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"Sand in the Wheels, Or Oiling the Wheels, of International Finance?

New Labour's Appeal to a 'New Bretton Woods'"

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Introduction

Tony Blair's political instinct typically is to associate himself only with the future. As such, his explicit appeal to 'the past' in his references to New Labour's desire to establish a "new Bretton Woods" is sufficient in itself to arouse some degree of analytical curiosity (see Blair 1998a). The fact that this appeal was made *specifically* in relation to Bretton Woods is even more interesting. The resonant image of the international economic context established by the original Bretton Woods agreements invokes a style and content of policy-making which Tony Blair typically dismisses as neither economically nor politically consistent with his preferred vision of the future (see Blair 2000c, 2001b).

Here, as elsewhere, Labour's leaders' tendency to place the adjective 'new' in front of concepts whose meaning was previously relatively settled in public discourse raises a number of questions. Does 'new' actually mean qualitatively novel in this instance? If so, why the appeal to the 'old' institutional framework of Bretton Woods? Alternatively, is this merely an attempt to re-invent the past? If so, why the use of the word 'new' at all? Does Labour envisage 'to throw sand in the wheels of international finance', as James Tobin famously put it in his proposals to use market incentives to slow the pace at which financial transactions are conducted (see Tobin 1978; Eichengreen, Tobin and Wyplosz 1995)? Or does it seek to quicken the pace at which financial transactions are conducted, effectively 'oiling' those wheels?

In an attempt to answer such questions, the paper proceeds in three stages. In the first section, I chart the main features of Labour's discourse on the international financial architecture. The Blair Government clearly believes that the existing institutional framework has become increasingly dysfunctional. It identifies misguided government policies as the primary source of increasing instability within the financial system, rejecting alternative assumptions that instability is a function of the operating logic of the system itself. In consequence, it dismisses proposals for market-correcting reforms along the lines of a ‘sand in the wheels’ model, preferring instead market-reinforcing reforms designed to create additional market-based incentives for governments to adopt ‘appropriate’ policies. This can be seen perhaps most clearly in attempts to institutionalise new codes for fiscal and monetary transparency at the international level. ‘Sand in the wheels’ reforms typically aim to increase the scope of autonomous national economic policy-making (Tobin 1978); New Labour’s transparency codes would appear more likely to have the opposite effect.

In the second section, I introduce a political economy critique of purely market-reinforcing reforms to the international financial architecture. I suggest that such proposals rely rather more on an unquestioning belief in the stabilising effects of market forces than on empirical research into the microstructure of actually existing financial markets. With prior processes of liberalisation now firmly rooted in the international financial system, speculative dynamics have come to dominate the way in which market prices form. With individual investors ever more able to bypass attempts to impose external regulation, herding mentalities increasingly determine the trajectory of financial markets. Knowledge of economic fundamentals is now less important as an indicator of which way the market will move next than knowledge of the prevailing market mood. In such circumstances, the concept of a rational market equilibrium is rendered ever more meaningless. Thus, existing patterns of market trading seem sure to blunt the potential impact of market-reinforcing reforms. Reforms designed to provide governments with incentives to act in a manner consistent with traders' perceived desire for equilibrium are unlikely to be suited to a context in which no such desire actually exists.

I use the final section of the paper to explore the likely implications of the Blair Government's reform proposals. My analysis is grounded on the assumption that all financial architectures are a means of distributing systemic risks within society. Set in such a context, it is clear that Labour imagines a future international financial architecture which reinforces the existing structure of social power, both domestically and internationally. Its reforms would institutionalise an ever greater asymmetry in the prevailing pattern of systemic risks. Proposals which serve to 'oil the wheels' of international finance are likely to induce further shifts in risk burdens from those who operate internally to the market to those who only have external connections to market outcomes. Given that higher levels of market volatility now tend to be created endogenously as a reflection of momentum trading, this means that risk burdens are likely to be shifted from those who generate increased risk to those who are entirely powerless to control such events. I conclude that New Labour's 'new Bretton Woods' represents an attempt to open up new channels of redistribution in which risk flows from financial markets to society in general, whilst wealth flows in the opposite direction.

Building a 'New Bretton Woods' on Disciplinary Codes for Transparency

Re-Shaping the Existing Institutional Framework

Attempted political mobilisation aimed at reforming the Bretton Woods institutions is as old as the institutions themselves. It would therefore be a mistake to see the Blair Government as the progenitor of this particular debate. The G7 has had an official dialogue concerning the international financial architecture that significantly pre-dates New Labour's period in office (see *The Economist*, 30.01.99, 5).

