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Deep Stall?

The euro zone crisis, banking reform and politics

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The euro zone crisis, banking reform and politics[1]

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ABSTRACT[2] *The Eurozone crisis presents as a confusing series of events which have two dominant interpretations: either the crisis is caused by the profligacy of South European governments or the crisis is symptom of a North/South divide in terms of trade imbalances and competitiveness. This paper presents a third account which focusses on problems arising from the character of banking and finance whose balance sheet interconnects and velocity through rehypothecation threaten sudden collapse. This political-cultural analysis is developed by analogy and disanalogy with an aircraft crash in October 1963 when a BAC 1-11 prototype crashed disastrously because the new T tail design configuration led to a "deep stall" which the pilot could not recover. In present day finance, control will fail unpredictably in event of major disturbance and there is no realistic prospect of engineering redesign as with the 1-11 after the crash. More seriously, private and social interests do not coincide in finance, as they do when passenger aircraft fall out of the sky. In our 'After the Great Complacence' analysis of the Wall Street and London crisis 2008-10, we focused on the policy elites who would not restrain finance before the crisis and could not radically reform it afterwards. We would now add that in the Eurozone crisis since 2010, there is an alarming gap between the interventions technically necessary to stabilise finance and what is currently politically possible; the reform agenda must therefore include political reforms which redistribute knowledges and rework institutions.*

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[1] The paper reports continuing research on the financial crisis at the Centre for Research on Socio-Cultural Change (CRESC), University of Manchester. It updates the book length argument of Engelen *et al*., *After the Great Complacence*, (Oxford University Press, 2011).
[2] Free download available from http://www.cresc.ac.uk/publications/deep-stall-the-euro-zone-crisis-banking-reform-and-politics
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> "To try to think outside of the manifold of combinations and outside of classification, outside of customs and fixed species, outside of discipline and specialty, outside the fossil remains of history, requires living outside of pressure groups and their quarrels as well."
> (Michel Serres, *Genesis*, 1995)

(1) Introduction: how to think about the crisis

The Eurozone crisis presents as a confusing series of events which for more than a year has threatened some kind of accident but not yet ended in general catastrophe. It is, as Barack Obama said, "scaring the world". It is clear that disintegrative forces are at work within an ill-conceived monetary union where sovereign default in Southern Europe would have dire consequences elsewhere. Beyond that, the nature of the crisis is in dispute. Some governments and electorates in North Europe diagnose it as a problem of profligacy by South European governments. This justifies the medicine of expenditure cuts and public austerity. Many others, in the commentariat and the financial markets, believe the underlying problem is one of North/South trade imbalance which reflects structural problems about competitiveness and specialisation. In this view, the problem is as much the strength of Germany as the weakness of the South.

The disagreement about nature and causes greatly complicates economic management and policy response. With EU-backed Eurobonds off the agenda and the ECB not empowered as lender of the last resort, EU governments bailed out Greece in May 2011 then spent much of the rest of the year in and out of Brussels summits disagreeing about the size and financing of a bail-out fund and/or about whether the ECB should adopt more aggressive monetary policies. By end of year, the EU national governments had anti climactically failed to agree on a large bail-out fund or anything else that could be represented as decisive and collective action. The situation changed in late 2011, when "technocrat" prime ministers were installed in Greece and Italy to replace obstructive democratically elected governments and the ECB unilaterally shifted its policy stance by offering more than €1 trillion 3 year loans to banks. A second Greek bail-out was patched up in February 2012, but many believed this only postponed a disorderly

Greek default and its probable exit from the Eurozone. Some in Germany and the Netherlands approached default as a lesser evil than fiscal transfer without guarantees, while others were fearful because the collateral damage from disorderly Greek default might not be contained. At the same time commentators watched the process of deleveraging in other and much larger Eurozone economies such as Spain, and remained of the view that a major crisis has only been postponed by European political and financial action to date.[3]

The immediate questions arising are threefold:

- why is our world now threatened by the dysfunctions of banking and finance?
- how is the ongoing and unresolved crisis to be managed? and
- is it possible to control banking in the longer term?

The collapse of Lehman in autumn 2008 required bank and market bail-outs which in retrospect bought some time but did not fix banking and finance. As a result, the financial crisis has now continued (with only a brief intermission in 2009-10) for four years. There are many different ways of answering these key questions, but to use the terms proposed by Michel Serres above, most of them work within the boundaries set by standard classifications and disciplines. For example, many would locate the Eurozone crisis by invoking a general (economic) concept of capitalism and a related understanding of the generic functions of banking and finance in such economies. Their answer would therefore be developed by locating events in what one might think of as a 'monological' framework. For instance, the Eurozone crisis might be understood as a case of Minskian dynamics arising from the general propensity of banks to lend in increasingly injudicious ways.

No doubt such approaches are helpful. However, our approach is rather different. This is because our aim is to rise to the challenge being set by Serres by mobilising multiple forms of knowledge – that is *knowledges* in the plural. Our object is to offer a political and cultural analysis of how a specific conjunctural form of finance threatens Europe as it is presently organised. But more strongly, we are also working on the assumption that the current state of crisis demands analysis and responses that draw on and juxtapose a range of different approaches: that 'monological' approaches are not sufficient by themselves. In practice this means that our team – and this paper – draw on the expertise of researchers from different disciplines and approaches, with the object of creating what one might think of a 'dialogic' or conversational form of knowledge. We work by relating diverse arguments and various forms of analysis (e.g. about technicalities in finance, the politics of reform, collapsing technologies)

[3] See Wölfgang Munchau, 'There is no Spanish siesta for the eurozone', *Financial Times*, 18 March 2012; http://www.ft.com/cms/s/0/28a4cfdc-6f6b-11e1-9c57-00144feab49a.html

rather like a remix in a digital music studio where different elements are added or subtracted, foregrounded or backgrounded, and speeded up or slowed down.

Our dialogic or conversational approach often starts from some kind of provocation, usually an image or analogy from one of our specialist fields which becomes the subject of internal conversation. In *After the Great Complacence,* our provocation was the elite hubris of Tony Blair's evidence to the Chilcott inquiry into the Iraq War. In this article, our provocation is quite different: it is a fatal airplane crash some fifty years ago. The aircraft in question – a BAC 1-11 prototype – crashed because a new design configuration unintentionally led to an irrecoverable "deep stall". The analogies between financial and aircraft crashes are not complete, but we argue both that they are real *and* that we can learn lessons relevant to finance from the disanalogies as well.

A dialogic or conversational way of thinking and writing is necessarily experimental. Sometimes it works very well, sometimes it works in part and there is also the inevitable risk that it doesn't work at all. To put it differently, multi-disciplinary dialogue of the kind being recommended by Michel Serres necessarily moves those willing to learn from it beyond the specialist comfort zones of their expertise, and produces new synthetic forms of knowledge that do not belong to any single discipline. In addition, the lessons to be learned may not necessarily be entirely consistent, premised as they may be on a range of different assumptions. No doubt there are circumstances in which this kind of intellectual and political risk-taking are not appropriate. If political, social, economic and technical arrangements are working well overall then it may be better to stay within the established boundaries of expert knowledge and focus instead on disciplinary-based intellectual tinkering. But, whatever else may be said, this is not the case for European finance in either its political or technical dimensions. After several years of drama, and notwithstanding the painful fixes that have been put in place, not even the most optimistic would deny that the Eurozone is in crisis. Bluntly, for many, including us, it still looks like an accident waiting to happen. And under circumstances where thinking *inside* the box isn't working, our argument is that thinking *outside* the box – dialogic or conversational understanding – is desperately needed. Hence this paper, risky and provocative though it may be.

So what do we bring to the dialogue? In the second section below, we focus on elite representations of the crisis after the endless meetings over the last year between the 27 EU countries. We show that the response of European political elites (and media commentators who identify with them) in 2011 was a chorus of demands for *incisive leadership* which connected high politics with romantic business school or military academy views about how charismatic CEOs and generals can master otherwise intractable events by force of leadership. This, we suggest, looks like nonsense. The third section then presents a technical analysis of European finance which focuses on two unintended design characteristics – those of *rehypothecation* and *interconnected balance sheets* – which are a consequence of bricolage in the banking sector. As section three argues, in the event of major disruption these characteristics will produce an unmanageable financial crisis. The fourth section then introduces the BAC 1-11 airplane crash where our internal conversation has registered analogy and disanalogy between collapsing technologies in the two domains of finance and aircraft design. The point of similarity with finance is that a new design of aircraft led to sudden and unexpected loss of control; the same, we argue, is what has happened in finance. The crucial difference between the two cases is that redesign was capable of delivering a solution in the context of the aircraft because relevant engineering knowledge was available and (crucially) because there was a shared private and general collective interest in solving the problem. Neither of these conditions applies to the case of European finance. The fifth section returns to political analysis of the current European crisis in Europe which we read as a failure to negotiate an outcome which reflects a version of the general interest. This is both because the EU is a failed elite project, and because within the national states mobilisation through mass parties has been replaced by forms of communication (dog whistle and Gouldite politics) in which politics is turned into marketing – a mode of problem-solving profoundly unsuited to negotiating shared views in the face of major conjunctural problems of the kind that we now confront.

Our argument is that the causes of financial instability may be technical but the problem of the Eurozone crisis is also inherently and intractably political. And it is political not because of the imagined absence of leadership, but because of the presence of an unconstructive politics of followership and a sharp division between the private interests of finance and the social interests of European citizens. In making this argument, we are updating and developing the theses of our book, *After the Great Complacence*. This made a double technical and political argument about the first phase of financial crisis from 2008-10 which was about the continuing importance of bricolage and trade narratives. Technically, "financial innovation" worked through bricolage which undermined regulation because rather than being an external constraint, regulation simply became an input or raw material for more financial bricolage. This was, for instance, the case for Basel 2 which encouraged banks to shift mortgages off balance sheet. Politically, elite politicians and the econocrats in finance ministries, central banking and regulation would not restrain finance before the crisis, or radically reform it afterwards, because policy elites had also been cognitively captured by a trade narrative about the benefits of the finance sector. Uncoincidentally, the latter was always a lobbyist and often a major contributor to party finances.

In this article we develop and update this techno-political argument for the second phase of financial crisis from early 2011 which is about financial interconnects and democratic disconnects. Technically, the European financial sector is liable to fail disastrously because bricolage has produced high velocity circulation and balance sheet interconnections. Politically, we are the victims of democratic disconnects in which the political classes at national and EU level multiply our problems with their new practice of politics as marketing. This reinforces our book's earlier argument about the need for "rat catcher" intervention whose explicit objective is a much smaller and simpler finance sector. "Rat catcher" intervention implies that we should now do for bankers what Thomas Carlyle argued the 1834 Poor Law reform did for paupers: the granary of finance needs to be made less accessible and less attractive by stopping holes, introducing cats, setting traps and laying poison. The conclusion to this paper explains why such active policies are currently impossible because of the tensions and contradictions between what is technically needed to fix international finance and what national politics can deliver.

(2) The romance of leadership: too little or too late?

> "the worry in Washington has been that it's a crisis without anybody in a leadership role. US officials are mightily frustrated over the way in which euro-zone governments have turned a debt problem in a small peripheral state -Greece- into a full-fledged crisis that has called the very existence of the currency union into question."
>
> Stephen Fifler, "Europe's debt crisis seen from America", *Wall Street Journal Europe*, 16-18 March 2012

How do the political elites in Europe and the US construct their problems? How do they imagine that these might be solved? In their imaginaries, what is missing? Why is Europe struggling – and continuing to struggle – with crisis? These are the topics we explore in this section. And the answer has to do with the *romance of leadership*. For many – perhaps most – of the elites, the spectre that is haunting Europe is *the apparent failure of fiscal and financial leadership*.

> "When we met in London two years ago, we knew that putting the global economy on the path to recovery would be neither easy nor quick. But together, we forged a response that pulled the global economy back from the brink of catastrophe. That's the leadership we've demonstrated before. That's the leadership we need now – to sustain economic recovery and put people back to work, in our own countries and around the world[4]."

This is Barack Obama in the pages of the *Financial Times* in late October 2011. He was writing two days after an emergency Eurozone summit, and a few days before an equally urgent meeting of the G20. A few days earlier, just before the Eurozone meeting, George Osborne was in the House of Commons, also speaking of the need for leadership. The Eurozone, he noted,

[4] Barack Obama, 'Now for a firewall to stop Europe's crisis spreading', *Financial Times*, 28 Oct 2011, page 13.

lay at the epicentre of a crisis that had led to large falls in the stock market and especially in bank shares[5]:

"There has not", he went on, "been a shortage of meetings; there has been a lack of leadership from eurozone leaders in those meetings[6]."

And the day before this David Cameron was mentioned in the *Financial Times* talking in similar terms:

> "The prime minister believes this autumn will define Europe and this generation of leaders, as they grapple with perhaps the Continent's most serious postwar economic challenge. Sitting in his Downing Street office after a draining week at the Conservative party's annual conference, it is clear he is not altogether sure they will rise to that challenge[7]."

Cameron's language on this occasion was guarded: he knew well that Eurozone government leaders, and particularly the mercurial Nicolas Sarkozy, would take ill to being lectured by a Eurosceptic British Prime Minister. But similar sentiments were widespread on mainland Europe too. For instance, a month earlier Christine Lagarde, the French incoming Managing Director of the IMF, was sounding this warning:

> "I believe there is a path to recovery, much narrower than before, and getting narrower. To navigate it, we need strong political will across the world, leadership over brinkmanship, co-operation over competition, action over reaction."[8]

In short, leadership, its absence, or its inadequacy, rose to top of the political and financial agenda in both Europe and North America during 2011. And at the beginning of 2012 it is still there.

The *Financial Times*, a journal of record for financial, economic and business elites, prints many articles each year on leadership – there were nearly 2000 in the year ending January 30th 2012. Many are on companies, appointments, business school curricula, or pieces by more or less inspirational management gurus. Alongside these, there are leadership pieces about particular countries, movements and international institutions. Their numbers rise and fall,

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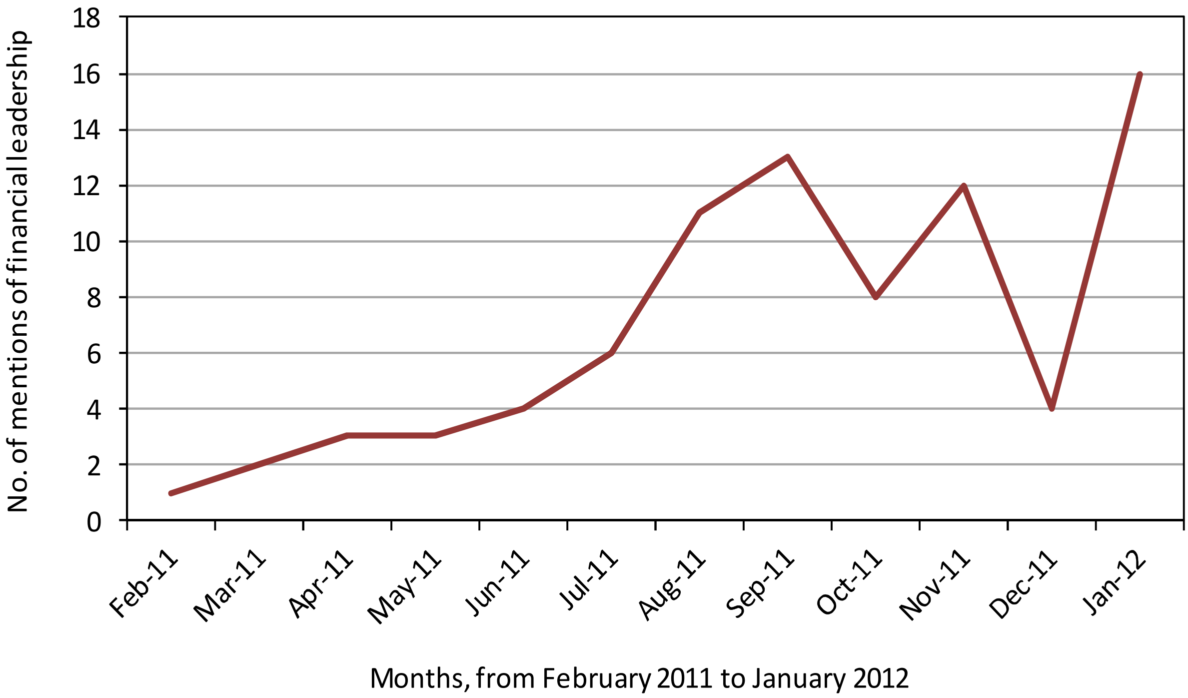
[5] George Osborne, House of Commons Official Report, Parliamentary Debates, (Hansard), Monday 10 October 2011, 533, 203, col 40, at http://www.publications.parliament.uk/pa/cm201011/cmhansrd/chan203.pdf.
[6] George Osborne, House of Commons Official Report, Parliamentary Debates, (Hansard), Monday 10 October 2011, 533, 203, col 44, at http://www.publications.parliament.uk/pa/cm201011/cmhansrd/chan203.pdf.
[7] George Parker and Lionel Barber, 'Cameron voices Eurozone frustration', *Financial Times*, 28 Oct 2011, 3.
[8] Quoted in Chris Giles, 'Financial institutions stare into the abyss', *Financial Times*, 23 Sep 2011, 1,3.

reflecting political events[9], though there is also a continuing and no doubt justified interest in the Chinese leadership, and to a lesser extent that of India. But the twelve-month period to the end of January 2012 is notable for the increasing number of articles on the economic and fiscal failures of leadership in Washington and in the Eurozone. Any statistics that might show this are gestural. Teasing comments about general leadership failures apart from more straightforward descriptions of leadership tactics within (say) the Washington Beltway or Berlin certainly counts as an art form rather than a science, and in any case the absolute numbers are very small. Nevertheless the statistics are mildly instructive:

Figure 1: Mentions of the need for financial leadership in the Financial Times



Source: Financial Times

Figure 1 suggests that there was little general discussion about leadership failings in the context of finance in the early months of 2011. But then, with fiscal pressure on Greece, Portugal, Ireland and Italy growing, in the summer such talk started to find its way onto the agenda. Add in the S&P downgrade of US sovereign debt in early August, French bank downgrades (on September 14th), continuing German concern about the legality of further EFSF subventions, the failure of EU negotiations with Greece (September 20th), the Dexia collapse in Belgium (October 10th), together with fears about the general stability of the Eurozone, and by the early autumn calls for stronger European leadership were becoming

[9] In the year in question these included: Libya, Egypt, Japan (following the Fukuyama nuclear incident), South Africa, Al Qaeda (following the death of Osama Bin Laden), and the IMF (following the political death of Dominique Strauss-Kahn).

common currency after the summer break. The words of Obama, Osborne, Cameron and Lagarde all exemplify the trend. Almost everyone agreed that the crisis needed *leadership*. But what was leadership supposed to do in this context of potential financial meltdown?

