

**"What Theory?  
The Theory in Mad Money"**

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CSGR Working Paper No. 18/98

December 1998



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### **Abstract:**

Mad Money (Manchester University Press, 1998) is the completely rewritten and updated version of Casino Capitalism (Blackwells, 1986). It has been suggested--of both volumes--that there was no theory underlying Strange's discussion of the international financial system in them. This she argues in this Working Paper is emphatically not the case. Both volumes always implicitly, and often explicitly, are underpinned by the dominant themes that are reflected in Strange's work since the publication of 'International Relations and International Economics: A Case of Mutual Neglect', International Affairs, 46 (2) 1970. These themes are threefold: Firstly a need to privilege the politics of the international financial system in the study of international relations; a discipline too long myopic in its focus on violent conflict and war between states at the expense of all else. (ii) A need to go beyond liberal political and economic theory and recognise the significance of 'structural power' in the international system. (iii) A need to recognise that 'the areas of significant ignorance' in our understanding of the role of the international financial system in an era of technological revolution and globalisation are becoming greater rather than smaller. For Strange, the structural power of capital is not constant and, therefore, cannot be accommodated in the logic of liberal economics. Thus, using the dictionary definition of mad--erratic, unpredictable, irrational behaviour, damaging not only to sufferers but also to others--we have, as she puts it 'mad money'.

Keywords: money, finance, international relations

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## **Susan Strange, 1923-1998**

This Working Paper was in preparation at the time of Susan Strange's untimely death. It was the last thing Susan wrote. It was unfinished and uncorrected. We publish it here 'as is'. We do so because we know how much Susan disapproved of anyone editing--indeed, tampering--with her work. She was well known for having told publishers that she would not accept copy editing by '22 year olds with a BA in literary criticism' making a mess of her text!

At the time of her death Susan was a Senior Fellow in the Centre for the Study of Globalisation and Regionalisation and Professor of International Political Economy at the University of Warwick where she had spent the last five years of her working life since returning to the UK from the European University Institute, where she had also been Professor of International Political Economy.

In the course of her career she had also been the Observer Correspondent in Washington (and at 23, perhaps the youngest ever White House Correspondent), a journalist at the Economist, a Senior Research Fellow at Chatham House and for 10 years between 1978-88, the Montague Burton Professor of International Relations at the London school of Economics and Political Science.

Amongst her other works were Sterling and British Policy (OUP, 1971); States and Markets (Pinter, 1988); Rival States, Rival Firms with John Stopford (CUP, 1992) and The Retreat of the State, (CUP, 1996). Susan was co-founder of the British International Studies Association, a President of the American International Studies Association (an honour conferred on only one other non American). She has left behind a generation of former graduate students who are now significant scholars and policy makers in their own right the world over. She left an impression on all those who were fortunate enough to have spent time in her presence. The idea of CSGR owes much to her inspiration. She is greatly missed by all those at Warwick who knew her.

Richard Higgott, December 3 1998

## What Theory ?

### The theory in Mad Money

"Although analysts readily admit that international trade and investment have important implications for the distribution of wealth and power among nations, no similar agreement exists regarding the significance of the international monetary system."

So Bob Gilpin began the fourth chapter of The Political Economy of International Relations, titled 'International Monetary Matters'. He went on to say,

" A well-functioning monetary system is the crucial nexus of the international economy...a prerequisite for a prosperous world economy...  
Money and financial flows now dwarf trade flows and have become the most crucial links among national economies. The efficiency and stability of the international monetary system, therefore, are major factors in the international political economy."

That was written more than a decade ago, in 1986. Gilpin argued that the enhanced role of the international monetary system constituted ' a virtual revolution in world politics'. It was a revolution that almost no one else in international relations or even the international studies business recognised or wrote about. A deafening silence followed Gilpin's clarion call.<sup>1</sup> One reason could have been that he did not distinguish clearly between the 'International monetary

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<sup>1</sup> My own work, Casino Capitalism (1986, reprinted 1997)) came out after Gilpin's big textbook. It evolved from earlier work on the pound sterling (Strange, 1971) and on international monetary and financial history in the 1960s (Strange, 1976). Its basic assumptions were the same as Gilpin's. and it suggested some proto-theoretical hypotheses about the causes and consequences of Gilpin's 'virtual revolution'.

system' that governed exchange rates between national currencies, and the 'international financial system' that governed the creation, access to and trade in credit. Indeed, only five out of more than fifty pages of the chapter focus on what I have called the 'financial structures' of political economy. Since the public debate since the middle 1960s, and consequently the bulk of the academic writing by economists and others, concentrated on the currency and exchange rate issues and not on the organisation and management of credit, it was hardly surprising that those five revolutionary pages got overlooked both by students and by Gilpin's colleagues in international relations (Gilpin 1987 ;118-123).

(A glaring example of this bias was the earlier and influential work of Keohane and Nye, Power and Interdependence (1977). Although their comparative study of US-Canadian and US-Australian relations claimed it was focussed on the two issue areas of money and oceans, the definition of the money issue area was not only state-centric to a degree but also narrowly confined to currency and exchange rate questions. There was nothing there about capital flows, nor about the informal 'regime' governing the allocation of transnational credit.)

All the same, 12 years is a long time for a challenging pronouncement by an acknowledged leader in an academic discipline like Gilpin to go unremarked. How can we explain this long neglect, this long and deafening silence ?

