HELMUT WILLKE
GERHARD WILLKE

# POLITICAL GOVERNANCE of CAPITALISM

## A Reassessment Beyond the Global Crisis

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Helmut Willke

*Professor of Global Governance, Zeppelin University, Friedrichshafen, Germany*

Gerhard Willke

*Chair of Economics, University of Applied Sciences, Nuertingen, Germany*

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# Abbreviations

| | |
|---|---|
| ABS | asset-backed securities |
| AIG | American International Group, the world's largest insurer |
| Attac | Association pour une taxation des transactions financières pour l'aide aux citoyens |
| BIS | Bank for International Settlements |
| CC | corporate citizenship |
| CDO | collateralized debt obligation |
| CDS | credit default swap |
| CMBS | commercial mortgage backed securities |
| CSR | corporate social responsibility |
| ECB | European Central Bank |
| EEAG | European Economic Advisory Group |
| FSB | Financial Stability Board |
| G-20 | Group of Twenty |
| HRE | Hypo Real Estate |
| IIF | Institute of International Finance |
| IMF | International Monetary Fund |
| INGO | international non-governmental organization |
| LTCM | Long Term Capital Management |
| LTMF | Longer Term Management Fund |
| OTC | over the counter (trades) |
| PPP | public-private partnership |
| RA | rating agency |
| RMBS | residential mortgage backed securities |
| SEC | Securities and Exchange Commission |
| SIV | structured investment vehicle |
| SPE | special purpose enterprise |
| SPV | special purpose vehicle |
| TAN | transnational advocacy network |
| TNC | Transnational Corporation |
| WB | World Bank |

| | |
|---|---|
| WEF | World Economic Forum |
| WHO | World Health Organization |
| WTO | World Trade Organization |

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# 1. Exposition – capitalism as systemic risk

What if capitalism were to collapse? Many critics of capitalism do not realize that there is no viable alternative to capitalism after the demise of socialism; there are only alternatives within market capitalism. Varieties of capitalism span a broad range from market fundamentalism to welfare capitalism, and these varieties correspond to varieties of democracy (Hall and Thelen 2005; Willke 2009a). As a specific governance regime for the economy, capitalism is based mainly on self-organization and self-governance of markets, supplemented with varying institutional arrangements to safeguard the proper functioning of the market. However, at the same time global capitalism has become a systemic risk, and the global financial crisis should be regarded as a 'normal accident' within an untenable architecture of global finance. This paradox of capitalism – presenting a systemic risk because of and in spite of its achievements – is the base-line for this book.

Even market fundamentalists do not doubt that markets require legal institutions, political frameworks and cultural patterns in order to function as markets. The details of the relations between politics and economy, of the political preconditions of a market economy and of the architectures of a political economy are, of course, contested. But it seems evident that a positive, self-reinforcing relationship between capitalism and democracy depends on reining in the self-destructive tendencies of an unfettered market capitalism by defining rules for public goods (Malkin and Wildavsky 1991), rules for accountability (Held 2004; Keohane 2003), rules against 'predatory' abuses of market power (Shiller 2009) and rules for coping with economic and financial globalization (Roubini and Mihm 2011; Stiglitz 2007: 269 ff.).

The global crisis of 2007 onwards has destroyed the myth of the gloriously self-regulating 'free' market. But what would be a more adequate description of the range and role of 'free' markets? Ironically, contrary to the epithet of 'neo-liberalism' it is the proponents of classical liberalism who have given answers to this question which still appear to be valid today (Willke G. 2003). The centerpiece of their argument is that the market cannot produce its own preconditions – for example rule of law, the institution of private property or prevention of monopolies – and therefore it needs the regulatory powers of polities.

This book will pursue the argument that revisiting capitalism after the global financial and economic crisis means assessing capitalism before the next crisis. The next crisis, however, will not be a crisis of capitalism but a crisis of governance, or more to the point, a crisis of the relation between capitalism and governance and, thus, a crisis pertaining to the governance of capitalism.

