



**Strong Financial Markets, Weak European States.
May a Sovereign Europe become the Democratic Issue?**

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Financial Markets and State Sovereignty in the Evolution of Modern Capitalism



The relationship between financial markets and state sovereignty is a central issue in modern history.

National sovereignty, since the emergence of representative democratic states, is based on the rule of law and the sovereignty of the people. Since then, sovereign states have been represented by democratic institutions contained within their national borders.

The relationship between global financial markets and state sovereignty came to be the relationship between global finance and representative democracy.



Financial Markets and State Sovereignty in the Evolution of Modern Capitalism



Capitalism has broken its mould several times from its birth in Italian communal life of the thirteenth century. In each case the cause of the crisis was connected to excessive growth in the power of financial markets over the state and society. Each cycle of expansion has ended in the destruction of institutions and prolonged conflict within and among states.

Giovanni Arrighi in *The Long Twentieth Century* has described this development as the onset of 'systemic chaos'.

Fernand Braudel has characterized the result as "systemic cycles of accumulation" -- intervals featuring rapid and stable expansion of world trade and production fuelled by an extraordinary growth of the financial superstructure.

Such periods invariably resulted in a crisis of over-accumulation and eventual breakdown of the organisational structures on which the previous expansion of trade and production had been based.

Financial Markets and State Sovereignty in the Evolution of Modern Capitalism



Is there a way to avoid crashes by facilitating swift transformations in the evolution of world capitalism?

A slow-down in the rate of change, and some important changes in the international regulations would be the best way to maintain progress while avoiding chaotic social disruption.

These changes may be achieved only by a strong national, supranational, and international regulation of market forces, recalibrating the relations between finance and the real economy as well as between the market and the political choices made by democratic institutions.

A new system of market regulation should parallel the establishment of an international order through a wide transfer of sovereign power from the national states to regional and international institutions.

While attempted, such a combined solution has not yet succeeded. In the wake of the current crisis, the need and the complexity of such a solution is the challenge which now confronts us.

The First and the Second Grand Globalisation



It may be useful to compare this current phase in world history – the so-called second grand globalisation – with the previous one.

The first globalisation began in the mid-eighteenth century and ended with the Great Depression of the 1930s.

The second globalisation started in the 1980s, accelerated suddenly with the fall of the Berlin Wall in 1998, the Doha Round of the WTO in 1994, the great financial crisis of recent years, and is still in the making.

The two phases share certain common elements, but they differ significantly in others.



The First Grand Globalisation



According to Karl Polanyi, the nineteenth-century first era of globalisation was based on four institutions :

the balance-of-power system, which assured a long phase of peace preventing war among the great nations;

the international monetary system based on the Gold Standard;

the concept of the self-regulating market;

and the liberal state.

Under this hypothesis, peace and economic development were assured for a period of time for over a century.

What happened in the beginning of the twentieth century, argues Polanyi, is that the mechanism of the self-regulating market turned out to be a “stark utopia”. The collapse of the system produced one of the greatest crises in human history.

The Role of International Finance



What kept this phase of modern capitalism functioning well was the power of international finance (*haute finance*) which reflected long-standing cooperation among nation states.

Some contended that international finance was a mere tool of governments; others argued that the opposite was true – that it was the real power and guarantor of the world order.

There is no question but that international finance provided the main link between the political and economic organisation of the world. Independent, but connected with single governments; independent, but connected with central banks – international finance was not a possession of any particular nation-state.

It flirted with diplomacy to grant grand peace (if favouring minor, short, and localised wars) with the only goal being to maintain the right conditions for constant accumulation of capital.

It embodied the abstract concept of internationalism based on self-interest.

The Role of International Finance



Anyway the recent Belle Époque of financial capitalism, no less than its historical predecessors - from Renaissance Florence to Britain's Edwardian era, through the Age of the Genoese to events in Dutch history - is based – I quote Giovanni Arrighi -

“on massive, system-wide redistributions of income and wealth from all kinds of communities to capitalist agencies”

In the past, redistributions of this kind engendered considerable political, economic and social turbulence.

The Return of States over Markets



The 20th century will be remembered as the century of the State.

The “Fin de siècle” represents the apotheosis of the first globalisation.

The First World War signalled the start of the crisis, which was to erupt in full force with the Great Depression of 1929.

Reaction to the crisis strengthened the role of the state in the economy.

