

Panic on the flight deck

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Disaster movie?

panic on the flight deck

- If the Eurozone crisis is a disaster movie, what's the title?
- ***It is a disaster movie:*** there is no mainstream policy alternative to fiscal austerity which everybody (including S&P + McKinsey) sees is “self defeating” undermines growth and debt reduction
- **Panic on the flight deck** = our title because the German captain + the European first officers are quarrelling about the control settings, the course, what to do next:

E.g. size of EFSF, ECB shift towards aggressive monetary policy
replacement of elected prime ministers in Greece and Italy,
ructions in Brussels and a Franco/Brit slanging match about who is weaker

Passengers? braced for the crash

- Captain has announce turbulence but cabin crew and passengers fear the worst ie suspect our flight officers don't know what they are doing and can't prevent a crash?
- In business class: financial elites and journalists are proclaiming crisis e.g. El Erian or FT on "capitalism in crisis"
- In economy class: the masses don't trust the pilots e.g. in UK only 19% of Brits in 2009 think banks are well run (90% in 1983) = "probably the biggest change in public attitudes ever recorded by the British Social Attitudes series"
- Hostile minority wants to storm the flight deck : Occupy Wall St pro 'the 99%' and the populist right e.g. Northern League and Vlaams Belang

Why is finance uncontrollable?

- Why does elite panic and mass hostility not lead to effective control of banking and finance?
- Lecture in three sections analysing obstacles to control of finance, each beginning with a vignette:
 1. **Deep stall:** how finance is technically intractable because of balance sheet interconnections and high velocity circulation
 2. **The arrogance of ignorance:** the limits of the econocrats + expertise (in regulation and central banking)
 3. **Democratic disconnects:** how the political classes (national and EU) multiply problems as 'Gouldite' politics replace mass parties
- Let's start with deep stall on another flight deck on a BAC 1-11 prototype in 1963

Obstacle 1
deep stall and the difficulty of
controlling finance

Deep stall?

