‘Global Finance, Economic Orthodoxy and the Reproduction of Neo-liberalism’

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Abstract

Since the 1970s, a profound transformation in global political economy has taken place. The Keynesian, socially-embedded regime of capital accumulation and social reproduction has been questioned and nowadays a neo-liberal, market-based disciplinary order dominates. Based on a political economy framework, the paper intends to investigate how the current liberal financial regime has contributed to the resurrection of neoclassical ‘orthodoxy’. The argument of this paper is that financial liberalisation has caused the formation of a new hegemonic structure that inflicts a deflationary bias on the choices and outcomes of contemporary policy making, through the sustention of a complex interaction between societal and ideological aspects. In terms of the former, focusing on some specific characteristics that govern the current functioning of financial markets, we stress the role of leading financial actors to impose an orthodox discipline on macroeconomic policy and to reduce the viability of expansionary policies. In terms of the latter, we highlight the role of neoclassical economics to provide an artificial, theoretical justification for the current liberal financial regime and shape the status of conventions in financial markets that ultimately determine policy outcomes. Taken as a whole, by stressing the ‘social basis’ and the shaky, yet strong, ideological elements of contemporary economic ‘orthodoxy’, this analysis aims to contribute to the growing political economy scholarship that challenges the ahistorical and depoliticised dynamics of recent neo-liberal restructuring.

1. Introduction

To borrow the concept of the distinguished sociologist K. Polanyi (1944), during the last quarter of the 20th century global capitalism has undergone a second ‘Great Transformation’. In the past two decades, a radical qualitative shift in economic structures and policies has taken place. The state- and socially-managed economy of the earlier Keynesian ‘orthodoxy’ that had marked the character of state’s policies during the Bretton Woods era has become subject of severe censure. Nowadays, almost globally, a new neo-liberal model of socio-economic restructuring dominates. The socially-disembedded, market-led economic system is perceived among leading economists, international organisations, decision-makers and even ordinary populace as the sole efficient approach to economic affairs. Macroeconomic policy, in
particular, has been formed on a set of ‘orthodox’ principles that have taken us ‘back to the future’. The fight against inflation has almost worldwidely become the overriding concern of domestic policy-makers. The call for ‘prudent’ monetary policies, balanced budgets positions, politically ‘independent’ institutional structures and extensive market deregulations dominates contemporary economic agenda and is seen as the best, and indeed the sole, way of achieving long-term economic prosperity.

Has the prevailing neo-liberal policy agenda however delivered its promises? The economic and financial instability faced many developed and developing countries from 1980s onwards seems to contradict the neo-liberal hypothesis and expectations. As such, the persistence of such a neo-liberal regime constitutes a puzzle. One would expect demands for its replacement and claims for a radical change in the character of the economic policy to be commonplace. ‘Paradoxically’, instead of such calls, both states and regulators continue to deem the current neo-liberal policy agenda satisfactory, and reform initiatives resolve to a single call for greater market-promoting reforms and macroeconomic austerity.

The purpose of this paper is to provide a political economy framework of analysis in an effort to resolve this puzzling, yet precarious, in terms of economic and social stability, situation. To do so, we try to interrogate the relationship between the recent neo-liberal restructuring of the world economy and the resurgence of the political power of financial interests, with the former being illustrative of the latter. We argue that neo-liberalism and the revival of neo-classical orthodoxy results from a new hegemonic structure of power that privileges the more mobile fractions of capital, predominately financial interests. The power of this hegemonic structure includes both material and normative dimensions of social life such as market structures and the role of dominant ideology. The interaction of those elements consolidates the representation of financial interests in the economic policy-making decision and in effect constructs the real constraints facing nowadays governments in the pursuit of alternatives to the dominant neo-liberal policy agenda. In sum, we attempt to explain the political sources of support for the current regime, and why this regime is likely to persist despite the dislocations it creates.

The paper is structured as follows. The second section is based on a growing body of scholarship in the field of the international political economy, which analyses the forces that contributed to the formation of this hegemonic structure. We focus on
some key social, political and institutional changes that emanated the process of financial globalisation. These changes in global monetary system signified the resurgence of the political power of financial interests that ultimately provoked the neo-liberal drift of states’ policies and institutional structures. The third part intends to illustrate the way through which this global structure restricts the conduct of autonomous and especially expansionary macroeconomic policies. Focusing on some intrinsic aspects in the functioning of global financial markets, we argue that financial liberalisation has provided global finance with a tremendous political power through which it imposes a deflationary and neo-liberal discipline on states. The fourth section attempts to highlight the role of normative aspects in legitimising deflationary policies and reproducing the neo-liberal order. In particular, we stress the role of neo-classical economics to defend and extend the current regime despite the social and economic dislocations it creates. The last section summarises and concludes the paper.

2. The revival of Global Finance

In the last thirty years, the economies of the world have undergone profound transformations. The globalisation of productive structures and the liberalisation of financial transactions and markets have been two critical dimensions of this transformation (Baker et al., 1998). The revival of global finance and the financialisation of the world economy - defined by Epstein (2006; p. 3) as the ‘increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies’ – and especially their impact on economic policy has been one the most topical issues in the field of international political economy in recent years.

In our view, conventional theorisations which prioritise the role of advances in communications and information technologies in their analysis about the causes and most importantly the consequences of recent economic restructuring do not add much in our understanding. On the contrary, the baseline of our argument is that such

1 The argument of the conventional wisdom goes as follows. By lowering transactions costs, technological developments reduced market frictions and provided a significant impetus to the process of broadening and integrating world markets. Expanding markets, in turn, have both increased competition and rendered alternative forms of policy action either ineffective or preserve. In sum, the
changes should be first and foremost perceived as formative and consequential aspects of social and political reality since they involve a thoroughgoing restructuring of the global political economy. Their origins lay in critical changes in societal dynamics, states’ policies and institutional structures that have all crucially transformed the global process of capital accumulation and social reproduction in a way that serve certain political masters and interest groups (Argitis and Pitelis, 2006).

Indeed, a growing bulk of scholarship associates these transformations with some radical developments in capitalist social formations and in particular with the emergence of a new social configuration at transnational level. These social fermentations appeared in line with the internationalisation of capital, especially financial capital and the global integration of domestic national productive structures and financial markets. Stephen Hymer (1979) identifies the emergence of an international capitalist class, whose interests are linked with the expansion and liberalisation of world markets. Cox (1987), Gill and Law (1989) observe the emergence of a new transnational global class structure grounded on the global circuit of products and capital and consisted of owners of multinationals and financial institutions. Relatedly, van der Pijl (1998) notices a fractionation of capital along functional lines in advanced capitalist countries, the increasing internationalisation of these fractions and the consequent emergence of a transnational class bourgeoisie.

In neo-Gramscian terms, all scholars seem to agree that what is occurring is the political reconstitution of a transnational capital class through the agency of a neo-liberal historic bloc. This transnational historic bloc comprises a political synthesis of economic interests and identities that includes national politicians, public technocratic elites, multinational firms, financiers, central bankers, ‘leading’ economists, elites that manage international policy institutions, media conglomerates and dominant political parties. The broad aim of this sociostructural force is to promote broad changes in the process of capitalist restructuring and co-ordinate national, regional and global dimensions of accumulation in accordance to the material interest of the dominant ruling classes in modern capitalism (Cox, 1993; Stubbs and Underhill, 1994). Recent scholarship agrees that it is the global finance in the form of institutional investors, financial globalisation is seen as the outcome of a politically neutral and historically inevitable process.
central and private bankers and rentiers whose politics and material interests are mostly conditioned by the way financial markets function, that possesses the dominant role within this new coalition of social and political forces (Argitis and Pitelis, 2008; Dumenil and Levy, 2006, 2004; Helleiner 1994a).