The Return of States over Markets



Roosevelt's New Deal in the US.

Nationalisation and the radical economic and social reforms of the *Front Populaire* in France.

Fascist neo-corporatism in Italy with the birth of the IRI (Institute for Industrial Reconstruction).

Nazism in Germany.

The emergence of Keynesian economics, the birth of the public corporation, the growing role of the unions and the philosophy of the New Welfare System in the United Kingdom.

They are all examples of the return to state-ownership, direct state intervention in the economy and the growing role of the Welfare State.

With the advent of the Second World War, economic forces rallied around the states to combat the “state of exception” created by the conflict.

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The Return of States over Markets



The Post-war period was characterised by the birth of mixed economies throughout Europe.

Protectionism, economic planning and state-owned enterprises are the hallmarks of this long period of economic and social well-being known as the Golden Age.

The growth of the Welfare State, which includes health insurance coverage, pensions, and other benefits, created a unique model of European citizenship.

The public spending/GDP ratio in the main European countries went from approximately 20% in 1950 to almost 40% in the eighties, then increasing to almost 50% at the end of the century. This development was possible thanks to very high rates of growth.

The European model was supported also by the United States, which considered it a defence against potential Soviet hegemony in Europe.

On the world economic front, the Cold War and the division of the globe into two large blocks contained the forces of globalisation.

The Return of States over Markets



The advent of the oil crisis called many certainties into question.

The following twenty years would force policymakers and theoreticians of the mixed state to radically review their positions. A new era was underway.

One of the reasons for the political crisis was a strong increase in public spending during the 1960s.

Now that the oil crises were putting a serious halt to growth, the high social spending policies of the previous decade became unsustainable (or were seen as unsustainable).

The crisis was affecting the economy as a whole, but it was especially damaging to the industrial sector.

To protect profits and investments, the government was not in a position to preserve all the benefits that were introduced in the previous decade.

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The Return of States over Markets



At the beginning of the 1980s, deregulation paved the way for a gradual transformation of the financial industry.

At the beginning of the nineties, two of the major American theorists in corporate law, Henry Hansmann and Reinier Kraakman, wrote an important essay called *“The End of History for Corporate Law,”* announcing the end of European, Japanese and Korean corporate ownership models, and the success of shareholder value over all other models.

It was the start of the extraordinary growth and development of corporate financial capitalism.

At the same time, Francis Fukuyama in *“The End of History and the Last Men”* proclaimed that the model of the liberal state and market economy was the final destination in the history of humanity and that it would be extended to the entire planet.

The EU and the Second Grand Globalisation



The fall of the Berlin Wall, the later WTO Doha Round and the financial crisis of 2008-2013 contributed to an acceleration in the speed of history.

With much of the world moving to “fast forward,” acquiring the market capitalism model in various forms and at different rates.

The second great globalisation stage was taking off, featuring the opening of markets and the end of neo-colonialism and global connectivity.

A new stage, the Grand Convergence, was about to characterize the 21st century.

The EU and the Second Grand Globalisation



In the meantime, in the EU, the Single European Act of 1987 and the Maastricht Treaty of 1992 overturned the original relationship between the state and markets.

Competitive convergence set a regime of competition at the centre of the economic constitution of the Union.

At the same time the Maastricht Treaty and the road towards the Euro imposed a fiscal consolidation which, as well as leading towards a reduction in public spending (which did not, as yet succeed), was steering towards the end of the system of public corporations and privatisation.

Lastly, the regime of competition (which includes the prohibition of state aid) reduced and transformed the European model of state intervention in the economy.

Combined with the rise of the new multinational financial powers a strong erosion of the EU Member States sovereignty in fiscal, economic, and industrial policy ensued.

The Second Grand Globalisation and Nations State



But the globalisation was undermining the national sovereignty even more strongly with the emergence of large countries that were once underdeveloped (initially China, India, Brazil and Russia, later joined by Indonesia, South Africa and Turkey, and within a few decades most likely augmented by Nigeria, Egypt, and Pakistan) whose population size and economic, military and political force, will risk triggering the marginalisation of many smaller sovereign states (including virtually most of the European states).

For these countries, the transfer of sovereign powers to larger political-institutional entities (regional or international) capable of counting on the international scene inevitably will be entertained as an option -- the surrender of ultimate sovereignty in order to participate in sharing arrangements at a higher level, a defensive move to protect against total loss of sovereignty, and, moreover, to give to the people sovereignty a new chance.