Although the debate per se is not new, a new intensity has been added to it in recent years. This is due to an ever more widespread assumption that, whilst never ideal, the current financial architecture is now more dysfunctional than at any time in its history. The much-derided performance of the international financial institutions in the midst of the Asian financial crisis is a salutary case in point. A significant contradiction has been identified between the competencies of the Bretton Woods institutions and the prevailing economic context in which those institutions operate. An institutional apparatus designed for a world of limited capital mobility would appear to be unable to perform regulative tasks suited to a world of increasingly interdependent capital markets. On this point, there is general agreement.

But this is also where agreement seems to stop. For some, the preferred means of ensuring a better fit between institutional competencies and the international economic context is to recast the institutional competencies in a manner which reflects the existence of an increasingly interdependent system of national capital markets. For others, the preferred means of ensuring a better fit between institutional competencies and international economic context is to restore some semblance of autonomy to national capital markets, thus forcing the international economic context back into line with existing institutional competencies. The Blair Government advocates the first, market-reinforcing, strategy. Indeed, the Party had explicitly rejected the latter, market-correcting, strategy whilst still in opposition (see Brown 1995). For New Labour, it is the competencies of the international financial institutions which are to be reshaped, not the highly liberalised international financial context in which those institutions operate. The past is most definitely not something to be re-invented.

As Gordon Brown told the House of Commons in a debate on the international financial architecture at a time of increasing instability within the world economy (Brown 1998a):

> At the heart of the weaknesses exposed in [the world's] financial systems is that for fifty years our policies for regulation, supervision, transparency and stability have been devised and developed for a world of relatively sheltered national economies with limited capital markets. A new age requires a new approach … Ministers agree that in this new interdependent and instantaneous global marketplace we must now create systems for supervision, transparency, regulation and stability that are as sophisticated as the markets they have to work with … Institutional architecture devised in the 1940s for the economies of the 1940s must be reformed and strengthened to meet the challenges of the 1990s and … the 21st century.

Such thoughts were also evident in a speech made around the same time by Patricia Hewitt, then Economic Secretary to the Treasury, to a seminar at Fleming's Investment

Bank. She argued (Hewitt 1998) that: “Today’s global economic problems are ones of the modern age. They could not have happened when finance was confined within sheltered and wholly national financial systems. These are new global problems which require new global solutions.”

Linking (International) Economic Ideology to (Domestic) Political Concerns

Labour has done more than merely re-position itself as an advocate of a global liberal status quo. It now projects itself as an active promoter of increasing financial liberalisation. The Prime Minister has argued that “capital liberalisation is right” (Blair 1998b) and that “the market is an ally not an enemy … we understand the benefits of open markets” (Blair 2001c). Such benefits, he suggests, will only accrue to an international community that is willing to engage in “a massive programme of liberalisation in opening up markets” (Blair 2001a). This general principle translates more specifically for New Labour into “favouring an approach to capital account liberalisation that is bold in concept” (Hewitt 1998).

It would seem to have become an issue of straightforward ideological commitment for New Labour that there is to be minimal, even no, public management of international capital flows. The regulation of capital markets is to remain overwhelmingly a matter for the private sector; state restraint is the key to the prudent regulation of the international financial environment (see, for instance, Smith 2000). So sure is Tony Blair of such a principle that he has started to use the word “axiomatic” to describe his commitment to it (Blair 2000a). In this way, he now routinely attempts to pass off a statement of ideology as a self-evident ‘truth’. Unlike some other areas, New Labour’s deeds have matched its words on this issue. Since the earliest days of the current administration, the Government has pushed for western finance ministers to accept proposals for a new IMF code of conduct on financial openness (Brown 1997).

Such proposals are not merely a statement of (international) economic ideology; they also reflect (domestic) political strategy. As Andrew Baker suggests, the reproduction of a distinctive social basis of the British state during the post-war period has ensured that Britain is "heavily integrated" into international circuits of finance (Baker 1999, 84). As a financial centre, London is conceptually distinguishable from New York, Chicago, Tokyo, Frankfurt and Zurich in the extent to which it specialises in servicing internationally oriented capital flows (Martin 1999). Domestic investors operating within London's markets can therefore expect to be advantaged by proposals to deepen existing tendencies towards financial market liberalisation.