a BAC 1-11 test flight

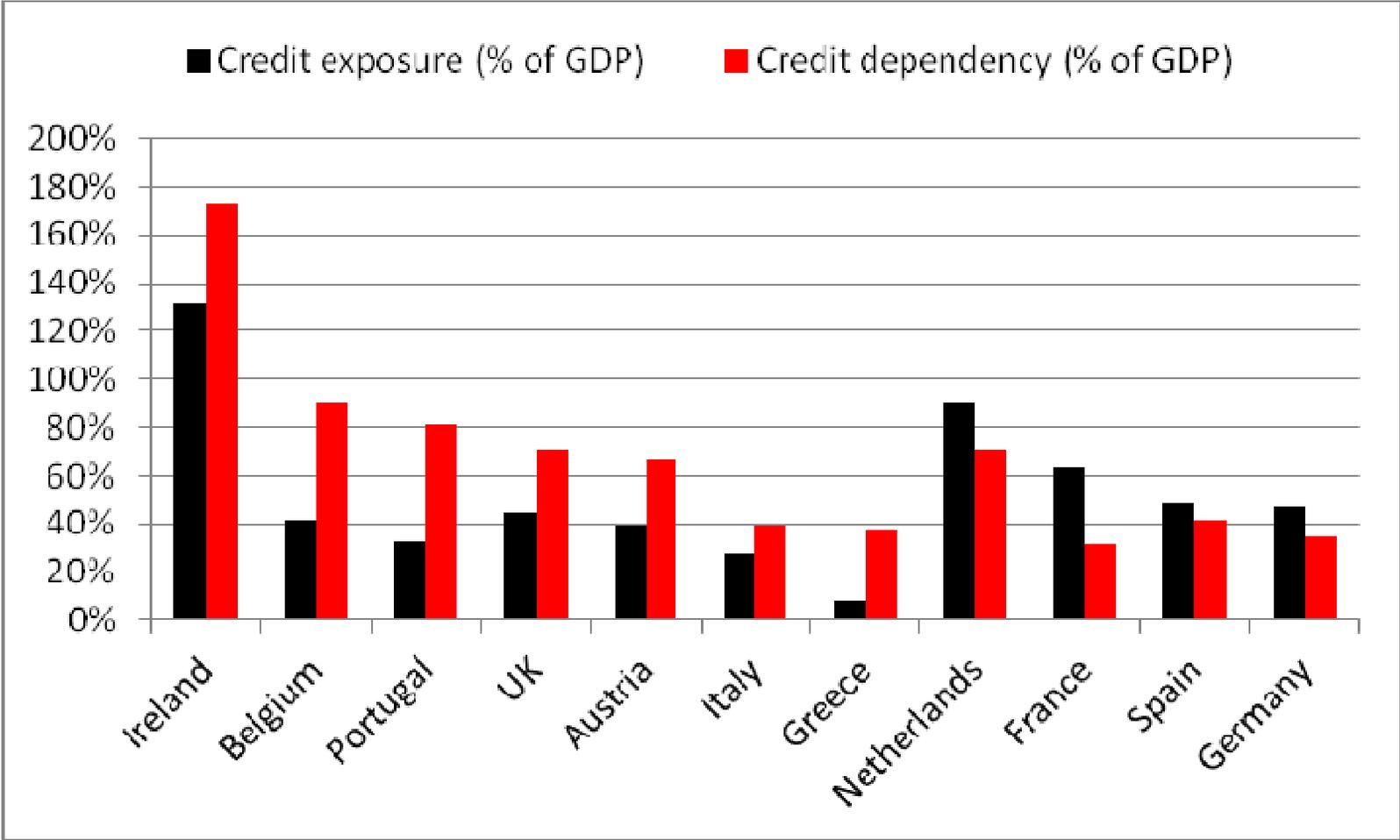
- Prototype test flight of October 22nd 1963; routine airworthiness test via induced stalls (vary angle and centre of gravity) recovery = nose down via stick forward /elevators down and add thrust; since Bleriot in 1908
- Fifth stall test of the day went wrong: didn't pull out although the pilot Mike Lithgow did everything correctly; the plane fell 16,000 feet, bellied onto the ground with little forward motion
- The accident report diagnosed what we now call “deep stall” = “recovery was impossible” because of aircraft design e.g. the 1-11 was a T-tailed rear engine jet aircraft = the turbulent air flow from the stalled wing and engine nacelles blanketed the tail elevator control surface

Undesigned finance: balance sheets and rehypothecation

- Why Eurozone crisis not amenable to finance ministry and central bank management via standard policies
- **Undesigned consequences of shareholder value and bricolage in the markets** = web of financial interconnects and flows ex unregulated private bank lending and market credit creation
- **Key interconnects:**
 - a. **ex bank balance sheets** = a complex pattern of interdependence and mutually assured destruction through illiquidity and insolvency across national boundaries when things go wrong
 - b. **ex rehypothecation** (i.e. lender's reuse of pledged collateral to fund the lender's further borrowing) = liquidity crisis in the markets whenever the velocity of circulation of funds falters

Cross border claims/ bank lending interconnects

- **Cross border claims** = hugely complex and unknown ex billions in OTC derivatives; but we can illustrate problem using BIS data on bank lending
- **Aggregate bank lending by country:**
 - a. **credit dependency** i.e. liabilities of domestic banks, public sector and non-bank priv. sector to banks in other E'zone countries and UK
 - b. **credit exposure** i.e. domestically owned banks foreign claims
- Very different ranking from that of imprudent sovereigns (e.g. Italy and Greece); high scores for (a) small countries: Ireland, Belgium, Portugal; (b) bank liabilities 4 or 5 times GDP: UK, NL etc.
- Bilateral claims are transmission mechanisms ex sovereign or bank troubles; domino effect if banks in any one large country call in their foreign claims or renege on their liabilities