The answer was and is partly a function of the particular character of the crisis at any given time. So when he addressed the House of Commons on October 10th 2011 at a moment when the future stability of the Eurozone was under threat and Germany and France were in disagreement about whether or not to increase the funds available to the EFSF, George Osborne linked this to what he called the "three rs":

> "… we need a comprehensive solution which ring-fences vulnerable eurozone countries, recapitalises Europe's banks and resolves the uncertainty about Greece. Ring-fence, recapitalise, resolve [10]…."

Leaders would do these three things. Cameron's language was more flamboyant. At almost the same moment he was asking for a five-part 'big bazooka' approach[11], adding to Osborne's shopping list above, fourth, that the IMF should 'be more active in "holding [the Eurozone leaders'] feet to the fire"', and fifth, that Eurozone governance should be improved and the single market deepened:

> "That's the menu. It's not à la carte - you have to do the whole thing," he said. This reflects growing frustration in London and Washington at the incremental approach so far adopted in response to the crisis. "Time is short, the situation is precarious."[12]

So as the crisis has unfolded the prescriptions for proper leadership have varied. And the absence of leadership has taken various forms. It's been assumed that the Eurozone leaders have shilly-shallied, that the US administration has not imposed fiscal discipline in Washington, and that the leaders of particular countries – Greece, Italy, perhaps Portugal – have failed. But what is leadership? Are there any recurring leitmotifs? Unsurprisingly, the answer is 'yes'.

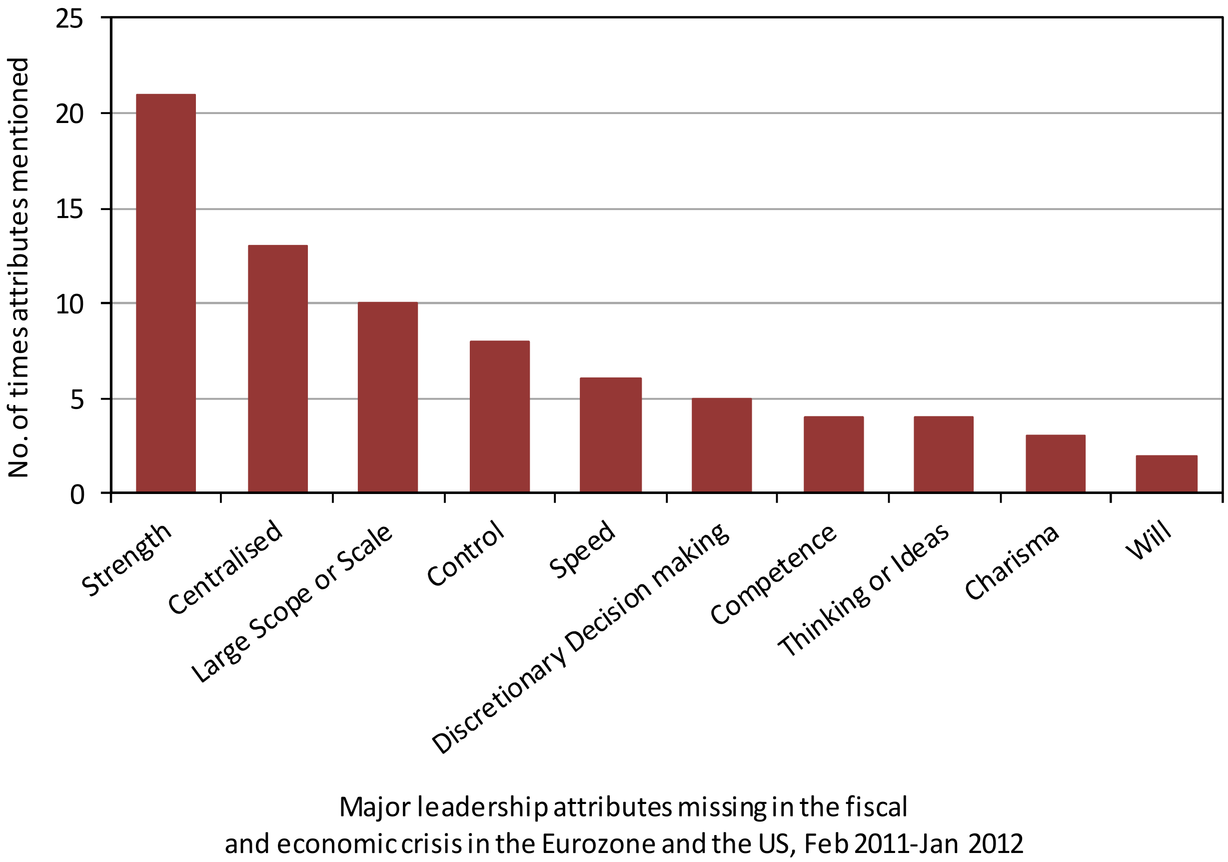
Figure 2 is again derived from an informal reading of *Financial Times*. It roughly reflects the preoccupations and foci of the articles over the same twelve month period that reported (or insisted) on the need for fiscal and economic leadership.

The numbers here are meaningless, except as relativities. But treated as relativities they are suggestive. It looks as if what was missing in the view of commentators and participants in 2011-2012 was leadership in a number of crucial dimensions. There was a shortage of

[10] George Osborne, House of Commons Official Report, Parliamentary Debates, (Hansard), Monday 10 October 2011, 533, 203, col 40, at http://www.publications.parliament.uk/pa/cm201011/cmhansrd/chan203.pdf.
[11] George Parker and Lionel Barber, ''Time is short' for the eurozone', *Financial Times*, 10 Oct 2011, 1.
[12] George Parker and Lionel Barber, 'Time is short' for the eurozone', *Financial Times*, 10 Oct 2011, 1.

leadership that was (1) *strong*, (2) *centralised*, (3) *large scale*, (4) able to take *control*, and (5) decisively capable of getting *ahead of events*. Other missing attributes included (6) the ability to make discretionary *choices*, (7) *competence*, an ability to think or offer intellectual leadership, (8) a dose of *charisma*, and finally (9) *willpower*.

Figure 2: Number of mentions in the Financial Times for economic and fiscal leadership



Source: Financial Times

Many of these missing leadership characteristics are illustrated in the quotations above. Christine Lagarde was asking for strong leadership with political will, for co-operation rather than competition (an implicit appeal for centralised leadership?), and action rather than reaction (with the need for speed in order to get ahead of events). David Cameron's 'big bazooka' metaphor was a way of talking about decisive action, about scope and scale, and about taking control. 'Time', he added, 'is short', so he was telling his audience that speed was crucial too. George Osborne asked for a 'comprehensive solution', again large in scope and scale. Other leadership attributes from the list are easily illustrated. Here, for instance, is Philip Stepens in the *Financial Times*:

> "The west is not blessed by decisive leadership. Mr Obama lacks the temperament of a Franklin Roosevelt. Ms Merkel's almost pathological caution has significantly raised the

> cost of rescuing the euro – if such a rescue remains possible. Nicolas Sarkozy, the French president, has energy and rhetorical ambition but lacks clarity and concentration[13]."

From this we learn that Barack Obama is indecisive so he is not strong and he does not take control. Angela Merkel's caution clearly does not gel with speed, will, charisma or indeed strength, while Nicolas Sarkozy may be strong and have the will to lead but seemingly lacks competence and the ability to make good decisions. In sum, we learn that from the summer of 2011 onwards the leader writers, the commentators, and many of the participants started to tell us that proper leadership was missing. And that proper leadership would fill the gap with its strength, speed, vision and all the rest.

But how to think about this? The romance of leadership is not new. It is classically represented in the popular literatures of management where "management is doing things right; leadership is doing the right things." This quote, attributed to management guru Peter Drucker[14], catches at least part of what is at stake. Leadership is more than management. It's more than competence. It's far-seeing. It's inspired. It's charismatic. In the broadest possible sense, it is also about political relations: that is, it's about persuasion, charm, will and inspiration. The real leader appeals to the management team, to his or her workforce and to consumers. He or she gets ahead of them and reshapes them and the political terrain within which they operate. This is the crucial FDR factor. And all these tropes are hard at work in many reports about the financial crisis. "Technical competence", wrote the *FT* sternly in a leader on 11th November 2011 about the crises in Italy and Greece, "is not enough". And it went on to conclude the same editorial with the following ringing Drucker-like sentiment:

> "The new leaders [of Italy and Greece] must also recognise that nothing will be achieved without popular support. They could struggle to get reforms through parliament. The answer will be to show real leadership. Managerial competence will simply not suffice.'[15]."

Three days later, and after the Berlusconi resignation, it returned to the same theme, writing that in Italy "[o]nly real reforms can restore the country's confidence" – and not only amongst the voters, but also for investors and allies. It was telling us, then, that real leaders inspire confidence among voters and in markets[16]. Reaching beyond the merely technocratic, they are

[13] Philip Stephens, 'Leaders who generate diminishing returns', *Financial Times*, 19 Jan 2012, 9.
[14] Stephen R. Covey *Seven Habits of Highly Effective People* (1989), 101.
[15] 'Leaders needed, not just managers', *Financial Times*, 11 November 2011, 12.
[16] 'Four years into the financial crisis, it is becoming increasingly clear that the biggest deficit is not in credit, but credibility. Markets can adjust to a downgrade of global growth, but they cannot cope with a spiralling loss of confidence in leadership and a growing sense that policymakers are disconnected from reality.' Kenneth Rogoff, 'The bullets yet to be fired to stop the crisis', *Financial Times*, 9 August 2011, 9.

also able to secure financial and electoral legitimacy. Here's an unnamed Brussels figure making the same point about electoral legitimacy:

> "We are in a state of emergency and we need leadership. At the same time we want that leadership to be accountable to the people," said the eurozone diplomat. "Without legitimacy, all the best intentions are doomed to fail. That is the conundrum we are facing[17]."

We will return to the issues of 'technocracy' and 'democratic deficit' in section 4 below. For the moment we simply need to note that in this romance, leadership goes beyond the technical, the mechanical and the predictable. It knows about these (because it is indeed necessarily competent) but it also works somewhat outside the rules. It sees further. It seizes the occasion. It is strong, deft, quick, and capable of rapid large scale decision-making. In particular, in the present context its charismatic magic is taken to be able to rework and reshape electorates and markets. In short, in this way of thinking real leadership is what is needed to fill the gap between the sad place where we are now – an endless and unresolved fiscal crisis – and the secure, balanced budgets, economic growth, and strong currencies that we need and which are promised for the future if only we can get the real leadership that we need.

But can this romantic version of leadership actually fill the gap? One answer is that there is also a very interesting, albeit small-scale, counter-discourse at work in the financial press. This tells us that the answer is 'no'; that leadership is beside the point. In one version this is a narrative that says that if you are fortunate enough to be in the right place at the right time then you may end up being attributed the romantic powers of leadership. It says, to put it differently, that good leadership is a simply matter of luck[18]. In another version the story runs that if you are in the wrong place at the wrong time, then whatever your putative powers of leadership, you stand no chance of filling the gap. Like this:

> "It is fashionable to pin today's problems on weak leadership. But this is missing the point. The present generation may not be particularly impressive - …
>
> "Both the eurozone and the global economy need more fundamental reforms than the cosy political processes currently in place are able to deliver. Unless we are ready to reverse monetary integration and financial globalisation, and accept the economic and political consequences, there is no alternative but to create a new institutional

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[17] Peter Spiegel, 'Brussels' new-found aggression raises hackles', *Financial Times,* 8 November 2011, 8.

[18] Richard Lampert made the argument in the pages of the *Financial Times*, albeit in the context of the political controversy about the bonus culture for top managers. See Richard Lampert, 'Shareholders should scrap fancy pay packages for top bosses', *Financial Times*, 27 January 2012, 13.

> framework, with new rules, both within the eurozone and at global level. Our policies have run out of control[19]."

This is Wolfgang Münchau. The problem is a structural mismatch between financial globalisation on the one hand, and national politics on the other. Leadership is neither here nor there. Gideon Rachman, also writing in the Financial Times, makes much the same argument. The eurozone crisis, he writes, is "not ultimately to do with leadership. It is more fundamental than that[20]." The problem for him (it's not quite financial globalisation) is the constraining structure of Europe's national loyalities. Philip Stevens, likewise writing in the Financial Times makes a similar point:

> "Behind all this, however, lies the structural problem – the mismatch between global economics and local politics. States have been shedding power to globalisation. The big lesson has been about the extent to which globalised capitalism has outstripped the capacity of national governments to manage it[21]."

And Samuel Brittan similarly argues that the problem is not leadership. It is that the financial markets have got out of control:

> "I have no 10-point programme for making "finance less proud", as Winston Churchill once put it. … It is more a matter of recognising, at every point of policy decision, that the free movement of artificially created electronic money across frontiers is not on a par with the free movement of goods and services, let alone more basic human freedoms, and recognising this not only for developing countries but for the so-called advanced ones as well[22]."

The counter-narrative, then, is that matters are out of control for structural reasons. And this again echoes positions in the classical popular literature on management. Thus, Warren Buffett writes that

> "When a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact[23]."

Translated to the financial crisis, Buffett's adage fits perfectly. As the months pass and the problems pile up, it is the reputations of the leaders that are being shredded, while that of the

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[19] Wolfgang Münchau 'Summitry once again proves its own irrelevance', *Financial Times*, 7 Nov 2011, 11.
[20] Gideon Rachman, 'The single currency's true fatal flaw', *Financial Times*, 20 Sep 2011, 13.
[21] Philip Stevens, 'Leaders who generate diminishing returns', *Financial Times*, 19 Jan 2012, 9.
[22] Samuel Brittan, 'Good servants can make bad masters', *Financial Times*, 10 June 2011, 11.
[23] Citation from Warren Buffett Secrets, at http://www.buffettsecrets.com/sound-management.htm.

European financial and fiscal system has changed little. Of course, as we write this piece the ECB's injection of €1 trillion into the European banking system and the second Greek bail out has temporarily halted the Eurorot. Perhaps, therefore, Mario Draghi should be counted as a strong and decisive leader, someone able to act on the scale and with the vision required by the romantic theories of leadership. But for reasons explained below, we take the ECB action to be a temporary fix at best. And it is our Buffett-like argument that as things stand: the financial system is *not* under control; it is not under control because it has (albeit unintentionally) been *designed* that way; that in the event of major disruption that absence of control will lead to *catastrophe*; and, crucially, that the character of *politics* is actively adding to the complications. This, then, is the real spectre that is haunting Europe, and it has little to do Any discussion of rehypothecation takes us into a domain of technicalities which are not recognised or discussed by front line politicians. Indeed, the dominant refrain about the absence of leadership qualities tends to divert attention from the analysis of specifics in the financial markets or bank balance sheets. The problem is that mainstream narratives (often from leaders) work by treating leadership as the necessary (and often sufficient) precondition of successful problem-solving. But, or so we are claiming, romantic leadership is more or less beside the point in the complex worlds of rehypothecation. Instead we share Samuel Brittan's alternative view that "…even a flawed proposal is better than inane cries for leadership[1]."