The social basis of financial trading has changed markedly in Britain in recent years. An ever greater number of people now have their savings invested in ways that are susceptible to financial fluctuations. As much, more are now exposed to the dominant pattern of trading exhibited on financial markets. For some, such exposure is consciously accepted as savings are increasingly being moved out of simple interest earning bank accounts and into PEPs and ISAs which offer higher returns. For others, increased exposure has been an unintended consequence of home ownership and private pension cover.

Significantly, many of these new investors also constitute the political constituencies of 'Middle England' to which New Labour has specifically tailored its electoral strategy. Thus, the social basis of the British state is currently oriented towards an international economic policy which is deeply rooted in the Government's own party political concerns. Whilst it would clearly be wrong to suggest that the tendency towards financial liberalisation is all of Labour's making, the policies of the Blair Government have certainly bolstered the existing orientation of the British state in this respect.

So long as Labour continues to act as if its future electability is tied directly to the reproduction of the prevailing social basis of the British state, it will be faced with a (largely self-induced) domestic political context which constrains its ability to argue the case for 'throwing sand in the wheels' of international finance. We must conclude from this that the core principle of increasing financial market openness is strategically embedded in the social and institutional relationships of the electoral coalition that the Government is seeking to hold together.

Transparency Codes and Rules-Based Governance Regimes

The Blair Government proposes a 'new Bretton Woods' based on the institutionalisation of free market norms within all the world's capital markets. It seeks to introduce binding rules, to be policed by the IMF on a truly global terrain, in order to limit the scope of government interventions into financial markets. As Gordon Brown has argued: "the answer to the uncertainty and unpredictability of ever more rapid financial flows is clear long-term policy objectives …[and]… the certainty and predictability of well understood procedural rules for monetary and fiscal policy" (Brown 1999). Tony Blair has been equally explicit in his support for a rules-based governance regime. He has made the case to "strengthen the IMF by agreeing new international rules of the game which match today's instantaneous and interdependent capital markets. This means new disciplines, new procedures and new thinking" (Blair 1998b).

The Blair Government has identified increased transparency as the means to reduce financial volatility through purely market-reinforcing reforms. As Alistair Darling argued whilst Chief Secretary to the Treasury, "economic policy must be open and transparent. Openness builds confidence and credibility" (Darling 1998). And it is upon such confidence and credibility that the Blair Government believes financial stability is secured (Blair 2001c). For New Labour, "the greater the degree of secrecy, the greater the suspicion that the truth is being obscured and the books cooked. But the greater the degree of transparency – the more information that is published on why decisions are made and the more the safeguards against the manipulation of information – the less likely is it that investors will be suspicious of the Government's intentions" (Brown 2000b). Working to these principles, the Chancellor used Britain's Presidency of the G7 in 1998 to commit the Bretton Woods institutions to ensuring that all countries "comply with an internationally agreed code of conduct on monetary and fiscal policy, requiring greater transparency". To this end, "each country should specify its objectives for monetary policy, identify responsibility for achieving these objectives, and for reporting and explaining monetary policy decisions and financial regulations" (Brown 1998a).

Within the terms of the Government's transparency discourse, volatility ensues when individual market participants act rationally on the basis of incomplete information. In circumstances in which governments impede transparency by preventing the release of market-sensitive data, significant distortions can be introduced into the market, turning volatility into systemic instability. The argument is that if markets can only be expected to be in equilibrium in an underlying context of complete information, then the solution to observed levels of instability is to provide the markets with such a context. As a consequence, market-reinforcing reforms concentrate on creating an incentive structure for governments that will force them to increase the flow of information into the market. Binding rules which lock-in a preferred pattern of behaviour offer a convenient means of establishing such a structure. In terms of their shared focus on the significance of binding rules, 'transparency' is the international economic equivalent of the 'prudence' which Labour consistently espouses at home.

The two quite clearly go together in New Labour discourse. Government thinking on the international financial architecture is that there must be "a rigorous adherence to a disciplined fiscal and monetary policy" if the implementation of transparency codes is to ensure that market actors receive information consistent with "long-term stability" (Blair 2000d). Likewise, although the Government believes that national monetary authorities must commit themselves to "better exchanges of information [in order to] reduce systemic risk", this is deemed insufficient in itself unless set within the context of "an internationally agreed code of conduct" relating to minimum standards of monetary "discipline" (Brown 1998b). In the Chancellor's words, "openness, accountability and transparency to keep markets and the public properly informed" are necessary counterparts to ensuring that "objectives and institutions are not only credible but seen to be credible" (Brown 2000a).