The answer seems to me to lie in the basic assumptions underlying the study of international relations, and in the related problematic that defines the discipline. The basic assumption is that world politics - international relations - are conceptually different from national/ domestic politics, and must therefore be studied separately, preferable in separate departments of universities, or in separate courses of study. The assumption is taken directly from the international lawyers who early on argued that international law was different from municipal law in that it was not sustained by established political authority and stable institutions of juridical responsibility. It was fluid where municipal law was much more static. Much of it was 'customary' law. The judgements of international courts, unlike those of national courts, could not always be enforced. If this was not

the result of a state of anarchy in world politics, it was certainly the result of the lack of an overarching political authority sustaining international law.

Today, it is true, this sharp distinction between international law and domestic law, and , correspondingly, between international politics (including foreign policies) and domestic politics is being widely questioned (Keohane and Milner, 1996 ? ; Rosenau, 1997). The evidence of overlap and of reciprocal influence is abundant. What is still generally lacking is any explanatory theory for why this has happened ; coining unlovely terms like 'fragnegration' is no substitute for theory (Rosenau, 1977).

Even more important in explaining the long neglect of the politics of the international financial system in the IR literature is the central problematic accepted by the great majority of contemporary scholars engaged in studying and teaching international relations/world politics. This central problematic is the prevalence of violent conflict and war between states. The historical background to this choice is important ; the coincidence of mass slaughter in two world wars and an academic interest in questions of war and peace highlighted the importance of studying world politics. It also favoured the realists of the 1930s( E.H. Carr , Georg Schwarzenberger, Frederick Schumann and others, mostly German refugees ) and the 1950s ( John Herz, Hans Morgenthau and - most of all perhaps, Ken Waltz) over the idealists of the

1920s.<sup>2</sup>

Search the booklists of standard IR courses today and the absence of any discussion at all of international finance, how it works and is managed or mismanaged is striking. Check out the most

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<sup>2</sup> Waltz' first and in the long run most influential work, Man, the State and War (1954) posed the basic question whether wars were caused by human nature, by the character of states claiming territorial sovereignty or by the system of states which ensured competition between them for power and wealth. As Waltz concluded, 'war will be perpetually associated with the existence of separate sovereign states ...there exists no consistent reliable process of reconciling the conflict of interest that inevitable arise among similar units in conditions of anarchy' (Waltz, 1954 ; 238). His later book, Theory of International Politics (1979) did not alter his basic realist assumptions, nor his essentially state-centric conception of world politics. (See his 1993 interview by Fred Halliday and Justin Rosenberg, RIS July 1998 ; 371-386).

used texts - Holsti, Waltz (1979), Ray (6th edition, 1995), Aron(1973), Claude (1962), Bull (1978). You will find in some of these texts appended chapters on transnational corporations, environmental and ethical issues, adding secondary actors to the cast-list of the state-centric system. You will not find analysis of the role of credit in the politics of the world market economy nor even of the politics of inter-national financial relations.

Or search the extensive literature now devoted to theories of international relations. There is nothing there about the international financial structure and how it may affect the power and wealth of states. Yet there is the prime example of Japan, once perceived as the leader of a third economic bloc, challenging both the United States and Europe for leadership. What else but international finance accounts for the different perceptions of 1998 : Japan as the weak link in the world market economy, dependent on support from the United States, its recovery from deep financial disorder delayed by its own political institutions. In recent months, I have searched this IR theory literature in vain for the slightest hint of concern about finance. There is none.<sup>3</sup>

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<sup>3</sup> See, for example, Dyer and Mangasarian (eds) (1989), The study of international relations ; the state of the art London, Macmillan ; S, Smith (ed.) ( 1985), International Relations ; British and American perspectives Oxford, Blackwell ; S. Smith and K. Booth (eds) ( 1995), Internrnational Relations Theory Today, London, Polity ; Smith, S, Booth,K and Zalewski,M (eds) (1996) International theory ; positivism and beyond Cambridge University Press ; Groom, J. and Light,M (eds.) (1994), Contemporary international relations ; a guide to theory London, Pinter ; C. Brown, International Relations theory ; new



Even the neo-gramscians and other critical theorists who are not usually inhibited when it comes to criticising the capitalist system have had astonishingly little to say about the role of finance , and financial policy, in deciding the 'who benefits ? question at the heart of international political economy.

If the myopia of international relations theorists is derived from their obsession with the problematic of war and peace and conflict between states, the equal myopia of western political theorists is derived from a similar obsession with values of political liberalism. Their current literature focusses a great deal on the nature, extent and promotion of democracy and liberty. Look in vain for any consideration of the structural power in democratic states based on the financial system which - as Polanyi clearly perceived - could directly affect both the international political system - the gold standard - and the relative influence of social classes over domestic politics.

Other social scientists share the general myopia. David Landes, an historian of repute whose recent book,(add title, 1997) made a comparative historical study of societies and their success or failure in adopting or discovering new technologies. Much of the detail is fascinating. But the key question of how innovations were financed, and whether access to credit was a deciding factor is totally overlooked. And a social theorist, Francis Fukuyama, identified the key variable

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normative approaches Hemel Hempstead, Harvester ; T. Knutsen, (1992), A history of international relations theory Manchester University Press ; S.Guzzini, (1998), Realism in International Relations and international political economy London, Routledge.

in societies as the level of trust developed between its members (Fukuyama, 1996). High-trust societies owed their advantage to social capital developed over time. Low-trust societies ;lacking such social capital were conversely handicapped. But he too fails to ask whether the society did or did not develop the trust in the value and stability of money necessary between buyers and sellers, debtors and creditors.