The 21st century may well be characterised by weak states in strong markets. The total absence of democratic legitimacy and accountability of the financial global players is, understandably, a troubling issue. The financial crisis has done nothing but highlight this fact.

The Institutions of the Second Grand Globalisation



We have seen institutions which were at the core of the first globalisation: balance-of-power among Great Powers; the international Gold Standard; the self-regulating market economy; and the liberal state.

Which are the institutions which characterise the twenty first century?

Balance-of-power among Great Powers under a plethora of international institutions;

the dollar standard under attack from the rise of the Euro and the Yuan;

the self-regulating market economy;

the liberal state extended, however, to a much larger number of countries in the world, but by no means to all of them.

The Institutions of the Second Grand Globalisation



The balance-of-power is still dominated by the United States and its closest allies.

The most widely recognised signs are the global impact of American popular culture and the growing importance of agencies of world governance that are influenced disproportionately by the United States and its closest allies, such as the IMF, the WB and the WTO.

New powers, however, are emerging within these institutions and the US hegemony is being slowly eroded.

The Institutions of the Second Grand Globalisation



The dollar-based international monetary system is still quite strong.

Nonetheless, the rise of the Euro and the Asian economies (China and Japan hold half of foreign US Treasury bonds) are putting strong pressure on the dollar.

Talks of a new multi-currency system are growing by the day.

It may still take time before the primacy of the dollar is abraded (the dollar is still a major yardstick in international trade), but the “currency war” is already in the making and it might increase its intensity in the next years.

The Institutions of the Second Grand Globalisation



The belief in the self-regulating economy has been the rule of thumb since the 1980s and, although there is much talk of change of paradigm, especially in Europe, very little has been done so far in terms of policy making, to introduce a real and effective regulation of the market economy.

The liberal state, after the fall of the Berlin Wall, has been found in a growing number of nations, although in most cases, the evolution from post-colonial dictatorship systems to liberal democracy, may take much more time than expected.

The institutional building needed for the introduction and development of liberal democratic systems, in countries that have had radically different political traditions and institutions, are long-term commitments.

Some of the great economic powers, such as China and some Arab states, do not indicate having any intention of turning into liberal states, at least not in the near future.

The Institutions of the Second Grand Globalisation



These considerations aside, there are much more important differences between the first and the second grand globalisations.

The first difference is the Great Convergence that characterises the world economy in the twenty-first century.

The first grand globalisation saw European countries dominating the world economy with their system of colonial states, fully under the influence of their colonial masters. Moreover, the Soviet Union and the countries that belonged to the socialist block were not part of the market economy wave of globalisation. They were consigned to another world.

Today, in the post-colonial and post-socialist era, nearly the entire globe participates in the arena of globalisation. Nearly two-thirds of the world population, mostly in Asia, is growing at rates very similar to European economies during the Golden Age.

The world economy will then experience a huge transformation, and together with it, an exceptional demand for capital investment, open to the global financial markets.

The Great Convergence



World population will grow from seven to nine billion by 2050; in Africa alone from one to two billion (UN).

GDP should rise, in the same period, from 72 trillion USD in 2012 to about 380 trillion USD in 2050 (then growing by five times in less than four decades). (OECD).

The fastest growing regions, according to forecasts, are Africa (7.0%) and developing Asia (5.4%).

As a result, North America and Western Europe are expected to fall from 41% of world GDP in 2012 to just 18% in 2050, while developing Asia's share is predicted to rise from 27% to almost 50% in 2050.

China is expected to overtake the US to become the largest economy in the world by 2020, to be, in turn, overtaken by India by 2050.

According to the concept of “personal empowerment,” in emerging economies alone, over three billion people will become the new bourgeoisie in the next ten years, This occurrence means that competition will be increasingly based on the size of markets, made up of global players and competitive consumers.

The Great Convergence



According to Arrighi, waves of financial expansion are engendered by a double tendency.

“On the one hand, capitalist organisations respond to the over-accumulation of capital over and above what can be reinvested profitably in established channels of trade and production by holding a growing proportion of their incoming cash flows in liquid form.” This penchant creates what he calls the "supply conditions" of financial expansion - an overabundant mass of liquidity that can be mobilised directly or through intermediaries in speculation, borrowing, and lending.

