18 décembre 2009

Global regulation in the aftermath of the subprime crisis

By Dominique Plihon, Centre d'Economie de Paris-Nord

At the beginning of the 21^{st} century, the planet has been facing a conjunction of disorders in the domains of finance, ecology, food and energy. This crisis appears to be systemic for it takes its roots in the global finance-led capitalism which has become the dominant regime in the world economy. This global crisis also has a geopolitical dimension since it raises the question of international governance in the context of changing relationships between developed countries and emerging market economies. Is there a need to change the principles which govern the regulation of the world economy, based on market-regulation, the liberalisation of trade and financial flows ? How the rules of the world economy should be reformed to prevent future crises and to organize a more sustainable international order ?

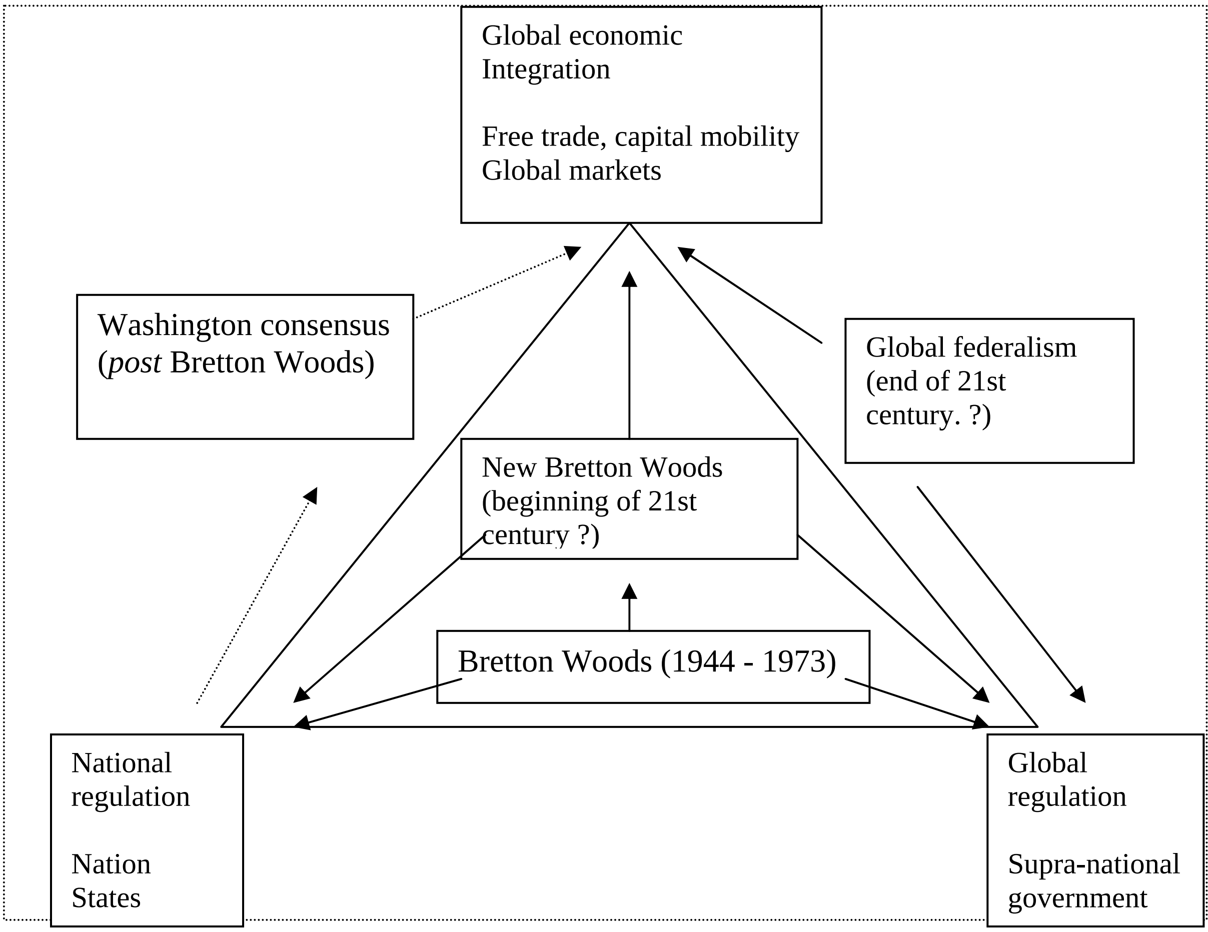
I/ Neoliberal globalization is unsustainable