In fact, financial interests have clearly the most to gain from the current regime. Financial liberalisation and the financialisation of the world economy have metamorphosed today’s capitalism into two crucial ways highly favourable for global finance. First, they have transformed modern economies from productive to speculation-led economies in which the short-range thinking of immediate financial gains and not long-range thinking of industrial developments prevails. This has in turn increased the severity and frequency of financial crises and has compelled governments to redefine their economic policies in a way that accommodates the deflationary interests of the financial community at the expense of less fortunate social classes. Such tendencies have established a finance-led mode of capitalist accumulation and new forms of income redistribution (Grabel, 2002).

It was exactly the tendency of unregulated finance to generate inequality and undermine real economic performance that led Keynes and his US counterparts after the disaster of the 1930s to call for a new type of financial regime in which trade was ‘in’, but financial speculation, arbitrage and ‘haute finance’ were ‘out’. The repression of financial interests was seen crucial to reconcile full employment strategies and sustained economic growth and efficiency with an open free trade regime (Helleiner, 1993). The international payment system of the Bretton Woods with its provisions for fixed exchange rates and regulations on mobility of speculative short-term capital accommodated Keynes’ thesis. In fact, safeguarding the policy autonomy of the post-war welfare state and endorsing industrial development and profitability, the Bretton Woods compromise of ‘embedded liberalism’ set up the proper economic, social, ideological and institutional conditions that ultimately led to a period of remarkably fast and widely shared growth known as the ‘Golden Age’ of capitalism (Epstein and Schor, 1992).

However, the origins of the resurrection of the power of global finance can be found in the economic prosperity of the 1950s and 1960s. Its empowerment came along with the internationalisation and deepening of financial operations, the gradual openness of financial systems and the rapid accumulation of savings of the period. Yet, it was the severe structural crisis of the Keynesian system and the two oil crises
in the 1970s that signified the turning points of the structural strengthening of finance (Glyn, 2006). The upsurge of labour militancy, the feeble efforts of governments to monetise the eroding Keynesian system of social integration as well as the oil shocks of the 1970s provoked a dramatic reshuffling of the pecking order of classes and ideologies. The accelerated inflation that many capitalist countries experienced at that period eroded the accumulated savings and wealth of national and international rentiers, while the strong labour institutions destructed industrial profitability. The upper fraction of finance which was constantly fighting for the restoration of its privileges and pre-eminence began to form a new social coalition with rentiers and multinational industrial interests and to become politically more powerful (Crotty and Epstein, 1996; Holloway, 1995).

By the late 1960s and early 1970s, the common ground of interests among economic elites began to take more concrete forms of actions. In the US and the UK, wealthy families, conservative industrial and financial interests initiated a massively funded intellectual movement against the eroding Keynesian ideological hegemony. To this end, conservative think tanks were established from which an army of reactionary academics propagandised public officials that state’s active interference in the otherwise flawless free market operation is the cause of economic problems of the period. At the same time, they artificially elaborated a new frame of rule-based, nondiscretionary macroeconomic management centred on the need to curb inflation, to liberalise markets and to transfer the burdens of the ongoing crisis to the working class. Like the shift to Keynesianism in the 1930s, the campaign of the new ‘neo-liberal bloc’ in conjunction with the aggravating crisis of the Keynesian system of macroeconomic management proved successful to mould the action, the behaviour and the way of thinking of policy-makers (Smithin, 1996). State officials began to embrace the neo-liberal policy framework as the only solution capable to deal with the troubles of the period (Crotty 2000a).

The spread of neo-liberalism and the emergence of the new, hegemonic social forces opened the way for two significant institutional changes to take place, which have marked the erosion of the old structures of power and the return of finance to hegemony. The first institutional change was the appearance and growth of the Euromarkets. These off-shore markets were the first unregulated international capital markets to be created after the WW II (Dickens, 2006). They offered a free-regulation setting, in which financial actors could trade, speculate and arbitrage financial assets.
denominated in foreign currencies. Their creation was partly related to the efforts of international financial capitalists and speculators to evade the stumbling blocks imposed by national and international regulators on the free circulation of capital. In this context, Euromarkets was an answer to the problem of both US and British financiers, who desired to revive the predominance of New York and London. But states were also particularly supportive to the creation of Euromarkets. Part of the political support of the US government stemmed from demands of large US financial institutions and multinationals to gain access to deposits and loans abroad as a means to compensate losses created by the voluntary introduction of capital controls in the mid-1960s. Further, the US bureaucrats endorsed the Euromarkets as a way of restoring investors’ confidence to the US dollar, especially in a period of growing US external imbalances. On the other hand, the British officials support stemmed from their determination to revive the London’s position as an international financial centre and to restore the old British financial predominance (Helleiner, 1994b).

The emergence and growth of Euromarkets represented a radical evolution in the structural basis of the international monetary system. Within the restrictive financial environment, these new markets brought a degree of financial openness and stimulated the internationalisation of financial capital. Unfortunately, their operations had hidden, yet profound, costs as they enabled private bankers and financial investors to engage in ‘hot money’ activities that the Bretton Woods system intended to remove. Providing a gigantic pool of short-term capital outside from any official state control, such ‘off-shore markets’ represented a fascinating playground, in which market participants could make profits through speculation. With advances in telecommunications and the internationalisation of production, trading in these markets became enormous and more integrated with national capital markets as both firms and governments began to resort to these markets to finance public and corporate debts (Strange, 1986; Gill, 1993).

Most significantly, however, re-enacting speculation as a common financial practise, altering the pre-existing channels of liquidity creation and escalating capital mobility, Euromarkets undermined the fixed exchange rate and the regulatory system of the Bretton Woods regime. Progressively, the Keynesian monetary nationalism began to fall in disuse. Monetary authorities started to become increasingly dependent on the emerging transnational rentier class and the domestic economic management hostage to the speculative activities of rentiers (Bhaduri and Steindl, 1983; Panitch
and Gindin 2005). In August 1971, the accelerating US inflation and the escalating budget and trade deficits provoked a run on the US dollar.\(^2\) The Nixon administration decided to act unilaterally abandoning the dollar convertibility into gold and dismantling two years later all capital controls.

As the institutional structures and the patterns of multilateral economic cooperation of the Bretton Woods regime began to erode, the nature of interaction among states started also to change. The demise of post-war financial institutions questioned the feasibility of the national mechanisms of regulation (Andrews, 1994). Indeed, the capacity of financial investors to evade ‘unfriendly’ regulatory rigidities constituted each state increasingly responsive to adjustments in the regulatory framework of its neighbour countries. During the 1970s and 1980s, when the US and Britain initiated financial liberalisation by removing capital controls, other advanced capitalist countries saw their financial markets to lose financial business and capital towards the two more attractive deregulated financial centres. In an effort to compete effectively for mobile capital, other capitalist countries followed suit undertaking an interactive series of unilateral measures to deregulate categories of financial transactions, markets and institutions (Helleiner, 1994b).

This dynamic process of ‘competitive financial deregulation’ represented the second institutional change that crucially contributed to the resurgence of financial power (Cerny, 1993). Progressively, a new system of truly integrated capital markets characterised by high mobility of speculative capital and capital account convertibility re-emerged and replaced the Bretton Woods system. The combination of flexible exchange rates and capital mobility triggered exchange rate instability and vigorous currency speculation. Highly volatile short-term international financial flows became the most important determinant of exchange rates. Financial instability and speculation reinforced each other in a vicious cycle and constituted currency overshooting a habitual case in the everyday workings of financial markets. The pre-existing strictly regulated, US-centred international financial system transformed into an anarchic, unstable and ‘casino-like’ system (Strange, 1986).