The neglect is the more astonishing because it is contradicted by the everyday experiences of people. What is it that causes most conflict at every level of social interaction , from the family, to the village and the local sports club, up to the management of the city, the state or international organizations ? It is the control of money - whether cash or credit. Who gets to spend it and under what constraints. Is it you or I, wives ask, who manages the housekeeping budget, or who signs for the social security cheque ? In the sports club, is it the members, or the club secretary and other paid employees, who decide between alternative uses of the funds ? In national governments, it is Finance ministries that try to control the spending of other departments, and thus to determine the hierarchies within the national bureaucracy. It is they who govern if anyone does the raising of revenue, the state's access to other peoples' money by borrowing, and the discharge of debts. International institutions too experience their sharpest clashes over finance - whence it comes and where it goes.

Are these not all highly political issues ? why then are writers on international politics or national politics so perversely oblivious to them ?

The answer, as I have suggested elsewhere, is to be found in their narrow and constricting understanding of what constitutes politics, and of how and by whom power is exercised within society (Strange, 1996, Ch. 2 and Ch.3). If you start from the assumption that politics is what politicians do, and that corporate politics or university politics don't count, you draw a restrictive line around the questions to be asked and investigated. Similarly, if you start from the assumption that power resides in resources, and overlook the kind of power derived from regimes or structures of political economy, you again draw a restrictive line around the questions to be asked

and the methodology to be used in answering them. The conceptual wall that was built to define the study of international relations has become a prison wall putting key questions like the politics of the financial system off-limits in the study of international politics.

This is precisely what Kal Holsti has done in a brave attempt to get to grips with the problematic of change in the international system ( Holsti, 1998). By defining that system as the way in which states relate to each other and conduct their business, he is unable to explain change, although he concedes that we live today in an era of profound change without having discovered a new way of seeing the world. He agrees with Ruggie that there is no consensus on what constitutes change, nor how to identify it (Holsti, 1998; 1 -2 ; Ruggie, 1993; 140-144)

Peter Dombrowski is a writer who asserts the contrary : that there is a consensus (Dombrowski, 1998). He concludes a long and exhaustive survey of the literature by writing, 'researchers have reached a consensus on a number of key questions emerging from the increasing importance of international finance within the global economy' (Dombrowski, : 24) One is that though capital mobility has greatly increased since the late 1960s, price and regulatory differentials still separate national financial markets. Second, the extent of regulatory or policy coordination between states ' has been more limited than might be expected', so that despite liberalisation and deregulation, significant regulatory differences remain. Lastly, there is 'some agreement' he finds, on the origins and management of financial crises, the relationship between states and financial markets, the role of finance in economic development and the interaction of financial markets and regulatory change. And the growing literature on international finance, he notes, is cumulative. That is, it slowly adds to our understanding of what is going on and why.

In fact, there is in reality wide disagreement on every one of these points. Some believe financial crises - the 1997 Asian crises, for example - were self-inflicted by incompetent and short-sighted national governments ; others blame the external factors and actors which brought hot money flooding in and setting off financial bubbles that were bound to burst. Equally, there is disagreement on how such crises should be managed ; whether rescue lifeboats are necessary

because otherwise the repercussions of, say, Indonesian bank failures will spread the contagion throughout the region and possibly to the whole world market economy.. And while the IMF and most liberal economists see capital mobility in the system as enhancing competition and therefore efficiency, others argue that it has not been in the interest of developing countries. They would point to the two or three Asian countries that escaped the worst of the turmoil - China, Taiwan and South Korea and find a common factor in their maintenance of exchange controls over financial transactions with the rest of the world.<sup>4</sup>

Hardly surprising, therefore, that the 'lessons' Dombrowski draws from his wide-ranging survey are equally dubious. First, he says the state is not in retreat. 'Even though globalized financial markets now appear beyond the control of individual states, states have not declined in significance.' They have just changed their role to a more permissive one and changed the way they operate in the financial system. That seems to me to be a retreat before the power of markets and financial operators. And if ever there was a description of the structural power of beliefs and ideas in political economy, this is surely it. It was not the power of the US or the IMF that persuaded France or Germany to privatise, to deregulate and to liberalise their financial markets. It was structural change in the world market economy, the imperative of competition for market shares and underlying change in the knowledge structure, reflected then in the power of the financial structure.

Students will find his 4-page bibliography useful, even though it is heavily weighted toward economists and US-published books and journals and towards the international monetary system rather than the financial system. Non-Americans- Cerny, Underhill, Corbridge and Strange - however, get credit for their work. Germain's recent seminal book should be added, precisely because it deals in historical perspective with the relations of state authority and financial markets (Germain, 1997). These works suggest that the neglect of finance noted earlier has been more marked in the US literature on international political economy than in the European. Perhaps the

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<sup>4</sup> For the Asian perspective on the crisis, see Richard Higgott, 'The Asian economic crisis ; a study in the politics of resentment'. CSGR working paper 02/98, Warwick, March, 1998.

prevailing ideology of liberal economics in America has something to do with this ?

In short, both of Dombrowski 's conclusions are complete rubbish. There is no consensus and no clear cumulative lessons to be drawn from the work surveyed about the power of states and other authorities in relation to financial markets.

