

THE FALL OF BABYLON LONDON

The large financial sectors in the USA and Great Britain have been hit hard by the financial crisis. *LookingGlass* asks why these financial sectors grew so big in the first place, and whether their expansion might have contributed to widening income gaps and short-termism. This crisis also marks the end of the deregulation era and the beginning of a new political paradigm.

*The broad wall of Babylon
Shall be levelled to the ground,
And her high gates
Shall be burned with fire.
The peoples labour for nothing,
And the nations weary themselves only for fire*

Jeremiah 51:58

The atmosphere has changed in the European capital of finance, London, in connection with the financial crisis. The *Financial Times* notes

that exuberance has given way to a new austerity (18/11 2008). The old indebtedness culture, which means servicing one's old debts by taking new ones, is said to be dead. The spirit of the age is more frugal and restrained with regard to conspicuous consumption. Those who still have money refrain from provoking them who have just lost theirs. Even shoplifting is showing signs of the new austerity. The British supermarket chain Tesco reports a 36 per cent increase in shoplifting. People are not stealing luxury items but to meet more mundane, practical needs.

The financial crisis is hitting London hard. According to the Centre for Economics and Business Research, the financial sector in Great Britain will shrink from a peak of 353,000 employees last year to 291,000 by 2009. The same source estimates that bonus payments will fall from 8 billion GBP in 2006 to 2.6 in 2009.

So it is not just a rumour that Babylondon, the financial capital that dwarfed the real economy, has fallen. The expansion of the financial sector in recent decades has been concentrated above all to the USA and Great Britain, that is, the metropoli of New York and London. In the USA, financial services in 2004–6 constituted 20–21 per cent of GDP, while manufacturing represented 12–13 per cent. In the USA and Great Britain, the financial sector accounted for 35 per cent of corporate profits in 2005 (see *Financial Times* 15/11 2008). British manufacturing today provides 13 per cent of the GDP.¹

Quite recently the City appeared to be the right place to be at. Today it is of no use to be skilled at handling the mathematical formulae of financial innovations: another type of calculation is on the way. Now we will be hearing all the questions surrounding the expansion of the finance sector that should really have come before the crisis, and which in some cases did, although with limited impact.

The American writer Kevin Phillips, a fervent and persistent critic of contemporary Anglo-Saxon capitalism, claims in his new book *Bad Money – Reckless Finance, Failed Politics, and the Global Crisis of American Capitalism* (2008) that one sign marking the start of a nation's decline is when people become too absorbed with

moving money around instead of manufacturing and moving products. There are many examples throughout history of countries that have lost control of their financial sector and gradually lost their position. Significantly, this phase often follows an extended period of affluence. Phillips mentions Spain under the Habsburgs, Holland in its imperial phase, and the British Empire. There is a heavy foreboding in the air due to fears that that the present crisis marks a turning point – the American century has ended and from now on the economic and political influence of the USA will gradually diminish.

Financial crises are much more frequent than most people would think. Based on more complete data than research has previously had, Carmen M. Reinhart and Kenneth S. Rogoff have shown that financial crises have been a constant feature in the international economy over the past eight centuries. Waves of increased mobility of capital are often followed by a series of national bank crises. The crises have often emanated from the financial centre and in that respect the American subprime crisis of 2007–2008 is not at all unique.²

Nor is criticism of the financial sector a new phenomenon, and it can easily take on a demagogic quality. To set actual manufacturing against abstract financial activities is a rhetorically suggestive method. To differentiate between

1) See "The return of manufacturing in Britain", *Prospect magazine supplement* October 2008.

2) See Carmen M. Reinhart, Kenneth S. Rogoff, "This time it is different: A panoramic view of eight centuries of financial crises", *NBER Working Paper* No. 13882, 2008.

manufacturing (German) and financial activities (Jewish) was prerequisite to the combination of pro- and anti-capitalism in modern anti-Semitism. One finds this polarity fully developed as early as in the German economist Werner Sombart's *Die Juden und das Wirtschaftsleben* ("The Jews and Economic Life") (1911). Naturally, this historical background does not preclude criticism of the financial sector, but one should be aware that there are powerful magnetic forces under the surface which easily take hold of arguments and order them to their own patterns.