As shown by Dany Rodrik (2002)[1], the short-comings of contemporary globalization may be explained in terms of a "political trilemma". The different groups of actors which take part to globalization (firms, governments, international institutions, NGOs, …) try to reach three types of goals :

- increase international economic integration with global markets in order to improve profits of firms and standard of livings of households;
- develop a supranational regulation of the world economy according to goals of democracy and efficiency;
- preserve Nation-states and national institutions to the extent that they are closer to the cultural and social needs of the people.

[1] Dany Rodrik (2002), « Feasible Globalizations », Working Paper, Harvard University, July.

Figure 1 : The political trilemna of globalization



The "political trilemna" put forward by Rodrik stems from the fact that these three goals cannot be achieved simultaneously. International integration, global democracy and a nation-states system are mutually exclusive. However, a compromise between these three dimensions of globalization may be obtained from the different groups of actors provided a sustainable equilibrium is reached within limits imposed to each goal.

During the three decades which followed World War II, such a compromise has been achieved. The world economy was regulated thanks to the Bretton Woods/Gatt international agreements. Limits were put on free-trade and capital mobility. Space was left for national policies and democratic control. This organization favoured post-war reconstruction and the fast economic growth which occurred during this thirty years period (1945 – 1975), often called "Trente Glorieuses".
The fragile Bretton Woods/Gatt compromise has been abandoned since the 1970s. The strategy of leading economic and political elites changed drastically. Global economic integration became the dominant goal of governments of the G 7 countries, transnational corporations and international institutions (IMF, World Bank and WTO). The ideological reference was the "Washington Consensus", put forward by John Williamson in 1990 which

promoted the three-pilar neoliberal policies agenda for all countries "stabilisation – liberalisation – privatisation"[2].
The results of the last three decades have been problematic both in terms of socio-economic performance (relative to the previous decades) and of democratic legitimacy (Rodrik, 2002). In most countries, income and wealth inequalities increased sharply. The share of labor income declined relative to capital income. The ability of elected governments to implement policies decided by citizens has been reduced by the constraints of globalization. The reason for such a situation is simple. Broader economic integration is unsustainable in a world where nation-states and democratic politics still play in important role. Clearly, at the outset of the 21st century, there is a need to build a new compromise to solve the political trilemna mentioned above.

The crisis of globalisation

The conception of globalization which prevails since the late 1970s – which may be called "neoliberal" globalization – has come to a dead-end. This is shown by the multi-dimensional crisis which has struck our planet since 2007 (see figure 2 below), on the one hand, and the incapacity of international institutions to regulate the world economy, on the other hand.
The major mistake made by the promoters of the neoliberal approach to globalization is their ignorance of the political trilemna of globalization mentioned above. They did not take into account the fact that global markets without appropriate – national and international - governance is unsustainable.
The promoters of neoliberal globalization had to deal with two series of obstacles : the resistance of populations and of the social movements fighting for democracy, on one side, and the reluctance of national governments to accept the reduction of their sovereignty, on the other side. The first obstacle is illustrated by the rising of anti-globalization movements starting from the Seattle World Trade organization (WTO) meeting in 1999; the Argentina experience in the 1990s give another illustration of a people's resistance to the neoliberal globalization process. Under Carlos Menem presidency, Argentina probably was the country which implemented in the most scrupulous way the policy agenda suggested by the Washington Consensus. However, international investors abandoned Argentina in 2001, causing a deep financial crisis, because they rightly realized that the local population refused to see their government giving the priority to international obligations relative to domestic targets.