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\(^2\) Such developments identified a fundamental flaw of the Bretton Woods regime. As Robert Triffin (1960) had earlier pointed out, US policies were incompatible with the maintenance of a US dollar centred international monetary system due to the sustainable convertibility when US reserves were shrinking and external deficits were growing.
The destruction of the Bretton Woods and the emergence of a new liberal financial order were coupled with a radical shift in power relations. Rentiers and financial investors observed an unprecedented expansion of their profit opportunities. The great increase in the size and velocity of capital flows stimulated financial speculation and profitability allowing investors to choose among different financial markets, while the veritable burst in the demand for financial intermediation, innovation and services amplified the types of financial instruments and the variety of assets on which financial could speculate (Epstein 1989; Strange, 1998). Unfortunately, financial liberalisation and integration was unable to improve economic performance and to mollify the signs of the death of the Golden Age. Governments gradually began to realise that the move to floating rates implied surrender at discretion of their policy autonomy. Although the shift to flexible rates freed national authorities from the disciplines of the fixed exchange rate, increasing capital mobility and financial instability restricted the ability of policy-makers to stabilise national currency without subordinating monetary policy (Crotty, 2000b; Pauly, 2000).

The clearest signpost of this process occurred with a second round of speculation against the US dollar. This event opened the way for the implementation of the neo-liberal agenda setting in effect the scene for the ‘revenge of rentiers’ (Smithin, 1996; Crotty and Epstein, 1996). The Paul Volcker’s ‘Saturday night massacre’ in October 1979 emanated the introduction and spread of the new neo-liberal system of accumulation and social domination. The ‘short-term pains’ came rapidly out; super tight monetary policy and the large jump in real interest rates led to a global recession. Across advanced capitalist countries, unemployment rates jumped to unprecedented levels, domestic demand blighted and income growth slumped. Meanwhile, higher levels of corporate and public debt set the conditions for an orchestrated attack against labour’s vested interests and political power (Harvey, 2007). Domestic capital asked for more weaken labour institutions, lower real wages and broad cuttings in business taxes. The onset of the debt crisis in the 1980s that threatened the solvency of US and European financial institutions became the scapegoat for further financial deregulation and monetary tightness. Financiers and bankers called for further abatement of regulatory controls on capital mobility, more monetary tightness and lower taxes on rentiers’ income. Under the threat of financial
capital to evade non-accommodative regulations, governments were forced to internalise rentiers’ pretensions in their political agenda.

The main issue deserving some clarification is how this unfolding process of neo-liberalisation has been integrally consequential to the resurgence of the power of global finance. Although the return to financial hegemony was accomplished in line with the internationalisation of capital and the globalisation of markets, it was finance that dictated the forms and contents of the recent neo-liberal restructuring. Two facts clearly affirm this assertion. First, it was the speculation against the US dollar in response to the declining US financial hegemony that caused the collapse of the Bretton Woods institutions and opened the way for financial liberalisation. Second, it was the run on the US dollar in 1979 that brought Volcker to power and engendered the ‘monetarist coup’ in the early 1980s. The deflationary policies implemented subsequently accelerated further the expansion and empowerment of the global finance as higher interest rates and stagnant growth rates led to a secular rise in public and corporate indebtedness. Gradually both the public and private sector began to be dependent on the parasitic activities of the new global financial class.

The process of financial liberalisation and the breakdown of the Bretton Woods institutions represent a structural break in financial affairs that has transformed the structure and the dynamics of the global political and economic order. The main features of the current regime are the absence of an explicit political or authority structure to control the international financial relations and the internationalisation of different national financial markets. The latter creates competition among national financial centres with destabilising effects on national macroeconomic management. The domestic financial regulatory structures that were crucial to domestic industrial and macroeconomic planning in most of the capitalist countries have been undermined as banks, investors and corporations have gained access to foreign financial markets.

But most significantly, the political autonomy of the Keynesian welfare state has been contained by the destabilising impact of short-term speculative financial flows. As we shall argue below, currency speculation and the resulting instability has transformed financial markets into a ‘structure of political discipline and power’ that encourages changes in government policy towards the deflationary preferences of those who control internationally mobile funds at the expense of domestic capital and labour. This shift in the power hierarchy and policy re-orientation finds its political
legitimacy in the globalist rhetoric of the benefits free and unregulated markets as well as in the diffusion of those pro-market principles into broad elements of global civil and state society. In this way, the combination of coercive and consensual aspects of hegemonic power has created a form of ‘governance without government’ that forces states to become more ‘internationalised’, responding to the prerogatives of the current powerful coalition of social forces that is not on the whole sympathetic to the socially embedded economic goals and welfarist principles of the early post-war Keynesian system (Cox, 1994).

3. Global Finance and Disciplinary Neo-liberalism

The highly integrated and largely unregulated financial markets have generated a broadening gap between the responsibility of sovereign governments to control their economic targets as defined by domestic political, social and economic conditions and the outcomes of their actions to meet these internal goals. While governments remain implicitly liable to their electorates concerning domestic macroeconomic performance in terms of employment, growth, balance of payments and inflation, the very means to control economic performance have been significantly reduced by the speculative attitudes of financial investors (Webb, 1991; Bhaduri, 1998). The major targets of economic policy are thus likely to have changed according to the needs and requirements of rentiers, bankers and financiers, who determine the functioning of the global financial markets.

In order to conceptualise the constraints that the global finance inflicts on the conduct of independent macroeconomic policy, we shall first detect the fundamental factors that define the rules of the international financial regime and determine the channels of capital flows in international capital markets. Nowadays, the vast majority of transactions in capital markets involve short-term speculative flows that transcend national borders in the search for the highest possible returns and make profitable business by selling and buying assets denominated in different national currencies (Baker et al, 1998). In this context, the degree of gross short-term capital mobility and asset substitutability between different financial markets represent the crucial factors that determine the impact of capital flows on exchange rates. To the extent that fiscal and especially monetary policy influence domestic real interest rates which, among
other factors, influence the value of domestic exchange rates in terms to the foreign ones, and thus the relative profitability of financial investors, policy interventions on the part of domestic monetary authorities that alter domestic real rates of interest relative to the foreign ones are likely to modify exchange rate expectations and risk premia and to generate overwhelming and unpredictable capital movements (Eatwell, 1996).

What the foregoing analysis reveals is that financial globalisation has, in practise, entailed an intrinsic linkage between the internal balance of national economies measured in terms of interest rates, inflation rates, savings, investment, output and employment growth, and their external balance in terms of external payment balances and exchange rate. In an open economic environment, in which international capital markets are highly integrated all of these measures inevitably affect one another. This situation inevitably entails certain policy trade-offs. Targeting one domestic policy variable inevitably requires the abandonment of control over an external policy variable (Pauly, 1997). This is the problem, or more accurately the dilemma, Keynes had in his mind and the Bretton Woods regime was designed to address, i.e. the difficulty for public officials overseeing an open economy in ensuring ‘an adequate local autonomy for each member over its domestic rate of interest’ and other macroeconomic policies, while retaining at the same stability in external monetary relations (Keynes, 1930:p. 272).