### **Keynes, Bagehot and Soros**

The most amazing omission in all this is the work of John Maynard Keynes. After all, it was Keynes who developed the only coherent, rigorous and influential theory concerning the conduct of financial markets. His General Theory influenced generations of economists , and still does despite the counter-influence of Friedman and Hayek (Keynes, 1936). In fact, the General Theory is more of a sociological theory than a purely economic one, even though it argues in economic terms and draws on empirical economic data. Keynes' target was not capitalism per se ; it was the capitalists who ran the system. When financial markets collapsed and profits fell, these capitalists lost their nerve. They lost their 'animal spirits' as Keynes put it. They went, suddenly and disruptingly, from illogical optimism to deepest pessimistic gloom. Drunken sailors one minute ; terrified rabbits the next. Market opportunities beckoned, but were ignored. The only remedy for the real economy was state intervention to restore demand and therefore economic growth.

Keynes' work had popular appeal partly because it drew on homely analogies familiar to most of his readers. He explained the illogical behaviour of the markets by drawing an analogy with the competitions run by newspapers in the 1930s to build circulation. Readers were shown pictures of pretty girls. They were asked to pick the prettiest. But the winner was not the best objective judge of beauty or sex-appeal. Nor was it the entry closest to others' judgment of the prettiest. Rather, it was the entry reflecting what other entrants thought other entrants would put down. This, Keynes said, was how financial markets behaved. They did not respond to objective truths, nor to prevailing opinions about objective truth. They reacted to perceptions of how others

perceived the likely behaviour of the markets<sup>5</sup>.

A nearly-forgotten elaboration of Keynes' analysis was the work of Hyman Minsky in his 'Financial Instability Hypothesis', written in the 1930s, reprinted in 1982 and rediscovered after the 1987 stockmarket collapse.

" Prices of capital assets depend on current views of future profits flows and the current subjective view placed upon the insurance embodied in money or quick cash ; these current views depend upon the expectations that are held about the future development of the economy." ( Strange, 1997 ;77).

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<sup>5</sup> This was explained in Casino Capitalism, which also discusses the criticism of the Oxford economist, S.H. Frankel and the connection with Georg Simmel's philosophical analysis of the role of money in society (Strange, 1997, ;133 following ).The previous chapter had also referred to the seminal work of Frank Knight in distinguishing between actuarial risks which could be calculated and business risks which were, essentially, bets in the dark which often resulted in loss rather than profit to the entrepreneur.

A source which surely influenced Keynes' thinking but is also ignored in Dombrowski's survey is that of Walter Bagehot, the longtime editor of The Economist before the first world war and author of Lombard Street (1873). Bagehot closely observed the relations between state authority, as exercised over banks in the City of London chiefly by the Bank of England and the House of Commons. His comments on the fall of Overend Gurney in the aftermath of the American Civil War and the reasons why the Bank of England allowed it to fall highlight the very similar difficult choices faced by regulators today - including the Fed, the European central banks or the Bank of Japan. To let a big bank fail threatens to destabilise the entire financial market ; to rescue it, enhances the moral hazard problem, encouraging others to think they can pursue profit at the expense of security.

Bagehot's judgments were not always the conventional ones. These were that the swift rescue of Barings in 1890 was necessary because Barings was not insolvent but merely illiquid and its failure would have had major repercussions for the City and the whole world system of credit. Overend Gurney, however was simply insolvent. It had lent too much and unwisely - even dishonestly and there was no way it could have met its commitments. But while not dissenting from this fundamental point, Bagehot thought there was a bit more to the two cases than met the eye. Baring's Argentine partners had been callously abandoned, sacrificed to City interests, and the rescue had well served the latter's interest by reinforcing the existing structures of power in London and increasing the Bank of England's control over the joint stock banks. Allowing Overend Gurney to go down too was not a simple case of exercising regulatory discipline over a bad bank. Overend Gurney was an inconvenient competitor for commercial business important to the Bank of England ; letting it fail while supporting the rest of the system was not simply an impartial regulatory act. In both cases, therefore, motivations were mixed ; preferences multiple and complex.<sup>6</sup>

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<sup>6</sup> See Cain and Hopkin, 1993, Volume 1 pp. 153 -160 on which I have drawn heavily for this paragraph. Their study of the changing role of the City of London in British domestic and foreign policy, and the emergence of what they call the 'gentlemanly capitalists' in London as the driving force behind British imperialism is a fine exercise in multidisciplinary international political economy based on detailed and perceptive use of historical material.

Finally, I would direct Dombroski's myopic vision to the contribution of George Soros. Like Bagehot, Soros is no professional academic but an observer of - and a successful player - in the financial market game. But his analysis of why financial markets behave as they do is actually more profound and radical than Keynes' explanation. Soros claims that it is derived from his studying with Karl Popper at the LSE in the 1950s; I would say it is much more based on direct personal experience and reflection.

The basic concept he calls the 'reflexive principle'. This is what fundamentally distinguishes natural from social science. In (most) natural science, theory is based on objective observation of the subject matter, which remains unaware and unmoved by the research. The behaviour of variable stars is a good example. But in social science, in Soros' estimation, a reflexive principle is at work, whereby the object of the research - financial markets, say - reacts to the opinions expressed by researchers and other observers; while, conversely, the researchers react to the behaviour of the markets. This cannot be properly described as objective science. An aspiration to scientific objectivity, or at least impartiality between vested interests may still be desirable and achievable. But a truly scientific result is not. Goodbye, social science, and the scientific study of society, national or international. Welcome, the necessary and welcome practice of multidisciplinary social studies including international studies.