Resistance to neoliberal globalization came not only from populations and social movements, but also from governments. This is illustrated by the failure of the Doha round organized by the WTO. This failure may be explained by the fact that some major countries do not comply with the rules of free trade. Indeed, the US and the European governments did not want to stop subsidizing their farmers and could not reach an agreement with countries like India which legitimately decided to protect its food-producing agriculture and its 800 millions peasants.

The flawed economic foundations of globalization

In the last of his Lionel Robbins lectures at the LSE on June 10th, 2009, Nobel price Paul Krugman indicated that most macroeconomics of the 30 years was "particularly useless at

[2] John Williamson, *Latin American Adjustment : How Much has happened ?*, Instiutte for International Economics, Washington DC, 1990.

best, and positively harmful at worst". Indeed some of the basic assumptions of recent economic theory may be seriously questioned in the light of the on going economic crisis. The first idea to question, which is at the heart of the so-called free-market paradigm, is the postulate that economic efficiency requires to reduce at minimum the role of government policies because elected bodies are supposed to defend their personal interests, whereas the anonymous "invisible hand" drives the global economy towards general interest. Privatisations, the independence of central banks, rules imposed to governments in the place of discretionary policies, which are at the core of the neoliberal dogma, have been designed to create the conditions of a free-market economy with minimal State interventions. This free-market paradigm gave an economic foundation to the neoliberal view which considers that globalization had to be governed by global markets with a minimalist role for national and international public policies. This view, which gave rise to the Washington consensus, represents a paradigm shift in thinking in economic theory since it is a more radical approach than that of 19th century classical economists, such as Adam Smith who championed the case for free markets but not for a minimalist State. In the *Wealth of Nations* (1776), Adam Smith accepted that the state has an important role to play in the provision of education and "certain public works and institutions". The Washington Consensus approach to globalization exerted considerable consequences on international organizations. It led to the IMF "structural adjustment programs" which put strong pressure on developing countries for deregulation, privatisation, the reduction of public expenditures and of social programs. It led to the WTO view that trade negotiations must consist not only in reducing barriers to free trade, as was the case within the framework of the GATT negotiations, but also in the privatisation of economic activity and of social programs as a way to increase free competition.
The multiplication of financial crises in most parts of the world since the 1990s gave rise to a reaction. The Washington consensus view was labelled "market fundamentalism" by authors such as Joseph Stiglitz[3] and George Soros[4] who asked for a more balanced approach to the respective role of Sate and market regarding regulation on the recognition that recent experience demonstrates the existence of both government failures and market failures.

Institutions matter

Another major weakness of standard economic analysis concerns the role of institutions. According to this view, the working of markets is reduced to a simple and global confrontation between supply and demand; the institutional framework does not matter. This view does not correspond to the real world. In fact, the paradox of markets is that they require to be controlled by institutions to perform well. Historians have shown quite convincingly that, in the past, the good performance capitalist economies was directly connected to the good quality of institutions in charge of the regulation and the supervision of markets[5]. Economists from the "Institutionalist school" also have shown that institutions play a crucial role in contemporary economies. They have come with two important conclusions :

- the institutional framework of market economies is not unique;
- the diversity of national institutional arrangements is not compatible with a complete international integration (Rodrik, 2002).

Indeed, we can see that all market economies have constructed institutions – taking the form of rules, standards, authorities - in order to provide a framework to major markets (goods and

[3] Joseph Stiglitz, Redefining the Role of the State, World economics, vol. 2, n° 3, July – September 2001.
[4] George Soros, The Crisis of Global Capitalism, Public Affairs, 1998.
[5] Fernand Braudel (1988), La dynamique du capitalisme, Flammarion, Paris.

services, labour, finance). These institutions are generally quite different from one country to the other. This explains why the American capitalism is not the same than the Japanese capitalism. This institutional variety is also very important among countries members of the European Union : the German capitalism is different from the French capitalism even though these two large countries have decided to build a common market fifty years ago. Developing countries too have specific institutions – among which informal markets – which work with specific rules. Economists who rightly emphasize the role of institutions have built the concept of "diversity of capitalisms" to analyse this situation[6].

This institutional diversity clearly is an obstacle to the deepening of economic integration in the world economy. The heterogeneity of national institutions – such as local legal systems – creates a segmentation of markets, in the same way as transportation costs or tariff on trade.

