] Public investments in infrastructure renewal have been launched but had already been planned prior to the current economic crisis. There have been several pragmatic, short-term measures designed to encourage banks to lend to medium-sized businesses and to bolster the car industry. And although the most recent measure was strongly criticized by France's European partners as being "protectionist," it simply follows France's long history of supporting its car industry.[4] The main political debate in March 2009 focuses on shareholder value, suppression of stock options, tax havens, and so forth. All of these issues have piqued controversy in recent years not only by left-wing intellectuals but also by prominent financial experts who appear to defend the old banking system.[5] The rise of Private Equity as competition to traditional banks has actually fueled anti-capitalistic criticism, even among the "elite."[6] Generally speaking, there is condemnation the system of shareholder value rather than the stakeholder value. They miss the time of "intermediate capitalism" where investors were satisfied with modest and long-term returns on equity and where banks were valuable and trustworthy partners for both the state and industry. As a consequence of this very sensitive atmosphere, companies now have to address both the shareholders and public opinion whenever they publish any report. They must face not only the financial crisis and the international market crisis but also a homegrown, infuriated, anti-capitalistic political atmosphere that condemns all signs of long despised inequality and social injustice.[7]

The current French economic policy backs the fundamental thesis of the regulation scholars who analyze the market forces as sociologists and deny the market any ability to rationally allocate resources. The idea of "stakeholder value," which is very fashionable these days, was originally developed by the Regulation School in France.[8] "Laisser-faire" capitalism and liberalism are publicly condemned today, just as they were in the 1930s, accused of being the source of all deregulation problems in the last ten years.

French management of the financial crisis is mainly a political reaction to the deep social frustration fed by the economic downturn. It clearly demonstrates a rush to find scapegoats (stock options, tax havens, etc.) and a quick response to the vast anti-capitalistic movement[9] that could threaten the country's social and political stability. It is framed through the still very vivid French intellectual tradition of neo-Marxist anti-capitalism and an even longer and deeper-rooted state interventionism. But it falls short of dealing efficiently with the financial and economic crisis itself.

Germany's Chancellor Angela Merkel initially seemed reluctant to back any French-led European rescue plan, for both financial and political reasons. Instead, the German government took advantage of the economic turmoil to try to get back to its old "Deutschland AG model,"[10] encouraging a big intra-German consolidation wave of major commercial banks (like Dresdner Bank and Commerzbank) and of regional *Länderbanken*, rather than a Europe-wide or global consolidation movement.

The German government has also made significant efforts to rescue German banks. Berlin has given German banks the chance to issue bonds with state guarantees. While several banks including Commerzbank have used such guarantees, the continued turmoil in the sector has led to calls for the support to be extended to five years in order to be more effective. This, however, raises the issue of market distortion.[11] Moreover, the German chancellor's cabinet recently agreed to change the country's bailout law. The government will now be allowed to expropriate shareholders of a bank that receives state aid. This is not meant to be a new rule which is systematically applied but rather to open up the possibility of nationalizing the major German mortgage lender Hypo Real Estate which received about €102 billion in state aid over the past three months. A second acquisition through a foreign bank, like Unicredito acquiring Hypovereinsbank, should be avoided since one of the expropriated shareholders is a Private Equity Group, J.C. Flowers in New York, which happens to own 34% of HRE.[12]

This expropriation of a Private Equity Group (PEG) has to be seen in the context of the fight against certain hedge funds and private equity funds which were considered as "locusts" (i.e., evil speculators) by a few social-democrat and even Christian-democrat policymakers a couple of years ago.[13] Until recently, primarily Anglo-Saxon private equity companies successfully financed, restructured and internationalized a considerable number of medium-sized companies in Germany. But there was little acceptance of demanding shareholders who imposed high returns on equity. The crisis seems to be feeding hopes of eliminating some of them. German companies may have a different position from the German government regarding foreign investors. Daimler Benz, for example, was happy to find a sovereign fund in Abu Dhabi to provide about 9% of its capital and cooperate in research for a new electric engine.