### **The implicit theories in Mad Money**

Having briefly justified my preferred sources for the study of international finance, it is time to explain why I think of Casino Capitalism, supplemented by Mad Money, as containing within them important contributions to the neglected role of credit and finance in the international political economy. They are rather more than analytical surveys of change in the world's system. Perhaps they are a bit like those children's comic-book puzzles in which the reader had to try to find the cat, the rabbit, the fox and the dog hidden in the foliage of a forest scene. A quick glance may not reveal them. But they are still there for the careful observer.



Some of the theoretical implications of both books are already apparent in Casino Capitalism. Mad Money, which takes the story on from the mid-1980s, asks the question what changed and what was still the same, and in answering adds further theoretical implications and conclusions. One important one is that both political theory and economic theory have ignored the power of technological change - and have impoverished and crippled all of social science in doing so. In international political economy, the omission is particularly disabling, for technological change, more than anything else, has driven change in the structures of power ( Stopford and Strange,1991). It has certainly changed the financial structure, as explained in chapter 2 of Mad Money ). And it has changed the production structure by shifting power over trade and production from governments to firms. Because it is firms - including financial enterprises - who have developed the new technologies, the knowledge structure (as described in States and Markets) has also been changed . In the post war decades and for much of the Cold War, technology was led and directed by states . By the 1990s, it was led and directed from the private sector - Microsoft, for example. Important for theory here is the tendency of technological change to accelerate, and to spread more easily over economic and political space.

You will not find much about the technology factor either in political theory nor economic theory. Both tend to take it for granted and to ignore the dynamism that produces ripples of change throughout the world economy. What there is, comes from observers of science policy (Freeman, 1991 ; 1995 ; Pavitt, 1982 in Giersch (ed) (refs in de la Mothe ) and from totally new directions. For example, John de la Mothe and Gilles Paquet both of Universite d'Ottawa are editing a new series, published by Pinter, showing how science and technology are shaping the world economy. Business schools and policy analysts are more aware of this than conventional social scientists.

The other thing that has changed from the earlier period is the involvement of organised crime in the international financial system. Of course, there have always been criminals active in financial markets (Strange, 1998 ;134 ), some of them respected pillars of society. Organised crime is

different. Large, rich transnational networks flushed with profits from the international trade in drugs, arms and illegal immigrants emerged during the 1980s as big players in international finance. Their operations were the basis for a boom in the business of money laundering -the conversion of dirty money derived from crime into untraceable , legitimate investment funds. Because organised crime has developed from mafias, especially the US and Italian mafias, it has not functioned like other economic enterprises. Secrecy between its members has protected it from state authority ( Paoli, 1997 ). The obligation not to bear witness against fellow-members - the principle of omerta - protected the Sicilians against prosecution until in 1993 the Italian law was changed, making membership a criminal offence (Strange 1998, 128).

The theoretical implication of the closer links between finance and crime, however, go deeper, into the structures of power in the international political economy. Mad Money identifies three structural features that not only allowed but encouraged these links. One was the strong demand for hallucinatory drugs in the rich countries. Second was the ready supply from poor ones - Colombia, Burma, Afghanistan. In the 1960s and 1970s, the developed countries had steadfastly refused UNCTAD pleas to apply the principles of agricultural support and protection that they used at home to support and protect export crops produced by developing countries. Poor returns for coffee, tobacco, sugar etc. compared with high returns from growing cannabis and opium and processing the material for the eager market. And third was the amazingly permissive market for transnational banking services, including the laundering of dirty money. Mad Money argues that the ideational sources of the permissiveness lie in the ambivalence of capitalist systems toward the 'learned professions'. This permissiveness allowed bankers and accountants to share with priests the privileges of client confidentiality. Banks and tax havens have exploited this privilege, and in doing so have punched a big hole in the governance system of international finance.

Nor was it the only one. A major change, noted in Mad Money, has been the change in the role of banks, and the diffusion of financial service business to all sorts of new players. The business of banking used to be what was called intermediation - that is the bank intermediated profitably between the wish of savers to lend money profitably and the interest of borrowers to make use

of OPM ( Other People's Money ). Their profit was the price difference to the savers and the borrowers. Liberalisation of financial markets going back to the Eurodollar story in the 1960s, increased competition between banks and cut profit margins. (Liberal economic theory fell into the error that competition necessarily lowered prices to the customer. Not so in banking; it induced bankers to take bigger risks (Strange 1998 ; ch. 8).

The policy implications of this change are far-reaching. They have been denied by conventional writers. Ethan Epstein, for example, wrote in the mid-1990s that the system was secure because it was regulated both at the national level by central banks and other regulatory bodies , and at the international level by cooperative accords reached through the the Bank for International Settlements in Basle, and the International Monetary Fund in Washington. But subsequent research has revealed the fallacies in this comfortable belt-and-braces analysis ( Strange, 1998 ; ch. 9). Globalisation of finance has poked big holes in national regulatory systems and bankers and others have not been slow to use them. Everywhere, these systems have been eroded to the point where they no longer deter nor control (Story and Walter, 1997). As for the international accords, the evidence again suggests that they are no longer effective. The BIS in 1996 abandoned its efforts to impose common capital- loan ratios on banks worldwide, deciding to leave the consequent risk-management to the banks themselves to take care of (Strange, 1998, Ch .9).