One of the major mistakes of proponents of the neoliberal view of globalization, which stems from a flawed representation of market economies, is that they have underestimated the role and the variety of national institutions. This mistaken view certainly is one the causes of the crisis of globalization at the outset of the 21st century.

Another problem comes from the fact that most international institutions – except the World Trade Organization which was launched in 1994 – have been created during the post-war period and are not quite adapted to the recent trends of globalization.

II/ Global governance : how should we proceed ?

Three types of strategies

The preceding analysis suggests that there exist three basic strategies for the governance of globalization, as illustrated by Rodrik's political trilemna (figure 1). The first strategy consists in giving the priority to market mechanisms to achieve global economic integration. This is the strategy defined by the "Washington Consensus" which is stuck in a dead end today, for the reasons mentioned above. This strategy is blocked by the resistance of social movement and by the institutional diversity of Nation States.

The second strategy corresponds to "global federalism". It gives the priority to global rules over national rules. According to this approach, the world is to be governed by a federal constitution and a supranational democratic government, with common laws and a common international currency. Nation States do not disappear but their policies are limited to local decisions, as is the case of the member States in existing federal systems, such as the United States and Germany. The construction of a federal government is a progressive and difficult process, as shown today by the European experience. Hence, we are entitled to assume that "global federalism" may be viewed as a long term strategy for the end of the 21st century.

The third strategy, which is the only acceptable and realistic one at the beginning of the 21st century, may take the form of a "New Bretton Woods" compromise, which would be located at the center of the triangle representing the political trilemna of globalization on figure 1. This new compromise consists in looking for an equilibrium between the three goals of globalization, each goal being only partially achieved. Compared to the initial Bretton Woods compromise, negotiated at the end of World War II, this modern compromise would give a more important role to economic and political integration. The construction of this new international order, based on increased cooperation at the international level, can be built on three major pilars :

[6] Bruno Amable, The diversity of Modern Capitalism, Oxford University Press, 2003.

- a reinforced regulation of international finance with a view to increase the role of economic policies
- a new paradigm for globalization
- a reform of global governance leading to new forms of democracy and a reform of existing international organizations

Reinforcing financial regulation to preserve economic policies

Excessive capital mobility is one of the major drawbacks of financial globalization. Capital inflows cause major economic imbalances (surge in credit, consumption, and non-productive investments), creating inflationary tendencies and giving rise to speculative bubbles. The international mobility of capital hinders the implementation of economic policies in developed countries, as well as in developing countries. Central banks, as well as budget and fiscal authorities, are dominated by financial markets which are quick to sanction with speculative attack policies they judge to be contrary to their interests. A country cannot maintain the stability of its currency and the autonomy of its economic policy simultaneously in a context of perfect mobility of capital (Mundell's impossible trilogy). Since international financial instability is directly linked to the deregulation policies implemented in the 1980s, one important channel for restoring financial stability is to give to every country that so wishes the possibility to introduce capital flows controls, at the national or regional (Europe) levels, through regulation and taxation. As James Tobin put it 30 years ago, at the outset of financial globalization, there is a need to "throw sand in the wheels of finance".

Besides reinforcing national economic policies through increased financial regulation, there is a need for more active inter-government cooperation. Indeed, due to the openness of most national economies, governments need to improve their coordination with a view to improving the efficiency of economic policies.