Last but not least, German policymakers are very afraid to fall back into hyperinflation, which they experienced in the 1920s. This was a terrible trauma. It ruined not only their economy but also their young democracy. For a vast majority of German policymakers, democracy is linked to welfare, as President Horst Köhler recently reiterated.[14] They are therefore very reluctant to deepen their state deficit (often considered a key cause of inflation). This is why they do not address American priorities to "do more" against the crisis and continue to focus on balancing their budgets. In addition, the Maastricht rules limiting budget deficit and creating a strong independent European Central Bank to prevent inflation were inspired by German neo-liberalism (also called ordo-liberalism). The main statutes of the European Central Bank are inspired by Germany's historically-rooted inflation phobia.

American Deflation Phobia and UK Fear of Bank Run

In contrast to the German inflation phobia, Americans tend to fear deflation. For years, Ben Bernanke, chairman of the Federal Reserve Bank, reflected on the Great Depression and came to the conclusion that credit crunch might lead to deflation and in turn to a depression.[15] This is why he continuously tried to bring more liquidity to the market. The dramatic experience of deflation during the Great Depression might strongly influence American economic policy as well.

Today, the constantly growing public and private debt in the US has reached amounts representing more than three times the GDP (i.e., double the levels found at the time of the 1929 Wall Street stock market crash). But the consequences of the deflation phobia might be the makings of the next bubble (i.e., the state debt bubble). And when it bursts, it could provoke devastating inflation in America with incalculable repercussions affecting the monetary equilibrium worldwide.

In a long-term perspective, similar trends hold true for the other Western countries. The recapitalization of the UK's quasi-nationalized banks will also prove very costly to the English taxpayer, as combined assets of the five biggest UK banks represent 400% of the UK's GDP. A mere 1% recapitalization of the sector would cost 4% of the UK's GDP, not to mention a 5% recapitalization of the system which would cost 20% of the GDP.[16]

Again, the quasi-nationalization of the UK banking system partly resulted from a path dependency: the fear of bank runs that used to happen in the 1930s and recently occurred with Northern Rock.

Therefore, state regulated capitalism at work everywhere through path dependency, might be less of a threat for capitalism than for the states themselves. Ireland, for instance, might default on its soaring national debts. Pledges made by Ireland to support its banking sector amount to 220% of the country's annual economic output. The total loans held by Irish banks are more than 11 times the size of the Irish economy.[17]

If a series of state insolvencies took place in Europe,[18] insolvent states might be forced out of the Euro Zone and would then have to come back to strongly devaluated national currencies. Hyperinflation would then become the definitive temptation for getting rid of the state's debts, socializing the losses by ruining capital owners and impoverishing the entire population.

After apparently having stopped the danger of a systemic melt down of the banking system (for now), current economic policies in major Western countries openly refer to past dramatic experiences related to the Great Depression. As does the chairman of the IMF, French socialist Dominique Strauss Kahn. On the one hand, this historical reference confirms that policymakers identify the current financial turmoil as much more serious than a cyclical downturn or a classical asset price correction. The problem is that the two largest Western economies (i.e., The United States and Germany) experienced opposite dramatic situations in the past and therefore developed opposite phobias: one taking strong measures to avoid deflation, the other trying to curb state deficit in order to avoid the risk of inflation at any price.[19] A common economic policy would supposedly overcome path dependencies in order to be open to more precise current studies by economists and bank analysts. Otherwise, countries might be reduced to political measures against commonly defined scapegoats (like tax havens and stock options here, or short selling and private equity there) or broad reflections about regulations, rather than tackling the currently rather acute problem: the still unresolved banking crisis spreading and the still worsening economic turmoil it creates.

More Path Dependencies in the American Economic Policy

European governments currently seem to forget about the bank crisis, focusing instead on fixing the social consequences of the economic downturn. As previously noted, intellectuals and policymakers see the crisis as a good opportunity to reform capitalism.

Far from the speculations about capitalism's refounding, current Treasury Secretary Timothy Geithner is desperately trying to restore confidence and liquidity in the financial system by helping the banks to get the toxic loans off their balance sheets. The technical content of this plan should not be discussed here. However, the path dependency of this special measure is worth noting. It seems to be a remake of a formula, which was successfully adopted 15 years ago by the Resolution Trust Corporation, the body that resolved the Savings and Loan Crisis between 1986 and 1992.[20] Geithner's plan appealing to the forces of the market, supposes therefore that this crisis might have to be managed like one of the numerous "bubbles" which burst in the last twenty years.[21] Many "classical" liberal economists in the US used to consider bubbles and crises as part of the financial capitalism system's endogenous instability. Most of them even consider market forces to be able to clear up the crisis before coming back to stability.