By contrast, territorial organisations respond to the tighter budget constraints, high public debts and rising costs of the Welfare State that is challenged from the slow-down in the expansion of trade and production by competing intensely with one another for the capital that accumulates in financial markets. Such a propensity creates what he calls the "demand conditions" of financial expansion.”

All financial expansion, past and present, is the outcome of the combined, if uneven, development of these two complementary tendencies

The Crisis of the Welfare State



The second difference from the first grand globalisation is the crisis of the Welfare States in European countries and the rise of public debt/GDP ratios, close to and above 100%, as a consequence of the Great Recession and the cost of rescuing financial institutions.

With the first globalisation, public spending was approximately 10% of GDP and public debt was much lower until before the war, curbed by inflation soon afterwards.

Today in most Western economies public spending is close to 50% of GDP.

Moreover, demographics in the advanced economies represent a dramatic burden for the future of social spending (health and pensions). If we add to this the low rates of growth in the advanced world, especially in Europe, then the high public debt/high public spending/low growth/ demographics equation becomes a nightmare for the future of these societies.

The Instruments of Financial Markets on Sovereign States



First, these players hold a large number of sovereign bonds and through this channel impose choices, even political ones, on states: the underlying principle is that “whoever owns part of your debt also owns part of your choices”, that is the typical power relationship that is created between creditors and debtors.

Second, markets are willing to invest as long as reforms that they believe are needed are implemented, influencing government policies on the regulation of the labour market, the tax burden, the welfare system, and privatisation.

Third, in democracies where politics have increasingly higher costs, whoever contributes to the electoral victory, and financial markets and large corporations and financial markets certainly do so, has the power to influence the democratic process of law making.

The Instruments of Financial Markets on Sovereign States



Finance utilises various tools in order to manage its power relationship over states: ratings agencies, powerful research departments in business banks, influence and/or direct or indirect ownership of specialist and general media, direct or indirect financing of large universities and research centres and/or individual commentators and, lastly, especially in developing countries, through the corruption of the governments and/or public officials.

Finance is therefore capable to model and reshape opinions concerning the state of health of an entire nation.

Finally, multinational large corporations and finance players elude the sovereign power of states, moving in several jurisdictions and tax havens, thus escaping two of the traditional powers of sovereign states, i.e. dictating the rules of law and enforce them through its courts and imposing taxes to implement democratically based policies.

Short-Term vs Long-Term



To a large extent, the problem is related to the temporal dimension of the interests involved.

Markets are looking for short-term private returns, while governments, have a duty to issue reforms that are in the long-term public interest.

The result has been an excessive reliance on short-term investment and a sizeable decrease in long-term investments. Long-term investments are crucial for the sustainable future of the world economy. They have strong positive externalities for the economy and for society as a whole, and they contribute to the creation of competitive economic systems that are based on technology and innovation.

Financial deregulation has created ever larger financial institutions with their sole mission being the accumulation of profits for shareholders and the compensation of managers for short-term increases in share value. American corporate governance systems, based on shareholders' value creation, have given strong incentive towards a short- rather than a long-term appreciation of banking and finance.

Short-Term vs Long-Term



Financial market globalisation and the excessive liquidity which has been poured into the global financial system, have contributed materially to financial arbitrage around the world. If one can borrow money at nearly zero rates and invest it in high-yield investments, why bother with costly and time-consuming valuation of long-term projects to finance the industry and investment projects in the real economy or in infrastructures?

After the crisis, which was mostly a crisis of excessive leverage, the new accounting rules of Basel III, with the good intention of restoring stability and good practices in the banking industry, has forced the European banking system, which historically provided a very large part of the global long-term financing of the economy and infrastructure, to a long and painful deleveraging process.

This development has increased speculation on the part of large banks to increase income, produced by financial short-term investments, and to transfer retained earnings to capital (instead of asking the market for capital increases) – thereby reducing the capacity of the banking system to finance long-term investment.

Short-Term vs Long-Term



Long-term institutional investors, such as pension funds and life insurance companies, for their part, could take up part of the long-term needs of the economy, but even in this case regulation does not seem to adequately reflect the important potential of such a role (see the Directive Solvency II in the EU).

Pension funds and insurance companies worldwide have more than 100 trillion in assets under management (source: OECD).