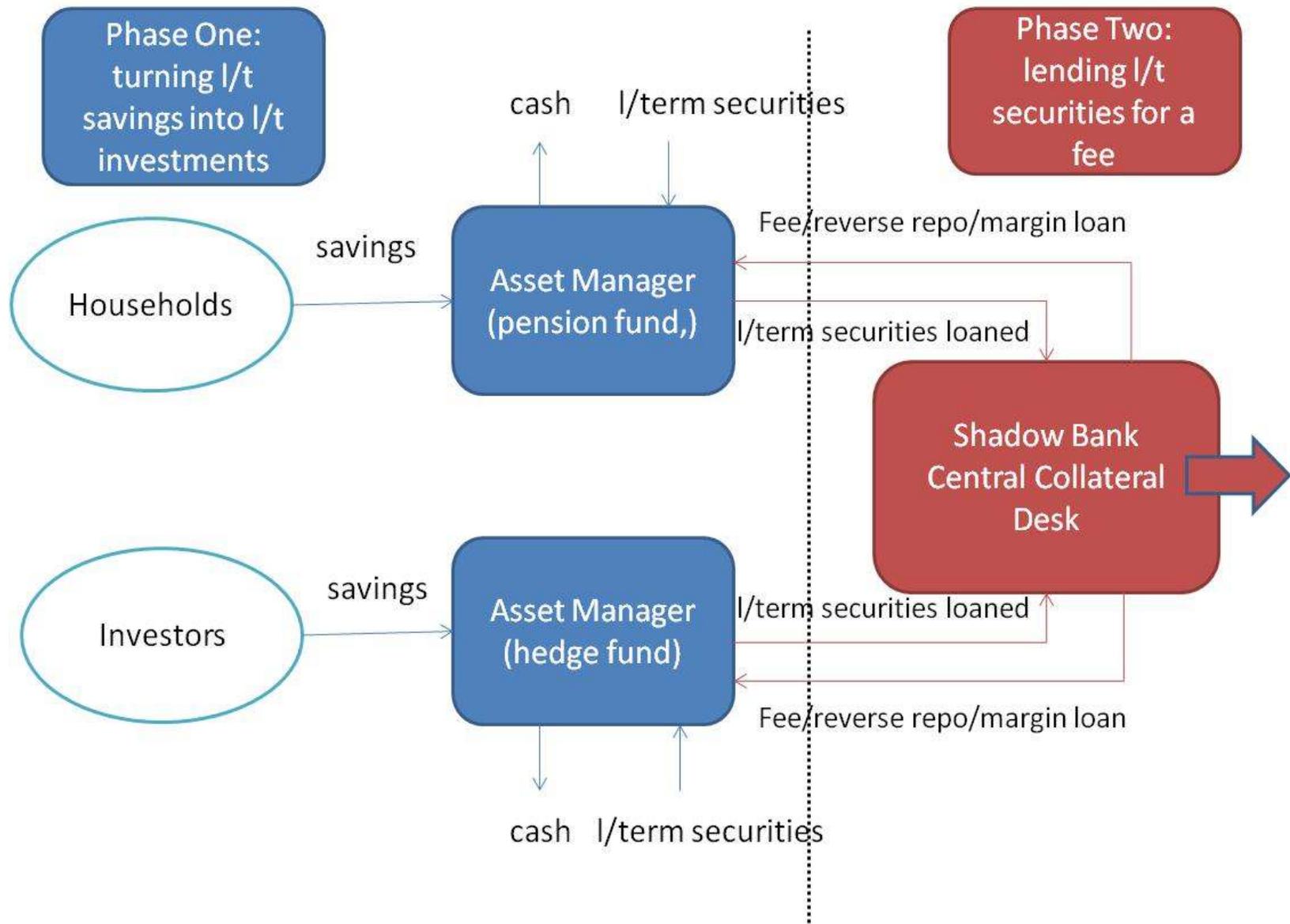


Domestically owned banks consolidated foreign claims (cross-border+local) -2011 Q2 % of GDP