The Contested Scope of Transparency Codes Post-Asian Financial Crisis

The Blair Government is by no means alone in proposing such arrangements. The Clinton Administration occupied much the same policy agenda during its period in office. For both, increased transparency in information disclosure holds the key to future systemic stability. As former US Treasury Secretary Lawrence Summers argued, international finance can only be successfully liberalised so long as it is possible to construct institutional guarantees of "more prudent management of national balance sheets" (Summers 1999).

Predictably, then, the Clinton administration welcomed Gordon Brown's proposals for a new IMF code of practice for fiscal transparency, identifying it as a means of locking-in the principle of sound money within an international institutional framework (see Baker 1999, 95). Summers' response to these proposals was to agree that "the international community should help shape the choices of countries" in the sphere of monetary policy (Summers 1999).

An institutional architecture designed specifically to constrain the scope of domestic policy is clearly contrary both to the operational rationale of the original Bretton Woods agreements and also to Tobin's proposals for international financial reform. However, neither Brown nor Blair would appear to have any qualms about acknowledging the additional constraints imposed by such a code on the policy autonomy of elected governments. Indeed, in speech after speech, they have extolled the virtues of an institutional framework that allows a suitably empowered IMF to impart more discipline on domestic policy choice (see, for instance, Blair 2000a; Brown 2000b, 2000c).

In this respect, Labour would appear to be pushing on a door which, if not yet fully open given the hesitance of many IMF member countries to such proposals, is certainly ajar. The IMF, for one, seems only too content to be granted these new disciplinary powers. It has welcomed the introduction of a Special Data Dissemination Standard, whereby the right to negotiate loans through the Fund is made conditional upon meeting international standards for full public disclosure of economic data (Presidential Commission 1999, 26). More controversially, it has proposed revisions to its own articles of agreement that would make fully liberalised capital accounts a prerequisite of continued membership (IMF 2000).

There would thus seem to be significant momentum behind elite political mobilisation designed to bring the operation of all national capital markets in line with a single global liberal norm. This momentum is firmly rooted in particularistic Anglo-American pressure for further financial liberalisation. Only when pressurised at G7 meetings to tone down the implied criticism of other countries' implementation of inappropriate policies have British and American leaders acknowledged that transparency codes should apply more broadly than just to 'imprudent' governments located in other regions of the world. The response to the Asian financial crisis, first from the Clinton Administration and latterly from the Blair Government, has been to suggest that transparency imperatives imply a two-way process of information dissemination between governments and markets.

It may well be the case that the burden of such imperatives falls disproportionately on the public rather than the private sector, but there is nonetheless some sense of burden-sharing. For example, the 1999 Report of the Presidential Commission investigating proposals for a new financial architecture reflected significant shifts in the public discourse on financial liberalisation that had become evident in the United States in the two years following the Asian financial crisis. It insisted that the demands for additional transparency applied not only to national monetary authorities, but also to individual market actors, the banking sector and international financial institutions (Presidential Commission 1999, 27). Similarly, in retrospective analyses of its own performance in Asia, the IMF became increasingly adamant that codes of practice for public information disclosure would not in themselves guarantee satisfactory prudential regulation unless extended to include the private sector (IMF 2000).

Towards the end of 1998, Gordon Brown also began to argue that transparency rules for corporate governance and for IMF interventions would be an appropriate supplement to those that applied solely to governments.[1] More recently, Brown has lent support for the creation of a permanent independent evaluation unit for the IMF.[2] However, at the same time that his Chancellor was effecting this subtle change in Britain's position on the international financial architecture, the Prime Minister made it clear that these were not responses to British concerns per se, so much as a strategic move to seek a compromise that would preserve Labour's multilateral codes for fiscal transparency in the face of potential dissent from other IMF member countries. In a speech to a British Chamber of Commerce dinner in China (Blair 1998b), he referred pointedly to these being "French and other ideas for strengthening the governance of International Financial Institutions".

Despite these shifts in public discourse, neither the British or American Governments nor the IMF has been willing to go as far as many academic commentators in suggesting that the true source of systemic instability within international financial markets stems *directly* from the private sector, because it is market actors who have a profit maximising incentive to obscure information flows about the structure of the market. Labour's discourse on the international financial architecture remains much closer to Blair's original statement that a 'new Bretton Woods' should be oriented towards the single strategic goal of allowing financial investors to "price risk more accurately [in relation to] future government policy" (Blair 1998a).