Aiming at sustainable development

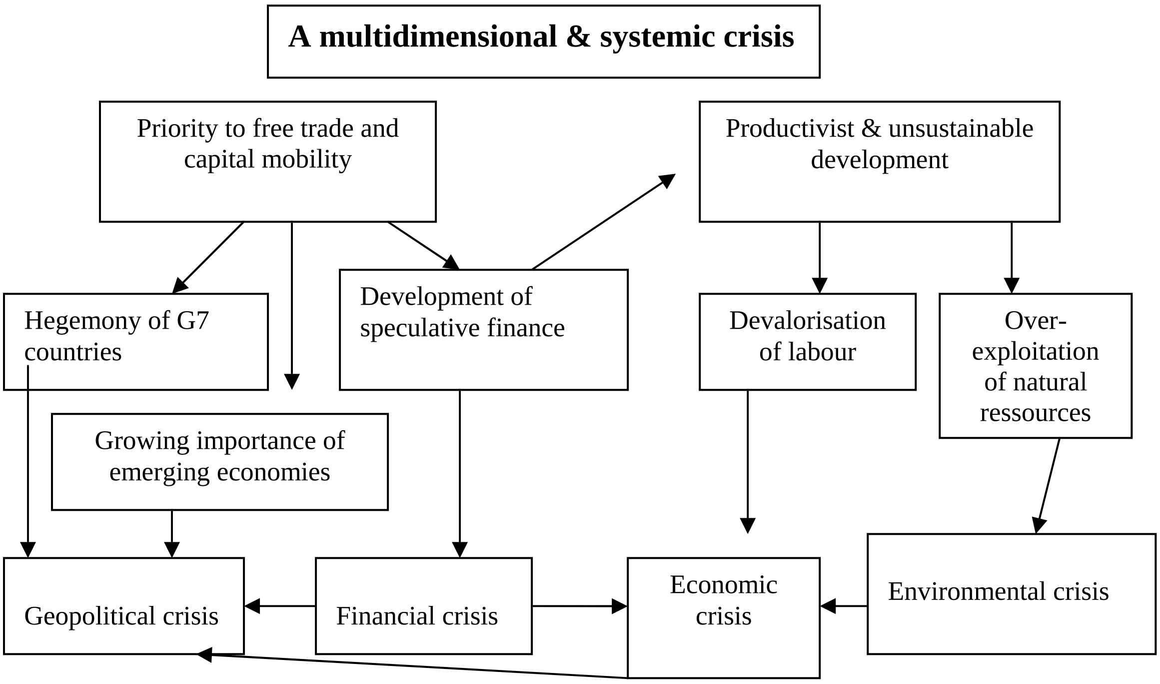
Prior to devising the new rules of global governance, it is necessary to define the ultimate goal of globalization. The relevant concept for that purpose is sustainable development defined by the Bruntland commission as development that "meets the needs of the present without compromising the ability of future generations to meet their own needs"[7]. Sustainable development comprises three major interdependent dimensions : environmental, economic and socio-political.

Sustainability takes a critical signification in the context of the profound crisis which has struck the world economy, starting from the United States in 2007. Indeed, one may consider that the ongoing crisis is systemic, unlike the preceding crises which took place during the post-war period. It reveals that the actual model of development is unsustainable. This conclusion stems from the fact that this crisis is multidimensional, as shown by figure 2. The productivist growth model - based on the overexploitation of natural resources and on the devalorisation of labor relative to capital – has reached its limits. The priority given to capital mobility has contributed to the rise of speculative finance and to international instability. Simultaneously, the development of international trade favoured the increasing role of large emerging market economies on the international scene, leading to geopolitical tensions. In

[7] Report of the World Commission on Environmental Development : Our Common future, UN documents, 1987

short, this crisis concerns the three major pillars - economic , environmental, and political – which define sustainability. It follows that one of the major goals of a reformed global governance should be to create the conditions for a sustainable development.

Figure 2



Reforming global governance

If sustainable development is to become a major objective for globalization, then important institutional changes should take place regarding global governance (see figure 3). This stems from our previous conclusion that institutions play a crucial to regulate markets. One of the reasons for the non sustainability of the current model of development is because it gives priority to trade and finance relative to other fundamental social and ecological goals. There is a need to promote a new hierarchy with respect to international standards and to introduce social, ecological and political goals among fundamental guidelines for globalization. This means that international agencies linked to the United Nations, such as the International labor organization (ILO), International health organization and the UNESCO, should play a role equivalent to the International monetary fund (IMF) and to the World trade organization (WTO) respectively in charge of the regulation of international finance and trade.