The financial sector has been a golden calf, above all to the USA and Great Britain, and to certain strata. (However, many must help pay the piper.) Nevertheless, as pointed out by George Soros among others, it is not in fact clear why the financial sector has become so big or for whose sake. There is also reason to wonder whether several of the problematic tendencies in contemporary capitalism that Glasshouse Forum wishes to spotlight in its project "Globalisation and the middle class in the West" and "Short-termism in the long run" are linked to financial sector expansion and influence on the economy and society.

For example, to what extent is the unequal distribution of prosperity a consequence of the development of the financial sector? Glasshouse Forum's investigation of the growth of income differentials in the Western world shows that differentials have grown most dramatically in countries like USA and Great Britain, which also have the largest financial sectors. It is striking also that the uppermost stratum in income distribution is accelerating ahead of other groups. Is it a coincidence, or are the generous salaries in the financial sector a significant factor in this context?

Steven N. Kaplan and Joshua Rauh at the University of Chicago in their paper "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes" have tried to estimate the contribution of the financial sector (Wall Street) to the increasing income differentials in the USA. Their focus is on the topmost level in operations and income distribution. They then compare this with developments in Main Street (non-financial top executives). By Wall Street they mean the investment banks, hedge funds, venture capital, private equity fund and mutual funds investors. There is considerable uncertainty in the estimates since many financial players are not required to disclose the number and size of individual payments, but the authors are certain that their estimates are on the low side.

This sector has grown dramatically in recent times and so has remuneration to those operating there. The top 25 individual hedge fund managers in the U.S. earned a combined total of 5.2 billion USD, 6.3 billion USD and over 9 billion USD respectively in 2003, 2004 and 2005. Kaplan and Rauh find twice as many players from Wall Street as players from Main Street in the top 0.5% and the top 0.1% of the AGI (adjusted gross income) distribution. They also find that Wall Street constitutes a greater proportion of the top 0.01% than Main Street, an equally large proportion of 0.001% and a substantially larger proportion of 0.0001%. Many of the richest citizens of what the journalist Robert Frank calls Richistan receive their incomes from the financial sector.³

Will the trend towards greater inequality be moderated by the financial crisis? The kind of impact you expect depends, as Camille Landais points out in his commentary on page 13, on how you see

the origin of the differentials. The American economist Frank Levy of MIT is among those who consider that changes in social norms play a vital role. In an essay written together with Peter Temin, he points out that if an American business leader in the 1960s had received remuneration of the kind which is commonplace today, it would have been an issue for the then President. It was quite simply not accepted under the social norms of the time.⁴ Glasshouse Forum asked Frank Levy whether the wheel has turned a complete revolution now. Politicians are criticising the generous remunerations in business, and companies have begun to block bonuses for the year 2008, for example the Swiss bank UBS. Seven leading Goldman Sachs executives plan to waive their bonuses. Perhaps this will set a trend. Perhaps a social norm is being re-created, that will put a check on this type of remuneration.

"The economics writer Robert J. Samuelson made an interesting comment on that paper and the point you quote", says Frank Levy. "He said that in this country, businessmen had come out of the Great Depression with a generally bad reputation and this was reinforced by World War II when there was some spirit of overall sacrifice (and occasional congressional hearings on war profiteering). So it would have looked very bad for CEOs to start taking huge salaries, even if they had the economic power to do so, and it would have been very popular for politicians to attack such power."

"This attitude changed in the 1980s – i.e. nothing wrong with being very wealthy – and as long as totally unregulated markets appeared to be bringing general prosperity that was likely to stay. But now that the activities that generated extremely

high financial incomes seem to have brought the economy to the edge of disaster, that attitude may well swing again."

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Frank Levy

"My guess is that in the last decade in particular, high incomes depended in part on the lack of regulation of certain kinds of financial instruments which allowed firms to take on enormous leverage – i.e. huge amounts of borrowing given their capital base – and it was the extent of the borrowing that generated much of the high incomes. Now that that has blown up, I think going forward that you will see a more regulated and, therefore, a smaller financial sector with somewhat more modest salaries. This won't affect the broad based inequality between, say, high school and college graduates – that was much more a supply/demand phenomena – but it will reduce some of the extreme upper tail inequality."

It appears probable that a downsizing of the financial sector in combination with stronger social norms will moderate the tendency for the uppermost stratum to outdistance others as regards income, something seen not only in the USA and Great Britain but also for example in

3) Robert Frank, *Richistan. A Journey Through the American Wealth Boom and the Lives of the New Rich*, 2007.