Labour's concern for establishing a new regulatory apparatus to protect the price mechanism would therefore seem to be aimed overwhelmingly at limiting destabilising price effects whose origin is *external* to the market, and located most particularly within the policy process.[3] Its proposals for a new financial architecture remain much less fully formed in relation to price volatility that has its roots in dynamics which are *internal* to capital markets themselves. Such reasoning is acceptable only in circumstances in which we can be sure that capital markets display a natural tendency to equilibrium, so that speculative dynamics do not unnecessarily prejudice market outcomes. However, in the following section, I argue that there are no grounds on which it is possible to sustain such an assumption. Even *The Economist*, doyen of liberal economic opinion as it is, suggests that purely market-reinforcing reforms "miss the point" if international financial markets do not exist in a context of perfectly rational risk-pricing dynamics (*The Economist*, 11.04.98, 78).

Speculative Activity and Endogenously Generated Market Volatility

The Practical Implications of Financial Liberalisation

Labour's proposals for a purely market-reinforcing 'new Bretton Woods' may provide little, even no, space for the introduction of a Tobin tax. Yet, even the most staunch advocate of financial liberalisation is unlikely to disagree with the underlying assumption on which Tobin grounds his argument for a deterrent tax on hot money: namely, that the importance of financial institutions on social outcomes is now more pronounced than ever before. A consensus exists amongst academic economists that financial markets now shape the trajectory of economic development to a greater extent than ever before.

This is undeniably true – for example, the daily trading volume on the world's foreign exchange markets alone now exceeds US $2 trillion. However, there is far less agreement amongst economists over the interpretation of figures such as this. Is it a good or a bad thing that trading on financial markets now dwarves all other kinds of economic activity? Do current patterns of financial trading impact upon the real economy? If so, do they have a detrimental effect (causing increased instability) or a positive effect (leading to more efficient outcomes)?

Sadly, answers to these questions cannot be found in New Labour's public pronouncements on the international financial architecture – indeed, there is no clear evidence that these questions have even been asked. Labour's stance tends to be to outline the conditions by which other governments must abide if further financial liberalisation is to be successful, rather than to ask whether liberalisation is desirable in the first place. The Government's commitment to liberalisation appears almost solely ideological. In this section, I seek answers to the above questions as a means of exploring the practical implications of ideological commitments to further financial liberalisation.

Despite the fact that public discourse on the international financial architecture suggests a single homogeneous market structure, real life markets are significantly more differentiated. My analysis in this section will focus specifically on the foreign exchange market. There are three reasons for this, which overlap the three broad concerns in this article. Firstly, it is typical for the foreign exchanges to be treated *as* the international financial markets in public discourse. Such is their influence (both real and perceived), that currency trading tends to be conflated with international financial market trading in general. Secondly, given London's status as leader in this particular market, it can reasonably be assumed that, whenever a British Government talks about a new international financial architecture, it is most interested in trying to determine future forms of regulation on the foreign exchanges. Thirdly, the principal goal of the original Bretton Woods agreement was to design an institutional framework that could pacify speculative activity on the foreign exchanges; proposals for Tobin-style taxes on international currency transactions have the same purpose.

Speculation and Exchange Rate Volatility

The ability to distinguish unambiguously between exchange rate variability which is 'excessively volatile' and that which is merely 'highly volatile' is a source of deep and lasting division within the economics literature. This distinction is extremely relevant to the public policy-making debate on the new financial architecture. In circumstances in which foreign exchange markets display structural features of excessive volatility, arguments for market-correcting reforms are greatly enhanced. Labour's transparency discourse suggests that the foreign exchange market needs reinforcing rather than correcting. As such, it would only appear to fit with a world in which exchange rate variability is highly rather than excessively volatile.