The channels through which such external pressures are manifested vary according to the policy choice of each country about the exchange rate system. In the case of a fixed exchange rate system, the ability of states to conduct autonomous monetary policies by states is contained by the international interest rate constraint (Epstein, 1993). Put it bluntly, changes in domestic interest rates will generate capital outflows and exchange market disequilibria that will be reflected to a rapid depletion of currency reserves. In this case, an integrated financial system renders policy ineffective: the central bank must gear its monetary stance to keeping its currency in line with those of other countries, and its monetary policies are unable to do anything else.³

³ The devaluation of the British pound in the summer of 1992 provides an excellent example of a policy stance that was internally contradictory in terms of abovementioned interdependency argument. The British government tried to use monetary policy to maintain fixed the pounds’ parity against the
But if monetary policy is not committed to fixing its exchange rate, then changes in interest rates can be used for domestic purposes. In such a context, monetary policy is expected to operate through changes in nominal currency values.\(^4\) Yet, while floating exchange rates restore in theory the ability of monetary policy to reconcile external and internal balance, a new problem emerges. This pertains to the distributional impact of the changes of exchange rate movements, in particular the altering of real wages in relation to labour productivity, which in turn and under realistic assumptions on wage/price formation, will lead to changes in domestic inflation. In this case the international interest rate constraint turns into an ‘inflation constraint’ (Epstein, 1993). Yet, how significant is this constraint on macroeconomic and especially monetary policy? Does really inflation represent a serious barrier on the conduct of expansionary policy?

In answering this question, we must first assess whether inflation has detrimental effect on economic performance. Several scholars have highlighted several theoretical and empirical problems concerning the negative aggregate economic consequence of inflation.\(^5\) Since there is no good reason to believe that moderate inflation has detrimental impact on economic performance, then what all the concern about? In our context, the essence of this inflation constraint is a political one. It is the politics, and not the economics, of money neutrality that matter in violating the inflation constraint. And here is the rub. While industrial capital, especially its section deployed in the export sector, may not be hostile to inflation, this is not true for financiers, rentiers and wealth holders.\(^6\) This capitalist fraction is likely

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\(^4\) In this context, a monetary expansion will induce financial investor to sell assets denominated in national currency. The resulting currency depreciation stimulates real sector as prices of foreign goods increase relative to those of domestically produced commodities. The increase in net exports represents the channel through which monetary policy is nowadays presumed to operate.

\(^5\) For an excellent literature review concerning distributional impact and the political economy of inflation, see Kirshner (2001).

\(^6\) Yet, this is not to say that industrial capital will support an expansionary program in any circumstance. As it is well known, full employment policies imply an increase in the bargaining power.
to feel more acutely threatened by the prospect of increasing inflation. For them, inflation is an instrument of income redistribution to the extent that financial assets are not indexed to inflation. As such, in the price un-indexed financial markets, asset holders will be obstinately opposed to any expansionary policy proposal, which, according to their view, could generate accelerating inflation, as their incomes will not rise with the rate of capacity utilisation, but will fall with inflation (Frieden 1991; Kirshner, 1998).

What economic implications may the political opposition of financiers, bankers, rentiers and financial institutions bear to moderate inflation rates? In evaluating the gravity of this ‘inflation constraint’ and its effects on macroeconomic policy and performance, attention should be called to a fundamental feature that nowadays governs the nature of capital allocation in liberal financial markets. Financial transactions differ in important ways from the free flow of goods. In capital markets, transactions are subject to a certain degree of uncertainty. Exchange between two parties takes place by means of promise to pay with higher social validity and liquidity. Lenders transfer funds to borrowers without receiving ex ante either a determinate or even a specific probability distribution of return. The future is principally unknowable and what is only there is only to ensure agents’ confidence is a contractually, yet enforceable, promise of future return.

The existence of fundamental Keynesian uncertainty as an intrinsic feature governing the operation of financial markets entails two important consequences. First, it implies that capital allocation may exhibit a collective nature, because in an environment distinguished by uncertainty expectations are not determined in isolation, but by actors’ expectations about the expectations of others. That means that the fundamentals become irrelevant and what matters is what financial agents collectively think assets are worth (Eatwell, 1996). The second implication of informational problems in financial relations is that financial trading may involve a sort of ‘contested exchange’ (Epstein and Gintis, 1992). As both borrowers and lenders are opportunistic, in the sense that they may not always fulfil what they have committed, of labour and a redistribution of income in favour of wages. This then creates the tendency for all fractions of capital to support a return to unemployment as a means of disciplining labour and regaining a higher share of income. However, it highlights how contemporary conditions create also intra-capitalist rivalries.
the case of insolvency on the part of debtors is likely. Consequently, creditors may tolerate lenders’ inactivity on debt correction only within definite limits. This in turn vindicates the case of credit rationing in financial relations.  

The fact that capital allocation in financial markets occurs in collective rather than in autonomous manner along with the existence of credit rationing attributes to financial and credit relations particular aspects of power. The essence of this power is not solely related to the ability of leading financial groups and institutions to judge the investment climate of one economy with regard to the climate that prevails elsewhere and to withdraw accordingly capital from countries that offer less attractive economic fundamentals (Gill and Law, 1989). More importantly, it is linked to the fact that, if this international exit option exercised it will result in harsh currency misalignments that public officials may be unable to manage. This aspect represents a powerful weapon at the hand of those who are able to coordinate the process of capital allocation in financial markets, such as institutional investors, hedge funds and bond-rating agencies, to create their own fundamentals according to their own material interests (Harmes, 1998).

Arguably, this power turns out to enclose a strong political element as choices among alternative macroeconomic policies turned out to be shaped by the power and the interests of purposeful market actors. Inasmuch as private financial groups have the capacity to mobilise large blocs of capital, they are able to narrow in a coercive manner the range of choices and the bargaining power of other, less powerful, social groups in the distributional conflict according to who is to bear the cost of ‘inflation’. In this way, we can infer that capital liberalisation has transformed financial markets into a veritable ‘structure of political power and discipline’.

Indeed, the implementation of a progressive policy with its reliance on lower interest rates and its promise of higher inflation rates represents a factor able to reserve investors’ expectations and to produce a full blown crisis. Any sudden initial capital outflow may heighten financial uncertainty and trigger a massive and

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7 The interaction of the abovementioned factors challenges the neo-classical hypothesis of a world of perfect capital mobility, within which rational rent-seeking investors act individually. Asymmetric capital mobility implies that capital mobility is not so ‘perfect’ and hence international lending and borrowing markets may not clear. As a result, the naïve replacement of one policy constraint, that of equalising balance of payments, by another, that of equalising domestic and international interest rates presumed by the conventional thesis may not hold.
unpredictable capital flight that swerves far from the path vindicated by any focus on ‘fundamentals’ (Grabel, 1995). Things may however worsen if policy-makers increase domestic interest to enhance investors’ confidence and defend exchange rate through higher interest rates striking a blow to domestic blow. Financial instability may rise as higher interest rates undermine the stability of the domestic banking system. Higher interest rates may also transform a difficult fiscal deficit into a fiscal nightmare undermining country’s creditworthiness positions. In the absence of compensating capital flows, the burden of restoring the external balance inevitably falls into national economic system in the form of fiscal contraction that usually includes severe sharp reductions in public investment and restrictive wage policy stance.

The central point that needs recognition is that the abovementioned economic costs do not appear smoothly and in concert with the benefits of an expansionary stance. Rather the problems are magnified and tend to appear in a rush before they even have any chance to be experienced. In this context, beliefs and expectations of financial investors represent another source of discipline (Glyn, 1998, Kirshner 2003a). Such expectations, about the likely, not the actual, inflationary impact of expansionary policies may engender an abrupt reaction from financial markets. The capital losses and higher nominal rates will tend to inhibit spending and stifle the expansion. The crucial role of financial markets is to anticipate future developments, and these very anticipations have real effects.