(3) Financial interconnects: rehypothecation and balance sheets

> 'In a typical example of rehypothecation, securities that have been posted with a prime brokerage as collateral by a hedge fund are used by the brokerage to back its own transactions and trades…. In the United States, rehypothecation of collateral by broker-dealers is limited to 140% of the loan amount to a client, under Rule 15c3-3 of the SEC'
>
> Investopaedia, explanation of rehypothecation

Any discussion of rehypothecation takes us into a domain of technicalities which are not recognised or discussed by front line politicians. Indeed, the dominant refrain about the absence of leadership qualities tends to divert attention from the analysis of specifics in the financial markets or bank balance sheets. The problem is that mainstream narratives (often from leaders) work by treating leadership as the necessary (and often sufficient) precondition of successful problem-solving. But, or so we are claiming, romantic leadership is more or less beside the point in the complex worlds of rehypothecation.

When we turn to examine banks and markets more technically we need to make two points. First, a cursory review of the empirics suggests that the very *nature* of the crisis in the markets is unclear and ambiguous. This is because it all depends on how the causal arrows are arranged – or rearranged. Specifically, while most commentators believe it is the unsustainable excess of low quality government debt on the *supply* side that is driving up interest rates, we would side with the minority (like those in *FT Alphaville*) and argue that it is market dynamics on the *demand* side that are pushing up interest rates on what would otherwise (Greece aside) be quite sustainable debt burdens. Second, a closer examination of market dynamics leads to queasiness and apprehension. This is because bricolage has resulted in design features that will create in problems which cannot be contained. If there is domino failure of several sovereigns in Southern Europe, this means that controlling the consequences will be beyond the management capacity of finance ministries and central banks. Specifically the problem is that there are two kinds of financial interconnections that have arisen as a result of unregulated private bank lending and market credit creation. First, there is rehypothecation (i.e. lender's reuse of pledged collateral to fund the lender's further borrowing) in the markets. We argue that this will lead to liquidity crisis if the velocity of circulation of funds falters. And second, interconnections between bank balance sheets have led to complex patterns of interdependence. If or when things go wrong, the result will be a proliferating pattern of mutually assured destruction as illiquidity and insolvency spread across national boundaries.

Let us begin by considering whether the current convulsions in sovereign debt markets are caused by government behaviour because the scale of government debt and probability of default is driving up yields to an unsustainable level; or whether, alternatively, other technical factors inside banks and markets are driving up the yields by creating a shortage of buyers for some countries' debt which makes the (relatively high, but still historically modest) debt impossible to finance from current income.

The high yields on sovereign debt paid in countries such as Greece, Ireland, Portugal and Italy are often represented as a rational market response to profligate state spending during the boom, and this market response in turn necessitates and justifies austerity cuts in government spending in such countries. Of course the government debt/GDP indicator does not alone explain the high yields. The maturity of the debt also matters, so that the UK benefits from smaller current refinancing requirements than Italy; so does the percentage of active foreign traders relative to the passive domestic holders who stabilise the outcome in Japan. As table 1 shows, when all the qualifications have been entered, the fundamental points are that, from a historical perspective, the current levels of government debt to GDP are not excessive for all the countries in difficulty and there is no direct correlation between debt-to-GDP ratios and bond yields.

If we consider large, high income countries, Germany, France, UK, USA and Japan are all now relatively indebted: 2009/10 represents their highest debt-to-GDP ratios in the last 30 years. In most of these countries, bond yields are low. In January 2012 Germany auctioned €3.9bn worth of 6 month bonds at an average negative yield of -0.0122%, such is the level of demand for its debt. But in Japan and the US, yields are also close to historic lows. Only in France, where private banks are exposed to Greek debt, have yields risen to any great degree. But perhaps more interesting is the data on the peripheral economies often rather dubiously grouped together as the 'PIGS' or 'PIIGS'. The two largest economies in this imagined group – Spain and Italy – had higher debt to GDP ratios in the early 1990s and Ireland had much higher rates in the late 1980s. Portugal's sovereign debt/GDP ratio peaks in 2010, but is half that of Japan. In any analysis, Greece stands out as the one exceptional national case because its debt/GDP ratio is now much higher than other similar sized economies and is unprecedented.

Table 1: Government debt to GDP for selected countries 1980-2010.

	1980 %	1985 %	1990 %	1995 %	2000 %	2005 %	2010 %	Peak year	%
Australia	8.0	11.3	6.1	18.6	11.4	6.3	11.0	1996	19.1
Austria	24.8	36.9	46.0	56.2	61.2	62.1	65.8	2010	65.8
Belgium	53.5	97.3	106.7	113.8	99.5	91.8	96.8	1993	118.3
Canada	n/a	41.0	46.6	56.8	40.9	30.2	36.1	1995	56.8
Denmark	34.6	69.9	62.4	74.9	54.8	39.3	39.6	1993	79.7
Finland	n/a	n/a	10.2	62.6	48.0	38.2	41.7	1996	66.7
France	n/a	n/a	n/a	41.6	47.4	53.3	67.4	2010	67.4
Germany	13.0	18.3	19.7	21.1	38.4	40.8	44.4	2010	44.4
Greece	n/a	n/a	n/a	104.8	108.9	110.6	147.8	2010	147.8
Hungary	n/a	n/a	n/a	82.4	54.1	58.1	73.9	1993	86.7
Iceland	22.9	31.6	32.0	52.3	33.8	19.4	81.3	2009	87.5
Ireland	n/a	104.6	86.8	72.2	34.8	23.5	60.7	1987	107.0
Italy	52.7	77.2	92.8	113.1	103.6	97.7	109.0	1994	113.7
Japan	37.1	48.6	47.0	65.2	106.1	164.5	n/a	2009	183.5
Mexico	16.0	36.3	42.3	37.3	21.2	20.3	27.5	1987	61.7
Netherlands	25.7	51.0	58.4	58.9	44.1	43.0	51.8	1993	60.6
New Zealand	n/a	n/a	n/a	49.1	32.1	22.1	30.5	1992	63.9
Norway	n/a	25.8	22.4	30.8	19.3	17.2	26.1	1993	35.4
Poland	n/a	n/a	n/a	49.6	35.8	44.8	49.7	1993	81.0
Portugal	29.2	51.6	51.7	60.1	52.1	66.2	88.0	2010	88.0
Slovak Republic	n/a	n/a	n/a	19.0	23.9	33.1	39.1	2010	39.1
Slovenia	n/a	n/a	n/a	n/a	n/a	26.9	36.0	2010	36.0
Spain	14.3	38.2	36.5	52.4	49.9	36.4	51.7	1996	56.1
Sweden	38.2	60.0	39.6	75.8	56.9	46.2	33.8	1996	78.0
Switzerland	n/a	n/a	12.3	22.0	25.6	28.1	20.2	2003	28.3
Turkey	n/a	14.8	10.8	13.0	38.2	51.1	42.9	2001	74.1
United Kingdom	n/a	n/a	n/a	n/a	42.2	43.5	85.5	2010	85.5
United States	25.7	35.4	41.5	49.0	33.9	36.1	61.3	2010	61.3

Source: OECD.StatExtracts, (accessed 16-3-2012)

In this discussion of the Eurozone crisis it is therefore important that we do not automatically assume that the yields on some government debt are high because debt levels are 'unsustainable' or historically unprecedented. It may be the case that the high yields simply reflect an absence of demand for certain countries' sovereign debt, which in turn makes servicing those government debts from current income financially impossible. So what else might explain these high yields relative to national debt/GDP levels?

The answer is that funding problems in the asset-manager-shadow banking nexus can explain why there is a lack of cash to drive up bond prices and chase down the yields in certain countries.

The importance of collateral to bank lending has been rightly emphasised in Gary Gorton's analysis of financial markets[24]. Collateral is important because most bank to bank short term lending requires the posting of an asset as security to access that credit. In a recent paper, Gorton and Ordonez[25] make a distinction between information sensitive and information insensitive debt. They argue that in boom years short term debt markets aim to produce debt that is 'information-insensitive' i.e. debt that is not responsive to private information about the collateral that backs it. This is beneficial and makes lending easier because all collateral then reverts to a kind of tacit 'perceived average quality' which is widely accepted. This explains the attraction of complicated, structured assets such as AAA-rated tranches of CDOs that were the basis for the repo circuit discussed in Engelen *et al*[26] and Erturk *et al*[27]. But in crisis situations, the interest in tacit, perceived value of collateral declines and a parallel demand for more detailed information about that collateral emerges; only firms with good collateral can borrow. This in turn may lead to a growing hyper-sensitivity to news flows and volatility. As Gorton & Ordonez put it: "the economy moves from a regime without fear of asymmetric information to a regime where asymmetric information is a credible threat"[28]. This observation is important when we look at how funding has changed post-crisis. Unsecured lending has all but disappeared, so access to potentially post-able collateral is paramount for many financial institutions. The problem for banks is that they are now less able to spontaneously create their own fungible collateral from the MBS market and so they have turned to mining collateral from other sources such as pension funds, insurance companies, mutual funds, hedge funds and sovereign wealth funds. Much of the ensuing Eurozone problems can be explained by looking at the asset-manager-shadow banking nexus, and private banks' ongoing reliance on short term funding.

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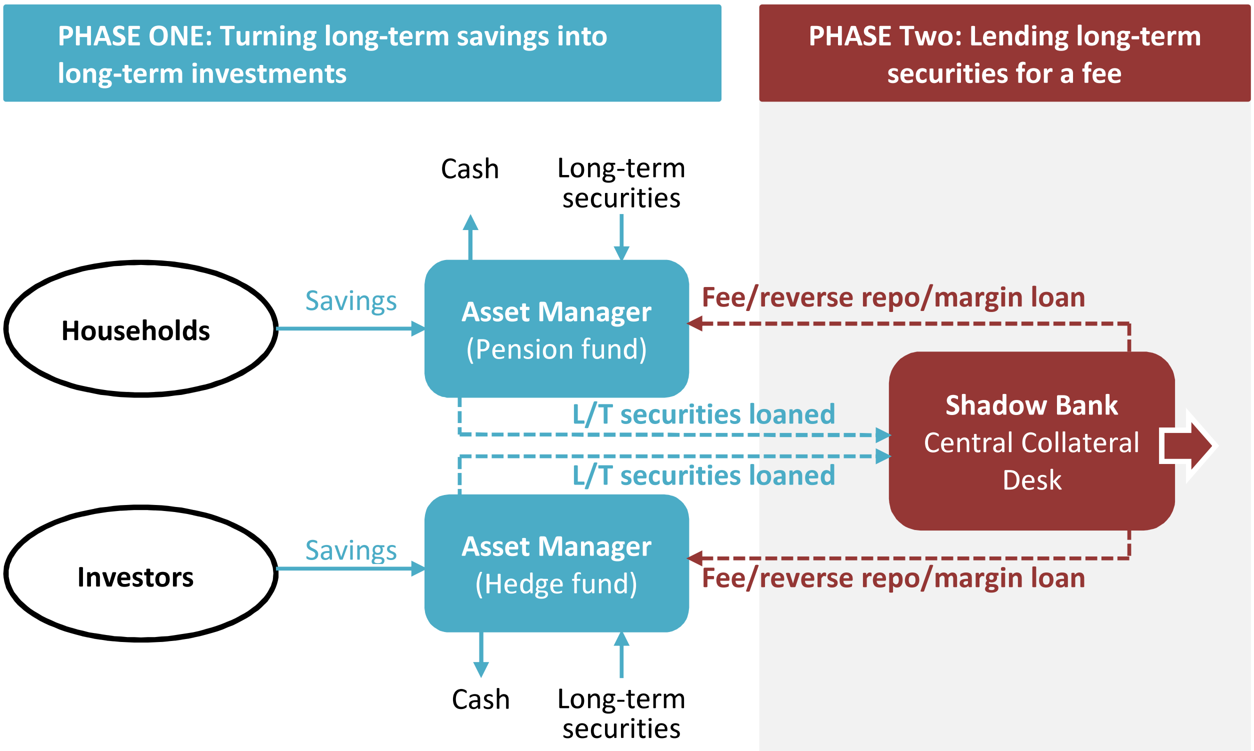
[24] see Gorton & Pennachi, 1990; Gorton 2008; 2009
[25] Gorton and Ordonez (2012)
[26] Engelen *et al.,* (2011)
[27] Erturk *et al.,* (2011)
[28] Gorton & Ordonez (2012)

So what is this nexus?

Beginning with the asset managers, households or investors give money to a pension fund, hedge fund or other kind of fund, which then invests those often long-term savings into long-term, mainly high-grade investments. But, since the crisis, returns on long term, safe assets have been very low and are often negative because fear in the markets drives strategies designed to preserve capital rather than make a return on it. One way asset managers can improve returns is by opening a margin account and lending their long-term securities to collateral desks in the shadow banking sector for a fee. The asset managers receive in return money or short-dated cash-like instruments (see figure 3).

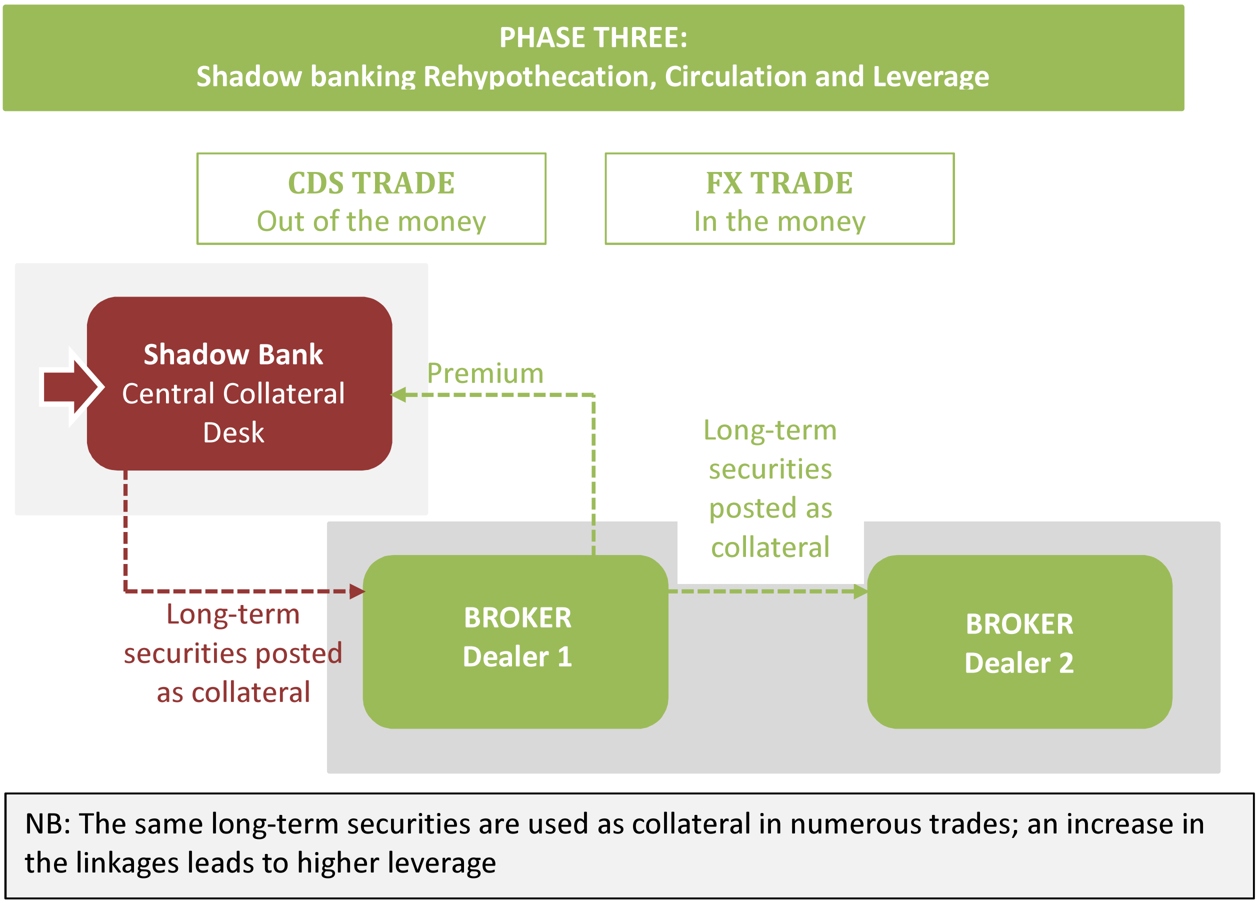
Figure 3: The Asset Manager – Shadow Bank Nexus



Once the shadow bank collateral desk has the long term collateral, it can reuse or 're-pledge' that collateral as it sees fit within certain legal limits. Under US Federal Reserve Board Regulation T, and SEC Rule 15c3-3, a prime broker may re-hypothecate an amount up to 140% of the customer's liability. That is, if a customer posts \$100m worth of collateral and 50% of it is on margin, then the broker can rehypothecate \$70m of the assets. By contrast, in the UK there is no limit – and this is why London remains the global centre of rehypothecation activity, and the locus of a number of firm wrecking examples, such as Lehman's repo 105 and MF Global's disastrous foray which ultimately led to its bankruptcy. Reused collateral creates liquidity and system leverage, as figure 3 demonstrates. In this example the broker posts the long term securities as collateral in a CDS trade with Broker Dealer 1. This is usual in non-naked

CDS trades. Here Broker dealer 1 pays the Shadow bank a premium (therefore income) to insure against a default event. The shadow bank has to post more collateral if risks of default increase (to insure Broker Dealer 1 against counterparty risk). Once Broker Dealer 1 has the l/t securities in its margin account, it too can re-pledge them in another trade – in this instance the settlement of an FX trade with Broker Dealer 2. This can go on and on, of course, with Broker Dealer 2 free to use the l/t securities as it sees fit.