But this financial turmoil is nothing comparable to the bubble crises from the previous years. First of all, the housing market crisis, the so-called subprime crisis, is one of the many asset market crises which produced a thus far unknown amount of toxic assets. The derivatives crisis is potentially endangering millions of pensions and deposits since the trading activities of investment banks have been collateralized by the insured deposits of the retail banks after repeal of the Glass-Steagall legislation in 1999. This is why the American government had to save a major insurance company like AIG. The market forces seem unable to work properly now, with central banks substituting for the inter-banking market. Finally, the American banks seem unwilling to clean up their balance sheets and therefore face potentially numerous insolvency cases. American and other Western financial institutions are badly damaged indeed, but seem reluctant to be cured.[22]

This crisis can no longer be characterized as a price asset correction or a bubble bursting, as Treasury Secretary Tim Geithner tries to see it, relying on previous US experiences instead of a fresh perspective on today's unique reality. It is a major systemic crisis that could harshly affect all Western economies for many years.[23] This is the reason why Geithner's plan might be quite unable to stop the financial turmoil. This is also why financial capitalism is now being questioned all around the world.

Heading Toward a Better-Controlled Financial Capitalism?

In preparation for the next G20 international summit, Sir Edmund Phelps, winner of the 2006 Nobel Memorial Prize in Economic Sciences, summarized the 6th Annual Conference of the Center on Capitalism and Society focused on "Emerging from the Financial Crisis." He recently addressed a long public letter to British Prime Minister Gordon Brown that has even been published in the German Handelsblatt.

One of the main criticisms of classical liberal market concepts expressed in this letter strongly resembles the numerous anti-liberal pamphlets printed in Germany back in the 1930s: "the belief that markets are self-correcting and hence should be left to their own devices, was a misconception."[24] Moreover, the criticisms of "oligopolistic" rating agencies and the "diversified conglomerate structure of the financial services industry producing extreme speculative excesses" call to mind the anti-monopolistic criticisms expressed by the German neo-liberal school, the so called ordo-liberal school, and more particularly those made by Walter Eucken in the 1930s.[25]

Lastly, the goal is supposed to now be "the creation of a new class of banks with the aim of reorienting the financial sector as to serve the business sector to finance long term investment and innovative projects by business firms." Phelps brought the concept of "narrow banks" financing the real economy. These banks would ensure "that consumers and employment creating small and medium enterprises are adequately financed and can contribute to the reactivation of the economy." Restoration of prosperity would require restoration of aggregate investment activity that should be controlled in terms of size and mainly industrial investment.

This is exactly what the German intermediate banking system was doing for years after World War II. The numerous Sparkassen and Länderbanken, Mittelstandsbanken were financing the German middle sized industry until worldwide financial competition and home made losses following the German Reunification pushed it into a deep crisis.[26] Such a banking program might positively address the European and especially German policymakers who are desperately trying to rebuild their national industry-oriented banking system. But it somewhat ignores the reality of growing worldwide competition in the finance industry. "Narrow banks" or Mittelstandsbanken might be competing with worldwide operating sovereign funds from emerging countries that happen to finance more and more German middle-sized companies.[27] In a fully globalized economy, banks need to become profitable again. Getting back to smaller banking systems might be a nice reminder of the good ol' days when intermediate banking was still successful, but it is a dangerous illusion in a global economy.

Aversion to Risk and Lack of Confidence Are Now the Main Defaults in Western Financial Capitalism

"Shock-and-propagation approaches" are used by banking crisis analysts who try to understand the way the financial crisis spread and continues to do so. In contrast to the current general criticism of deregulation, they recently came to the conclusion that deregulation cannot be considered as a main cause of "credit crunches." Credit crunches mostly result from "banks' attempts to limit their risk of failure."[28] Limiting the risk by sharing it worldwide like the hyper-developed derivative and CDO/CLO instruments did, or very rapidly moving from one investment to another to maximize return on equity like investment funds did (sometimes with little regard to long-term consequences of this practice on the underlying assets), awarding rapid short-term success like many corporations did with their top management. All of these are examples of an underdeveloped sense of risk by economic agents.