												Total
	Austria	Belgium	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal	Spain	UK	claims (\$m)
Austria		0.69%	3.17%	15.65%	0.88%	0.70%	6.46%	4.45%	0.38%	2.10%	5.29%	150,057
Belgium	0.56%		13.30%	3.59%	0.37%	5.44%	5.13%	5.28%	0.75%	0.00%	7.66%	196,931
France	0.9%	9.0%		10.8%	2.2%	1.2%	16.2%	5.2%	1.0%	5.9%	11.0%	1,626,507
Germany	2.7%	1.1%	6.8%		0.7%	3.4%	4.9%	5.2%	1.1%	5.4%	15.6%	1,539,246
Greece	0.04%	0.11%	0.61%	2.27%		0.16%	0.17%	1.35%	0.01%	0.12%	3.96%	26,867
Ireland	1.47%	2.15%	7.10%	29.75%	0.40%		5.81%	2.95%	1.04%	7.09%	73.87%	272,399
Italy	5.4%	0.2%	2.5%	13.3%	0.2%	0.7%		1.3%	0.2%	1.5%	2.3%	565,100
Netherlands	1.18%	15.39%	13.22%	25.69%	0.56%	2.22%	6.67%		0.86%	9.93%	14.68%	705,831
Portugal	0.15%	0.20%	3.23%	1.46%	4.42%	2.59%	1.33%	4.55%		11.57%	2.64%	73,655
Spain	0.4%	0.3%	2.3%	4.2%	0.1%	0.7%	2.8%	1.5%	6.3%		30.3%	688,527
UK	0.3%	0.8%	13.6%	8.4%	0.6%	6.3%	3.3%	6.0%	1.1%	4.5%		1,010,567

Circulation of collateral: rehypothecation

- **Circulation of good quality collateral** is central to the funding of the financial system
- **Liquidity problems ex (a) limits of collateral creation ex a smaller MBS market and zero rates of interest plus (b) *slowing of long chain, high speed rehypothecation circuits***
 - i. asset managers lend long-term securities to collateral desks in the shadow banking sector and
 - ii. the same securities are used serially as collateral in a number of trades; increasing leverage on equity/good quality collateral
- **What if circulation slows? Estimated \$5.8 trillion of balance sheet items in banks are backed by this kind of collateral reuse;** difficulties of selling sovereign government debt ex absence of buyers with funds as well as quality of what is sold



Phase Three:
Shadow Banking
Rehypotheccation,
Circulation &
Leverage

NB: the same I/t securities are used as collateral in a no. of trades;
the more linkages, the higher the leverage

CDS TRADE

Out of the money

FX TRADE

In the money



Dec 2011 /Jan 2012 at a Serresian moment?

- **Michel Serres on transition from (a) orderly ‘turbo’ movement** e.g. circular vortex to **(b) disorderly ‘turba’** a “streaming chaos” of paths and layers
- **Loss of momentum is a threat** e.g. as the spinning top slows, the gyroscopic effect fails to hold the top on its axis; as the aircraft wing slows to stall speed, lift fails as the attached air flow breaks away and drag increases
- **The threat is of deep stall: sovereign default via interconnects creates turbulence so the *elevators won’t work*;** illiquidity already requires surreal ECB intervention e.g. lent €489.2 billion in 24 hours on 21st December to fearful European banks (which also have huge short term deposits with ECB)

**Obstacle 2:
The arrogance of ignorance:
the limits of econocacy**

Knowing what to do?

Pre-2008 complacency

- **Eg Bernanke's Nov 2002 encomium on Milton Friedman's 90th birthday;** a Federal Reserve Board member reviews Friedman and Schwarz (1963) on how post '29 Fed policy error of monetary contraction and letting banks fail turned recession into depression:
"Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again"
- **Technocrats with economics PhDs in central banking believed they knew better/would avoid mistakes/could assert control** = pre-crisis complacency + post crisis TARP + Quantitative Easing = framing of bank reform as an expert/ technical issue

Central bank led capitalism?