The abovementioned reaction of financial markets reveals the way the financial community is capable of controlling the room and the scope of macroeconomic policy and influencing domestic social deliberations and the overall political process. Even if the underlying macroeconomic indicators, such as country’s trade position or relative inflation and interest rates, do not justify such an abrupt reaction on the part of financial markets, the ability of financial elites to control and mobilise large blocs of capital on a short-time horizon and to instigate massive swings of asset values, has in practise inhibited the conduct of progressive economic and social policies. Anything that resembles a left-oriented full employment strategy is frequently perceived by financial speculators as suspect. Under the fear and the potential of a capital flight, governments are often prevented from even designing policies that might signal international investors that the country might deviate from their norms.
Governments facing the irresistible threat of potential capital flight are nowadays obliged, as never before, to maintain market credibility. Credibility has become a keystone and popular policy notion among contemporary policy-makers and essentially summarises the central priority of contemporary macroeconomic policy. It is the unique policy-option that is able to enforce confidence and to win the support of international money-lenders. The policy credibility argument simply asserts that the only possible way to avoid speculative attacks is to follow the predilection of financial community, which simply implies that the only way to save policy autonomy is to surrender (Cohen, 1996). In this context, the role of financial investors is to reveal and demonstrate the credibility of policy. The reversal of capital outflows or the infusion of capital flows are perceived as an exogenous, independent and unobjectionable verification of the credibility of these policy measures; and to the extent that those flows are able to relax, at least temporarily, the external constraint, they define also the degree of independence of national policy-making (Grabel, 2000).8

However, how could the economic policy be exercised in this complex environment, in which the policy effectiveness largely relies on agents’ perceptions of its validity? A credible government is a government that insistently follows a policy which intends to follow macroeconomic policies and to promote a series of market friendly regulatory reforms that aim to enhance governments’ trustworthiness in the

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8 Yet, this thesis should not be overstated. As Blecker (2002) argue, large short-term capital inflows should not be perceived as a sound long-term policy prescription. Although sustained capital flows may ostensibly finance trade deficits relaxing thus external constraints of governments’ macroeconomic management, they may generate long-term destabilising macro effects. On the one hand, capital influx may provoke severe contractionary impacts on the level of economic activity due to the negative multiplier effect that may bring a sustained substitution of imports for domestic production. On the other hand, insofar as short-term capital influx exceeds current account deficits, they may cause an increase in foreign exchange reserves forcing an appreciation of domestic currency. The combination of overvalued currency rates and declining economic performance represents a veritable prescription of financial crisis, as they may feed expectations in financial markets concerning the sustainability of large current account deficits and increased debt positions over the next few years prompting thus a collapse of investors’ confidence. Therefore, once again the issue is for how long a ‘credible’ policy stance will be so as to induce financial investors to continue to inflate a domestic bubble. In this context, even a credible economy seems to be trapped in the endemic obstacles that the financial structure imposes.
eyes of financial investors, i.e. a policy that is in strict accordance with what financial markets believe to be sound, prudent and efficient. From this perspective, governments, failing to pursue such kind of policies, may experience a loss of credibility and be punished by paying higher premium in terms of market-determined interest rates; whilst in case of harsh loss of credibility the possible market punishment may be a generalised financial crisis (Eatwell and Taylor, 1998).

To the extent that policy credibility is directly related to the preferences of market agents and acts as a disciplinary devise with which global financial markets exert severe pressures on governments, it also creates a powerful political illusion among policy-makers that financial markets know the ‘best’ policy-making practises. This perception has in turn forced public officials to internalise such practises into their policy goals. Given that financial community desires a reliable liberal institutional framework and a ‘sound’ macroeconomic environment that minimises the risk-exposure, policy credibility can be seen to impose a framework that Gill (1995) coins as ‘disciplinary neo-liberalism’. This political agenda, explicitly emphasising on the mono-dimensionality of national economic policy towards objectives that enhance its credibility and consistency in the eyes of global financial capital, lies so strongly at the centre of the neo-liberal restructuring of contemporary capitalism, that has motivated several scholars to argue that the broad discursive tenet of neo-liberalism is itself the ideological expression of the coercive power that modern finance exercises upon states and policy-makers (Dumenil and Levy, 2006).

Disciplinary neo-liberalism and policy credibility should not be perceived as mere consequential aspects of financial market pressures. Rather, they are institutionalised through the mobilisation of specific forms of political arrangements and multilevel governance taking the form of a ‘new constitutionalism’. The aim of this political project is to legally enforce preferential rights on financial capital and to define ‘appropriate’ behavioural standards in an attempt to make public institutions more responsive to the discipline of financial forces. From this perspective, new constitutionalism can be seen as a project of multilevel governance that provides a politico-legal dimension of disciplinary neo-liberalism (Gill, 2001, 1995).

This new form of governance functions at both international and domestic level. At international level, it is reflected to the principles and rules governing the operation of intergovernmental financial institutions (IMF, World Bank, NAFTA, and EMU). The aim of such politico-economic structures is to harmonise states policies
by policing deviance from orthodox neo-liberalism and to impose practices, norms and rules that minimise investors’ risk. This is achieved through both indirect and direct forms of authoritative power such as policy recommendations and conditionality policies (Pieper and Taylor, 1998; Felix, 2006). At domestic level, new constitutionalism is related to the quasi-restructuring of states to an active agency of adjusting national policies to the exigencies of the global economy. As Cerny and Ewans (2004) accurately argue, during the last decades, we are witnessing a gradual transition from the post-war industrial welfare state towards a contemporary ‘competition state’. While the former’s objective was to accommodate citizens claims via the conduct of progressive policies and to subordinate social tensions to a broad social contract, the impetus for the emergence of the ‘competition state’ is closely related to the adoption of an ‘appropriate’ set of economic policies, targets and institutions aiming at conforming the prerogatives of international financial markets and subordinating thus any form of democratic and social accountability. Such a radical reconfiguration of state’s institutions and practices includes a concrete re-orientation of economic policy at both macroeconomic and microeconomic level.

Given that financial investors seek low inflation and the preservation of the value of currencies in which bonds are denominated, and to the extent that expansionary policies generate changes in inflation and destabilising perceptions of financial risk, credibility over macroeconomic policy is assumed to be secured through the deflationary stabilisation of nominal targets. Indeed, in contrast to the early post-war period, during which public sector’s objectives were typically manifested in terms of socially-embedded real policy targets, nowadays there is a policy shift towards financial and monetary targets - a new policy consensus typically recapitulated as ‘macroeconomic discipline’. The main attribute of this new dominant policy course is the replacement of the assumption that there is a maximum level of unemployment that is politically acceptable by the need to maintain a minimum level of unemployment to keep inflation in check.

For enhancing policy credibility mainstream economists put forward a series of key domestic institutional reforms. The aim of such institutional adjustments is to legally expel any aspect of social deliberation, instruction, guidance or interference from the conduct of monetary policy-making (Grabel, 2000, 2003). According to their insights, only when monetary institutions are staffed with politically insulated, non-partisan technocrats, policy can be insusceptible from any inflationary-prompting
political influence and unwaveringly committed to a sound disinflationary policy agenda. The most favoured institutional reform presumed to curry out successfully price stability is the central bank independence. In the logic of their argument, only independent central bankers are expected to pursue a rule-based, anti-inflationary policy that prohibits the monetisation of government deficits. Such rules often take the form of inflation targets. The hallmark of inflation targeting refers to the firm commitment on the part of central bank that the overriding concern and objective of monetary policy is the control of inflation and hence the creation of a favourable investment climate for wealth holders (Epstein, 2002). It is the only way governments and policy-makers can avoid speculative capital flows and detrimental fluctuations in national economy.