Figure 4: An Example Of Rehypothecation



The diagram above shows how in the boom years the abundance of information insensitive collateral was used to back multiple trades between brokers and thus ramp system leverage. It also shows that the movement and circulation of good quality collateral is central to the funding of the financial system. Despite its central importance to Eurozone problems, the relation between pension funds and shadow banks is barely discussed in any media outlet. This is a surprising omission given that something like $5.8trillion of off-balance sheet items in banks are backed by this kind of collateral mining and re-use activity[29].

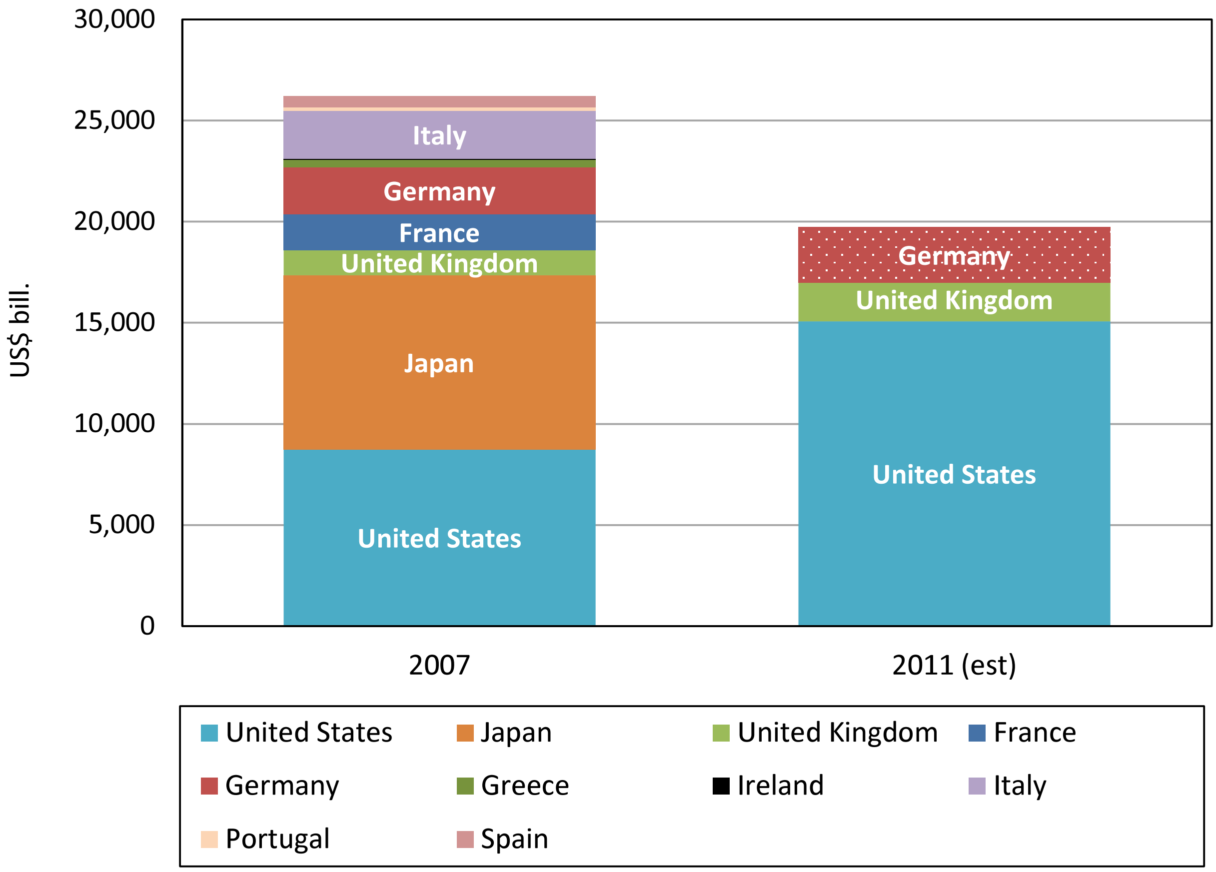
[29] IMF, 2011

But we are now in a very different world – one where lenders are more risk averse and demand more information about the collateral posted in such trades. This is also a world where credit rating agencies have much reputational damage to put right, and so are more circumspect in their analysis of risk – and quicker to judge. It is also a world fraught with uncertainty, where small items of bad news may amplify with self-fulfilling effects. In this context, we can frame the current Eurozone crisis, rather differently, as the regional manifestation of a global collateral crunch in which certain banks horde the remaining good collateral. This may result in restricted liquidity to other institutions. It may also mean that there is less liquidity circulating between banks, and this in turn may have implications for the sovereign debt of certain nations which may be expected to backstop losses going forward. It was mooted that this was the case with French banks, whose wholesale funders withdrew, leaving the French state on the hook for potential losses, driving up the yields on their sovereign debt. There has been much focus on the contagion from sovereigns to banks, but not nearly so much on the contagion running the other way.

But at a more sophisticated level, the deterioration in the quality of some collateral means there is a parallel decline in the value of that collateral as a fungible asset in rehypothecation activity. In essence, downgraded sovereign debt loses both an economic value which reflects changes to its apparent risk profile *and* a re-use value, which reflects its lost fungibility as a unit of rehypothecation. Downgrades, or even the news that might suggest a downgrade in a panicked market, might create an amplification spiral which drives yields higher on some sovereign debt as investors flee. Its corollary may be the crowding in of demand on those securities rated as AAA, or viewed as inherently safer and thus re-pledgable. This kind of dynamic is characteristic of other asset markets, such as collectors' markets, where in times of recession, investors move their funds into the 'top end' because their rarity and desirability gives them a safe haven status, with self-fulfilling effects. Thus the collective movement into safe haven assets makes those assets liquid in a time of turmoil, and in itself justifies a kind of 'liquidity premium'. These dynamics may be exacerbated if the credit rating of pledged or repledged collateral falls, which may initiate a sell-off in secondary markets, pushing down bond prices and raising yields. We can now see similar results in sovereign debt markets with growing spreads between the low yields on UK, US, German and Japanese debt and the high yields on Italian, Irish, Portuguese and Spanish debt, even though this latter group have lower debt to GDP ratios than in the early 1990s. Figure 4 shows the quantum of good sovereign debt outstanding (measured by CDS spreads under 100bps). It shows the complete deterioration of non-German Eurozone debt and the significant increase in good UK and US debt where governments are able to issue much more debt at historically low rates of return.

Taking one step back, none of this makes sense because we know that all major Western economies are tied together through their financial sectors. If Greece has a disorderly default this will not just affect French lenders, but will probably have domino-like effects which will almost certainly fall back onto the UK. It is almost a nonsense that in an interconnected world at a time of crisis, that the yields on sovereign debt should diverge so greatly; and that in the cases of the UK and US, sovereign debt yields are lower than they were in the credit boom of the 2000s. From this perspective 'austerity' in the UK is more a rhetoric for a panicked sovereign debt market, than a carefully thought out economic strategy.

Figure 5: Stock of 'safe' general government gross debt (US$bill.)

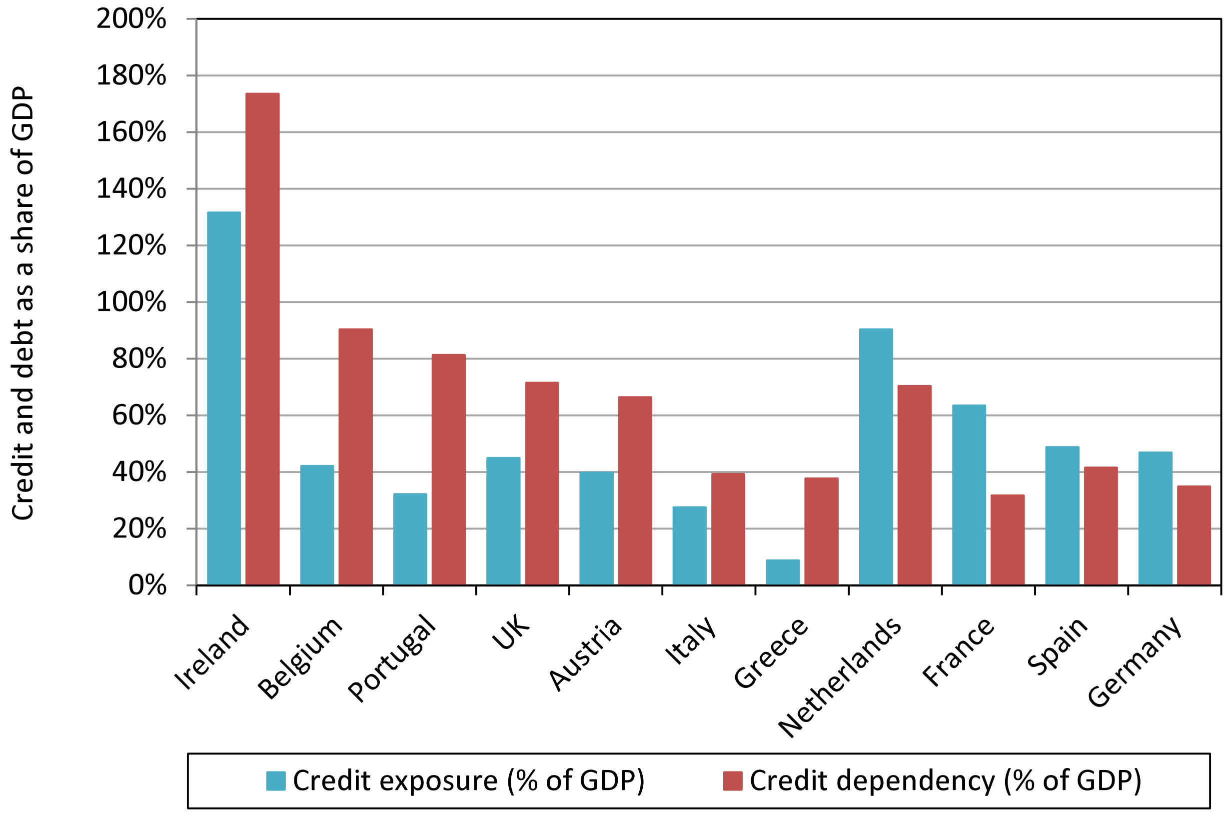


Source: Data on 5yr sovereign CDS spreads: Bloomberg terminal, derived from CDL Markit data; data on stock of general government gross debt: International Monetary Fund, World Economic Outlook Database, September 2011.
Note: 'Safe' debt defined as debt with 5yr CDS spreads < 100bps, as defined by US Treasury (2012).
Note: 2011 calculation includes German bonds, whose 5yr CDS spreads were marginally over 100bps at end Dec 2011, but nevertheless regularly range above and below the 100bps threshold.

But it is also important to explore how the different economies are connected. In the most common accounts, the surplus running north of the EU is opposed to the deficit running south. Those who recognise that the *fiscal* surplus/deficit opposition does not fit the facts instead propose a variant *trade* surplus/deficit opposition explanation. So, as Martin Wolf has repeatedly argued, "this is, at its bottom, a balance of payments crisis. ... That is truth. All else is commentary"[30]. This payments narrative fits rather better but displaces attention from other relevant interconnections which produce a different taxonomy of connection and a pattern of grouping which dissolves the North-South opposition.

Figure 6 and table 2 below present data on bank lending interconnects, derived from BIS data, which gives a different bank balance sheet centred view of the debt and credit relationships between the ten leading Eurozone countries plus the UK (10EZ+UK henceforward). Black bars in figure 1 show credit exposure and red bars credit dependency as a percentage of GDP in each country in relation to all 10 Eurozone countries and the UK. Credit exposure is domestically owned banks' consolidated foreign claims through cross-border lending and local subsidiaries, while credit dependency is total liabilities of domestic banks, public sector and non-bank private sector.

Figure 6: Credit exposure and dependency in the eurozone and the UK- 2011 Q2



Sources: Bank of International Settlements (for banking data) and IMF for GDP data.
Note: Credit exposure is domestically owned banks foreign claims and credit dependency is total liabilities of domestic banks, public sector and non-bank private sector to other 10 Eurozone countries and the UK.

[30] Financial Times, 6 December 2011

The key message of figure 6 is that all 10 Eurozone countries (and the UK outside the Eurozone) are *simultaneously* significant creditors *and* debtors, and that the balance sheets of their national banking systems are interconnected in complex ways. The extent of credit exposure and dependency varies considerably. However, if we average credit exposure and dependency to get one measure of interconnection, that is the arithmetic mean result for the 11 countries, the average European country has a credit interconnection equal to 200% of GDP. The best single predictor of EZ 10 interconnectendness is the size of the country; because Ireland, Belgium, Portugal, Austria and the Netherlands all score high on this measure. "Problem" countries do not consistently score high on bank interconnectedness because Italy and Greece are more insulated and continue to operate with relatively self-enclosed domestic banking systems. Furthermore, on credit exposure and dependency metrics, there is no unitary group of PIIGS or Southern economies. Spain is actually a net creditor to 10EZ+UK and is therefore closer to the Netherlands, France and Germany than to other southern European countries. The extent of credit exposure and dependency in Southern countries varies wildly, with Ireland massively engaged and Portugal heavily dependent (in marked contrast to Italy and Greece). Ireland depends heavily on foreign credit from the EZ10+UK for a total equal to 173.6% of Irish GDP but its domestically owned banks lend huge sums equal to 139.6% of GDP to the EZ10+UK. The UK derives no protection from being outside the Eurozone because it is heavily connected to the 10EZ via its bank balance sheets, and the UK's economy is heavily dependent on credit from 10 EZ. Figure 1 shows that the UK has credit dependency to the ten Eurozone countries equivalent to a staggering 71.5% of its GDP and has credit exposure of almost 45% of its GDP. Though it is outside the Eurozone, the U.K.'s credit Eurozone dependency is much higher than Italy's.

Table 2 gives a more disaggregated bilateral view of the position by showing how one country's exposure and dependence relates to other named individual countries (rather than the group of 10EZ countries and the UK. The most frightening case then becomes that of Ireland, because of the scale of its connections with a few major countries. Domestically owned Irish banks have a credit exposure of 73.9% of Irish GDP to UK entities and 29.8% of GDP to the German entities. The pattern of relations elsewhere is complex with different national partners usually providing credit and absorbing loans. Consider, for example, Spain which has a credit exposure equivalent to 48.8% of its GDP and has credit dependency of 41.6%. It is linked most strongly to the UK in credit exposure, and with Portugal in credit dependency – and not with prudent Germany or France. Overall, if we consider the aggregated and disaggregated measures, they highlight the vulnerability of France within the Eurozone, because of its high level of bank balance sheet interconnectedness and especially its credit exposure. France has a high aggregate credit exposure 3.5% of its GDP to the EZ10+UK; and, worse still, the disaggregated data shows the French banks have credit exposure of 16.2% of the French GDP to entities in Italy. From this point of view, Italy seems to be less of a sovereign risk but more of a credit risk to the French banks that are increasingly attracting the uncomfortable attention of the credit rating agencies.

Table 2 also highlights the interconnected vulnerability of the UK to the Eurozone partly because it has the highest interconnectedness with France in credit exposure. We decompose this interconnectedness into its component parts in Table 3 which shows that the UK banks have credit exposure of almost $150bn to French banks, about $100bn to the French non-bank private sector, and about $50bn to the French public sector. Therefore any downgrading of France's sovereign credit rating and the French banks' credit rating has a direct impact on the solvency of the UK banks, because any downgrading means the UK banks have to keep more capital against such exposure and have less capability to lend to the UK economy.