The crises inherent in the deployment of capitalism have always nurtured the suspicion that capitalism is not only running the periodic risks of boom and bust but that capitalism as an unfettered economic regime *is* a systemic risk threatening the collapse of society as a whole. Karl Marx perceived the devastations of 19th- century Manchester capitalism as evidence of a built-in propensity to self-destruction. In 1910 Rudolf Hilferding published a scathing criticism of financial capital, again focusing on the 'general conditions of crises' (Hilferding 1981 (1910): part IV). A century later, Nouriel Roubini and Stephen Mihm, among others, expound global financial capitalism as a crisis-prone economy, maintaining that 'capitalism *is* crisis; it introduced a level of instability and uncertainty that had no precedent in human history . . . [T]he rise of a small coterie of incredibly powerful, opaque financial firms has generated a far more unsettling problem . . . [it] created a system that is extraordinarily vulnerable to systemic risk' (Roubini and Mihm 2011: 46 and 210).

Indeed, in view of the global financial crisis and its continuing effects on economy, international trade, trade imbalances or public debt, the question is whether Schumpeter's conceptualization of market competition as a process of 'creative destruction' (Schumpeter 1975) is but a euphemism and needs to be reinterpreted as creating destruction on a grand scale. As long as 'capitalism' actually was a distributed system of nationally defined and delimited spaces, a combination of Schumpeter's creative destruction and Ricardo's comparative advantages, even serious crises were limited to regional or national levels. The 1990s saw a series of national economic, financial and currency crises which sent shock waves over the globe but seemed to be solvable, temporary and necessary to correct bad economics and bad economic governance.

This complacent interpretation of economic crises appears to have outlived its appeal with the global financial crisis and its aftermath. The challenge now is to devise ways to steer between the Scylla of capitalism as systemic risk and the Charybdis of missing alternatives to capitalism. This book will argue that any viable way out of this conundrum must involve a revised and reconsidered role of political governance of capitalism. Capitalism has become a global force, sustained within a network of economic, financial, technological and regulatory interdependencies and, at the same time, deprived in some crucial respects of the moderating powers of the nation-state. Political governance of capitalism, therefore, needs to be configured as a multi-level system comprising national, regional and global levels. This kind of governance is more exacting and more difficult to achieve than previous models of political-economic regimes because it has to tackle the fundamental problem of balancing national egotisms and global public goods – which do have repercussions on the welfare of nations. And it has to come to grips with an increasingly pressing antinomy between a democratic mode of political governance (as exemplified by most OECD nations) and an authoritarian mode of politico-economic governance (as exemplified mainly by China and Russia).

It turns out that capitalism is a systemic risk for two reasons. As economic operational mode it is plagued by internal contradictions that threaten to undermine the very preconditions of its own functioning. As part of a politico-economic constellation capitalism is coupled with democracy (an apparently ideal combination promising the end of history, Fukuyama 1992) but in reality opening up a battle zone of continuous conflict between differing rationalities. Whereas democracy builds on the principle of equality, the 'axial principle of equality' (Bell 1976b: XVII) – one person one vote –, capitalism's driving force is difference (as inducement for exchange), resulting in vast differences of wealth, influence and authority. As providers of jobs, taxes and other incentives large corporations, trusts, foundations, banks and other financial organizations are in a position to derogate the egalitarian principles of democracy. The more an ideology of market fundamentalism and deregulation prevails in a democracy, the more the gates are opened for unfettered collusion between economic and political elites inviting, for example, the creation of a huge and unregulated 'shadow banking system' or the revocation of the Glass-Steagall Act by the infamous Gramm-Leach-Bliley Act of 1999, thus abolishing the barriers against devastating internal conflicts of interest in huge financial conglomerates (Roubini and Mihm 2011: 74 f.).

In addition, a regulatory focus on single firms and their risk behavior is neglecting structural issues and negative externalities of the risk strategies of single firms. New types of operational risks emanating from individual firms might coalesce to systemic operational risks and market risks that overwhelm the coping capacities of individual actors of the financial system: 'The internal risk management regime – for credit and market risk, operational risk, compliance risk – needs to meet a more exacting standard. The requirements for operational resilience for technology systems are necessarily more demanding' (Geithner 2004: 4). Obviously, this also increases the complexities of financial governance to manage systemic risk.