4) "Inequality and Institutions in 20th Century America", *NBER Working Paper* No. W13106 2007.

France and Germany, although in a less marked form.

Why then has the financial sector grown so dramatically? The so called efficient market hypothesis has no problem with this. Growth is quite simply a consequence of efficiency. According to this hypothesis the collapse that has now occurred cannot in fact occur, since market mechanisms quickly create a new equilibrium. This view has lost much of its credibility now that the financial sector has destabilised itself with dire consequences to the real economy. Nor is it particularly convincing as an explanation for the expansion of the financial sector.

A completely different approach to the financial sector is put forward by the British economist Paul Woolley of the London School of Economics. He has a background both as an assets manager and IMF economist. Woolley's formative professional years were during the IT bubble, when his company lost customers because it did not follow the trend, but insisted on a more sober and traditional valuation. (They later returned.) One of his initiatives was to start, and fund, The Paul Woolley Centre for the Study of Capital Market Dysfunctionality, which has quite recently issued a report that has caused quite a stir: "An Institutional Theory of Momentum and Reversal", written by Woolley and Dimitri Vayanos.

Irrational motives are often invoked in order to understand the bubbles and the almost inexplicable vagaries of the stock markets, both in the form of shares rising far more than is justified and suddenly falling in them for reasons equally difficult to explain. For example, Robert J. Shiller in his new book *The Subprime Solution. How*

Today's Global Financial Crisis Happened, and What to Do about It (2008) speaks of contagion, in a social sense, a concept that is reminiscent of the classical sociologists. Woolley is critical to this tendency and considers it a scientific dead-end. These phenomena are not due to irrationality among the players, but are the result of the interaction between the investors and those who manage their money.

"You don't have to blame irrational exuberance for bubbles", says Paul Woolley to Glasshouse Forum. "You can actually get bubbles in a perfectly rational framework because of the agency problem and momentum and short-termism that go along with it. My co-author and I explain bubbles and collapses and reversal in a formal, rational expectation framework. It seems to me if economics is going to be treated as a science, it needs as far as possible to explain things in rational terms."⁵

It is above all the money managers' role that Woolley deems of crucial importance to the growth and actions of the financial sector. Through their preponderance of information – reinforced of course by financial innovations, they can to great extent dictate the conditions for the traffic. Since these managers of other people's money earn on each transaction they benefit from an increase in the turnover rate. In 1965 the annual turnover of British equities was worth 10 per cent of the nominal GDP, and in 2007 almost 300 per cent (*Financial Times*, 15/11 2008). Woolley illustrates the fact with the following example: we have the manager of an actively managed pension fund with a 100 per cent turnover of holdings per year. Over a 25 year period, he will exchange the same equities with other managers for no collec-

tive gain. The end value of the fund falls by 25 per cent. But the manager himself earns by it. It is a kind of taxation to which the managers expose the savers.⁶

The actual prerequisite for this is that there is asymmetry of information in the relations between the banker, fund manager, broker etc; and the end investors. These players have an enormous preponderance of knowledge over the end investors and use this to benefit their own prosperity. This preponderance has been reinforced by financial innovations which are beyond the comprehension of a good many players.

"I regard the size of the financial sector as a function of the inefficiency of markets. If markets were efficient, as the academics have preached for many decades, the financial sector wouldn't have grown to such a ridiculous size."
Paul Woolley

"I regard the size of the financial sector as a function of the inefficiency of markets. If markets were efficient, as the academics have preached for many decades, the financial sector wouldn't have grown to such a ridiculous size. It's only grown to account for about 35, 40 per cent of corporate profits in the UK, the US and some other countries, because it is fundamentally inefficient. Inefficient is too weak a word. Inefficient suggests mispricings of a minor degree or of a systematic degree, but in fact what we have is a propensity for dysfunctionality, sometimes on a gross scale", says Woolley.

"Practitioners have enjoyed the situation and have exploited the agency problem to the full with the endorsement of the academic community, and indeed with the encouragement of governments who see the finance sector as a source of tax and employment and foreign exchange."