Table 2: Web of interconnectedness in the Eurozone banking and the UK banking (Q2, 2011)

	Share of debt as a share of GDP owed by domestically owned banks (%)											Total exposure
	AT	BE	FR	DE	EL	IE	IT	NL	PT	ES	UK	
	%	%	%	%	%	%	%	%	%	%	%	$ bill.
Austria		0.7	3.2	15.7	0.9	0.7	6.5	4.4	0.4	2.1	5.3	150.1
Belgium	0.6		13.3	3.6	0.4	5.4	5.1	5.3	0.8	0.0	7.7	196.9
France	0.9	9.0		10.8	2.2	1.2	16.2	5.2	1.0	5.9	11.0	*1,626.5*
Germany	2.7	1.1	6.8		0.7	3.4	4.9	5.2	1.1	5.4	15.6	*1,539.2*
Greece	0.0	0.1	0.6	2.3		0.2	0.2	1.4	0.0	0.1	4.0	*26.9*
Ireland	1.5	2.2	7.1	29.7	0.4		5.8	2.9	1.0	7.1	73.9	*272.4*
Italy	5.4	0.2	2.5	13.3	0.2	0.7		1.3	0.2	1.5	2.3	*565.1*
Netherlands	1.2	15.4	13.2	25.7	0.6	2.2	6.7		0.9	9.9	14.7	*705.8*
Portugal	0.2	0.2	3.2	1.5	4.4	2.6	1.3	4.5		11.6	2.6	*73.7*
Spain	0.4	0.3	2.3	4.2	0.1	0.7	2.8	1.5	6.3		30.3	*688.5*
UK	0.3	0.8	13.6	8.4	0.6	6.3	3.3	6.0	1.1	4.5		*1,010.6*
Total credit dependency ($bill)	250.7	422.8	813.3	1,148.0	115.0	359.2	807.7	549.4	186.5	586.2	1,609.9	
Total credit exposure (% of GDP)	39.8	42.1	63.5	46.8	8.80	131.6	27.5	90.4	32.1	48.8	44.9	
Total credit dependency (% of GDP)	66.4	90.4	31.7	34.9	37.7	173.6	39.3	70.4	81.4	41.6	71.5	

Source: Bank of International Settlements (bank data) and IMF (GDP data)
Note: Data refers to domestically owned banks consolidated foreign claims (cross-border and local).

This data on bank balance sheet interconnections displaces the conventional framing of the Eurozone crisis as a crisis about Southern sovereign debt or North South trade imbalances where crisis is located in the periphery. Instead, our interconnection data shows that what we have is a spectacular banking fragility in the Northern core countries as a result of large scale interconnectedness in a web of bank balance sheets. The game of politics is such that some North European politicians claim that banking weakness and economic vulnerability are located elsewhere. Thus The British government brags that it has banking reform in hand after Vickers and that as Chancellor Osborne argued, "UK banks are much better capitalised and more liquid than many of their European counterparts"[31]. However, this claim is more or less irrelevant, because the magnitude of the exposures in relation to GDP are such that the cost of breakdown of the Euro through serial sovereign defaults would be catastrophically high both for all Northern Eurozone countries and the UK. The interconnects thus create a fragility that threatens mutually assured destruction from a chain of defaults.

Table 3: Domestically owned UK banks foreign claims (cross-border and local), 2011 Q2 (in $m)

	AT $bill.	BE $bill.	DE $bill.	ES $bill.	FR $bill.	EL $bill.	IE $bill.	IT $bill.	NL $bill.	PT $bill.	All claims $bill.
Banks	3.5	5.7	61.2	18.0	148.9	1.1	16.9	8.9	40.7	4.0	308.6
Public sector	1.7	5.5	62.9	7.6	56.2	3.3	3.7	17.4	20.3	1.9	180.4
Non-bank private sector	2.1	7.1	66.0	75.3	100.2	8.3	120.2	47.4	75.2	19.6	521.5
Total Foreign claims	7.3	18.4	190.0	100.9	305.3	12.6	140.9	73.7	136.1	25.4	1,010.6
Derivatives contracts	5.9	19.5	145.8	16.7	107.1	2.2	40.2	17.3	72.6	2.2	429.4
Guarantees extended	0.9	1.1	39.3	5.1	37.0	0.8	2.2	6.9	18.4	0.7	112.5
Credit commitments	1.0	2.8	29.1	8.8	53.9	1.3	8.1	6.2	22.7	1.1	134.8
% of GDP	0.3%	0.8%	8.4%	4.5%	13.6%	0.6%	6.3%	3.3%	6.0%	1.1%	44.9%

Source: Bank of International Settlements (bank data) and IMF (GDP data)
Note: Data refers to domestically owned banks consolidated foreign claims (cross-border and local).

In the short and medium term it is clear that in the absence of extreme crisis, much lower limits to support are being set by the conservative econocracy (around the Bundesbank chairman Jens Weidmann) which is already leaking disapproving letters[32] as part of a plan for

[31] The Guardian, October 10, 2011
[32] FT 1st March 2012

reining in the ECB. We are now living in a precarious and fractious central bank led capitalism where recent interventions by the ECB and plans by the Bank of England suggest that the system is already under some stress, and that it is fragile in ways that policy intervention is both easing and aggravating. Faced with EU political stalemate over policies to tackle rising interest rates on Italian and Spanish debt refinance and sensible of worsening market liquidity problems, Mario Draghi as incoming head of the ECB offered more than €1 trillion in cheap loans to European banks as part of a long term refinancing operation (LTRO). The ECB provided three year loans at 1 per cent to private banks in what was a crude liquidity injection exercise – crude because there were no restrictions on quality of collateral, no limit on what individual banks could borrow, and no suggestion that injected funds should be turned into loans for the non-financial sector. This ECB intervention is very much in line with interventionist current central bank thinking in the UK and USA. The Bank of England has a Draghi style scheme, the Extended Collateral Term Repo Facility, that has not been used but is ready to go if there is a shortage of short term sterling liquidity in the market[33]. So what to make of the current forms of intervention?

The first point to make about the ECB's LTRO scheme is that a system which is stressed but not in crisis is already absorbing massive liquidity injections. Some 500 European banks borrowed €489 billion in late December 2011 and just two months later some 800 banks borrowed €530 billion. The injections are huge partly because of international interconnects within Europe and from European banking to the rest of the world which is withdrawing funding just as the ECB is injecting funding. The future now depends partly on the movement of offsetting stocks and flows whose magnitudes are uncertain. But the more pessimistic bloggers such as John Mauldin argue that the Italian banks which are now 6.5% funded by the ECB are still 12% funded by foreign, mostly private bank funders. In Southern Europe, the sums required to shore up liquidity are huge because the ECB is pouring water into a tank with a large waste pipe. Nevertheless, the ECB correctly analysed market liquidity problems and has succeeded in the short term in easing those problems, increasing demand for paper and thereby reducing South European sovereign borrowing rates below the "unsustainable " level of 7% before LTRO was launched. After LTRO 1 and 2, borrowing rates are down overall by some 2 per cent for Southern sovereigns. The spread over German rates on short term borrowing has narrowed even more dramatically. Italian one year bonds paid 6% over similar German bonds in November 2011 and now in March 2012 the difference is just 1%.

The second point to make is that a short term improvement in market liquidity has been achieved by storing up longer term problems about bank solvency and without assuaging bankers' fears about counterparties in the interbank market. Demand for South European

[33] FT Alphaville, 6 December 2011

government bonds has increased because the ECB has in effect been encouraging a carry trade whereby banks which borrow from the ECB can earn substantially more by investing in longer term Italian or Spanish bonds which still yield more than 5%. In effect, as commentators like Plender[34] argue, the ECB is simply loading more sovereign risk onto the already fragile balance sheets of the European banks. And many of the banks that are prudently avoiding this carry trade seem to be hoarding cash or placing it with the ECB rather than the interbank market. As the ever cynical Lex pointed out, overnight deposits at the ECB on March 1st reached a record level of €777 billion[35] in the same week that LTRO 2 injected more than €500 billion. The attraction was hardly the 25 basis points paid on deposits by the ECB but the absolute security which ECB overnight accounts offer in an uncertain world.

From a broader point of view, Mario Draghi the head of the ECB in the second phase of the financial crisis looks to be a figure like Gordon Brown or Ben Bernanke in the first phase of the crisis: the hero of the hour whose longer term reputation is uncertain. But perhaps this is too optimistic. For the enduring objective of European and American policy makers since autumn 2008 has been to keep the banks going, but this will be increasingly difficult if, as we have argued, the rehypothecation and balance sheet connections render finance unmanageable in crisis, regardless of technical and political leadership quality.

In the longer term, then, the key issue arising from our analysis of rehypothecation and bank balance sheets is how much domino failure (of sovereigns and/or banks) the European system can withstand before the system passes beyond expert management by the ECB and the central banks. And here the straight answer is that *no one knows*. On the one hand there is what one might think of as a *cognitive* or *intellectual failure*. The question about limits cannot be precisely answered in part because there is no existing intellectual framework capable of modelling the complex lines of transmission and their multiple interrelated failures. But if there is no expert unanimity, then *the politics, too, are equally uncertain*. Will the lay political mandate for continuing support still exist if the sums required for market support and bank recapitalisation increase into tens of trillions? And when will national political elites take fright at the electoral consequences of a second, much larger round of bank recapitalisation? Again, the answer is: no one knows. We are flying into unknown territory.

[34] Financial Times, 28 Feb 2012
[35] FT, 2 March 2012

(4) Deep stall? analogy and disanalogy

> "During a stalling test, the aircraft entered a stable stalled condition, recovery from which was impossible"
>
> (Accident Report on crash of BAC 1-11 G- ASHG, 22nd October 1963)

So how can we move our analysis forward to engage with the characteristics of finance that have not previously been disclosed? How can we start to think simultaneously about the *cognitive or intellectual failures* on the one hand, and the *uncertainties of the politics* on the other?

Elsewhere[36] we have argued that academic responses to this challenge have been overwhelmingly conservative. This is because response to crisis has generally reinforced commitments to pre-crisis problematics. Mainstream economists who talked of the "great moderation" and did not anticipate crisis beforehand, have turned to their concepts and methods to explain the crisis *ex post facto*. At the same time, heterodox Minskian or Keynesian economists have taken credit for prescience despite the fact that the continuing financial crisis is clearly much more than just another bubble. Against this, a radical thinker such as Andrew Haldane has argued for the need to shift problematics, and in his case has pressed for biology-based, epidemiological knowledge of the finance sector rather than models based on physics. Perhaps this is progress, but major changes of problematic involve decades of development and, if the existing community of orthodoxy is to be won over, the current scientism of quants, algebra and formalisation will also have to be maintained. This is why we are interested in exploring a third way of unsettling the relevant intellectual and political frameworks – the conversational and multidisciplinary potential of *provocative analogy*.

Our argument is that the story we told of banking and finance in the last section can be understood as a narrative about technologies unwittingly extended and systems unintentionally reconfigured in ways that have led – or will lead – to unexpected and disastrous collapse. Posed this way and thinking analogically, this suggests that it may be productive to draw on the lessons to be learned from other contexts in which collapsing technologies have led to unexpected disaster. There are many possibilities: the history of technical innovation is littered with instructive failures. In the present paper, however, we will argue that there are instructive analogies and disanalogies between the present problems of finance, and those encountered by the British aircraft industry in the 1950s and early 1960.

Why this analogy? Why has it been useful as a basis for team conversation? One answer is that powered flight and modern finance are both marvels of technical complexity. A second is that

[36] For example Engelen *et al*., 2012

they mostly work unproblematically whilst also, albeit rarely, failing catastrophically. Third, there are also similarities between the tasks of the political and technical policy elites who manage finance, and the work of pilots. In stable operation in both contexts, routine control manoeuvres generally produce predictable results, or at worst deviations that don't matter. Exceptionally, however, control interventions may lead to or beyond the brink of disaster into full-blown catastrophe. This is because politicians, bankers, plane makers and airline pilots all (and necessarily) work within the practical limits of knowledge. To put it differently, and this is the fourth point of analogy, the understanding by participants of the conditions and consequences of control is (necessarily) shadowed by and depends on *undisclosed corollary realities*. Sometimes those undisclosed realities change shape and reveal themselves, and it is when there is a sudden and unexpected loss of control that they most obviously bite back. It is at such moments (our fifth point of analogy) when those undisclosed realities become susceptible to analysis after the event: accident reports or accounts of financial failure are at least in principle able to help us to expand our understanding of what was previously undisclosed – and offer new insights into accident prevention. Now the case.

In October 1963 a BAC 1-11 prototype crashed over Wiltshire. Analysis of the crash based on flight data led to the recognition of a phenomenon now called *deep stall* (it was called 'stable stall' at the time). In this airframe design simply prevents pilot recovery. The aircraft in question, G-ASHG, the first BAC 1-11 civil jet prototype, was on its 52nd test flight after 81 airborne hours. Most of these flights were short and were intended to test the controllability of the aircraft during specific manoeuvres in order to secure airworthiness certification. Stall tests, begun on flights 47 and 48, required the pilot to stall the aircraft deliberately in different circumstances and then recover control. In a fixed wing aircraft stall describes the moment when lift fails and drag increases because the air flow has broken away from the top surface of the wing. This usually happens when a plane loses engine thrust, though it is dependent on other factors including wing angle and centre of gravity. When this happens the plane starts to fall, though if the plane has sufficient height and power the pilot can usually recover lift. In a routine that is over a century old the pilot brings the plane's nose down by pushing the stick forward to lower the tail elevators, at the same time increasing thrust. On the fatal October 22nd flight, the test crew had carried out four stalls with undercarriage and flaps up, and recovery had been achieved in all of these. However, the plane never recovered from the fifth stall test which was carried out at 15,000-16,000 feet in good weather with flaps lowered and the centre of gravity moved aft. Just 90 seconds after the pilot initiated the stall the aircraft struck the ground in a flat attitude with little forward motion. The plane was destroyed and all seven crew members were killed.

Air accidents are followed by quasi-forensic investigations. In this case the air accident inquiry completely exonerated the pilot, and in an understated British way criticised the newly formed BAC group (which had inherited the design) for failures of procedure and design evaluation.

After six years of WW2 flying and 15 years as chief test pilot for Vickers, the pilot, Mike Lithgow, was hugely experienced. Lithgow neither panicked nor delayed and, within nine seconds of initial stall, was systematically trying everything that was sensible to regain control of the falling plane. But (as it turned out) control was impossible because the tail elevators had been pushed hard up by air turbulence despite his best efforts to wrestle them down[37]. In an attempt to change attitude the engines were briefly opened to full power (which brought the nose up instead of down because the tail elevators were jammed in the up position) and the pilot immediately and correctly responded by shutting them down. The stalled plane was also banked twice to the right and once to the left to see whether this would restore controllability. Nothing helped and the pilot was exonerated, but BAC was deemed in part culpable because it already had some knowledge of stall problems with other aircraft, and the report observed that “stalling tests should have been more cautiously approached, more closely controlled and more carefully correlated with wind tunnel and flight-recorder data”[38].

So what are the analogies and the disanalogies between this crash and our current financial difficulties? Remembering that the object of a good analogy is to provoke thought, we want to suggest that the differences in the present case are as instructive as the similarities.

(1) A change in design configuration may create the possibility of sudden, unexpected and irrecoverable loss of control. This occurred in the 1950s aircraft industry, and it also applies to contemporary finance.

The BAC 1-11 elevators jammed in the up position because a new design configuration had been created. After some 50 years of powered flight, aircraft manufacturers in the 1950s and 1960s were discovering problems with a new T tail air frame configuration. The new design put the jet engines in nacelles at the rear of the fuselage (see the Figure). But then it was necessarily to put the rear elevator control surfaces right at the top of the tail plane instead of in their usual position on the fuselage.

In normal flight this was fine. But in some (though not all) stalls, if the nose lifted too far and the tail dropped, then the turbulent air from the wings enveloped the top of the tail. This stopped the elevators from controlling the plane – or the pilot from operating those elevators. This novel and catastrophic combination of circumstances was discovered as a result of a series

[37] Ministry of Aviation, 1965, p. 4
[38] Ministry of Aviation, 1965, p. 11

of disastrous crashes – the BAC 1-11 1963 crash was the second or the third such incident which had previously led to crashes of military jets.[39]

Now we shift back to finance. Our argument is that something similar has happened here too. Specifically, we propose that *rehypothecation and interconnected balance sheets at the velocity and scale introduced by the 2000's finance bubble represent the equivalent of a T tail configuration*. It is new in profoundly important ways. And then we want to say, following the argument we made in the last section, that *this major reconfiguration has the potential to destabilise the flows of credit*. We are saying, then, that the novel financial interconnections we have detailed represent a major change in design. And then we are saying that under certain circumstances the unintended and unpredictable effect of these changes will be loss of control in the turbulence arising from a major market disturbance. And here is another and crucial part of the analogy: *most of the time everything works*. It is business as usual. In other words, the fact that there is a catastrophic problem is hidden. On previous flights of the doomed 1-11 aircraft Lithgow found that it behaved "innocuously" - and then it fell out of the sky in 90 seconds on the fifth test despite the fact that he was an ace pilot. Returning to finance, this tells us that we should take no consolation from the fact that deep stall has not yet happened here. Our argument is not that every market disturbance results in disaster. Rather it is that *the possibility of a disastrous crash is inscribed in every new disturbance*. That the Eurozone fixes have worked up until now makes no difference to this chilling reality.