One of the major changes in the recent trends of globalization is the rise of large emerging markets economies, such as China, India, South Corea, Brasil, Russia, South Africa. A democratisation of all international organizations is necessary to include these large countries, as well as smaller ones, in the decision process regarding the governance of globalization. The creation of the G20 in the place of the G8 has been a first step in this direction. There is a need to go further towards a broader participation to the global decision process of all countries (including developing countries) and of all major social forces and NGOs.

New forms of global democracy have already taken place and need to be developed. Two major international events have plaid a decisive role in this respect. The first event is the WTO summit which took place in Seattle in 1999. Economic and government leaders from 135 countries tried in vain to reach to reach a new trade agreement. They were confronted with 50.000 demonstrators from all over the world ready to offer organized resistance. The lesson of the Seattle summit was that the fate of the word could no longer be determined by a bi-polar power struggle between governments of nation states and big business (especially transnational corporations and lobbies). The WTO had reflected this bi-polar power structure to its very core. A third force had emerged with elemental strength to contest the monopoly of the two other powers (economics and politics). This third force was global civil society advocating for such fundamental values as justice, democracy, respect for nature, fair trade and human rights.

The second step towards a new process of global regulation was the World Summit on Sustainable Development organized by the United Nations in Johannesburg in 2002. This summit brought tens of thousands of participants, including heads of State and Government, national delegates and leaders from non-government organizations (NGOs), business and economic lobbies to focus the world's attention and direct action on crucial challenges, including improving people's lives and conserving natural resources in a world that is growing in population. It was recognized that broad participation and inclusiveness are key to the success of sustainable development. All sectors of society have a role to play in building a future in which global resources are protected, and prosperity and health are within the reach of for all the world's citizens. Therefore, in addition to governments and States, there was an active participation at the Summit by business, industry and farmers, and by representatives of global civil society, including trade unions and NGOs. Talks and negotiations took place between governments, world-business and global civil society. More recently, there has been again an active participation of the three groups of powers at the summit on climate change which took place in Copenhagen in December 2009. This new process has been called "threefolding" by Nicanor Perlas, a NGO activist from Philippines[8]. In threefolding, the three major powers of the world-business, government and civil society mobilize their unique economic, political and cultural perspectives, talents, and resources to create a different and more beneficial kind of globalization.

Corporate social responsability : voluntarism or binding standards ?

Under the pressure of civil society, transnational corporations proposed a new strategy under the heading of "corporate social responsibility" (CSR). CSR appears to be one of the answers of leading elites to the social movements which are increasingly challenging the exorbitant powers of the multinationals, which political decisions of deregulation and generalized privatization have been reinforcing for twenty years now. Two tendancies can be recognized about CSR. First, CSR can be viewed as falling under the more global trend towards the privatization[9] of law. The field of the «social responsibility" is thus that of " soft law ", non-constraining, freely chosen, made from engaging with moral value, not judicially punishable, instead of state legal regulations. It is a matter of promoting self-regulation, in

[8] Nicanor Perlas, Shaping Globalization : Civil society, Cultural Power and Threefolding, 2000.

[9] Or of «Re-feudalization " according to the expression of the lawyer Alain Supiot concerning «the employers' self-regulation". See *Beyond Employment. Changes in Work and the Future of Labour Law in Europe* Oxford University Press, 2001, 245 p.

cooperation with chosen partners, instead of the collective bargaining with compulsory partners. In this view, CSR could be a way for the short-circuiting of trade unions. The majority of corporations belong to the first category.

The so-called subprime crisis which was initiated in 2007 suggests that major actors in the financial sector (transnational investors and banks) have to be constrained by international regulation. The objective of these rules should not only aim at reducing financial instability but also at promoting social and ecological goals among these actors. Indeed, CSR is not as important in the finance sector as it is in the industry sector. However some new categories of investors, which we may call "long term investors", are starting to introduce new forms of management based on extra-financial standards, such as social and ecological standards.