More generally speaking, economic agents are always subject to the natural temptation to limit their risk of failure by creating vast safety nets. Empirical research on the banking collapses of the last two decades of the 20th century produced a consensus that the greater the protection offered by a country's bank safety net, the greater the risk of a banking collapse. Several US states that had adopted deposit insurance during the early 20th century did indeed experience bad banking collapses.[29]

Overdeveloping safety nets and runs for short-termism are two sides of the same coin. They result from a widespread panic in times of growing uncertainty. During such times, as pointed out by John Maynard Keynes in 1937 and further developed by Douglas North,[30] economic reasoning might be of little value. Quick decisions are often made based on insufficient or incomplete information, consequently lacking in rational thinking. In the case of bank trading, demands of rapid high returns on equity or development from extremely complex "futures" (i.e., bets on future value of shares) might be seen as desperate attempts to secure things in unpredictable environments. Derivatives are of course a necessary part of finance in a world of impersonal exchange created by international trade and globalization and therefore cannot be suppressed. But the uncontrolled surge of collateralized debt obligations (CDOs) could reveal an underlying lack of confidence and impending panic reactions, long before an official crisis takes shape. Moreover, the desperate search for safety and security is coupled with longer life expectancy and thus huge pension needs. The millions of capitalists (saving for retirement) put extra pressure on recurring high returns on equity as well.

The natural temptation to limit the risk of failure could increase amidst declining hope for progress. As the banks stagger to stay afloat, the domino effect becomes more likely. The current lack of long-term perspectives in Western societies, combined with the creation of vast safety nets in the banking system, insurances and welfare states as well, might have encouraged all economic agents, not only bankers, to act recklessly, looking to maximize short-term profit regardless of the long-term consequences.[31] As in the 1930s, times of high uncertainty are typically full of financial scandals and a general decay of values. Anti-capitalism then affects capitalists themselves who get tired of the ongoing process of social selection determining each individual's position and income in the free market economy.[32] When faced with social catastrophe, the whole value system collapses.[33]

The Grapes of Anti-Capitalistic Wrath

The rampant anti-capitalism now resurfacing all across Europe is primarily an outburst of long-brewing wrath. Traders, bankers, and the economic elite are all considered to be responsible for the current turmoil. Policymakers in search of convenient scapegoats peg them as evil individuals whose misbehavior stigmatizes the whole community.[34] The vocabulary used by politicians from various Western countries[35] is strangely similar to that of the era when successful Jews, merchants, tycoons, and bankers were blamed for tough financial times. Even before the terrible Holocaust, Jews were publicly labeled as dishonest, unscrupulous scoundrels, swindlers, exploiters, and rugged individualists in political propaganda. Numerous historic and psycholinguistic studies have already proven the link between public verbal attacks and the pogroms of the 1930s and 1940s. In the 1970s, the RAF (Rote Armee Fraktion) carried out terrorist attacks in Germany as a consequence of a prevalent anti-capitalist scorn.

In recent weeks, anarchist websites have been running "burn a banker" campaigns. In the UK, the house of the former head of the Royal Bank of Scotland was vandalized. April 1, the day before the G20 summit, is being dubbed "Financial Fools' Day." The G20 "Meltdown group" is planning to reclaim the city of London. The Internet is flooded with appeals to attack the banks during the London Summit. Police fear violence and riots could plague the summer holidays. Again, old anti-capitalist path dependencies are clearly at work here.

Conclusion

Anti-capitalism is not only an ideological and theoretical mindset. It is a vast hate movement targeting capitalists, blaming them for severe economic downturns. Financial capitalists who operate internationally and therefore escape state control are particularly in the hot seat now, just as they were in the 1930s. Since many countries are being dragged down by the financial turmoil, many policymakers are publicly criticizing financial capitalists. A closer look at path dependencies in European countries indicates a probable shift towards greater violence, racism, and xenophobia as well. The pervasive anti-capitalism might not actually destroy capitalism but could very well chase many capitalists out of the main Western countries and into emerging economies.