- **Hence post-2010 creation of central bank led capitalism** ; as jammed or contractionary fiscal policy is counteracted by ultra loose monetary policy and ballooning central bank balance sheets
- **From pre-crisis hubristic complacency to post-crisis hubristic intervention with Quantitative Easing** in US and UK printing money by buying securities from banks. UK by Oct 2011 planned £275 billion and 0.5% interest = cheap feedstock for financial market carry trades and doubtful trickle down
- **ECB is less heroic because Euro politicians and technocrats are divided**; technocrats are all **mainstream economics trained** but divided (a) the **structural reformers** in a transatlantic field and (b) the **national champions** grounded in diverse national attitudes

Structural reformers: Lucas Papademos or Mario Monti

- **Formed within a particular trans-Atlantic field** with three defining peculiarities:
 - a. **Main stream economics PhD in a prestige US University**; “give me an undergraduate at 21 and I will give you the man”
 - b. **Position of responsibility in a major EU institution** where loyalty is performed (P = VP ECB; M = EU commissioner)
 - c. **Relation to big finance** as adviser or customer (Goldman Sachs for P and M) performs sympathy for the sector
- **Result = not repetitive behaviour expertise and a kind of Aspergers of the imagination** as Monti backs flexibilised labour markets, utility privatisation and state asset sales

National Champions

Juergen Stark vs. Andy Haldane

- **Champions formed in national fields** e.g. Andy Haldane, B of E Financial Stability Director= undergrad at Sheffield, Masters at Warwick, lifer at Bank of England since 1989
- **National differences** e.g. *Juergen Stark* resigned in Sept 2011 in protest over ECB bond purchases (Die Welt interview, 20 Dec) c.f. *Haldane* extended critique of SV banking in his Wincott response to Vickers (e.g. capital ratios of up to 20%, no tax breaks on debt, end shareholder monopoly of government, target ROA not ROE)
- **UK as home of radical econocrats** challenging cross party support for Vickers ring fencing e.g. Armstrong (NIESR, Oct. 2011) pro “deeper and more fundamental reforms” because UK cannot bear risks ex “one of the biggest financial sectors in the world”

Technocrats and politics?

- **Structural reformers meet politics as mass resistance via “fight the cuts”**; need the strikes and demos to become ineffectual coalitions of losers (i.e. public sector workers and service consumers)
- **Radicals like Haldane do high politics without allies in civil society** e.g. never mentioned in the British general election of 2010 and has never met Occupy LSX/St Pauls; an expert on safer banking and no position on broader policy issues (e.g. party financing)
- **Econocracy = a professionalization of expertise (standard background in main stream economics) which does not abolish dissent but narrows identity** and sphere of operation c.f. Haldane as the darling of the intelligentsia c.f. Keynes and Beveridge moved between civil service, advising parties, independent research and journalism

**Obstacle 3:
Democratic disconnects as politics
multiplies problems**

Conditions of progress? the post war settlement

- **Politics is not an input output machine but effective reform depends on alignment or connection** between constituencies and institutions **e.g. post 1945 settlement:**
 - **social technologies make problems amenable** ex technocrats like Keynes and Beveridge
 - **mass parties (liberal or social democratic) turn technologies into programmatic policies** with parliamentary majorities
 - **the civil society impulse for change** depends on interconnects via institutional overlap and personnel (e.g. party and Trade Unions)

But transmission now difficult because of a series of democratic disconnects twixt parties , civil society (and the technocrats)