Consistent with the intended anti-inflationary policy stance is also the abatement of fiscal management techniques. In this manner, discretionary fiscal policy as an instrument of striving cyclical downturns is ruled out. Fiscal policy is rather bounded by strict fiscal rules. Chief intention of these rules is the public debt as proportion of national income to be held over the economic cycle at a stable and ‘prudent level’. In this way, budgetary discipline is seen to mitigate ‘irreversibility problems’ provoked by vested interests and potential distributional conflicts related with increased tax burdens for deficit financing that all can deteriorate the investment climate in the eyes of financial investors (Pringle, 1992).

Whereas ‘new economic orthodoxy’ identifies price stability as the fundamental economic concern of modern societies, microeconomic structural

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9 Apart from central bank independence, another policy prescription put forward by neo-liberal economists seen to promote policy credibility is the establishment of a currency board. Currency board is a monetary institution that issues local currency that is fully backed by and convertible into a hard foreign ‘reserve currency’. The rational for setting up a currency board is to fill the credibility gap of emerging economies - in practise to import credibility from the country to which national currency is pegged. Examples of currency boards is the Argentine board that pegged peso to the US dollar in an attempt to counter inflation and maintain ‘macroeconomic nominal stabilisation’ during the Mexican financial crisis, as well as the Estonian, Lithuanian and Bulgarian currency boards pegged to the Deutsch mark established as mainstay of those countries’ subsequent integration into the E.U. Since, the introduction of currency boards is basically contained to emerging economies and to the extent that it complements the operation of independent central banks by offering another way by which financial investors can be ensured that a ‘sound’ monetary stance will not be interrupted by political interferences, the current analysis will solely put emphasis on central bank independence.
adjustments are also required if economies intend to gain a higher degree of policy credibility. To the degree that extensive tax-burdens, health, safety and labour regulations and other governmental initiatives for the protection of the welfare state represent market distortions as well as deficit/inflation-prompting governmental microeconomic interventions, may restrain investors’ confidence and undermine country’s competitive position in global capital markets. States, fearing a potential loss of external credit supply, have no choice but to be engaged into a process of lowering their regulatory standards. Such microeconomic reforms may be implemented gradually or abruptly in the form of ‘shock therapy’ measures (Grabel, 2000).10 In both cases, however, they include extensive neo-liberal reforms that involve privatisation of state-owned firms, total liberalisation of investment flexibilisation, flexibilisation of labour market institutions and sharp cutbacks of social welfare programs (Glyn, 2006).

To summarise, financial liberalisation and the ability of speculative capital to penetrate national borders have compelled states to transform economic intervention from welfare state to competition state. This transformation involves the subordination of crucial social institutions of the state apparatus and the internalisation of a notion of internal obligation to the material interests of global finance. A new orthodox framework of governance has been crystallised that pushes states to adopt neo-liberal restructuring of their policies that stresses ‘sound’ macroeconomic policies, deregulation and privatisation. Consequently, nation states become increasingly oriented towards facilitating capital accumulation for the most internationalised investors at the expense of less fortunate classes, such as labour and national industrial capital.

10 As Grabel (2000) argues ‘shock therapy’ is viewed as a more credible policy stance with regard to a more gradual implementation of neo-liberal micro-adjustments. This is because, first a rapid and decisive implementation of reform agenda sends to financial agents a more uniform and consistent information concerning the direction of the economy; and second, policy-makers are able to introduce radical policy change only in the early stages of a new regime before there is any social opposition that could interrupt the program.
4. Globalitarian Market Ideology: Neo-liberalism in Consent

If the return to capital mobility and the liberalisation of economic activities inherent in contemporary economic globalisation have caused the formation of a highly integrated liberal financial regime that circumscribes the ability of sovereign states to deliberately shape their own domestic policy agenda, constraints the conduct of alternative policy paradigms and coercively disembeds social relations from the economic system, then we could argue that the persistence of such a global structure remains an unresolved puzzle. Following Polanyi’s (1944) concept of ‘double-movement’, one would expect that states and decision-makers, in the face of increasing economic dislocations and of a possible mobilisation of the populace to self-protect from the ravages of market forces, would possibly respond by undertaking concrete political initiatives to redesign the contemporary financial institutional architecture. Nonetheless, both states and international regulators seem to hold a rather apathetic stance and, in some cases, continue to argue in favour of the current financial regime and to regard it as the only optimal way of organising the world’s payment system.¹¹

Why is it so? Is the earlier mentioned structural position of financial capital within the current economic order so powerful to render all forms of extra-market interventions obsolete? While not downsizing the role of structural factors and especially the role of market forces to influence policy decisions and to determine the path of institutional restructuring, in our opinion a particular attention on ideational factors is also required to conceptualise in depth the emergence and consolidation of the current regime and to comprehend accordingly the hegemonic position of global finance within contemporary global capitalist order. Emphasis on normative discourses is crucial, because ideas can function as an interpretative framework and normative ‘instructor’ enabling policy-makers to ‘understand’ the dubious and complex relationships that make up a monetary production economy and to judge ‘proper’ (and hence ‘improper’) policy practises. Most importantly, given that monetary policies are not politically neutral, ideas can shift policy-making in such a

¹¹ This is not to say that policy-makers do not recognise that the existing institutional framework has become increasingly dysfunctional. However, as we shall see below, recent proposals rely more on an unquestioning belief in the stabilising effects of market forces, rather on empirical research into the destabilising microstructure of existing financial markets.
way so that to preserve a particular pattern of asymmetric distribution that favours certain interest groups (McNamara, 1999).

Set in such a context, an integral part of the hegemony of global finance stems from the cultivation and dominance of a ‘globalitarian market culture’ that consistently contends to manifest the current liberal financial order as the best way to organise the world’s payment system and to manifest the neo-liberal policies (and hence disciplinary neo-liberalism) as the best policy practises. To do so, the dominant discursive formation includes both negative and positive forms of ideology. A positive aspect is the equation of free financial exchange with economic efficiency and individual freedom. A negative aspect is related to the ideological condemnation of earlier developmental models from socialism to Keynesian state-led capitalism. This includes the view about the vainness and even the folly of politically accountable institutions to effectively manipulate the economic life and in general to pursue economic policies that are at variance with the ‘beneficial’ dictates of the international capital markets.

The theoretical justification of the dominant view is found on two principal assumptions of neo-classical economics about the nature of economic life. The first is the ‘efficient market hypothesis’ that states that markets collect and distribute information effectively, in effect ensuring that market prices are accurate depictions of the real economy. The second proposition is the ‘fundamental theorem of welfare economics’ that declares that an efficient market structure will inevitably provide the most optimal allocation of resources yielding Pareto optimal equilibria and social welfare. To those neo-classical tenets, new classical theory adds a third: the ‘rational expectations hypothesis’ that states that all market actors converge on a correct model of the economy. Together these three axiomatic propositions provide a powerful argument for the superiority of unregulated markets. As economic efficiency corresponds to the free exchange of goods, labour and capital, market liberalisation is beneficial because it entails the removal of any extra-market distortion. Market liberalisation is therefore not solely the best, but the only way of organising economic life (Eatwell, 1996; Best, 2003).