According to a second view, the emergence of corporate social responsibility testifies to the weakening of the hegemony of the neo-liberal doctrine on "corporate governance " by only " shareholder value " and of the growing interest for the reformist approach known as "stakeholder", which recognizes the legitimacy of the interests of all the "stakeholders" of the company. Deep down and to a large extent, the rise of the "socially responsible" theme is linked to the crippling illegitimacy of the pure neo-liberal doctrine which considers that the exclusive mission of the corporation is to maximize the income of shareholders. In this view, CSR can prove beneficial for the all partners of corporations, besides shareholders. CSR can be a way to increase the room for manoeuvre of the labor unions, independent NGOs, and international organizations like ILO. CSR should be used to take the multinational companies and their managers "at their word"[10].

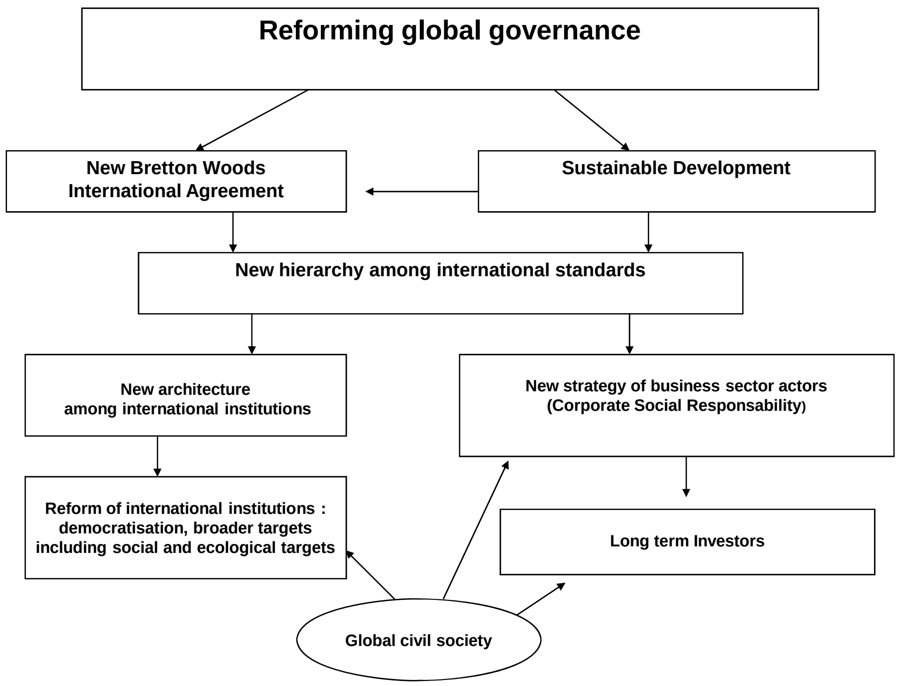
If one is to take seriously the second view which considers that CSR matters, binding standards are needed to take CSR beyond voluntarism. The existing experience shows that the voluntary commitment of business is insufficient to guarantee good practice[11]. Today, there are no mechanisms for making ethical and human rights standards binding for business. International procedures are lacking and resorting to national laws is not efficient for the regulation of transnational corporations. Parent companies establish separate entities to operate in different countries. It is then difficult to hold transnational corporations responsible for the misconduct of their subsidiaries. Among NGOs and the UN adminisrations, such as the UN sub-commission on the promotion of Human Rights, there is an emerging consensus for the definition of international binding standards.

To conclude, the global crisis which started in 2007 raises the question of the construction of an alternative international order. A new international agreement – called "New Bretton Woods" – is required in the place of the Washington Consensus order which was imposed by leading political and economic elites. Since the ongoing systemic crisis is multidimensional, reforms must not only improve the regulation of finance, but should also deal with the sustainability of global development. International institutions and world-business need to comply with fundamental standards in terms of democracy, ecology and social needs, as illustrated by figure 3.

[10] « Corporate Social Responsibility or democratic control of economic decisions ? », Attac scientific council, Paris, 2002.

[11] Christian Aid, « Behind the mask – The real face of corporate responsability », 2005

Figure 3


Reforming global governance
New Bretton Woods International Agreement
Sustainable Development
New hierarchy among international standards
New architecture among international institutions
New strategy of business sector actors (Corporate Social Responsability)
Reform of international institutions : democratisation, broader targets including social and ecological targets
Long term Investors
Global civil society