Economists have always assumed that, under conditions of freely floating exchange rates, those rates could never be more stable than the economies that they are supposed to reflect (Friedman 1953). As Jeffrey Frankel argues, "Even if foreign exchange markets are functioning properly, fundamental economic determinants, such as monetary policy, should produce a lot of variability in the exchange rate" (Frankel 1996, 52). Indeed, Rudiger Dornbusch's classic 'overshooting' model posits that some degree of variability is built into the very fabric of foreign exchange markets. Dornbusch argues that the price mechanism adjusts much more rapidly in foreign exchange markets than it does in the commodities markets to which they are linked. This mismatch in the speed of adjustment causes the short-run equilibrium in foreign exchange markets to overshoot the long-run equilibrium (Dornbusch 1976). The potentially destabilising impact of speculators on foreign exchange prices is entirely absent from Dornbusch's model. Yet, even in these circumstances, the tendency is towards volatility. If a hypothetical world in which there is no speculation is typified by systemic market volatility, what effects are likely to be visible in the real world in which speculation is pervasive?

If rational overshooting were the only source of variability within foreign exchange markets, then the extent of market volatility would be wholly predictable. However, the influence of speculative dynamics within the market is now so pronounced that it renders even the future *direction* of volatility largely unpredictable (Kearney 1996, 92-3).

Trade in foreign exchange is no longer a function either of trade in commodities or investment in long-term productive capacity. The speculative demand for money now clearly dominates all combined sources of monetary demand that are embedded within the real economy. The Bank for International Settlements calculates that 'ultimate' customers – that is, those located within the real economy – have been all but crowded out of the foreign exchange market. Less than one in five foreign exchange market transactions are now conducted with a non-financial customer (Frankel 1996, 41). In London, that percentage is even lower (Frieden and Dornbusch 1993, 19). With daily turnover on the foreign exchanges now averaging over US $2 trillion (*The Economist* 1999), the 82% of worldwide market trades which are speculative in nature constitute an enormous influence on the operation of the international financial system more generally.

Numerous academic analyses have concluded that the ever greater influence of speculation on overall patterns of market trading has ensured that trading volume is increasingly closely correlated with volatility (see, for example, Frankel and Froot 1990; Hsieh and Kleidon 1996; Jorion 1996). Given the recent exponential increase in the flow of foreign exchange, a similar increase in market volatility is also to be expected. Indeed, such is the influence of speculative dynamics on foreign exchange prices that textbook models are now almost entirely superfluous to an understanding of the price mechanism within currency markets. Even Dornbusch's 'overshooting' model looks dated. Dornbusch himself talks of the way in which foreign exchange markets now routinely 'overshoot the overshooting equilibrium' (Frieden and Dornbusch 1993, 16). To the extent that overshooting theory can explain long-term tendencies within the real exchange rate, it leaves short-term movements completely unexplained. Over short time horizons, the concept of equilibrium would seem to be altogether redundant (Watson 1999).

Labour's Silence on Speculation

Labour's purely market-reinforcing proposals for a new international financial architecture sit uneasily alongside these conclusions. The rationale for maintaining purely private regulation of international capital flows is that the market will always be better than the government in identifying its own equilibrium position. Here, however, the impact of speculative dynamics on the price mechanism is so pronounced that the very idea of an equilibrium position has become increasingly meaningless. Even the very existence of speculative activity undermines the theoretical basis of the Blair Government's transparency discourse. Additional transparency is only the optimal institutional fix for market instability in circumstances in which market traders act solely in line with economic fundamentals.

Given the pervasive nature of speculation within contemporary financial markets, the assumption that *any* market has a unique and stable equilibrium relating solely to economic fundamentals tends to be made more as a matter of faith than on the basis of empirical evidence. Yet, more so than any other, the market in foreign exchange betrays the fact that it has no mysterious alchemy outlining where its equilibrium position should be. As Paul Krugman argues, "foreign exchange markets behave much more like the unstable and irrational asset markets described by Keynes than the efficient markets described by modern finance theory" (Krugman 1989, 61).

If this is indeed the case (and there would seem to be no reason to think that it is not), New Labour's silence on the issue of speculation would seem to be a significant omission from its public pronouncements on the international financial architecture. As detailed in the previous section, Labour's official position has shifted in the wake of the Asian financial crisis to suggest that the private sector, whilst definitely not to blame for the instability exhibited by international financial markets, must not be exempt from transparency codes. However, the proposed extension of transparency codes to the private sector appears only to require that firms located within the productive economy feed financial markets with information relating to their company accounts (see Brown 1998a, b). At no stage has it been suggested that the same principle applies also to those firms that operate within the financial markets themselves.