The theoretical implications are even more far-reaching.

Economic and social theories of regulation make the assumption that regulation has a clear purpose - to reduce pollution for example , or to protect consumers against monopoly pricing - and that the market and its operators to be regulated are clearly defined ( Majone,, 1994 ?). These assumptions no longer hold for financial services. Where banking used to be clearly defined and its essence was intermediation of OPM, so that the banker was not himself risking capital, the present competitive market for financial services , in which banks compete with non-banks, and in which they are tempted to bet their own as well as their clients' money, is poorly defined. That, essentially, is why the Basle rules were abandoned and the prudential role left to the managers of banks themselves.

### **States' role in globalization**

Perhaps least obvious of the theoretical implications of the two studies are those concerning the role of states in the liberating the forces of globalization. A lot of the literature on globalization has presented the power of states as being under threat from the forces of the market. The alternative view, tenaciously held by realists in IR and some economists, is that the erosion of state power has been exaggerated and that the changes encapsulated in the term globalization have not been nearly so great as the opposing school asserts.

Although it was never explicitly stated, the resolution of this important disagreement lies in the attention given in both my books to decisions and non-decisions. They are picked out for their longer-term effects on the structures of the world economy.

Casino Capitalism chose just five decisions or non-decisions that seemed to have contributed to the heightened volatility in financial and other markets that was the leitmotiv of the whole study. They were, first, the refusal of Europeans to accept more equal burden-sharing with the Americans for the costs of Western defence and particularly NATO. Second and third were the rich countries' refusal to undertake redistributive UN aid, and the decision to opt for case-by-case, ad hoc treatment of sovereign debt ( Strange 1998 ; 5-6; Strange 1986 ; 31-58). Fourth, was the failure to make and keep rules about subsidised export credits ; and fifth was the British Labour government's decision to reopen the City of London for international financial business.

These were all early postwar decisions. I added five more critical political choices taken in the later period 1971-1985. Briefly, these were the US withdrawal from foreign exchange markets in the mid-1970s ; the cynical pantomime ( as I called it) of continued discussion on international monetary reform in the 1960s ; American refusal after the oil-price rise in 1973 to negotiate with the oil-producing states ; and the stonewalling strategy chosen by Washington to deal with the French-led Conference on International Economic Cooperation (CIEC) in 1974. The only positive key decision was the US response to bank failures - the Franklin National Bank and Bankhaus

Herstatt, both in 1974.

Note that all these key decisions were decisions of state policymakers - mainly but not all, American. That was also true of the key decisions picked out as important in Mad Money. In 1987, the stockmarket crash in October of that year might have led the US authorities to reimpose stricter rules on share dealing, insider trading, entry conditions etc. It did not. The light stayed green for deregulation and liberalisation not just in the US but in competing markets in London, Europe, Tokyo and the markets emerging in the developing world. Second, in 1988, there was a positive decision on the regulation of banks. The BIS, led by the US and supported by Britain, adopted to 8:1 capital-assets ratio. Third, came the decisions following the fall of the Berlin Wall and the collapse of the Soviet rule in central Europe. Germany unilaterally decided to reunite east with west Germany but all the other decisions were negative. Fourth, was the reversal in 1996 of the Basle Accord on capital-assets ratios, already referred to. Fifth, was the response of the US, the IMF and the Group of Ten to the turmoil in Asian currency and investment markets in the summer and autumn of 1997. Even when it meant rescuing insolvent banks in Mexico or in Asia, the security of the system took precedence in policymaking over the principles of bank regulation.

In a nutshell, it was the governments of states - especially that of the United States - that decided in favour of deregulation and globalization. Sometimes pushed by market forces, they still had freedom of choice, and by and large opted to give way, rather than resist. If this caused problems for them later, it was their own doing, their choice.

We are back, therefore, with the old International Relations question of the national interest. Looking after national interests is the responsibility of national governments. But who decides what policies are in the national interest? History gives us many examples of states choosing policies supposedly in the national interest, but which in fact were chosen to serve the interests of social, political or economic elites, and burdened society in general with high costs and risks that could hardly be avoided. What we have to ask, therefore, is whether, and how far, the decisions and non-decisions taken by the United States were really in the long-term interests of

the American people or whether, and how far, they served the vested interests of Wall Street and big business.

This is not a new question. History has many examples of national policies serving special interests. The British government decision in the mid-nineteenth century, after the Indian Mutiny, to take over government from the East India Company might be one example. This clearly served the interests of British traders in India, opened new career possibilities in the army and civil service for the younger sons of an expanding British middle class and added imperial glamour to the monarchy - 'the brightest jewel in the imperial crown'. But the longer-run consequences for the British economy and society generally were negative. The British education system was shaped to produce young colonial administrators, rather than the technologically trained industrial managers produced in Germany (Corelli Barnett, Maurice Zinkin etc). The Indian tail came to wag the British dog, despite the subordination of Indian trade and production to British interests and the extraction of gold to finance persistent payments deficits ( Kenwood and Lougheed, de Cecco etc )

A comparable case would be the French decision to annex Algeria and to use it as a cheap way of rewarding underpaid French army veterans with land taken from the locals - a policy first practised systematically by the Romans. Although special state and economic interests benefited, the end result was the creation of the 'pieds noirs' - the settlers who bitterly resisted de Gaulle's decision to give Algeria its independence, cutting the material and human losses to French society.