Until now, state regulated capitalism has mostly emerged through national emergency economic rescue plans in an effort to save key institutions and manage the social consequences of severe downturns. However, this type of state regulated capitalism is more dangerous for the states themselves than capitalism. Western countries appear to be grabbing at straws as they try to cope with the huge and still unpredictable financial turmoil that is far from having hit rock bottom. Some are turning to former successful models like ordo-liberal capitalism (i.e., social market economy) that might be illusory in the near future. Instead, development of new economic models should integrate more about de-industrialization induced by globalization and the likelihood of powerful emerging countries dominating the world in the coming decades.

In closing, one should also note that many capitalists themselves have behaved like anti-capitalists by building endless safety nets. Short-termism is a symptom of a lack of confidence in the future. And yet confidence and responsibility are vital, core values for capitalism. Throwing huge amounts of unfinanced liquidities on the markets might not be the right way to restore them. More thought should be given to how such feelings and values can be restored. Examining the emerging economies where capitalism is now very vivid might provide valuable insight as to why it is so badly damaged in the West and how we can fix it. Comparative cultural economics could unveil the secret to our future stability and prosperity.

Notes

1 Denzau, A.T. and D.C. North (1994), *Shared Mental Models: Ideologies and Institutions*, *Kyklos*, 47 (1), 3–31. See also: Gerold Blümle, Nils Goldschmidt, Rainer Klump, Bernd Schauenberg, Harro von Senger (eds.), (2004), Perspektiven einer kulturellen Ökonomik, Lit Verlag, Münster. Cultural Economics in Germany can be seen as a revival of Max Weber and of the German Historical School.

2 On October 16, 2008, within the framework of the Amending Finance Act for 2008, the French Parliament decided to create a dedicated structure to issue debt securities guaranteed by the French Republic to raise funds that will be made available to various credit institutions. Under the French Law, the aggregate guarantee that the French Republic can provide to this structure is capped at €265,000,000,000. Source: *Review of Worldwide Government Initiatives of 2008 to Guarantee Financial Institution Obligations*, Orrick, January 2009.

3 For example Natexis, now merging with Banque Populaire Caisses d'Epargne.

4 The French government's €6 bn loan to the financing arms of the two major car manufacturers was not a subsidy but just a loan at a preferential rate. However big this amount may seem, it is far too small when compared with the sums needed for renewal investments and the development of new car models.

5 Jean Peyrelevade (2005), "Le capitalisme total," Paris, Seuil; P. Arthus, M. P. Virard (2005) "Le capitalisme est en train de s'autodétruire," Paris, La découverte.

6 Former students from the Elite Universities ENA, HEC and Polytechnique organized a symposium in March 2006 questioning the future of capitalism: "Le capitalisme a-t-il un avenir?"

7 More recently, the French oil giant Total was heavily criticized for having announced the destruction of about 500 jobs, despite the fact that the same company intends to create 3,300 jobs elsewhere in France.

8 Michel Aglietta laid the foundation for the Regulation School of Economics with his book *A Theory of Capitalist Regulation: The US Experience*, Paris, 1976. He already warned against the excesses of Financial capitalism in his book published 2004, Dérives du capitalisme financier. His idea of "stakeholder value" has been overtaken by the German Social-Democrats. Stakeholder Values Perspective, as opposed to Shareholder Values emphasizes responsibility over profitability and sees organizations primarily as coalitions to serve all parties involved.

9 Besancenot, a former Trotskyite, recently created the "anti-capitalistic party." According to recent polls, he is deemed the second-best person to fight against the crisis, after French President Sarkozy.

10 It meant an economic model where banks and industry were strongly intertwined as mutual shareholders.

11 The banks behind Germany's €800 bn market in covered bonds (Pfandsbriefe) are now warning of market distortion if the government extends the guarantees it has offered to financial sector bond issuers. Source: "German banks warn of market distortion," by James Wilson, Financial Times, Feb. 3, 2009.

12 www.tagesschau.de 26.03.2009. HRE already got more than € Billion 102 and is supposed to need at least about €billion 200 more state capital.