What the foregoing analysis reveals is that the modern economic theory contains a powerful ideological element as it is partly an explanatory theory and partly a filter that prevents contrary data from being interpreted as invalidating it. In fact, as Grabel (2003; p. 26) notes ‘the theory is elevated to a single truth’ and ‘the
policies inspired by it are fundamentally untestable and empirically irrefutable’. However, there are also good reasons to see the modern theory as a more ideological and political discourse. For even if one accepts its propositions as true, and the efficiency market hypothesis as the true condition of markets, it is still possible to argue that the modern theory has a strong ideological background and a particular social purpose. Masked under a socially neutral, analytically delicate and visionary optimistic cloak such ideas act as a powerful weapon of legitimising a particular set of policies and of defining a concrete pattern of economic reconstruction that profoundly favours financial interests.

Indeed by defining what the economy is and how it operates, the modern theory offers a ‘scientific’ and ‘normative’ critique of the Keynesian institutions. In a period of increasing economic dislocations, the modern theory became a crucial power resource of financial interests to de-legitimise the Keynesian system and the restrictive financial context, on which it essentially rested (Gamble, 2001). Monetarism and new classical economics became an integral part of this struggle. By demonstrating that Keynesian economics were ill-equipped to deal with inflation and the Keynesian welfare state was the cause of the economic problems of the day, they succeeded to cast previous solutions as the contemporary problems (Smithin, 1996). The particular economic problem is the social-democratic macroeconomic management that guarantees employment above the structurally determined ‘natural rate’. Similarly, the reconstitution of capital controls is by definition ineffective simply because clever, fully informed and rationally acting actors evade them.

12 This seems plausible, since agents forming by definition their expectations from the same correct model, they would be act accordingly, that is rationally, so as to ensure the propositions and the correctness of the policies that the very theory generates. At the same time, any rejection of this assumption makes impossible any ex-ante judgment concerning the outcome of any economic policy. Putting it bluntly, if agents form their expectations on the basis of different economic models, they will behave diversely in the context of any particular policy and hence the policy outcomes would be inevitably unpredictable (Grabel, 2003).

13 As Smithin (1996) and Best and Midmaier (2006) argue, the empirical problems of the Keynesian orthodoxy stemmed from the false conceptual framework, on which Keynesian economics had been developed. Specifically, the Keynesian orthodoxy of the period relying more on a utilitarian form of Keynesianism, i.e. on a neo-classical ‘synthesis’ of Keynesianism and classical views, rather than on the authentic theoretical underpinnings of Keynes, appeared enough vulnerable to the micro-oriented counter-attack of the more methodologically pure monetarist and new classical economists.
Still, the modern theory provides a normative layout of prudential institutional restructuring and macroeconomic management. In that way, it assigns, frames and theoretically legitimises the institutional forms of neo-liberal governance (i.e. the new constitutionalism) and the ‘sound’ deflationary economic practices that are coercively imposed by the global finance. Given that inflation represents a social cost, it must be tamed at any cost. Governments must forgo to enhance the short-term performance of the economy. Discretionary industrial, fiscal and monetary policy and financial regulations are all endemically sceptical. Instead, the state can exert its authoritative power to make central bank independent, enforce credible disinflationary norms, deregulate capital markets and let the market sort things out of its operative fields. In response, rational agents will adjust their expectations downwards, prices and wages will fall, and competitiveness will be improved by the ‘invisible hand’ of the market.

Not accidentally, though, the fight against inflation is not a sufficient policy practise on its own. Rather, an ideological justification should be rediscovered to allow financial capital to be released from its spatial rigidities. In this respect, the modern theory postulates that deflationary policies must be accompanied with a comprehensive program of extensive financial deregulation. The liberalisation of financial activities is perceived desirable from a broad social point of view since it is supportive to long-run growth and acts as a beneficial force that discourages the conduct of ‘risky’ expansionary policies and forces governments to implement market-promoting structural adjustments.

Offering an interpretive framework of how the economy really operates and proposing specific institutional and policy solutions to cure the ‘problem’ of inflation such ideas provide governments a way of translating its tenets into a concrete programme of policy action (Blyth, 2003). Partly as a consequence of the global decline of the left such ideas proved influential in setting the course of macroeconomic policy and institutional restructuring from the 1970s onwards. Governments are nowadays cognitively locked to the idea that inflation is primarily a function of trade unionism, social democracy and the public sector and accept the idea that Keynesianism represents an anachronistic and risky model of socioeconomic organisation. Under the truly ideological slogan ‘there is no other alternative’, political energy is used up in liberalising domestic and external financial systems, downsizing government intervention, targeting inflation, liberalising in the ‘hope’ of more efficiency and faster growth (Harvey, 2007). Other policy goals like the
promotion of full employment are all excluded as the neo-classical models dictate that they would bear substantial efficiency losses and disruptive impact on economic performance.

This is not to say that such policies responses did not succeed in checking inflation. True, evidence shows that the new economic orthodoxy policy prescriptions proved successful in curbing inflation. But what is at stake is whether such policies were beneficial from a broad social point of view, as the ‘irrefutable’ propositions of the modern theory declare. ‘Strangely’, data substantiate that the neo-liberal and deflationary shift in government policies and the utopianism of the modern theory have tended to subject the majority of the population to the power of financial market forces whilst preserving social protection for the miniscule transnational class of financial investors. Credible policies have been associated with higher interests rates, lower growth and employment rates and increasing financial turbulence (Crotty, 2000b, Grabel, 2002).

While there are economic and social problems that demand attention, national authorities and multilateral institutions continue to push for more macroeconomic discipline and market liberalisation. It is here that the role of ideas becomes once again important. As Kirshner (2003c:p. 264) notes ideas, especially when they become unquestioning and ‘harden into ideology’, can skew ‘the ways in which policy makers understand and react to problems’ creating an artificial, yet powerful, constraint on policy. One prominent example of this is the tentative monetary stance of central banks in the face of recessionary conditions. Confronting the ‘dilemma’ between higher inflationary and greater recessionary risks, central bankers prefer the latter option and react accordingly by hesitant short-term reduction (Epstein, 1993). But in cases of financial panic the credible anchor to inflation fighting may prove even more disastrous. Credibility is usually associated with deflationary policy reactions and new banking standards that only exacerbate financial distress extend pro-cyclical deflation and lead into a massive collapse. The crises in Argentina and South East Asia are two cases in point of such crises of the mind (Felix, 2006).

What it is more unsettling though is that ordinary people pay the cost of adjustment during such episodes in terms of losing jobs, lost savings and lower living standards. Meanwhile the financial community is able to rely on the market-friendly rhetoric of national and international regulators. Persuaded that the current liberal system is the ‘only possible, and indeed the best, way’ of organising capital flows,
top-level policy-makers reject alternative theorisations that locate financial instability in endemic dynamics that are *internal* to capital markets instability, and diagnose the primary cause of financial instability to *external* to the markets factors such as misguided governmental policies, weak financial institutions and seek the cure to transparency codes and more vigorous macroeconomic discipline (Best and Widmaier, 2006). Once again the role of modern theory to render tremendous political power to financial interests is important in this regards. It represents an ideational shield that protects speculators against calls for more fundamental reforms, while it absolves them from any responsibility about the outcome of their own actions. Offering an ‘indisputable’ interpretative framework, it allows market participants to accuse the victim and to take the reward for managing risks (Watson, 2002; Blyth, 2003).14