Another might be the American decision, first taken by Kennedy, to intervene with 'military advisers' in Vietnam. Military and ideological interests were given priority in the name of containment and the US national interest in resisting communism. But the cost and the involvement escalated under Johnson to the point where American society, seeing no national interest worth pursuing, turned against the Vietnam war.

And a more recent one might be Chancellor Kohl's unilateral decision on German unification after 1989. His decision found widespread popular support. But was it really in the longterm national interest of west German citizens ? It was certainly very costly for west German taxpayers, particularly when Kohl insisted against the advice of the central bank on an exchange rate of 1:1 between west and east German currencies. And who benefited ? German ( and some foreign ) companies who were given protection and generous state subsidies to expand in the new Lander ; a miscellany of administrators, employed east German workers, west German academics and others who climbed on the unification bandwagon. History and sentiment assured popular support. But was it really a rational choice ?

One could go back through history collecting more of the same : the British rejection of autonomy for the American colonies, the Spanish and Portuguese invasions of south America in search of gold and silver, and many, many more. Moreover, ideas and ideologies - 'manifest destiny', 'the white man's burden', 'la mission civilisatrice', 'the final triumph of socialism worldwide' - have often served to veil the conflict between special and national interests. In the period covered by Mad Money, the concealing ideology has been that of liberal economics and specifically, monetarism and supply-side economic logic. The failures of Soviet planning and the successes of US capitalism carried the message to the developing countries and then to the ex-socialist ones.

### **American Decline ?**

It is hardly necessary, in view of the record since the mid-1980s, to reiterate the point that the power of the US, far from declining as conventional American thinking had it in the 1980s, is greater than ever , and that there is growing asymmetry between the structural power of US decision making over the world economy ( and especially the financial system ) and that of other states has greatly increased. The US is more powerful ; they are less powerful. The Retreat of the State, therefore, is imposed on most national societies, but is self-imposed on US society. Joseph Nye's notion of the 'soft power' of the United States in the world is not wrong, but still distorts the truth, which is that there is nothing very soft about the way US administrations can take

unilateral decisions affecting others, military or monetary, with immunity (Nye,1990) . Most of such decisions, we have seen, have enhanced the power of market forces, increasing volatility and uncertainty. But some have also been consciously system-preserving, imposing re-regulation rather than deregulation, and undertaking new costs and responsibilities in the interests of global financial stability rather than simply the shorter term interests of the US economy and its taxpayers.

This ambiguity in US policies towards the international financial system, - permissive in some directions, re-regulatory in others - reflects in miniature the continuing but ill-founded controversy over globalisation. Is it real or a myth ? The clear conclusion to be drawn from the evidence in Mad Money is that globalisation is real. It can be exaggerated, but change there undoubtedly has been. State power , on the other hand, still exists and can be - and has been - used to limit the local consequences of globalisation. The erosion of national controls over banks and non-banks (Strange ,1998 ; ch. 8) however, shows that this state power is increasingly shared with markets, enterprises and non-state authorities (Strange, 1996).

But the evidence also shows the wide diversity of experience - for states and governments, for enterprises and for social classes. The theoretical implication is clear : the search for general theories is a vain one. Social scientists - and especially economists - have always hoped to find such general theories - theories of economic growth and development, theories of the business cycle, theories of the firm, theories of inflation. A recent study in international political economy by Jonathan Nitzan has explained why such hopes were always vain and exposed the hollowness of theoretical pretensions in economics (Nitzan, 1998 ). Nitzan argues that economists always left the power of capital out the picture. It could not be accommodated in the logic of liberal economics ; and no agreed definition of what constituted capital was therefore possible among economists. Without an agreed definition, no general theory could be found. Nitzan, interestingly, draws inspiration from Thorstein Veblen and Lewis Mumford, arguing that the power of capital is not a constant. Rather, the differential power of capital (DPK) and variations in the rate of differential accumulation (DA ) help explain the widening rich-poor gap in incomes and the progressively



higher returns in the United States to financial business than to manufacturing or agriculture.

In their vain search for general theories, social scientists have for a long time put great faith in the value of quantitative data. The more, the better. Both Casino Capitalism and Mad Money poured cold water on such hopes. The earlier work introduced the concept of the 'areas of significant ignorance' developing in international finance. As capital became more and more mobile across national jurisdictions, regulatory authorities had less and less reliable information about behaviour in financial markets and about the effectiveness - or otherwise - of government fiscal and monetary interventions. The evidence in Mad Money strongly suggests that the areas of significant ignorance are even more extensive today than they were in the mid-1980s.

### **Bad Theory Misleads Policy**

To sum up, the description of change in international finance does not merely show there is very little good theory to discover. It shows that there is a lot of bad theory out there that continues to dominate research agendas and teaching practices. Students should be warned against these bad theories. They may choose to disregard the warnings for career reasons, or they may cling to them in desperation as drowning men clutch at straws. In the United States especially, researchers are told that you must find an hypothesis and proceed to test it against the available data ( Keohane on research methods, 1990? ). This imperative derives from Karl Popper who defined a theory as a proposition that could be falsified ( Popper, 197? ). The alternative approach to research - generally ignored in contemporary social science - was that of Feyerabend. In Against Method, this eccentric writer argued that all you needed for research was a good question. Forget theory. Ibn Khaldun in North Africa in the 14th century would have agreed. His question was, simply, 'Why and how are things as they are.'

Two examples of bad theory, leading to counterproductive policy decisions were , first, the theories of declining US power just mentioned ; and, second, theories of the beneficent effects

of capital mobility.