Yet, it is the actions of these firms that have led to the prevalence of speculative dynamics within the market environment. Set against such a fact, the absence of the very idea of speculation from Labour's public discourse on international finance appears somewhat anomalous. It warrants no mention irrespective of the nature of the audience that is being addressed – whether this is an audience of financial market actors (where we might reasonably expect Labour to be cautious in broaching the subject of excessive speculation – see Blair 2000c); MPs (see Brown 1998b); fellow Labour Party members (who might be rather more welcoming of such a critique – see Brown 1995); academics (see Brown 2000b); or people in developing countries most directly affected by financial instability (who are likely to be most receptive of attempts to refocus the debate about international finance onto the issue of speculation – see Blair 2001c).

Given the absence of a discussion of speculation, we are left to conclude that Labour assumes that international financial markets operate in the manner of textbook markets. In other words, in all instances the market-clearing price is determined according to the forces of supply and demand within that market. However, in circumstances in which speculation is rife, it makes no sense to follow the textbook model in which the market's demand and supply schedules are formed independently – the former by a relatively closed class of buyers, the latter by a relatively closed class of sellers. Within speculative foreign exchange markets, individual market actors are both buyers and sellers at the same time. The distinction between the market's demand and supply schedules consequently breaks down. Demand and supply are not independently given; they are mutually constituted to reflect the dominant expectation about which way the market is most likely to move next.

Speculators consciously try to ride on the back of trends within the foreign exchanges, as a trendless market embodies risk-return equations which are much less conducive to quick and easy profit-making than a market exhibiting an obvious momentum. The most important fact about such trends is that the market actors who find them to be so much to their advantage are themselves responsible for creating them. Each actor within the market knows that, should flows of private speculative capital be organised 'collectively' with the specific aim of embedding a certain trend, then this will always become the dominant trend. This knowledge is sufficient in itself to act as a further incentive to trend-chasing speculative behaviour (Watson 1999).

Internally Generated Market Instability

The Blair Government has thus far ignored arguments for correcting excessive market volatility by re-imposing capital market segmentation (see, for example, Brown 2000b; Blair 2001b; Smith 2000; Hewitt 1998; Byers 1999b). Such arguments – like those for a Tobin tax – are based on the assumption that trend-chasing speculative behaviour drives the market away from prices that are consistent with underlying economic fundamentals. Empirical evidence shows that investors devote far less resources to gaining a full knowledge of fundamentals than they do to identifying the dominant market trend (see, for instance, Grossman and Stiglitz 1980; Lyons 1995; Obstfeld 1995). The most successful forecasters of speculative price movements would appear, somewhat paradoxically, to be those who look least at fundamentals (Taylor and Allen 1992). The knowledge that matters most to the typical foreign exchange trader does not concern the macroeconomic stance of the governments whose currencies are being traded. Rather, it concerns the kind of deals that other traders are offering, plus an expectation of how those deals are likely to change over the short-run (see Goodhart, Ito and Payne 1996).

Set in such a context, most of the short-term variance in exchange rates appears unconnected to 'news' relating to the economy. As a consequence, it is difficult to believe that public policy-making decisions are the source of excessive volatility on the foreign exchanges. In turn, Labour's reform proposals for the international financial architecture, which attempt to protect the price mechanism from shocks that are external to the market and concentrated in the policy environment, would seem to be almost wholly directed at the wrong target. How can this be expected to dampen down volatility on the foreign exchanges when most of the volatility is generated internally to the market itself? No degree of transparency in the information flows from government to market can ever be sufficient to ensure market stability when the majority of individual market actors pay so little attention to what governments are doing in the first place. Prudence may well be a virtue in New Labour's eyes, but there can be no guarantee that any amount of prudence will ever be rewarded with tranquillity on the foreign exchanges.

Indeed, there is little incentive for market actors to provide such tranquillity in circumstances in which they can force self-fulfilling speculative prophecies that prove to be far more profitable (see Eichengreen, Tobin and Wyplosz 1995, 165). Such is the contemporary dominance of the speculative motive for trading foreign exchange that individual speculators often engage in deliberate destabilisation as the easiest way to make money. The phenomenon of 'noise' trading, for instance, materialises only because it is possible to generate profit from intentionally prolonging existing market volatility (Davis 1996, 138). 'Noise' traders both react to extrapolative expectations of the future trajectory of the market and, by their own trend-chasing actions, serve to harden such expectations within the market (Dunbar 2000; Shiller 2000). An expectations bias has become a structural feature of the foreign exchange market, such that the forward discount rate within the futures market now typically "points the wrong way as a predictor of the [long-run real] exchange rate" (Frankel 1996, 53). The persistence of this expectations bias can be understood in two ways: firstly, as conclusive evidence of market inefficiency; and, secondly, as conclusive evidence of excessive volatility.