"But it's like a tumour and nobody has really realized that. I find it totally extraordinary that the only academic papers that have looked at the size of the financial sector have done so with regard to developing countries and they said that it helps to provide growth. If something is efficient, you don't expect it to be ballooning like that. It's a tax on the productive sector of 40 per cent."

Woolley considers also that the financial sector has had major significance in the spread of short-termism. It is in the interests of the financial players to increase the tempo, since they earn on each transaction.

"One of the most serious aspects of the financial sector is the short-termism or momentum effect in stock markets. The trouble we're in now internationally derives from the technology bubble in the stock markets in 1999–2000, and then the policy response of the central banks to keep interest rates too low too long which stoked the real estate and debt bubble, which is now collapsing. Low rates promoted not only the bubble but also the

⁵ Editors' note: Agency problem is a conflict of interest arising between the creditors, shareholders and management because of different goals, for example when managers and stockholders have conflicting ideas of how the company should be run.

⁶ See also Jonathan Ford, "A greedy giant out of control", *Prospect*, November 2008.

carry trade and the hedge funds with high leverage. What we've seen now is simply the unwinding of that. The origins of the crisis lay in the short-term momentum-driven investment strategies adopted in the tech bubble and then pursued again in response to the low interest rates that prevailed in the early 2000s."

"You only have to look at the level of turnover in equity markets to realize how short-termist we've become around the world in our investment strategies. For an equity portfolio you typically have 100 per cent turnover per annum, which means the holding period is a year. And the hedge funds have even shorter holding periods on average."

Even if the financial sector is temporarily under pressure and will probably shrink, one of its basic preconditions is still in place and will perhaps lead to new bubbles in the future. The stratum of managers has of course been dependent on the capital that has been made available from pension funds, insurance companies and similar, and which is in search of returns. This will not decrease in the future. Simply consider what Asian pension savings can lead to when its population, such as in China, quickly begins to age. So the task for the future is to develop strategies so that the capital managed by institutes will not be exploited in the same way.

"That's obviously the key question," says Woolley to Glasshouse Forum, "and unfortunately all people are doing now is trying to patch up the system. The great danger is that lowering interest rates to zero will just set the stage for the next great bubble without actually addressing the fundamental problem."

"There are fundamental problems in the way that the finance sector works. Adam Smith's dictum that 'everybody pursuing their own self-interest leads to the highest utility for all' doesn't work in finance. The agency problem gives rise to mispricing which misallocates capital and can have huge macroeconomic implications. The other problem is that it also captures increasing chunks of the return from productive investment. That's what we've seen over the last 20 years. Now the profits are down, but look at the damage that's being done and the costs to society. We're just paying for the finance sector by a different route now, instead of their profits."

"And frankly, the finance sector actually benefits from volatility of the system. They won't see it as them benefiting now, but there will be huge gains made when they rebuild the private sector entities over the next 10 years. They've benefited not only from the volatility of prices of stocks and bonds. They will benefit from the volatility of the infrastructure itself. An efficient, smooth-functioning, stable market is death on wheels to them."

"I think the absolutely prime thing is to understand that finance doesn't work like everything else. The agency problem creates these two major problems of mispricing and capture of the rents. It's handled in the contracts between pension funds and their managers, their agents. It's handled by getting a focus on medium- and long-term investment. It can be resolved by trying to reduce moral hazards among agents by extending the period over which performance is measured, and thus bonuses and performance fees and so on."

"Principals and end investors and trustees must change the way they act. There's nothing wrong

with active management, it's just that the fee structure is ridiculous. The argument is that it's irrational exuberance and we are just paying the price for that and that all you need are a few more instruments to hedge risk – in that way, you're just pandering to the finance sector and making it even bigger. The scale of the derivatives markets was simply a function of the fundamental inefficiency of the underlying equity markets."

"We should focus on the old fashioned idea of investing for dividends and investing for the medium and long term."
Paul Woolley

"Jane Austen, when she described somebody's wealth, she very rightly described the eligibility of a bachelor in terms of his annual income, not his mark-to-market value. And we should focus on the old fashioned idea of investing for dividends and investing for the medium and long term."

It is perhaps time now to rejoin Jeremiah and the sermons of retribution about Babylon and the triumph at its fall. There are overtones of such Old Testament indignation in the debate about Babylondon. It is difficult to resist temptation. One stratum has, with the help of other people's money, known as financial innovations, and the goodwill/compliance of politicians, succeeded in favouring itself by taking risks which in many ways are handed over to the man on the street, both through taxes and through the downturn which is now due to hit not only Wall Street but also Main Street.