13 Patricia Commun, "Le capitalisme financier en France et en Allemagne: Critiques, réalités et consequences" in Claire Demesmay, Hans Stark (eds.), "*Radioscopies de l'Allemagne*," IFRI, Paris 2007, pp. 77–120. See p. 79: especially severe cost cutting made by Private Equity managers KKR in the well known German middle-sized company Siemens-Demag arouse considerable outrage by social-democrat policymakers in Rhineland 2005.

14 Horst Köhler, *Berliner Rede*, March 24, 2009.

15 Ben Bernanke, "Nonmonetary Effects of the Financial Crisis in Propagation of the Great Depression," *The American Economic Review*, 1983. Looking back at data from the 1930s, Bernanke demonstrated how problems in the financial system tended to lead to output declines as there was a sharp contraction in lending to less credit-worthy borrowers. The effects of this credit crunch on aggregate demand helped convert the severe, but not unprecedented, economic downturn of 1929 into a severe and protracted depression.

16 According to Alain Le Berre, Managing Director, Huron Consulting Group in London.

17 *Sunday Times*, Feb. 15, 2009.

18 Countries like Hungary and the Baltic States have had to be rescued by IMF. Some worry that Greece might as well be on the verge of insolvency. Spain has already been downgraded by the rating agency Standard and Poor's. France and Italy are exploding their state deficits as well.

19 Actual strong pricedowns worldwide as a consequence of the brutal slowdown of international trade and industrial production seem to argue in favor of an upcoming deflationist situation.

20 "Back then, the Resolution Trust Corporation extended 85% non-resource loans to private investors to kickstart a market for Savings and Loans assets." "The US Treasury hopes actions speak louder than words," by Gillian Tett, *Financial Times*, March 24, 2009.

21 The plan to handle this first break down of the mortgage market already cost about $153 billion (i.e., 2.8% of the 1986 American GDP. The next bubble to come was the Dot-com bubble in 2000. Other major financial crises affected other countries worldwide. The worst and the longest one affected Japan 1990–2000. During the Asian Crisis 1997–1998, the Federal Reserve had to bail out the big Hedge Funds LTCM. (Source: "Note de veille du Centre d'analyse stratégique" no. 113, October 2008.)

22 Banks were unable to sum up their toxic assets so far.

23 This is what the IMF has been asserting over the past couple of months.

24 Ludwig Erhard, 1st Minister of Economy after World War II reintroduced 1948 economic liberalism, condemning dirigisme and war economy. In the 1930s though, his numerous anti-liberal declarations condemned laisser-faire capitalism as a cause of the deflation crisis. See: Patricia Commun (2004), "Erhards Bekehrung zum Ordoliberalismus: Die Bedeutung des wirtschaftspolitischen Diskurses in Umbruchszeiten" in: Freiburger Discussion Papers on Constitutional Economics, Walter Eucken Institut, Freiburg, 04/2004.

25 Walter Eucken (1951), *The Foundation of Economics: History and Theory in the Analysis of Economic Reality.*

26 Patricia Commun, "La crise bancaire allemande," *Geoeconomie* No. 47, November 2008.

27 For instance a sovereign fund from Abu Dhabi recently got 10% of Daimler AG.

28 Charles Calomiris (2008), *NBER Report, Research Summary 2008*, No. 4. Charles Calomiris is a Professor of Financial Institutions at the Columbia University Graduate School of Business.

29 Ibid.

30 The linkage between Economics and Cognitive Science enables us to understand more about irrationalities on the financial markets. See: Andre Orlean, "Les croyances et représentations collectives en économie," in: Bernard Waliser (ed.) 2008, *Economie Cognitive*, Ed. Opkris.