Belief in the decline of US power dominated American thinking in the 1970s and 1980s. Paul Kennedy's Rise and Fall of the Great Powers (1987) and a number of other works promoted the idea that hegemonic power in the international system was fated to be temporary, either because of military over-commitment ( Kennedy, Calleo ) or because of the economic burdens of maintaining stability in the world trade and finance. Events reinforced academic interpretation : the Americans were shocked by the oil-price rise engineered by OPEC, by the fall of the Shah of Iran, by the depreciation of the dollar, and the loss of export and manufacturing production share to Japan .

But the policies adopted in accord with the theory were often - not always - counterproductive and contrary to US longterm interests. 'Strategic' trade policies designed to promote US exports and protect US industry from Asian competition meant adopting bullying tactics - as in the Super 301 programme - not only toward Japan but generally to Europeans, Latin Americans and other allies. The Cold War had suppressed resentment. When it ended, the legitimacy of US structural power was damaged.

The other example of bad theory leading to counterproductive policy is much more controversial. The theory plays a central role in liberal economics. It holds that the market economy requires the free , unobstructed movement of capital to achieve the efficient allocation of resources, from which all will benefit. In the last decade, country after country has appeared to subscribe to that belief by opening its economy to foreign capital. They did so not only because many of their policymakers came to accept liberal economic theory, but pragmatically to gain and hold market share with the help of foreign firms who brought access to capital, new technology and access to rich-country markets (Stopford and Strange, 1991 ). And they did not always distinguish between opening up to foreign investors in longterm production and foreign investors looking for short-term speculative gains.

The most coherent, radical attack on the theory is to be found in a recent 50-page UNDP monograph by the British economist John Eatwell. He challenges the validity of every theoretical claim made for the liberalisation of capital as being contrary to the experience of countries that have obediently liberalised ( Eatwell, 1998 ). The clear conclusion is that theory has led to bad policy. First, he says, theory argues that markets will efficiently allocate capital from capital rich-economies to capital- poor ones. In fact, capital moves in the opposite direction, from poor countries to rich ones. Second, liberalisation in theory would lower costs to borrowers. In fact, the borrowers have paid and the lenders have profited. Third, the theory praised the market for discovering derivatives and other devices for moderating risk. But in fact, the growth of derivatives has created new systemic risks unforeseen in theory. Fourth, the more efficient allocation of capital and other resources predicted by theory should have resulted in faster growth and more investment. It has not. Fifth and last, theory promised that the discipline of market forces would force states into policies that would promote both growth and stability. It has not done so.

Eatwell points out that none of these theoretical claims were reflected in the Bretton Woods agreement to maintain fixed exchange rates between national currencies. That was conditional on national currencies becoming by the late 1950s freely convertible with each other for current account transactions, not for transactions on the capital account. Thus, it was assumed states would keep exchange controls over capital coming in, and going out of the country. American financial and business interests, however, had other ideas. They sought freedom to produce and sell goods in Europe, and did not want exchange controls to stop them. The result was a revision of Bretton Woods rules to allow convertibility - and therefore IMF help - for countries (like Britain) with problems arising on the capital account as well as on the current account (Strange, 1976).

By comparing the theoretical claims with actual experience over the last 2 or 3 decades, Eatwell

arrives at the conclusion that the theory, far from producing greater efficiency and stability in the world economy, has resulted in policies that greatly increased its fragility. That fragility, he suggests, is manifest in four ways. The liquidity crises - as in Asia - actually cut GNP, lose jobs and choke food supplies. Second, higher risks in the market sectors increases the bias toward short-term responses rather than productive longterm ones. Third, increased risks to states produces a deflationary bias in policy making. And fourth, market operators aware of the fragility of local currencies and markets, press for greater ease of exit - flexibility, which in effect relieves them of the costs of their own risk-taking.

The two examples are enough to reiterate Cox's point that theory is always for someone. US decline suited interests that wanted US power to be used to open Japan's domestic markets to American competition. Liberal economic theories about the beneficent effects of financial liberalisation for developing as well as developed economies suited Wall Street and its associated financial elites.

The Asian story also reinforces the contention that the pursuit of a general theory is futile. The only common feature in Asia in 1997 was the fatal combination of external pressures on Asian states to liberalise too fast and the weakness of state regulation and supervision of banks. Beyond that, the experience of China and Taiwan was quite different from that of Indonesia or Thailand. Explanatory theory should say why this was.

Eatwell concludes by asking the So What ? question : If liberal theory has misled policymakers, what is to be done to save the international financial system from the consequences ? It is a question neither economists nor other social scientists should ignore. They have a social responsibility - the price of academic freedom - to enlighten, to explain and to prescribe if they can. Yet, although expectations of a bear market in shares, even of an ensuing decade of world recession, have grown, there has been a curious absence of serious academic discussion of measures that might be taken, even now, to avert or to moderate the downturn. Yet a number

of proposals have been made, independently of others. Some, like the Tobin tax on foreign exchange transactions, have been debated. Others, like Soros' idea of a voluntary insurance fund for international banks, have not. Such free and open discussion can only be arranged by academics - national and international officials and market operators both have too many interests and prejudices to protect. And although academic debate by itself rarely changes the basic ideas - whether pro-market or pro-state - that at any time dominate the knowledge structure, academic debate when it takes place against a background of growing disillusion, of doubt and uncertainty can act as a catalyst to action.

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