The opinion of David Goodhart, for example, in *Prospect*, is that there may be such a thing as

a good recession, which allows us to see things more clearly.⁷ It would among other things encompass a reduction in income differentials, renewed interest in major political issues and the political institutions, and strengthened focus on the middle stratum instead of as now the upper and lower strata. This middle Britain has nothing at all against seeing the kings of finance humiliated a little, Goodhart thinks.

It is too early to declare winners and losers, because we do not know how deep the crisis will be. It may well be as Jeremiah says:

*The peoples labour for nothing,
And the nations weary themselves only for fire*

Intellectually and politically it is somewhat easier to identify winners and losers.

That which we usually call Washington Consensus has used up its credibility, now that the market has destabilised itself in this fundamental way. The idea that the solution to the problem was deregulation and rolling back the state has been a dominant idea for almost exactly 30 years, the space of time that in the past was called a generation. As pointed out by José Ortega y Gasset among others, history often turns out to have a rhythm created by this type of generation hand-over. Completely new climates appear with these intervals; that which was – if not impossible to imagine, then at least difficult to gain support for – suddenly becomes something worth discussing. That which was the rearguard suddenly becomes the vanguard. George Soros asserts that a market

⁷) *Prospect*, November 2008.

ideology that rejected regulation has been a basic cause of a super-bubble built up over decades. Now the state must act to regulate the market tendency toward instability.

It is no coincidence that at this time people are remembering a maverick among economists, Hyman Minsky, whose theory of the instability of the financial market has become the object of renewed interest.⁸ Minsky held that the capitalistic economy is inherently unstable and that disequilibrium and unemployment are so to speak a normal condition. Its own driving forces sooner or later create a transition from robustness to fragility and if the state does not intervene, a boom-bust cycle arises, to which the banks contribute by meeting credit needs in an increasingly aggressive way. The unsustainable boom, which is characterised by speculative financial action, is corrected by the creative destruction of the depression.

Creative destruction is one of the things that are much more fun to talk about than to live through. The costs for society generally become far too great and it is therefore important for the state to intervene with Keynesian measures. In that sense Minsky was a follower of Keynes. But he went a step further and formulated what Gary Dimski and Robert Pollin have called “the Minsky Paradox”. Interventions maintain an existing fragile financial structure which would otherwise have been corrected through a depression. When borrowers and lenders realise that there is a safety net, their inclination to take risks and debts increases. This means that attempts to combat economic depressions will be less effective over time, according to Minsky. It is such a paradox we are living in right now: the financial markets have

shown themselves to be intrinsically unstable and state intervention ultimately risks underpinning the behaviour it aims to deal with. It would not seem a reasonable political solution for the state to intervene in order then to give back the reins to the market forces. The state will remain present, for a generation or two, however long a paradigm lasts.

Another cornerstone in the philosophy of neo-classical economics is the notion of the rational actions of homo economicus. Its reasoning assumes that the individual makes rational decisions after having systematically absorbed information. All one needs to do is create a maximum of individual freedom of choice, and rationality will dominate. This perception is undermined from various angles. Robert J. Shiller shows in *The Subprime Solution* the ways in which contagion disabled rational thinking during the housing bubble. All the explanations of why house prices should continue to rise lack foundation. There is nothing to support the fact that raw materials – or land – should become scarcer. One problem is that we do not measure inflation correctly and therefore we do not understand the extent to which property price rises are an illusion. The action programme which Shiller above all recommends is democratisation of financial advice, so that people in general understand what they are investing in. Additionally, there are indications that in recent years there has been a particular focus on for example the elderly to get them to make fateful decisions.

From elsewhere too, well planned death blows are dealt to the notion of the rationality of market players. Richard Thaler and Cass Sunstein summarise a good portion of behavioural science

research in their book *Nudge* (2008) which quintessentially holds that we as individuals are very bad at choosing, and need constant support from what they call choice architectures. The neo-classical economy’s conception of homo economicus, who makes decisions with icy rationality, is completely unrealistic. The creature of flesh and blood that actually exists acts in a far less rational way. There is no need for a guardian of the old-fashioned sort, but rather a companion to encourage this creature through friendly nudges in the right direction. Glasshouse Forum asked Cass Sunstein whether right now we are going through a paradigm shift. What is known as the Washington Consensus, which was essentially a question of deregulating and letting market forces have their way, and was based on the conception of the rational human is being replaced by – what?