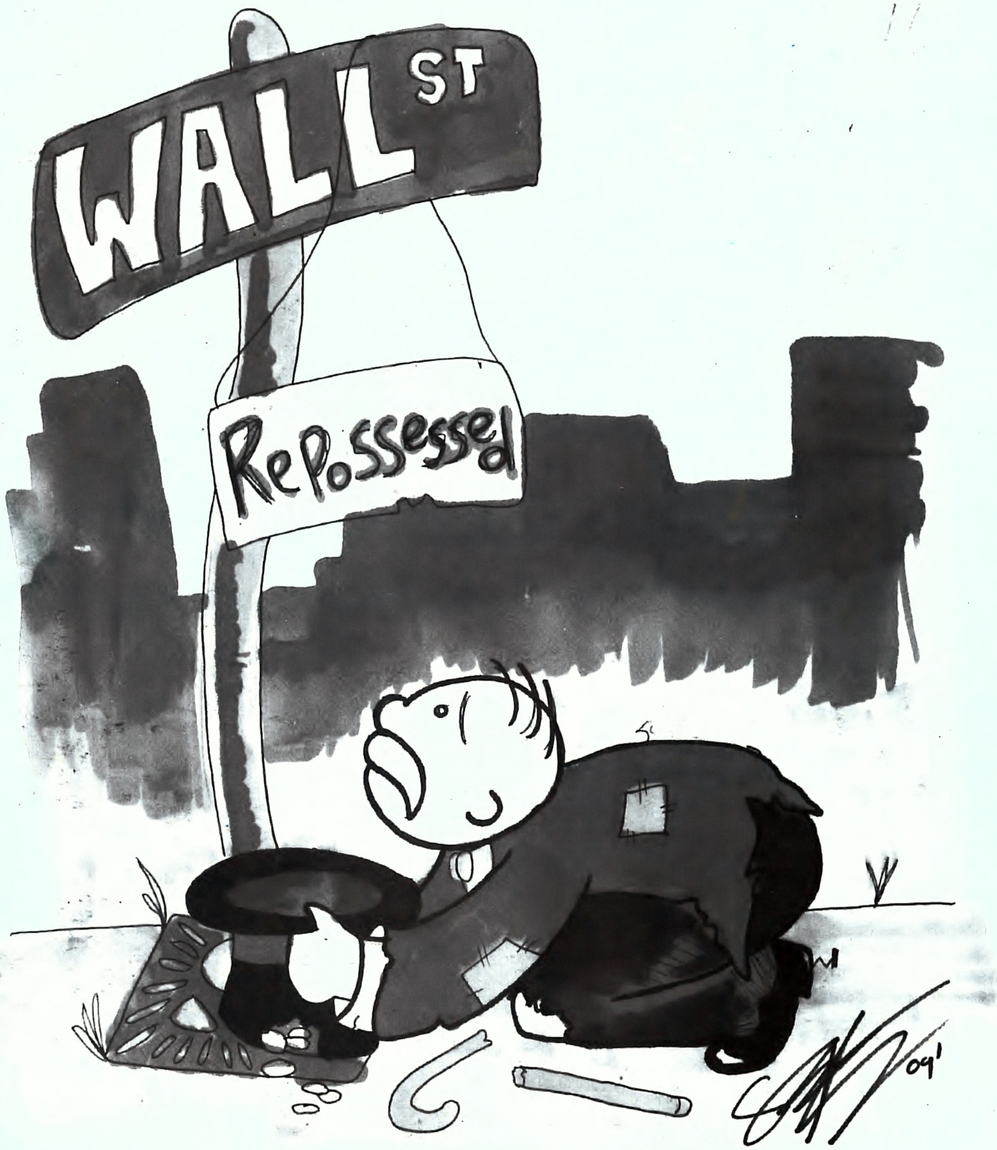
31 Daily newspapers or publications edited by tax payers' organizations in Germany, France and the UK are full of examples of swindlers being active everywhere.

32 Ludwig von Mises (1956), *The Anticapitalistic Mentality*, p.80.

33 Bertram Schefold, *The German Historical School and the Belief in Ethical Progress*, F. Neil Brady (ed.), Ethical Universals and the Belief in International Business, Berlin, Springer, 1996.

34 In the USA during the 1930s, socialists and communists thought that capitalism should be abolished. Lots of people thought that Wall Street was bad, many others enjoyed the discomfort of the rich and powerful and felt that some of the elites had to be found guilty. See: John Galbraith, The Great Crash 1929, Hamilton, 1955.

35 Luxemburg's Premier Jean-Claude Juncker, who is also chairman of the 15-nation Eurogroup of eurozone finance ministers, recently called excessive executive pay a "scourge." France's President Nicolas Sarkozy has criticized "rogue directors." Last but not least, even German President Horst Köhler described global financial markets as a monster.



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