The mass party, national politics and the EU project

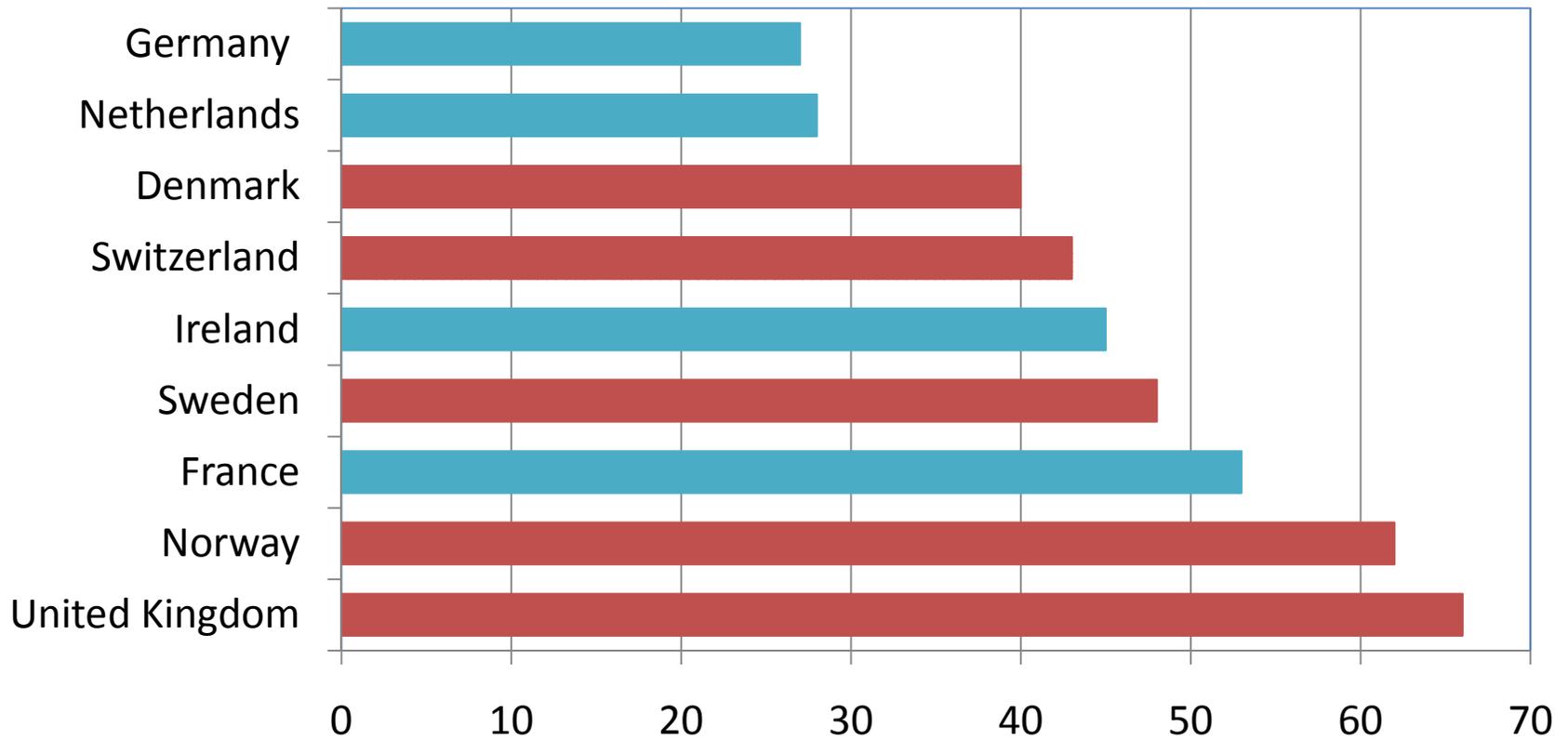
- **Crucial development = the hollowing out of the mass party/the key mobilising institution** right across the EU and most radically in the UK where 2/3rds of the members are gone e.g. van Biezen data
- **Result = a permanent deficit of democracy even as mass franchise produces crowd pleasing populism** (by political elites within the frame of hollowed out parties at national level)
- **EU becomes the sphere of posturing national politicians and haggling governments.** Adds its own dynamic because the single market and the Eurozone was a project of elites, alliance of technocrats in Brussels and Franco-German political elites

% Change in party membership size in selected European countries:

1980-2009

(van Biezen *et al.* 2009)

% Decline



Change in party membership size in selected European countries:
1980-2009
(van Biezen et al. 2009)