The shifting grounds for regulatory supervision correspond with a marked change in risk perception within global finance during the last decade. In the 1990s, major risks derived from aberrant or criminal behavior of single firms and persons. By 2003, the sources of risks had shifted to complex (if not outright deceitful) financial instruments and adverse macroeconomic conditions for the business strategies of financial firms. At present, the systemic effects of individual risk taking are becoming more accentuated, because the traditional separation of different types of financial institutions, in particular the separation between banks, insurance companies, securities and funds, already loosened by the Gramm-Leach-Bliley Act of 1999 (for the USA) is undermined by a non-transparent concatenation of risk propensities via diffusing effects of structured credit instruments (Plender 2005) and the creation of a massive shadow banking system intended to hide major transactions, to enhance lack of transparency and to cover serious parts of the financial system under a veil of ignorance by operating outside regular banking supervision and national regulation. The shadow banking system 'is a nexus of private equity and hedge funds, money-market funds and auction-rate securities, non-banks such as GE Capital and new securities such as CDOs and credit-default swaps . . . On the eve of the crash, more capital was flowing through it than through the conventional banks' (Economist 2009: 20 f.).

As the field of options within the financial system is extended into the abyss of structured derivative instruments and into the labyrinths of prolonged chains of conditioned events, the chances and risks of aggregate or even systemic effects of mutual reinforcement, snowballing, leverage and positive feedback loops beyond single firms loom large. A complex array of options corresponds with chances of 'low-probability, high-impact events' (Kohn 2004). A regulatory focus on single firms necessarily makes governance blind to systemic turbulences. These turbulences certainly start with some actions and decisions of single firms, like kids throwing snowballs, but these actions then turn into avalanches by setting off chain reactions that follow the logic of the financial system and defy the motives and reasons of individual people or firms involved.

When the bubble bursts and the crisis is unfolding, systemic risks turn into systemically relevant threats of meltdown. Again, nobody can know for sure what event and what organization/institution exactly is systemically relevant. The notion covers various aspects: (1) an organization is 'too big to fail', meaning that its failure precipitates the downfall of an entire sector of the financial system; (2) an organization's failure would kick off an avalanche of related failures within the financial system, particularly by destroying the quintessential trust which fuels financial transactions (like interbank loans); (3) the failure of a sector of the financial system would expand into the 'real' economy, putting firms and jobs at risk, thus impinging on the social security system and thereby connecting to politically touchy fields; and (4) an organization's failure would trigger social unrest, protest and more violent expressions of deception and insecurity from affected people, thus again connecting to politically touchy arenas.

The notion of 'systemic relevance' implies a responsibility of politics to prevent a critical state of financial/economic affairs. Its definition derives less from financial/economic reasoning than from political judgments of *political* relevance. Politics finds itself in a double-bind of unavoidable non-knowledge and non-transparency: political decision-makers have no way to know the exact financial/economic implication of a critical situation since even most of the financial and economic agents involved have no clue of what is going on – or going wrong; and they have no way of knowing whether or not political action (such as bailout, guarantees, grants, the creation of 'bad banks' or even nationalization of firms and so on) will solve the problem or whether the solution will trigger the next crisis.

A case in point: The bailout of the investment bank Bear Stearns by the US Federal Reserve in March 2007 was seen as a successful intervention against the risk of 'systemic shocks' from the failure of a large financial corporation. 'The bailout was justified on the grounds that the collapse of Bear Stearns appeared to be driven by marked illiquidity rather than insolvency . . . Yet, it has been noted . . . that the Fed did not have first-hand information on Bear Stearns, as this was outside its supervision. How can a central bank with no supervisory power over investment banks tell whether one such institution is or is not insolvent?' (Sinn 2009: 85).

In spite of many remaining doubts, the notion of 'systemic relevance' is helpful in configuring the transition points in the relation between economy and polity. Politics is defined as the functional subsystem of (modern) societies responsible for making collectively binding decisions. Politics is in charge of deciding on the range of public goods – and of providing them. Thus, political action seems appropriate as soon as a public good (for example systemic stability) appears to be at risk. Although the distinction between private concern and public interest will remain controversial in most cases, the distinction itself must be made, and the political system is entitled to define 'systemic relevance' along its own operational decision criteria.