Figure 7: BAC 1-11 by RuthAS;

Source: http://commons.wikimedia.org/wiki/File:BAC_1-11_G-AWEJ_Channel_Aws_Ringway_08.69_edited-1.jpg

[39] In the 1963 BAC 1-11 crash, the unpowered elevators jammed in the up position; in a Gloster Javelin crash on 11th June 1953 (and perhaps a Victor bomber crash of 23rd March 1962) turbulent airflow apparently stopped correctly positioned elevators working to control the aircraft.

(2) Major design changes generated in fragmented ways are particularly liable to catastrophic failure, since the levels of expertise that generate them are themselves fragmented and therefore limited. Both conditions apply to the 1950s aircraft industry and to contemporary finance.

The British aviation industry in the 1950s and early 1960s consisted of many small companies. These were alike in that they produced innovative civil and military jet powered aircraft involving step changes with new features such as T tails, swept wings and pressurised cabins. At the same time the level of aerodynamic expertise and structural knowledge in the industry was restricted because design offices were small, wind tunnel and stress rig testing was limited, and there was no computer simulation. As a result major changes in design such as T tails were introduced without any anticipation of disaster by designers who were not in a position to understand the complexities of the relevant interactions.[40] Organisationally, then, we need to note two points. One, the arrangements for innovation were relatively *fragmented*, and two, the *levels of expertise* for understanding the overall behaviour of novel aircraft design in unusual circumstances were relatively low and, as it turned out, inadequate

Like the aircraft industry, the financial industry is *fragmented* and that fragmentation means that it is similarly short of relevant system-wide expertise. Specifically, it has created high velocity rehypothecation within a diverse ecology of many different types of firms (pension funds and insurance companies, hedge funds, prime broker and trading desks at the investment banks, to name but some). None of these actors have deep understanding of the overall design of the financial system. At the same time the latter is continuously being changed by the actions of agents whose major concern is to seek a private return at a particular point or node in that system rather than thinking about its overall integrity. The system is therefore an ever changing effect of more or less 'local' innovations. The result of all this is that the financial industry is courting disaster in much the same way that happened to the aircraft industry in the 1950s and early 1960s. Small design innovations have accumulated in ways that have led to step changes in the structure of the system which as a result is now liable to deep financial stall. To put it bluntly, *if finance were an aircraft then fear of flying would be entirely reasonable*. *Few of us would consent to fly as passengers*. As it is, however, whether willingly or otherwise, we are all on board when it comes to finance. We have no choice. And when and if it crashes, we will all go down too.

[40] There were other examples, including for instance the De Havilland Comet crashes of 1954. Two Comet 1 aircraft broke up in mid flight. In this case De Havilland designers had rigorously tested the passenger cabin's ability to withstand pressure and built in a large margin of safety but had not anticipated that repeated in service cycles of pressurisation and depressurisation (compounded by construction techniques) would cause metal fatigue and disastrous failure of the outer skin.

(3) Catastrophe becomes a learning opportunity only if appropriate expertise can be developed and mobilised on a large scale. This was done in the case of aircraft innovation, but has not been achieved in finance.

Now we move to the differences between the aircraft industry and finance. Thus in the case of aerospace there was (and is) a large body of systematic and relevant knowledge of aerodynamics and materials. This meant that the British aviation industry was able to respond to air crashes by deploying systematic knowledges, testing relevant linkages and identifying patterns of failure that could be rectified by re-engineering. The short term power of such techniques was first demonstrated in water tank tests for skin fatigue after the 1954 Comet crashes. The long term solution was the application of large-scale corporate resources and systems which BAC subsequently deployed in the Concorde design. Meanwhile, before the second BAC1-11 prototype flew again in July 1964, the design of the aircraft was extensively and systematically re-engineered to inhibit deep stall and assist recovery. Innovations included revised wing leading edges, powered elevators, modified reverse thrusters, and an emergency tail parachute[41]. And within five years the industry had also introduced the stick shaker to warn pilots of impending stall.

But what of finance? If we take the aircraft industry and its response to catastrophe as a benchmark, it immediately becomes clear that there are no equivalent mechanisms in place. The BAC may have been at fault in the BAC 1-11 crash, but it and the airworthiness regulator were in a position to be able to learn about what had happened, and then to apply their new expertise in ways that made aircraft safer. Though they were 'cognitively challenged' initially – they didn't understand what had happened – they rose to that challenge. But in finance the expertise simply isn't there, and neither are there the organisational and political structures needed to develop it and put it into practice. The aircraft analogy makes it clear that another iteration of the not so onerous Basel regulations on capital, or the US Dodd Frank and UK Vickers reform proposals (limiting prop trading by banks or ring fencing of retail and wholesale) are all more or less comically irrelevant. The root reason for this is that *none of the responses seriously engages the problem of financial interconnects*. Equally irrelevant is the stress testing of European banks in June 2010 – tests that were made on the assumption that sovereigns could not default.

(4) Learning after (potential) catastrophic failure is easiest if there are shared common interests in understanding the complexities that led to that failure. There were shared and powerful common interests in the case of aircraft crashes, but this is not true for finance.

[41] Ministry of Aviation, 1964, p.2

In the case of aircraft diverse private and public interests are aligned. Everyone wants to prevent planes from falling out of the sky. So one of the reasons why the BAC 1-11 (and other aircraft) failures were resolved was that there was a general overlap of interests by all concerned – everyone was after a particular agreed solution. 'All concerned' in this case included the manufacturer BAC, the British Ministry of Aviation, the airline purchaser and operator British European Airways, and the travelling public. Though they may have done so for different reasons, all of these shared the objective of safe flight.

The contrast with finance could hardly be starker. Here there is a profound conflict of interest between the private interest in forms of finance that are profitable to individual players, and the general social interest in a safer financial system. The depth of this conflict is only partially obscured by the endless discussion about bonus and other incentives to encourage less risky and more responsible private behaviour by banks and market players – incentives that are most unlikely to bridge the gap in any substantial way. After a cycle of privatised gains and socialised losses in the first phase of crisis, the finance sector in 2009-11 still resisted any reform of finance which seriously limited profitability or crimped the comp ratio joint venture between shareholders and investment bankers. In effect, finance has insisted that UK national politicians negotiate weak domestic reforms with the sector, and persuaded most European governments to reflect the interests of their national financial industries in international negotiations – as, for instance, the German government did over capital adequacy.

Here, then, is the conclusion. Aircraft crashes like that of the BAC 1-11 can be understood a technical in character in the first instance. But this is only because there is *a background of shared social and/or political alignment of interests amongst all concerned*. This means that, give or take, there is little difficulty in achieving a shared view about what would count as a solution. And given the shared and extensive character of the relevant expert knowledge there is a similar likelihood that agreement can be reached about how best to arrive at that solution. Or, to put it differently, for the aircraft industry what was being confronted was both a technical and a social and political problem or issue, but to a first approximation its social and political dimensions were so unproblematic and so well aligned amongst those involved that those dimensions disappeared from view after the crash. But this does not apply to finance. There is not a shared view about what is to be done. There *is* no alignment. And, as a part of this, there are *no mechanisms for aligning interests* – and in particular there are no effective democratic mechanisms for defining what would count at the general interest and imposing this on the sectional interests of finance.

So why is democratic politics so hobbled? This is the issue that we explore in the next section.

(5) Democratic disconnects (without popular mobilisation)

> "We are not in business at all, we are in politics"
>
> (Walter Hallstein, President of the European Commission, 1961)

If Hallstein's vision of politics was about building the United States of Europe, what has actually been created is a Disunited States of Europe. In this dysfunctional political collective there is no effective way of mobilising the general interest, nor of restraining sectional interests. Rather than working to restrain the potentially catastrophic complexities of finance there is displacement activity instead. Technocrats and Northern European politicians visit expenditure cuts and vicious economic austerity on the economies of Southern Europe. As a part of this, democracy is also in the process of being eroded in Greece and in Italy, and private financial interests are being protected. Finally, there is no reason to suppose that the prescribed medicine is actually going to work.

For instance, after the second bail out the Greeks have a debt to GDP ratio of 160%, an economy that has been in free fall for four years with GDP declining by a further 7% in 2011 and the prospect of a decade of austerity without economic growth. Further default seems inevitable and the main effect of bail outs has not been to assist Greece or protect North European taxpayers but rather to allow private banks to take their money off the table. Thus Open Europe calculates that bail outs and the ECB have made €282 billion total funds available to Greece, but 43 % of this total has gone to banks and bond holders rather than Greece itself. Meanwhile, further losses are being socialised because, after voluntary restructuring and second bail out, the share of Greek debt held by taxpayer backed institutions (ECB, IMF, EFSF) could double to more than 80%.[42]

It does not have to be like this. Compare and contrast the policy response to the last systemic crisis of the European economy in the period after World War 2, when economies were in ruins and starvation threatened large parts of the continent. We know that this crisis was overcome by a mobilisation of the power of democratic states, allied to policy creativity with European national efforts supported by the US sponsorship of the Marshall Plan. The problem in the present crisis has been the failure to replicate this experience of mobilisation and creativity. In part this reflects the weakening United States power and the absence of an external communist enemy: the US contribution to the present crisis has been mainly to send Tim Geithner to encourage the Europeans to be more serious. But the decisive differences are internal. The reconstruction of Western Europe after 1945, for all the differences between different national traditions, and for all the problems involved in the creation of democratic institutions in the former Axis dictatorships, fundamentally involved mobilising the power of

[42] p. 1 http://www.openeurope.org.uk/Content/Documents/Pdfs/Greece_Bad_Deal.pdf

European democratic states for positive economic outcomes of employment and welfare within and beyond their national boundaries. And although this required elite management, it was sustained by the political mobilisation of the masses in support of a post war settlement and a better world. Compare and contrast how the German tabloids now feed popular distrust of the lazy Greeks who are, of course, in their turn remembering the Nazi war.

The imposition of austerity amidst scapegoating is only one symptom of a more fundamental set of problems to do with governing institutions in both the national members of the Union, and at the level of the Union itself. Democratic engagement demands two rather obvious conditions: actual engagement by citizens with democratic institutions; and confidence on the part of citizens that institutions have the capacity, and the integrity, to tackle key policy problems. The great tasks of rebuilding the European economy – or at least that part of it that composed the original members of the 'Common Market' – were done in precisely those circumstances: in an age when the European idea commanded support as an alternative to the destructive nationalism which had led to the catastrophic European wars; in an age when democratic institutions were being built in the former axis dictatorship; and in an age when mass parties were at the heart both of popular mobilisation and the selection of governments with popular economic and social objectives. In making this argument, we are not taking the position that traditional forms of representative parliamentary democracy are the best or only way of mobilising populations so as to identify and enforce a general interest. Rather our point is that the decline of the old institutional forms has left us with new forms of politics as marketing which (with or without technocratic direction by elites) fragment populations and are simply not up to the current task of negotiating a major redirection of the European economy which would, inter alia, involve the restraint of finance.

The mass party was the dominant means by which citizens were mobilised into political activism in the era of economic and political reconstruction in the aftermath of the Second World War. The British case can serve as an example. At the height of mass membership in the 1950s there were about 2.8 million members of the Conservative Party, and 1.2 million individual members of the Labour Party. Naturally much of this membership had only the most distant political implications: membership of the Conservative Party, in particular, was linked to integration into the social life of middle class communities. But the sheer weight of membership meant that the parties had almost a monopoly of political activism: there were, at the height of the mass party in the UK, about 250,000 members of the Young Conservatives alone. Moreover, the mass party had other important consequences for the relationship between parties and the surrounding civil society. Mass membership was both an important resource in itself and an important generator of financial muscle. The mass party developed to provide the labour power needed to mobilise the wider electorate in competitive elections: it was a huge resource of free labour in grass roots campaigning. And the mass party was often a hugely effective fund raising machine: it was the (often non-political) social life in the constituency parties which turned the Conservative Party into the richest movement in British politics. Mass membership was a key means by which metropolitan political elites were connected with provincial communities and interests and obliged to think of something outside Westminster.

The work of Van Biezen *et al*[43] summarised in table 4 shows some of the magnitude of the change in Britain and right across Europe. In fact the often dramatic declines summarised here actually underestimate the scale of things: in the British case, for instance, by the end of the 1970s, when the series assembled in table 4 begins, there had already been a marked decline: the estimates by the Houghton Committee on party funding in 1976 showed, for instance, that Conservative Party membership had already fallen from the peak of 2.8 million to about 1.5 million[44]. The consequences of these changes vary between national systems, as the comparative literature on party systems shows. Nevertheless, in all systems the declines in membership (coupled with partly associated changes in campaigning methods) have created serious financial problems for parties. These problems arise from the simultaneous loss of sources of fundraising, and the turn to often expensive modes of campaigning and probing of public opinion to replace the mechanisms provided by the mass party. In some systems the gap in funding has been substantially made up by state support, in turn often transforming parties into quasi-public agencies. From this derives the system of 'cartel parties' documented by Katz and Mair (1995), in which the parties provide a set of public functions (supplying governments, most obviously) in return for arrangements that allow them to cartelise the market in competition for votes.

In systems where this kind of symbiosis with the state has not proved possible (in the UK, for instance, where public funding remains comparatively unimportant) the parties have been driven increasingly close to large funding sources from the private sector. In particular, the plutocracy created by booming financial markets has become an important source of funding for both main parties but, especially in the era of the Eurocrisis, for the dominant Conservative partner in the coalition.

The decline of party membership has also caused profound changes in the way parties seek to monitor and probe public opinion and to assemble party programmes in the competition for the support of such publics. The implications of this have been nicely teased out by van Biezen *et al.,*[45]. The diminished membership now seems to have shrunk to a core of political

[43] Van Biezen, I., Mair, P. and Poguntke (2011). 'Going, going, ….gone? The decline of party membership in contemporary Europe.' European Journal of Political Research 51: 24-56.
[44] Houghton, D. (1976). Report of the Committee on Financial Aid to Political Parties, CMND 6601. London: HMSO.
[45] Van Biezen, I., Mair, P. and Poguntke (2011). 'Going, going .gone? The decline of party membership in contemporary Europe.' European Journal of Political Research 51: 24-56.

professionals (public office holders, aspirant career professionals[46]). As they remark, "it might be reasonable to regard (the parties) not as constituting part of civil society – with which party membership has traditionally been associated – but rather as constituting the outer ring of an extended political class."[47] Viewed in this light, a movement like 'Forza Italia' is not an Italian eccentricity; the very inspiration for the party, which is the range of supporters for a football team, exactly expresses the emerging relationship between the modern party and the electorate.

Table 4: Political party membership change in selected EU states, 1980-2009.

Country	Period	Change in membership to electorate ratio	Change in number of members	% change in number of members
Czech Republic	1993-2008	-5.05	-379,575	-69.7
United Kingdom	1980-2008	-2.91	1,158,492	-68.4
Norway	1980-2008	-10.31	-288,554	-62.6
France	1978-2009	-3.20	923,788	-53.2
Sweden	1980-2008	-4.54	-241,130	-47.5
Ireland	1980-2008	-2.97	-50,856	-44.7
Switzerland	1977-2007	-5.90	-178,000	-43.2
Finland	1980-2006	-7.66	-260,261	-42.9
Denmark	1980-2008	-3.17	-109,467	-39.7
Italy	1980-2007	-4.09	-1,450,623	-35.6
Slovakia	1994-2007	-1.27	-41,204	-32.3
Belgium	1980-2008	-3.45	-191,133	-31.0
Netherlands	1980-2009	1.81	-126,459	-23.4
Austria	1980-2008	-11.21	-422,661	-28.6
Germany	1980-2007	-2.22	-531,856	-27.2
Hungary	1990-2008	-0.57	-41,368	-25.0
Portugal	1980-2008	-1.05	+4,306	+1.3
Greece	1980-2008	+3.40	+335,000	+148.9
Spain	1980-2008	+3.16	+1,208,258	+374.6

Source: Van Biezen *et al*., (2011).

[46] Van Biezen *et al.,* (2011) p.38-9.
[47] Van Biezen *et al.,* (2011) p.40.