“Decades of work have shown that people are not fully rational”, says Sunstein. “We are biased in our assessment; for example, many people are unrealistically optimistic. We use mental shortcuts, or heuristics, that create serious problems. For example, recent events have a big effect on us. If a disaster has occurred in the recent past, we think it will recur, even if statistics suggest that it won’t.

“A new paradigm is indeed emerging. It includes ‘libertarian paternalism’ – an approach that respects freedom of choice but that is likely to move people in directions that will improve their welfare. We should expect to see a lot of libertarian paternalism – or ‘nudges’ – in the future.”

Indebtedness has not only characterised the financial elites of the state. Generally speaking,

we live in a debt culture that encompasses more or less every class. Sociologist Daniel Bell stated in his classic work *The Cultural Contradictions of Capitalism* (1976) that the credit card was a far greater change than we realised and that the mentality it brings will in time undermine capitalism. It encourages infantile behaviour which basically feels that immediate gratification is a little too slow. But the background is that American real incomes have stagnated and that households are increasingly compensating for this by becoming indebted and by using their homes as a kind of cash dispenser to finance consumerism. There is much talk of the US national debt, but it is quite small compared to private debt. The indebtedness of American households has increased from 680 billion USD in 1974 to 12, 873 billion in 2006.⁹

Cass Sunstein says that both state and companies must make commitments to prevent people falling victim to temptation. Glasshouse Forum objects that when it comes to companies it would be rather like asking a wolf to watch sheep, since it is in the nature of the market to tempt and arouse needs.

“A good question. But some companies do try to counteract temptation; consider green products (trying to get you to consider the long term) and those who sell especially healthy foods (trying to get you to think about your future). Markets often tempt, but some companies try to work against temptation, and they sometimes do really well.

8) Hyman P. Minsky, “The Financial Instability Hypothesis”, 1992.

9) See US Federal Reserve’s Flow of Funds Accounts of the United States, “Debt Outstanding by Sector”, September 17, 2007.

For financial services, companies might well start to say: Consider the long-term risks!

“We need to have a new set of social norms, so that people start planning for their future, and realize that the long-term is crucial.”

Cass Sunstein

“We need to have a new set of social norms, so that people start planning for their future, and realize that the long-term is crucial. It’s not too late to stop borrowing and to start paying off your debts, if you possibly can.”

The American economic miracle, the long economic boom, has been largely fuelled by over-consumption, a consumption bubble. The USA has lived beyond its resources and in that capacity has kept the world economy going, supported by China. These two great powers have been in symbiosis: one under-consuming, and the other over-consuming. Such constellations do not usually last. As a Western company leader recently said when visiting China: “When a country gets into such large debt, it is very likely to lose a lot of its political power also” (*Financial Times*, 21/11 2008). It may be the case that the financial crises will be the catalyst for the relocation of the power centre to Asia as many predict, even though China seems hesitant. It is quite clear that the economic policy requires basic reforms so that domestic Chinese demand takes off. If that is successful, then the shift in the centre of gravity will accelerate dramatically.

What will happen with the openness of the world and with globalisation if such a transfer of influ-

ence becomes marked? So far it has been possible to sell globalisation to the broad masses in the West with the argument that everyone benefits in the long run. It is more difficult to do so today, and perhaps the loss of manufacturing jobs will be seen in a new light as the financial sector shrinks.

A sceptical attitude towards globalisation is not necessarily based on narrow-mindedness. It also applies that equality and social responsibility are not always completely compatible with mobility. It is difficult to make demands on capital when it always has the option of moving elsewhere. It can even be difficult for business leaders themselves to take a social responsibility if they have that option. The German sociologist Wolfgang Streeck illustrated this by invoking the famous reasoning by Karl Marx in *Das Kapital* regarding child labour in England. The individual capitalist could be well aware that child labour in the long run could damage both society and him, since the workforce does not procreate sufficiently. Nevertheless it could be difficult for him to refrain from it, since it would make him less competitive. Therefore he could welcome an intervention by the state with regulations making the conditions the same for everyone.