To be sure, there is no guarantee that even legitimate and appropriate regulation will prevent crises: 'Given the financial system's fallibility, regulation is bound to be fallible too' (Economist 2009: 20). The point here is that capitalism is not a free floating system but is necessarily embedded in societal contexts in general and in democratic prerogatives in particular. 'The case for a government-led capitalistic approach (and for not allowing the free market to run roughshod) has seen no more compelling evidence than the 2008 credit crisis' (Moyo 2011: 141). As soon as the gyrations of markets impinge on public goods or concerns, as in some instances they inevitably do, democracy must impinge on capitalism, too. In this sense, core components of democracy, i.e. legitimacy, participation, accountability and transparency, have repercussions on the selection of valid models out of a variety of optional forms of capitalism – including its financial system. And thus, major changes in the constitution of systemic risk in the global financial system demand adequate responses from democratic polities (and even non-democratic ones) which try to regulate global finance: 'Given our current knowledge, it is not realistic to expect a single measure of systemic risk to cater to all purposes; in fact, it is actually dangerous to do so' (Borio 2011: 6).

A first step of the following reasoning will be to delineate some of the democratic interfaces of capitalism, perceived as the contextual framework providing the ground-rules for separating and recombining public and private goods, public and private authority, public and private accountability and, increasingly, public and private risk. An intricate interplay of private and public aspects of major dimensions of democratic societies exposes the public sphere to private concerns and interests, including an influx of expertise and commitment of private actors and organizations promoting specific common goods such as transparency, accountability, sustainability or responsiveness. At the same time the interleaving of public and private is sustaining the embedding of capitalism in societal contexts. It is by confronting capitalism with the elaborate demands of public responsibilities that capitalist dynamics impinge on public goods. When this containment and embedding fails (corresponding to a failure of politics), as in the global financial and economic crisis, capitalism becomes a systemic risk – that is, a risk of destroying capitalist democracy.

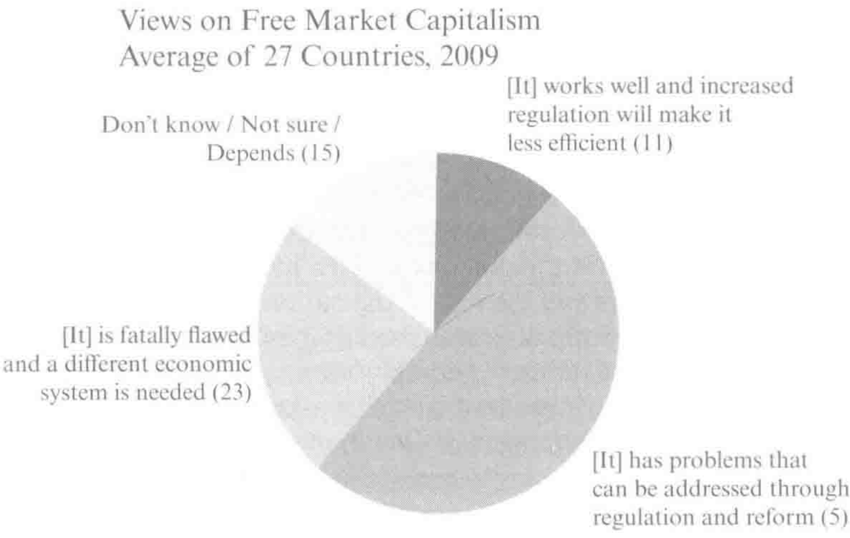
The second step in the reasoning of the book is concerned with globalization as the most important new factor changing the face of capitalism and reconfiguring the relation between capitalism and governance. Globalization has created a fundamental incongruence between a truly global reach of economic and financial transactions on the one hand and a domestic/national reach of public rules and regulations on the other, exposing the nation-states' incompetence to deal efficiently with a global crisis: 'Globalisation of financial markets has systematically and vastly outpaced the development of their governance: governments have lagged behind in reshaping domestic and international institutions as well as in changing and adapting policy behavior' (Sinn 2009: 59). This incongruence becomes more threatening for the stability and viability of the global economic and financial system if the proposition is taken seriously that a poorly governed capitalism is amounting to a systemic risk. Chapter 3 will address this problem.