Today they invest a rather small quota of their asset allocation in long-term investments (such as fixed and social and intangible infrastructure).

Regulation could increase that quota so that investors, who have long-term liabilities, would allocate their assets in long-term assets, which are good for the economy today and a benefit for future generations.

Can a Sovereign Europe be the Solution?



An important case study of this relationship between financial markets and states is that of Europe.

The transfer by the Member States to the Union of important sovereign powers was made in order to safeguard peace, to gain influence on the international scene, to deal with the lack of raw materials, and to expand national markets. The economic purpose, in a liberalist format, takes precedence (disguised by time priority) over all else.

The Treaty of Lisbon only put a partial brake on matter, choosing the social market economy as the model for the European economic constitution.

The crisis, however, unleashed this brake.

In the name of competition, the economic policies of (some) states were restricted (regulation of state aid, stability pact, fiscal compact), but no action was undertaken to reduce the macro imbalances and the asymmetries which alter competition.

Where is the level playing field when an Italian firm pays twice as much interest on credit as a competing German firm and when other disparities between the two involve up to 30-40% higher costs for energy, regulation, bureaucracy, logistic, tax and pension burdens?

Can a Sovereign Europe be the Solution?



The dramatic crisis in recent years produced a growing awareness that in this way Europe cannot survive.

The phase in which it was considered sufficient for an intergovernmental EU to share national policies in a very “soft” way is now over.

European States will not be able to recover their sovereign powers, which have departed for Wall Street, the City of London, and other centres of financial power around the world.

They will suffer an unstoppable deterioration of their national sovereignty (and therefore also of popular/democratic sovereignty) unless we quickly manage to shape a European Union capable of having its voice heard and making its own objectives count against the (old and emerging) great powers and the increasingly global, stateless market players.

Can a Sovereign Europe be the Solution?



It is important to reinstate the sovereignty of the people in democratic states over global players who are without country and accountability except towards themselves. Countries need the capacity and power to make new global regulations and have the means to enforce them.

Experience, however, indicates that the United Nations and its satellite institutions (IMF, WB, WTO et al.) are not strong enough at this juncture to effect meaningful change. It is suggested that to be truly constructive instrumentalities, they require more effective governance mechanisms led by a country or a group of counties with the same power held by a traditional sovereign state.

The candidates are the great states with continental dimensions such as the United States, China, in the near future India, and, subsequently, perhaps Brazil, Russia and Indonesia. It would be critical for the interested parties to reach unanimous agreement that, in principle, they would develop the necessary means and powers within the G20 and the UN to construct a regulatory system capable of directing the global financial markets towards the real needs of the global economy and society.

Can a Sovereign Europe be the Solution?



With strong agreement among them, each participant, using the great territorial powers of enforcement, could bend the rules to achieve the design and application of new global regulation.

Financial regulations, except for technical details, cannot be left in the hands of non-governmental technocratic institutions which are not informed by the priorities of the people.

Only if united, with legitimate institutions that are fully and democratically recognized, can Europe occupy an influential seat at the table where global decision-making processes could take place.

A divided European Union will not have the necessary critical mass to weigh in on the governance institutions of the global world. Even Germany alone, with its increasingly expensive welfare system due to demographics and a general fear to include young people from other parts of the world belonging to different cultures, will not prosper alone. The European political Union requires, of course, a wide reshaping of the European constitution in order to assure the democratic representativeness of the EU institutions.

And it needs to do I soon.

Can a Sovereign Europe be the Solution?



Europe must be a significant player on the global scene. It has the potential of being an invaluable participant in mediating between the US, the old hegemonic super power which is determined to keep alive the “exorbitant privilege” of the dollar notwithstanding its high external debt, and the new emerging economies, with China at the top of the list.

A new multi-currency global monetary system is already written in the future. However, it will not happen tomorrow.

It must be clear, and it is probably already clear to all governments in the world, that without the Euro, it will not be a good new multi currency monetary global system.

The Euro, as a currency, in fact, contains within itself the culture, the history, the political and economic power of Europe, which has the historical duty to be the engine and the “pedagogue” in the complex search for a “grand and long-standing global balancing point”.

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Can a Sovereign Europe be the Solution?



In the end, a sovereign Europe is the solution to the relationship between and among state sovereignty, democracy and global financial markets.

Perhaps we are describing Utopia, but the absence of alternatives may make Utopia real.