This has parallels to this day, according to Streeck. A capitalist should realise that he is dependent on positive demographic development and that there is therefore a need to organise working life so that giving birth to children is encouraged. In the same way, he should further the interests of capitalists that people should not burn out by the age of 35, but manage to work until their seventies to reduce the consequences of an ageing society. To an individual capitalist, it is

perhaps not possible to bear the possible costs for this if it impairs competitiveness, so that in principle a societal intervention should be welcome. But today’s mobility makes such an intervention more difficult, since the companies can lay claim to the population of another company by relocating, in particular to Asia.¹⁰

There are parallels to what happened during the last wave of globalisation, the one preceding 1914. Then, as Jeffry Frieden has shown in *Global Capitalism* (2006), the world was in many ways more globalised than today. National governments gave higher priority to their credibility with international players than listening to the demands of their own populace. This was possible among other things because the majority of the population had limited influence. But the wave of globalisation gave way to a back-slide with strivings for autarchy in many cases. Naturally, this must be seen in the light of the First World War, but also of the crises that followed in the 1920s and 1930s. The populations saw globalisation as a threat, as a source of insecurity. Acceptance of globalisation has always been dependent on its ability to create and spread prosperity, writes Frieden.

It is not difficult to find examples of recent reactions to globalisation. Listed Japanese companies began to protect themselves against takeovers last year through poison pills. The French President Sarkozy has argued for a European sovereign wealth fund which could buy up important European companies in the event of a recession – in other words so that they do not end up in foreign hands. European companies that previously turned to China have to a greater extent begun to locate production to Eastern Europe, which is

known as near-shoring. It is also possible that the multipolar world that is taking shape in the political sense will form a catalyst for the erection of barriers between different blocs. Glasshouse Forum asked Jeffry Frieden how he thinks the current crisis will affect people’s attitude towards globalisation.

“Over the course of the 1980s and 1990s, there was a strong tendency for governments to reduce their direct involvement in the economy”, says Frieden. “Much of this trend was undoubtedly justified, as there were many countries and many markets in which government involvement was counter-productive. However, it is almost certainly the case that this trend went too far – especially in financial markets.”

“The current crisis will almost certainly lead to a swing of the pendulum in the other direction, toward more government regulation of markets. I think there are likely to be two dimensions of this new focus. First, national governments will attempt to monitor the activities of their financial institutions more closely, and will probably try to limit some of the more exotic financial instruments. This can be justified because some of these exotic instruments reduce the transparency of financial operations to borrowers, lenders, and other investors.”

“Second, national governments – especially of the principal financial centers – will try to work together to develop collaborative approaches to regulating international financial transactions.

¹⁰ Wolfgang Streeck: “Industrial Relations Today: Reining in Flexibility”, *MPIfG Working Paper* 08/03.

We have long understood that well-functioning financial markets require some forms of government involvement in order to operate smoothly: regulation, oversight, lender of last resort facilities. It is now clearer than ever that we have global financial markets, and this means that some form of global financial regulation is desirable. We are unlikely to see a global financial regulator emerge very soon – we still live in a world of nation states – but there is a broad and deep desire for international cooperation to provide a higher level of global financial oversight.”

“The current crisis will almost certainly give rise to demands for assistance from those hardest hit by the economic downturn. And this is fully justified. Up to now, many governments have focused their attention on those who have benefited from globalization – helping the winners. Most governments have paid too little attention to providing a social safety net for those who do not benefit, and may indeed be harmed, by international economic integration.”

“National governments need to pay attention to the social effects of economic trends, and try to alleviate some of the suffering that adverse eco-

nomie conditions can cause. Otherwise, we are likely to experience a very serious backlash against involvement in the world economy – something that would probably lead to policies that would be bad for overall economic growth.”

“If governments chose to turn inward in a major way, they could do so. I think that this would be a bad idea, but the option is still there.”

Jeffry Frieden

“Contemporary technologies have spurred some of the developments that have tied international markets together. It would be much more difficult to impede the flow of funds – not to speak of information – across borders today, in the age of the internet, than it was in the nineteenth century. However, governments have enormous powers, and retain the ability to restrict the economic activities of their citizens. So there is little technological barrier to a turn away from the world economy. If governments chose to turn inward in a major way, they could do so. I think that this would be a bad idea, but the option is still there.”