The crucial question that arises is that if the current regime provides skewed distributions, low growth and instability, why do states still favour it? Posen (1995) notes that independent central banks can exist only where there is a sizeable political coalition in favour of the policies such institutions produce. By analogy, it is reasonable to argue that political strategies that sustain and reproduce the current regime should be conceptualised with a focus on the degree to which liberal economic ideas are embedded within civil society. If so, then ideas can provide the necessary ideological legitimisation of what Cox (2001; p. 475) labels as ‘the social construction of the need to reform’ and to affect the political strategy of dominant political parties with regard to domestic and international monetary politics. In fact, Argitis and Pitelis (2008) observe the appearance of a ‘financial market civilisation’ that refers to the ‘institutionalisation of financial motives, money-making norms and practises’, and in effect to the ‘financialisation of economic and social life’. This process increasing financial marketisation of broad elements of civil society have brought about the creation of a new class structure that tends to adopt the core principles of the current

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14 On that issue, Blyth (2003) underlines the role of the IMF-sponsored bailouts. Such bailouts, while may stabilise countries in crisis, they constitute in practise a means of redistributing the burdens of post-crisis adjustment. As these funds are not grants but interest-bearing loans, they must be paid back by the local taxpayers, while at the same time collateralising the risk exposure, they ensure a free lunch to financial interests. As result, international financial investors can speculate without any considerable risk, since risk premia are usually socialised by local citizens’ ability to pay taxes.
financial orthodoxy and to support an economic policy that endorse neo-liberal restructuring and market-promoting reforms.

The impact of beliefs, ideology and norms upon the lives of ordinary people goes however beyond their capacity to control events, to influence political strategies and to determine political choices about monetary politics. As Kirshner (2003b) argues, what distinguishes ideas about money is their tendency to shape market sentiments in such a way, so that to determine even the outcome of macroeconomic policies. From this perspective, ideas do not merely determine which is possible, but what is feasible. In fact, if financial asset values reflect the investors’ expectations about which way the market is probably to move in the future and if such expectations are myopic and nonrational, then any information that could provide a guide for the swings of the market is of profound significant. And it is here why the modern theory crucially matters once again. To the extent that the tenets of the modern theory are socially embedded and are held as articles of faith among market participants, then such tenets become ‘self-fulfilling’ prophecies (Eatwell, 1996; Kirshner, 2003a).

In this context, expansionary policies may be proved unsustainable as long as modern theory dictates so. To the extent that conventional wisdom suggests that progressive policies – primarily conducted through fiscal and/or monetary expansion - will *by definition* cause accelerating inflation without any real outcome, any expansionary and redistributive policy package is *de facto* doomed to fail. Acting as a normative instructor to investors’ decisions, the modern theory invigorates the inherent tendency of financial markets to not give to expansionary policies the benefit of the doubt, by informing market actors about the anticipating inflationary outcomes of an expansionary policy stance. Such anticipations eventually tend to ‘front load’ the possible inflationary impact of the expansion leading to larger fall in exchange rate than that suggested by the standard model. Large currency depreciation will then produce the very inflation that financial markets expected forcing monetary authorities to raise interest rates, dampening thus any expansion.

It is exactly this unique attribute of financial and monetary factors to influence, and in effect to determine, the actual performance of the real economy that ascribes such powerful ideological aspects to the modern theory. Providing a picture of how the economy operates, the modern theory is able to produce the same order that it claims. Guided by its conventions, if the market participants believe that higher deficits will lead to higher interest rates, then so they will, no matter the underlying
fundamentals of the economy. Similarly, even if the current economic environment makes plausible the conduct of pro-growth and more egalitarian economic policies, if market participants believe that progressive policies will be unsustainable, so they will, solely because of their own responses to such policies.

The fact that in a non-ergodic and non-deterministic financial environment, orthodox economic principles are becoming self-confirming reveals how they can bestow a legitimacy that convinces financiers and rentiers that they are right, while masking sharp distributional conflicts. Indeed, the political power of ideas is not solely related to their ability to make policy-makers regard expansionary and egalitarian policies as a not ‘prudent’ and ‘sound’ course of macroeconomic management. True, acting as cognitive locks, ideas are important in charting the course of institutional change and policy-making. But what is more significant is their ability to make any left-oriented economic management a veritably unfeasible policy option. As long as there is neither the political will nor a broad social coalition capable to put the international financial system in a subordinate position, ideas will continue to shape conventions and to coordinate myopic and divergent market expectations towards a false model of the economy. In doing so, they will continue to represent the legitimising backdrop for the implementation of the new conservative politics of sharp pro-capital redistribution and to force contemporary policy-makers to embrace Thatcher’s notorious slogan ‘there is no alternative’ to neo-liberalism.

It was exactly this Keynes had in his mind when he proposed the Bretton Woods institutions. Such institutional arrangements were not merely required to contain the ability of financial speculators to impose a contractionary bias on all domestic economies. They were rather considered as a mechanism necessary in a world of inherent uncertainty to structure the divergent and myopic expectations and coordinate them in such a way so as to ensure market stability and long-lasting income and employment growth. This is why Keynes favoured a managed capitalist system. The extension of the traditional governmental functions and the so-called ‘socialisation of the investment’ were perceived as vital to create a common baseline of expectations necessary for economic stability and prosperity to become endogenised.
5. Conclusions

In this paper, we have argued that the transition from embedded to disembedded liberalism and the shift from the Keynesian welfare state era to the contemporary neoliberal, market-based disciplinary order, is the product of radical changes in the social basis as well as in the political and institutional structures of global capitalism. These changes have eroded the foundations of the post-war international order, enacted by the Bretton Woods financial order, and have led to a new liberal financial structure and to the formation of a powerful political synthesis of political and economic forces that seeks to co-ordinate global dimensions of accumulation and legitimisation in accordance with the material interests of global finance.

The ability of speculative financial funds to freely transcend national borders has heightened the costs imposed on governments whose policies are not deemed credible by financial markets. This has given financial capital the power to determine national political priorities. A deflationary and pro-market policy bias has been created that is legally institutionalised by new forms of domestic and multilateral neoliberal governance. This radical shift in economic structures and policies is legitimised by a new dominant normative formation that acting as what Gramsci (1971) calls as ‘common sense’ frames and legitimises the current neo-liberal restructuring and the ensuing austere macroeconomic policies. The combination of such coercive and consent aspects of financial power has undermined the foundations of productive economy, full employment, prosperity and has stimulated a perverse political power relation between capital and the citizenry.

Changing this situation requires an intensification of political pressures of the left and a new political contract to alter the structures of asymmetric distribution and unequal representation that have emerged in the era of financialisation and disciplinary neo-liberalism. The realisation of such a counter-hegemonic potential presupposes a radical shift in thinking among public officials and the adoption of a different theory away from the orthodox view that currently governs economic and political debates. This theory must recognise the dialectic between international market and national forces, the social and political purpose of the current regime and it must seek to deal with the existing socioeconomic dislocations proposing longer-term policies. In particular, monetary and fiscal policies must once again, as in the
Golden Age, be targeted at healthy growth and sustained full employment, not just price stability.

To this end, following Keynes’ suggestion a new financial architecture able to break down the constraints imposed by financial markets and the dichotomies concerning productive and unproductive members of the society should be put forward. A widespread implementation of effective national and international regulations on financial markets are seen necessary to control exchange rate instability, reduce financial crises and deep recessions and channel financial resources towards real economy. Only if these objectives achieved, governments will once again become a force of economic expansion and a guarantor of social justice and equity. However, the creation of a new financial environment and the re-orientation of policy targets are issues strongly political in nature. To the extent that international monetary systems and macroeconomic policies have significant economic, social and political outcomes, it is uncertain considering the existing balance of the power of conflicting social interests.
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