Country	Period	Change in M/E Ratio	Change in Number of Members	% Change in Number of Members
Czech Republic	1993-2008	- 5.05	- 379,575	- 69.65
United Kingdom	1980-2008	- 2.82	- 1,118,274	- 66.05
Norway	1980-2007	- 10.20	- 284,603	- 61.75
France	1978-2009	- 3.20	- 923,788	- 53.17
Sweden	1980-2008	- 4.54	- 241,130	- 47.46
Ireland	1980-2008	- 2.97	- 50,856	- 44.67
Switzerland	1977-2007	- 5.90	- 178,000	- 43.22
Finland	1980-2006	- 7.66	- 260,261	- 42.86
Denmark	1980-2008	- 3.17	- 109,467	- 39.70
Italy	1980-2007	- 4.09	- 1,450,623	- 35.61
Slovakia	1994-2007	- 1.27	- 41,204	- 32.32
Belgium	1980-2008	- 3.45	- 191,133	- 30.97
Austria	1980-2008	- 11.21	- 422,661	- 28.61
Netherlands	1980-2008	- 1.77	- 121,499	- 28.19
Germany	1980-2007	- 2.22	- 531,856	- 27.20
Hungary	1990-2008	- 0.57	- 41,368	- 25.03
Portugal	1980-2008	- 1.05	+ 4,306	+ 1.28
Greece	1980-2008	+ 3.40	+ 335,000	+ 148.89
Spain	1980-2008	+ 3.16	+ 1,208,258	+ 374.60

Biezen, Mair and Poguntke. 2009. 'Going goinggone: Party Membership in the 21st century' van Biezen, I., Mair, P. and T. Poguntke. Paper presented at the ECPR Jt Sessions, Lisbon

The triumph of Gouldite politics

e.g. Cameron's Brussels veto

- **“Parties” are metropolitan cliques whose leaders make narrow calculations of national political advantage ex**
 - 1. What unrepresentative activists and parliamentary party want:**
Cameron “I couldn’t get it through my Parliament even if I signed the treaty” (Daily Mail, 11 December 2011)
 - 2. Engagement with the mass electorate via the Philip Gould use of polls/focus groups** to (a) target swing voters and segments of electorate and (b) work on the contradictions and inconsistencies in popular attitudes

E.g. the Brussels veto which did not stop anything but did poll well
e.g. in Populus poll, 56% think Cameron was diminishing British influence in Europe but 57% think Cameron was right to use the veto and 44% think it will protect the City of London

EU as a house built on sand

- **EU is built on three foundational failures**
- **Deficit of mass democracy:** failure to engage national populations, low rates of electoral turn out and disastrous referenda
- **Bureaucratic miscalculation** e.g. extension of the single market philosophy to financial deregulation under the EU Second Banking Directive of 1993 and then a consultative system dominated by the industry
- **Intra institutional shift of power from the active Commission** of the Delors period from 1985-1994; response to crisis after 2009 shaped by a European Council of heads of state (dominated by German-French axis) and the Eurogroup (i.e. head of the ECB + Ezone finance ministers) within the Council of Ministers.

Dec 2011/Jan 2012

Merkel and ECB's pyrrhic victories

- **Merkel and ECB get their way:** the Council is now a game between the big member states; EU agenda on priorities and possibilities (EFSF etc.) is publicly set at 'Merkozy' summits before other states support; independent ECB's agenda aligns broadly with German government e.g. pre-2008 on price stability
- **If we have more of their victories we shall all be undone:** (a) incoherently resisting bank failure and sovereign default while varying position on hair cuts for bond holders e.g. Anglo Irish Bank vs Greek sovereign debt (b) dishing out the pain for South Europeans by endorsing punitive interest rates on bail outs and publicly insisting that Spanish and Italian bailouts should be dependent on structural reforms

**Implications:
and so?**

Implications of our analysis: technical

1. **We are in grave danger:** if or when things go wrong, European finance will probably go into deep stall as turbulence undermines control
2. **We do know where to go:** if finance is uncontrollable we need to construct a smaller, simpler finance system = utility banking with controls on property lending
3. **A few key players like Haldane see the need for radical reform,** but right now there is no econocratic consensus for radical intervention to simplify finance.

Implications of our analysis: political

1. **Things will have to get worse** before they can get better: Glass-Steagall after 50% of US Banks had failed or been taken over
2. **Democratic disconnects limit our political capacity** to process the finance problem; mainstream political classes (in UK, US and EU) disabled by their electoral calculations and their identification with big finance
3. **As long as civil society is not organised or programmatic on finance**, the impetus for change will most likely come from opportunist populism in the main stream and the rise of radical right