Although there are periodic membership drives, most parties now seem to have given up on their membership as a means of probing and shaping public opinion, in favour of modern marketing techniques: "the large majority of parties seem relatively unconcerned about their memberships and are instead much more focused on reaching out to the wider public through professional campaigning and marketing techniques."[48] The new forms of direct electoral mobilisation work through the media and are marketing driven. In much the same way as supermarket retailers, politics is concerned with a double objective: first, differentiating and fragmenting target demographics that can be persuaded to switch; and second, not alienating the very large number of inertia voters whose loyalty should not be upset. Hence, the Gould/Mandelson revolution and the Labour Party's target group approach to campaigning which was carried over into the Cameron/Osborne rebranding of the Conservatives when in opposition: here the emphasis is on focus groups, on responding to polls and on designing particular policies for particular slivers of the electorate, all in the manner of a marketing campaign identifying niche markets. But, of course, at the same time, an electoral majority is required and this reinforces the importance of "dog whistle politics" which signals commitment to the objectives of hard core supporters or targets while wrapping them in the language of reasonableness which is acceptable to the moderate centre. Hence the success of premier John Howard in Australia, especially on issues like race and immigration; or the bizarre politics of the Cameron coalition where every reactionary cut (to housing benefit, legal aid, taxes or whatever) has a justification in terms of fairness so that surely no reasonable voter could disagree.

The marketing techniques of focus group and coded dog whistle communication no doubt have a place in democratic political practice. But, we should remember that many designers of innovative new products, like Apple's Jonathan Ive, insist that "We don't do focus groups" because they produce bland, inoffensive, iterative refinements of existing products.[49] The focus technique is ill adapted to the calculative needs of any firm (or party) mobilising consumers (or voters) for a product they have not seen and do not know they want. It is also likely to have secondary effects where electoral systems are more proportional in the relationship they produce between the popular vote and assembly representation. In such cases, the targeting of 'niche' groups of voters contributes further to the dissolution of the old, formerly dominant, parties. Since the party organisationally no longer means anything significant, and since parties are in the business of identifying niches in the electoral market, the incentive to accept the compromises involved in subordination within an existing party is considerably reduced. Why not cut out the middle man and devise a new message, and a new party, to aim at particular niches, where the electoral system allows the possibility of converting popular success into

[48] Van Biezen *et al.,* (2011) p.40.
[49] http://www.bbc.co.uk/blogs/technology/2009/07/listening_to_mr_iphone.html

some proportional legislative representation? Thus we have had a multiplication of these specialised parties, of which the most successful have been those catering for territorial separatism and those catering for various kinds of new right populism.

This decay of the old institutions of popular mobilisation at national level plainly potentially creates a space for alternative mechanisms of crisis management. The most obvious of these, and the most resorted to in the Eurocrisis, are the institutions of the European Union. There is now ample documentation that the crisis has created an opportunity to increase union level oversight of national economic policies, and to strengthen the power of those institutions to impose sanctions on national governments that fail to observe policies on public spending and public debt limits. The convoluted struggles over the allocation of Union and national powers has for the moment culminated in the 'fiscal compact' agreement reached by 25 of the 27 members of the Union at the meeting of the European Council (summit of leaders) in Brussels in January 2012 for increased Union oversight and control of national budgets by Union institutions. The critical point here is that, as the price of German financial support, an attempt is being made to significantly increase Union oversight of national policies.

The institutional developments created in the crisis can thus be seen as the result of attempts to cope with two key political weaknesses. At the national level modes of democratic mobilisation that were central in the post war period, especially in the period of the 'glorious thirty years' after the Second World War, are failing to work at national level; at their most extreme they are forcing some democratic systems (Italy and Greece) to in effect suspend key features of democratic government by installing governments of non-elected econocrats to manage the extremity of crisis. At the Union level the responses are conditioned by well-known problems in the decision making mechanisms of the Union. They have been identified in the formal academic literature as what Scharpf called 'the joint decision trap.'[50] In other words, the rules of decision-making in the EU enforce a large element of joint decision-making and create huge obstacles to the kind of decisive outcomes needed in a crisis. The joint decision trap was catastrophic in Union level management at the start of the crisis. The plaintive words of the EU Commissioner for financial regulation and of the ECB President at the start of the crisis symbolise the sclerotic character of decision making in this system. Thus, here is the 'don't panic' response of the ECB president, Jean-Claude Trichet, in mid-August 2007 – 'I call on all parties concerned to continue to keep their composure'. And the even more plaintive response of Commissioner Charles McCreevy after the mid-September meeting held when the Northern Rock crisis was still at its most intense: 'We are making progress, but I would not want to put it

[50] Scharpf, F. (1988). 'The Joint-Decision Trap. Lessons From German Federalism and European Integration'. Public Administration, Vol. 66, No. 2. pp. 239–78)

any stronger than that….. We are moving to the next stage. You can only move as fast as you are allowed'[51].

The blocked character of decision making is in turn a product of a well-documented feature of the whole movement that helped create the project for a Single Market and for a single currency: it was an elitist project, the product of an alliance between technocrats, of the European business elite and of some 'visionary' politicians like Helmut Kohl[52]. On the rare occasions when it encountered popular politics, in the form of referenda to approve elite compacts, the outcomes were fiascos: the Irish electorate only ratified the Treaties of Nice (2001) and Lisbon (2005) after two attempts, having 'failed' to give the 'right' answer on the first occasions. The Lisbon Treaty itself was concocted as a successor to a full blown constitution, when the latter was rejected by electorates in popular referenda in the Netherlands and France. These EU fiascos in encounters with popular politics are not the product of the tactical mistakes or persuasive shortcomings of individual leaders – or at least not solely the product of these. They arise in part from two features we have already identified: the draining away of the capacity for popular mobilisation at national level, and the engrained attachment to policy making by elite bargaining at EU level. But they also reflect a something more: the striking disjunction between the capacity of elites to build new institutions and policies of integration, and their consistent failure to engage popular support for, or affective response to, those institutions. Europe as a popular project in the sense of creating institutions that command high levels of participation from the wider population has been a consistent failure; and as we shall see in a moment popular confidence in European institutions has now been considerably damaged by the experience of the crisis and of its management at EU level.

The most obvious failure concerns the European Parliament, whose powers and significance in the EU level policy-making process have been significantly enhanced over several landmark treaties. But the Parliament has consistently failed to approach anything like even the comparatively weak attachment of national parliaments to populations. The most striking sign of this concerns voting in elections to the European Parliament. Voting is the most elementary, but also the most fundamental, mode of democratic engagement. Since national and European Parliament elections do not take place on a synchronised cycle simple comparisons are hard to make. Nevertheless, the summary figures convey a clear message. The turnout for the EU 27 in the last round of European Parliament elections was 43 per cent; the figure for the EU 25 in 2004 was just over 45 per cent. It is well known that national turnouts in EU parliament

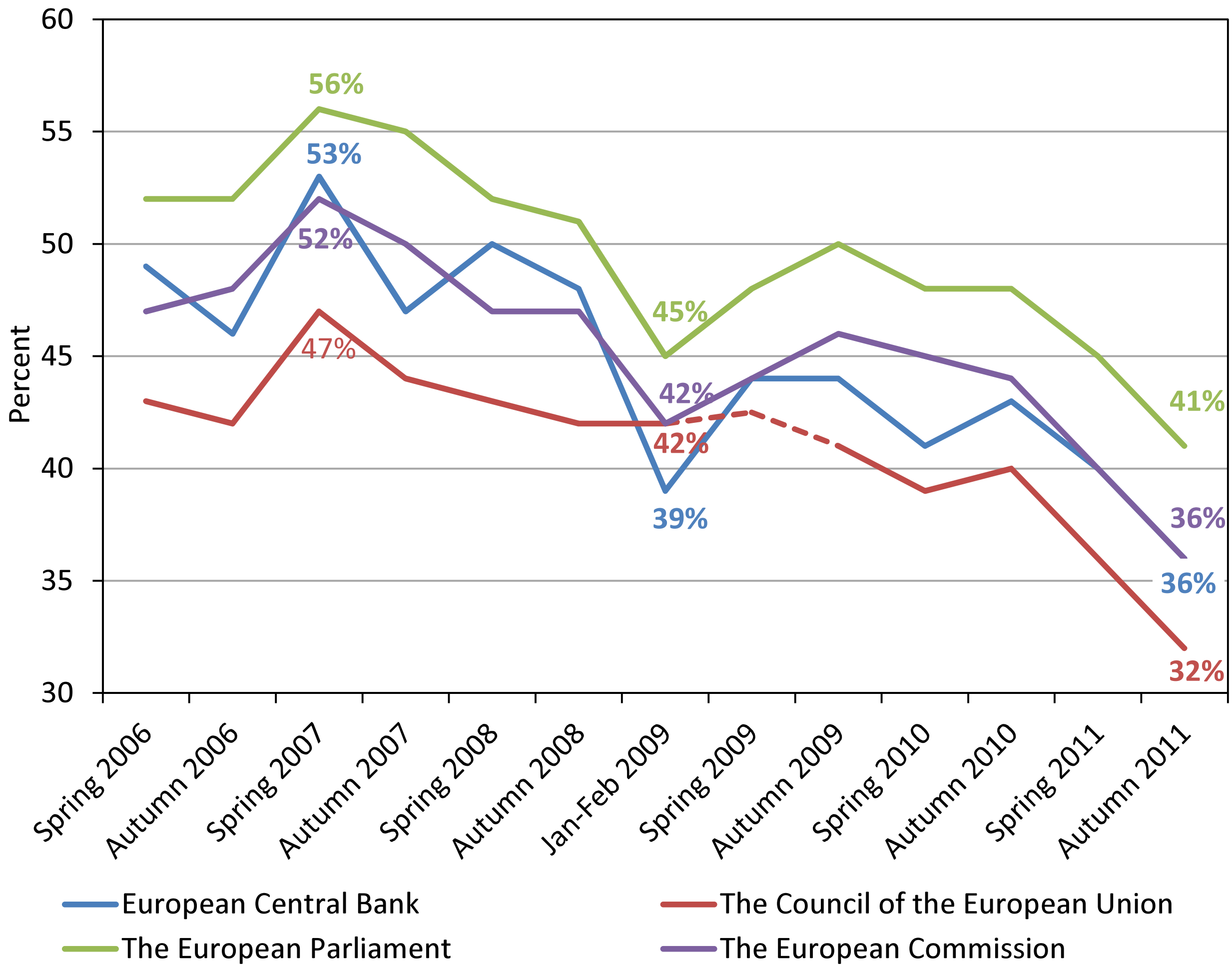
[51] Quoted in Barber, T. (2007). 'EU Adopts Flexible Stance on Bank Crises.' Financial Times, 16 September.
[52] van Apeldoorn , B. (2002) Transnational Capitalism and the Struggle over European Integration. London : Routledge; and Dyson, K. and Featherstone, K. (1999). The Road To Maastricht: Negotiating Economic and Monetary Union. Oxford: Oxford University Press.

elections vary greatly around this average. Belgium, which has compulsory voting, typically records turnouts in excess of 90 per cent (as it does in elections for national institutions); Lithuania recorded a turnout of just under 21 per cent; and the United Kingdom a turnout of just under 35 per cent. For comparison: the most recent national figures for Belgium are just over 89 per cent (2010), for Lithuania just under 49 per cent (2008) and for the UK 65.5 per cent (2010.) For the pre enlargement EU 15 (which of course also compose most of the members of the Eurozone) the turnout in the run of national elections in the new millennium has been in the range 70 to 73 per cent. These differences in turnout cannot be explained by the argument that the European Parliament is an insignificant institution (though of course they do suggest that populations may believe precisely this.) Under the authority enhancing provisions of successive treaties it has become a significant player in European economic government. The turnout figures suggest that the affective hold of the only EU institution that makes an attempt to claim popular legitimacy is very limited – much more limited, even, than the often discredited national popular institutions. The Commission has for decades sponsored civil society movements in the Union, but what is striking is exactly how thin is the mobilisation of popular opinion on a European scale. The biggest environmental movement in Europe is probably the UK based Royal Society for the Protection of Birds. The most effective cross national movements of recent decades were outside the union: they involved alliances against the old Communist autocracies before 1989, often drawing on highly traditional non-democratic cross national organisations like the Catholic Church.

Institutions that have problems with popular engagement, as the institutions of the Union plainly do, are also likely to have problems in managing crises that afflict whole populations – as the financial crisis and its wider economic aftermath plainly does. Figure 8 below shows precisely this effect. Under the impact of the crisis levels of expressed trust (which can be interpreted as diffuse sense of confidence in the competence of these institutions) has systematically fallen away.

The governing dimensions of the Eurocrisis may thus be summarised as follows. The ‘building blocks’ of the Union are obviously the nationally constituted member states. The voices of these states in the European Council are still leaders who, in general, owe their positions to their command of domestic institutions legitimised by the processes of democratic politics: more concretely, by virtue of their ability to command political parties and, in turn by virtue of that command, to control the institutions of national decision making. As the data on elections suggest, and as the data on political parties show emphatically, that popular legitimacy is considerably weakened because the old forms of mobilisation are hollowed out and the new forms of mobilisation are not fit for purpose in the crisis. At the same time the intensity of the crisis has dramatically illuminated the limits of the elitist projects condensed into the construction of a single European market and single European currency. The immediate manifestation of this limit is, of course, the disjunction between the high ambitions of single currency creation and the very limited – to put it mildly – extent of coordination of fiscal policies across the Union. But that immediately manifesting gap is itself only a sign of Scharpf's 'joint decision trap.' The attempts to escape that trap have necessarily involved the attempt to create, and recreate, elite bargains. And it has been necessary to create these bargains within European elites because the institutions of the Union have so little popular purchase. Successive iterations of the integration project have involved periodic catastrophes when versions were tried out on national populations (the Irish experiences) or casuistry designed to keep populations away from those agreements (the conversion of a constitution into a Lisbon Treaty when Dutch and French voters gave destructive answers in referenda.) These fundamental problems of making popular connection have then been intensified by the experience of crisis itself, as the confidence of populations across the Union in its institutions have been drained away by the sufferings of populations experiencing a new great depression.

Figure 8: Public trust in EU institutions drains away under the impact of crisis management



Source: European Union
Note: Proportion of respondents replying "Tend to Trust" each European Union institution. The question related to the Council of the European Union was not asked between autumn 2008 and 2009.

(6) International finance and national politics; or what is to be done?

We are saying that the crisis is *technical*, but also *political*. The crisis reflects simultaneous failures of *expertise*, *and elite political projects*. The crisis reflects *cognitive and disciplinary inadequacies*, and the loss of any effective ability to mobilise a version of the *collective good*. And the crisis also reflects the creation and operation of rapid, uncontrolled and opaque *innovations* in the absence of a corresponding capacity to understand and control their consequences.

No-one – perhaps not even those who have most profited from the financial bricolage that has so contributed to the crisis – likes the place that we have got to as we stutter from one manifestation of instability to the next. The livelihoods of millions, the fiscal stability of sovereign states, the financial health of productive industries, the security of asset holders, and the stability of banks and payment systems, all of these have been put at risk. And they are still at risk. There is anger, insecurity, and frustration in the air. And yes, there are fixes – the most obvious no doubt being the ECB's credit-line to European banks – but we share the view of many commentators that these are little more than fixes: that the system generated in this process of bricolage is complex and fragile in ways that no-one properly understands; and that in due course it will crash in a financial version of deep stall.

At the beginning of this paper we posed three questions:

- why is our world now threatened by the dysfunctions of banking and finance?
- how is the ongoing and unresolved crisis to be managed? and
- is it possible to control banking in the longer term?

The conversational approach and the shared analogy helps us to think about these questions. The innovations in rehypothecation, and the interconnections between European bank balance sheets are, we have argued, both opaque and extremely dangerous. A catastrophe waiting to happen, they are important features of the fundamental instability of the European financial system. If we are to understand what is happening, this means that it is essential that any dialogue includes research findings and voices that explore, understand, reflect upon and interpret the 'technical' aspects of finance.

But then to understand the crisis we need to add in other voices too. First, we need to understand how politics works – or doesn't – in the context of finance. For this reason we have introduced a second voice into the conversation, this time from political science. This intervention highlights the difficulty of finding ways of articulating the general interest in the face of entrenched special interests. Thus we have an account from political science about the decline of the mass political party and its mobilising capacity in Europe since the Second World War. Woven into this is a related story about the growth of Gouldite and dog-whistle politics which respond to the interests of specific groups. Equally relevant is the development of

Europe as a technocratic project which projects and implements its own particular version of the collective good – for instance in the form of the Euro itself – but does so in the absence of any democratic mandate.

With these two voices – expertise in banking and finance on the one hand and political science on the other – we have put the two most important pieces into play: unstable financial systems on the one hand, and failing democratic control on the other. But then we have added two further voices to the conversation. One, on leadership and its failings, comes from an epistemic interest in knowledges and how forms of discourse set limits to what can be imagined. In the face of self-evident dysfunctions, the press and the elites are asking for leaders endowed with the heroic attributes purportedly needed to bridge the gap between the Eurozone crisis on the one hand and the need for action that will lead to a solution on the other. But this is nonsense because, as media sceptics argue, leadership however heroic won't do it, and what is needed is structural change.