The disparity between globalized markets and national political systems brings forth new challenges for a global political economy. Chapter 4 argues that governing global capitalism remains a euphemism as long as the means of governance remain tied to nation-states. A sober evaluation of the capacity of governance and self-governance of politics is needed to gain an understanding of the reach and restrictions of political governance of capitalism. Equally important are the means of self-governance of capitalism as a system of self-regulating economic activities. Capitalism, however, is not self-sufficient but depends on contextual conditions provided by political systems as the institutions for making collectively binding decisions. Creating a framework for global capitalism is the most demanding task of the fledgling institutions of global governance.

In chapter 5 we describe core elements of a governance regime for global capitalism, connecting the future of capitalism with future developments of democracy. Essentials of democracy, such as the components creating input-, output- and throughput-legitimacy, increasingly are influenced by consequences of globalization and thus are changing the option space for democracy and for political governance. The Chinese case of combining political dictatorship with economic freedom of sorts poses a serious challenge to the 'Western' ideal of combining political freedom with economic liberalism. Rising competition between global varieties of capitalism forces the traditional 'Western' model of combining democracy and capitalism to elaborate its idea of democratic ethics and to specify its notion of 'the spirit of capitalism'.

This, we surmise, should be understood as a chance to revise capitalism and, in particular, to devise more intelligent modes of political governance of capitalism. The ongoing global crisis has shown the face of an 'ugly capitalism', mainly portraying managers of some large investment banks and hedge funds but also some systemic traits of global finance (for example excessive risk taking and 'irrational exuberance'). So it seems all the more important to think about a 'responsible' variety of capitalism which acknowledges its embedding in democracy and which addresses the smoldering global problems of asymmetries and unjust terms of trade, of predatory exploitation and wasteful exhaustion, and of social and environmental destructiveness in the interest of its own survival, thus making a revised capitalism more attractive even in the eyes of the more sophisticated of its discontents.

There are plenty of discontents. In a survey conducted for the BBC during June and October 2009, including almost thirty thousand adults in 27 countries, only 11 percent of respondents




*Source:* *BBC World Service 2009.*

*Figure 1.1* *Views on free market capitalism*

considered capitalism to work well, whereas about half of the respondents answered that regulation and reform were needed to cure capitalism (see Figure 1.1). In spite of continuing predictions of capitalism's imminent demise (Kotz 2009: 316), however, capitalism, including global finance, is recuperating from the serious downturn of the ongoing crisis. It is another indication of historical evidence that capitalism is more flexible, dynamic and resilient than its radical critics like to assume.

Delineating some crucial prerequisites for political governance of global capitalism means to bring up again the dormant dilemmas of political economy within an intensifying debate about the relationship between democracy and capitalism (Iversen 2006; Nelson 2009; Streeck 2010, 2011). This theme will run through the entire book and will be treated from different angles in the various chapters.

The legitimacy of global capitalism hinges on the ability of modern democracies to reconcile democratic ethics and a spirit of capitalism which is based on responsiveness and resilience. In this sense, revising a variety of capitalism which has become a systemic risk encompasses three distinctive but related spheres of transformation.

- First, global capitalism as a self-regulating social system needs to adapt to new challenges created by various processes of globalization, global interdependencies and global concatenation. While systemic failures are the most salient new challenges, other global problems such as environmental decline, depletion of resources, and poverty need to be addressed, too.
- A second transformation concerns the recurrent 'dream of a strong state' (Hofmann 2008) which has been renewed by the ongoing crisis and the role of the nation-state as savior of last resort. While this role was forced upon the nation-states for fear of system failure – and only a few nations took advantage of it – a more sober look at the capacities of the nation-state reveals that the dangers of over-extension and involvement in micro-management of economic affairs loom large.
- Thirdly, political governance of capitalism then means to transform the lessons learnt from history and from the ongoing crisis into rules and principles for a balanced combination of self-governance of a self-referential economic system and contextual guidance by a variety of political actors and regulatory institutions. What makes this a daunting task is the complexity of global capitalism on the one hand and the fragmentation and diffusion of political authority in global contexts on the other. Concerning governance of capitalism, the supreme – and sufficient – role of the nation-state definitely is history. As long as there is no global correlate to the nation-states' regulatory powers global capitalism will be volatile and disruptive. However, the strengths of democracy as a mode of governance extend beyond the confines of the nation-state and should be taken into account in devising modes and models of global governance in general and political governance of capitalism in particular.