And then we have added a fourth voice. This comes from our collective discussion of technological innovation and its failures via the BAC 1-11 analogy. This suggests that deep stall happens when safety-critical structures change and no-one is in the position to work out how they may fail. This is this provocation, because, or so our argument runs, this is exactly what has happened in the case of the Euro crisis. Our position is that it is possible to learn how to avoid deep stall so long as all the relevant interests are lined up around a version of the general good which underpins and supports expert investigation of failure. We would add, pessimistically, that while the aircraft industry in the 1950s was organised in a way that made this possible, this is signally not the case for current-day finance and its innovations.

This conversation offers a distinctive answer to the first question: why our world is now threatened by the dysfunctions of banking and finance. The answer is that it is threatened by innovatory finance which is profoundly fragile in ways that are not fully understood. So there's a *cognitive deficit* here, but it is also *political*. Politics *can't* control finance, *doesn't understand* it, and doesn't know *what to do* in order to control it. Worse, our analogy suggests that the preconditions for either understanding or controlling finance are substantially absent too. Given the democratic deficit, there is no effective way of defining, let alone implementing, a legitimate version of the common good. The consequence is that powerful sectional interests define agendas in ways which limit scrutiny and control.

The conversation leads to an argument which takes all of us outside our zones of expertise. Necessarily, then, the analysis that we are attempting is experimental in ways which would be unnecessary if all was well with controlling finance. But all is not well and our political and policy elites are making such a bad fist of how to handle the crisis that experiments about how to know finance better and how to control it are most urgently needed. Note, then, that one of the virtues of a dialogical or conversational approach is that it works to change the field of visibility, especially when it is stimulated by provocative analogy. It *sees* things that monological approaches don't because it throws inconsistencies and lacunae into relief. It offers tools for making sense of the dysfunctional incoherences and disorganisation not only within, but also *between* different institutions and forms of activity. To put it differently, if our analyses are experimentally multivocal then this is partly because the different institutions in finance and politics are themselves dangerously multivocal. And this, of course, is a large part of the control problem. A fragmented and non-rational system in finance is susceptible, at least in its own terms, neither to understanding nor to control.

But what does this suggest with respect to our second and third questions? How is the ongoing and unresolved crisis to be managed? And is it possible to control banking in the longer term? We cannot offer a single and coherent set of policy recommendations. This is partly because conversation identifies multiple difficulties and various interventions. But more fundamentally it is (as we have just rehearsed) because the financial-political system is itself fragmented and non-rational. This means that a single list of recommendations simply isn't appropriate. Different policies or changes are needed in different places. Indeed different *kinds* of policies or changes are needed in different places. And this is what we attempt in what follows.

We start with the technical quasi-economic domain of banking reform. Here we imagine how national finance and markets could be adapted to the requirements of monetary union and the single market (which European elites insist must be preserved). The proposals we offer – no doubt they should be supplemented by others – are urgently needed but we can't see how they can actually be implemented in the present political circumstances. This is because – for the reasons we have rehearsed – we don't see where the political ability or the will needed to put them into practice is coming from. We don't have a strong EU, or national governments able resist sectional interests and articulate European-wide policies in the general interest. So this democratic deficit has to be put right too.

This is the problem that we move on to tackle. And the conversation continues because we work on this in two different, albeit complementary, ways. Indeed, our argument is that both of these are needed. One is *epistemic*. Here the political problem has to do with knowledge. How is this formed? How does it circulate? How can we lever it out from narrow forms of specialism? How can we create forms of knowledge that work more openly to secure broader dialogues with the potential to articulate definitions of the general interest? These, then, are the questions addressed in our second epistemic set of policy-relevant recommendations. And then our third set of recommendations takes us to the *institutional* issues that are the classic focus of political science. Here the chronic problem can be simply stated: how is the deficit of representative democracy at the national level to be undone?

In practice the epistemic and the institutional suggestions overlap because they share and seek to address a single core problem: the fact of the capture and centralisation of knowledge and state power by special interests and the failure of questionable expertise. The larger dilemma is that the control of banking and finance depends on centralised states whose lack of intelligence and legitimacy can only be addressed by long term institutional and epistemic strategies which redistribute knowledge and state power.

Ten technical proposals for redesigning banks and markets to make the sector safer.

1) **The Basel Accord should be scrapped**. Basel is finance theory alchemised, statistically suspect and business model ignorant. It discourages the flow of credit to SMEs and international trade finance, and causes risk concentration on shareholder-value driven bank balance sheets by encouraging systemically risky regulatory arbitrage. Consequently bank intermediation creates credit-driven real estate bubbles and fragile interconnectedness between the banks.

2) **Two or three new banks should be created in the EU that invest only in re-structured and re-scheduled sovereign debt and are funded by bonds issued to institutional investors** such as pension funds and insurance companies. The current financial architecture for re-structuring and financing sovereign debt in the EU is a high cost accident due to the fractured nature of maturity mismatches at hundreds of financial institutions suffering from post-crisis weaknesses in the EU. As previous sovereign debt and bank crises in history have shown, pooling bad assets in specialist quasi-public asset management vehicles that are financed by long-term funds – for example capital risk averse pension funds and insurance companies – is less costly economically and socially.

3) **Cross-border interconnectedness of bank balance sheets should be severely reduced** by setting limits on national banking systems' cross-border credit exposures and cross-border credit dependence as a percentage of national GDP. Just as global macro imbalances in trade accounts and current accounts need to be kept at sustainable levels, so too should the cross-border bank balance sheet interconnectedness discussed above be kept at low levels. 10% of national GDP would be a prudential long term target. This ratio needs managing down from present levels but must be quickly reduced. Or we will have the current unsustainable ECB support to the euro zone banking system and sovereign credit ratings coming under pressure due to cross-border exposure of national banks.

4) **Mergers (to reduce interconnectedness) should not be allowed to create financial conglomerates**. Cross border mergers would be one of the easiest ways of quickly reducing interconnectedness because they would internationalise bank balance sheets. But any mergers justified by proposal 3 above should be disallowed if they threaten to create financial conglomerates driven by shareholder value. The objective under 5-8 below is to create utility

retail banks that are not under shareholder pressure and investment banks that are specialist financiers working for corporate and institutional customers and prohibited from proprietary trading.

5) **Banks should be split nationally and EU-wide into utility and investment banks**. We should go beyond the British Vickers recommendations for ring fencing. Both nationally and in the EU, the aim should be the clean separation of utility retail banks and corporate and institutional client-serving investment banks. As under 7 below, investment banks should be reformed so that they facilitate the flow of funds into non-financial sectors through brokering information and expertise.

6) **Utility banks should be primarily bond and deposit financed and listed in the stock markets alongside utilities such as water companies**. No utility bank should promise a high return on equity to shareholders and all should be promoted to long-term institutional investors as a modest but secure utility stock. Bond and deposit financing should be the priority because such financing provides capital security and realistic long-term yields to pension funds.

7) **Investment banks should not be allowed to do proprietary trading** (by rules more fierce than envisaged in Dodd Frank) **and their role should be to facilitate funding and investments in specific industries and regions of which they have specialist knowledge**. They should also offer expertise to support the growth of SMEs. Proprietary trading should be forbidden. In wholesale markets investment banking activity should be limited to market-making where the revenues come from bid-ask spreads.

8) **All derivatives should be licenced on a case-by-case basis, all synthetic derivatives should be banned in principle, and new European-wide limits on rehypothecation should be introduced**. Each derivative product should be licensed only if the economic benefit to the users is demonstrated to a regulator. Synthetic derivatives should be banned because the risk management calculations behind such synthetics have been found to be seriously flawed with potential systemic risks. Rehypothecation should be discouraged by rules more restrictive than those adopted in United States.

9) **The trading income of investment and utility banks should be limited** to 20% of total income and the fee income of utility banks should be restricted to 30% of total income. Banks should be allowed to undertake trading on their own account but this should be limited, for example to 20% of total income, to discourage excessive risk taking. In utility retail banks the share of fee income in total income should be limited, for example to 30% of total income to discourage retail mis-selling.

10) **The highest pay in banking should be capped at €500,000 and annual bonuses should be abolished** whether immediately paid in cash or, as more recently, withheld. The banking sector is (and will be) state subsidised explicitly by deposit insurance and implicitly by state bail-out. If

the state as guarantor creates the possibility of high incomes, it has a legitimate interest in capping such incomes in line with a wider understanding of the general interest. Banking is unlike many other industries because in this sector it is not possible to argue for remuneration that compensates for entrepreneurial risk and skills.

Six proposals for avoiding the capture of knowledge by special interests and expanding debate about what is in the collective interest.

As we noted above, knowledge and politics have both been narrowed and captured by special interests. There is no magic fix here, but the direction of travel is clear. If the problem is cognitive closure and elite mindscapes, the antidote must be openness in terms of information and empirics and heterogeneity in terms of social and political involvement/participation which should be encouraged in the nations, regions and localities. Arrangements for redistributing knowledges, breaking down silos and adding checks to power might include the following

11) **A system for creating public interest reports and publicising difficult empirics, effectively distributed across a range of social locations**. This is what we sought to do with CRESC research on banking, especially the *Alternative Banking Report*, as well as on related work on the UK's national business model and its base in activities such as train manufacture. We are not alone. For instance, the LSE and Warwick University have also produced useful public interest reports on the crisis. But such work is marginalised in a world of paid consultancy and think tanks with ideological agendas. Public interest activity and its institutionalisation are both equally important and the latter is grossly neglected so that much academic knowledge does not reach non-academic locations.

12) **The creation of a Contrarian Funding Council** with a small proportion of the UK's total research budget to back up the system of difficult empirics and public interest reports. The mission of a CFC would be to fund contrarian, socially relevant, and (this is most important) intellectually heterogeneous research, so that there would be a steady output of policy reports, contrarian empirics, and the like. The research would come mainly though not exclusively from the public universities which would need to accept that public funding brings with it social responsibilities. The universities would need to move away from full cost management accounting where that damages their research mission.

13) **A mechanism for favouring intellectually pluralist research in key disciplines such as economics**. The narrow professional character of mainstream economics (and indeed of many other social sciences) is a problem because the result is publications intended for a narrow group of peers where rigour involves exploring shared assumptions. One possibility would be to insist that even 'technical' projects should, in addition, also attend to the conjunctural limits and implications of their modelling by including historical or other social research. To put it differently, technical research needs to understand that it also embeds both social and political

values and corollary realities, and devote some time and effort to reflecting on these. One model here is the EU farm animal welfare 'Welfare Quality©' FP7 project, which put together natural and social sciences, and brought a range of stakeholders on board to articulate a combined general-interest Europe-wide approach to farm animal welfare.

14) **One or more well-resourced and independent institutional locations or mechanisms for formulating difficult questions and obtaining answers**. We envisage something like Parliamentary Select Committees without connection to Parliament, with the addition of expert cross-examiners and with the extension of the Freedom of Information Act to private institutions deemed to be systemically important. Such scrutiny committees should have heterogeneous memberships of some insiders but many outsiders. Governance sometimes requires expertise and the FSA may be right to object to a Methodist minister and a nurse on the board of the Cooperative bank, but proper scrutiny and oversight always requires outsiders.

15) **Extra scrutiny for financial innovation and the financial sector** whose activities remain in a unique high risk category for the foreseeable future. Specifically, the creation of (a) 'can it be explained?' (for instance to a nurse or a Methodist minister) and (b) 'can it be justified as *not* being against the public interest?' tests for all forms of financial innovation. The test to be conducted in public perhaps in a new 'star chamber', or by Parliamentary Select Committee as a version of the precautionary principle. Knowledge of financial failures to be increased by extending a version of the aircraft industry mandatory system of no fault (potential) accident reporting to all financial activities where 'near misses' point to the possibility of significant losses to firms or firm failures; and the subsequent publication of open access public inquiry reports.

16) **Compulsory 'life experience' for senior managers and policy elites**. Anyone earning more than (say) £100,000 a year in a systemically important institution should spend (say) two weeks a year on the shop floor, or its equivalent. Since many of our institutions no longer have shop floors, senior managers in those institutions should spend time working alongside those they regulate or represent.

Four institutional proposals for expanding the power and scope of representative democracy.

Looked as from a political science point of view the problem is: 'it's the institutions, stupid.' Our reform agenda here involves a reworking of institutions in order to disempower (unchecked and detached) elites and to make representative democracy more effective by mobilising higher levels of participation through a variety of new fora at national, regional and local levels.

17) **More decentralisation and devolution** is the institutional precondition for much else. In the UK this means continuing to unpick central power through existing devolution to the Celtic

nations and through new devolution to the regions in England; this should be backed by a transfer of authority and resources to existing non-metropolitan institutions, such as those in local government, which should be encouraged to take the initiative in finance-related matters of local and regional development. The debacle of the financial crisis epitomises one of the great problems of the British system of government. Over-centralisation has produced a succession of political debacles for three intersecting sets of reasons: first, we have government by metropolitan cliques closely tied to organised lobbies; second, an overloaded central machine which simply hasn't the expertise or other capacity to understand what is going on; and third, an 'all eggs in one basket' mode which means that when something goes wrong, it goes wrong big time. The story in finance is only one variant on a generation-long, dismal succession of central government-led debacles in the UK, with NHS reorganisation under the Coalition as the next mess.

18) **Strengthen democratic scrutiny of the institutions of financial regulation through much stronger Select Committees with powers to veto executive policy**. Democratic scrutiny of the finance sector and of its regulators before 2007 was woeful; since then, Select Committee investigations have been patchy, and shaped by short term political calculation. This reflects the woeful character of the system of scrutiny and accountability, especially in the House of Commons. We need a power shift here. This means not just better resourced Select Committees (though we need those). The UK needs a system where Select Committees are actually empowered to have a say (or at least a veto) over important policies which directly regulate finance or reinforce questionable processes of financialisation. It is intolerable that the executive should be able to ignore a Select Committee Report which has produced a reasoned and compelling argument that PFI project funding has not worked in the public interest.

19) **Recognise that representative democracy without popular institutions for mobilisation is a charade interrupted by meaningless elections**. The subservience of the Westminster political elite to financial interests was part of the cause of the crisis, and is a large part of the cause of the inadequate response to the crisis. Sorting that out goes well beyond the domain of finance because it involves rebuilding or reinventing institutions of mass mobilisation. The first question is whether the decline of the political parties can be reversed. This project requires new sources of party funding; and a new role for members to debate, propose and veto party policy however inconvenient that may be for Westminster politicians. And if that aim is thought too long term or utopian, then the parties must be circumvented. This involves trying to mobilise/ally with actors in civil society, especially those outside the Westminster bubble. There are real possibilities here, since we have also documented elsewhere that some of the highest costs of the crisis lie in the English regions and in the devolved jurisdictions.

20) **We need to democratise the City of London and limit the lobbying power of finance**. Maurice Glassman's work has shown that there was in effect an anti-democratic coup in the

reform of City government early in the millennium with the 2002 reforms. It has put control of this critical space in the British economy into business hands – the only unit of local government where this is so. The government of the City must be opened, like any other unit of government in a democracy, to public control and public participation. The reforms of 2002 must be challenged, with the aim of reversal, and the Corporation must be treated as a great public institution – and subjected to the accountability which we demand of all great and powerful public institutions. The lobbying machine of finance should be subject to an American style system of activity disclosure by lobbyists which, in British political culture, is likely to produce a feeling of revulsion.

The argument of this paper is that we face a continuing and threatening financial crisis with inadequate national and European political resources. Faced with dramatic structural failure we have argued that heroic leadership is beside the point. The character of the techno-political failure we face is highlighted by the BAC 1-11 analogy where there was an alignment of social interests around air crash prevention. By contrast, the current system of politics cannot create a general and shared interest in order to underpin attempts to solve the problems generated by the prospect of financial deep stall. The collapse of the old mobilising mechanism of the mass party and the rise of politics as marketing (via polls and focus groups) might just work practically when the conjuncture is stable, but is quite hopeless if the task is to navigate radical change. In practice it is worse than this, because political interests in finance (divorced from effective definitions of the common interest) have generated the problem in the first place. This means, as we have argued above, that the 'purely technical' interventions necessary to manage the system of rehypothecation and balance sheet interconnects are not within the realm of what is currently politically possible.

It is clear that financial system is beyond control and liable to sudden catastrophic failure. The policy aim of the elites since autumn 2008 has been to keep the banks going, but that outcome can no longer be guaranteed. Indeed bank failure may even now be a necessary precondition for serious reform – as it was before Roosevelt's New Deal. But there is no mechanical link between the scale of crisis and the extent of banking reform, so we hope our readers will want to take up the challenge of joining in the conversation. The shared and urgent object is to imagine mechanisms and policies that will help to articulate and mobilise versions of the collective interest which can replace the dangerous rule of a failed 'bankocracy'.

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