As the above analysis suggests, the source of excessive exchange-rate volatility is endogenous to the market itself. As such, it would seem to be relatively easy to explain proposals that seek to implement market-*correcting* reforms to the existing financial architecture. The available evidence highlights the extent to which a deregulated foreign exchange market produces patterns of trading which are detrimental to the economy as a whole; therefore, additional layers of regulation would seem to be required to produce more efficient market outcomes. By contrast, further explanation would seem to be necessary where we see purely market-*reinforcing* reforms being advocated. For, it is previous market-reinforcing reforms and, in particular, the prior liberalisation of the financial system, which would appear to set the context within which current market failures have become possible.

If this is indeed correct, then New Labour's proposals for a 'new Bretton Woods' must be unpacked further. At the very least, those proposals would not seem to be shaped by an empirically grounded analysis of the existing microstructure of international financial markets. In the following section, I return to the suggestion that those proposals are shaped more by the politics than the economics of New Labour, by assessing the probable impact of its market-reinforcing reforms on the wider political environment. In particular, I focus on changes to the distribution of risk which are likely to be triggered within the financial system in the event of the Blair Government's proposals for additional transparency being broadly implemented in international law.

The International Financial Architecture and Systemic Risk Distributions

Risk-Sharing Within Financial Markets

Two elements explain the existence of all financial markets: time and uncertainty. The inability definitively to predict the future state of the economy means that private saving and investment decisions are constrained multi-period optimisation problems. Throughout their history, financial markets have been created in order to match creditors and debtors who hold the same assumptions about the most likely trajectory of future economic fundamentals.[4] In circumstances in which a suitable 'pair' is found for everyone, the market will tend to display a stable risk-return structure. In theory, then, financial markets should act as a force for stabilisation. Their whole raison d'être is to facilitate risk-sharing, to ensure that no-one is exposed to undue levels of risk emerging from exogenous shocks to the economic system.

Set in such a context, there would seem to be one supreme irony in the current pattern of trading on the foreign exchanges. The development of a complex structure of foreign exchange markets has been for the ostensible purpose of risk management. Yet, the current dominance of speculative activity within those markets has generated such pronounced volatility that this in turn has increased the overall level of risk within the economy. Far from the market serving to ameliorate the effects of exogenous shocks on the economic system, it actually serves to diffuse shocks *which it produces endogenously* into that system.

How, then, is it possible to explain New Labour's 'new Bretton Woods' proposals? For, by advocating further liberalisation of international finance, such proposals would create a context still *more* conducive to the speculative activity that generates excessive volatility on the foreign exchanges. Viewed merely from a systemic perspective, there appears to be a clear contradiction here. Indeed, so pronounced is that contradiction that it is perhaps necessary to look beyond systemic explanations altogether, to locate an understanding of the Blair Government's proposals for international financial reform within the context of the dynamics of the British economy.

Financial Liberalisation and British Economic History

The political science literature on Britain's relative economic decline offers one possible point of departure. The argument to be found there can be simply stated. It is suggested that the British economy has experienced a persistent shortfall in productive capacity, and that this can be attributed to the particular social basis of the British state. Britain is assumed to stand out in comparison to other states, to the extent that its institutions have locked-in 'financial interests' at the very heart of the public policy-making process (see for instance Ingham 1984; Glyn and Sutcliffe 1986; Rubinstein 1994; see also English and Kenny 2000). A self-perpetuating cycle has consequently been set in motion, whereby the dominance of finance skews the policy output of the British state in a way that merely serves to reinforce that dominance. Set in such a context, Labour's refusal to contemplate market-correcting reforms to the international financial architecture can simply be read off from the overbearing influence of 'financial interests' on the domestic political agenda. London's status as the world's foremost foreign exchange market can, of course, be enlisted as evidence to support such a view.

However, whilst superficially attractive, this account is clearly limited. The idea of a single set of 'financial interests' on which the whole argument rests suggests financial market homogeneity. Yet, there are no grounds to sustain such an assumption. The financial system represents the complex aggregation of a whole series of individual markets which, because they trade in assets that are competitive investments, often have mutually incompatible interests. For instance, should the volatility which 'noise' traders bring to foreign exchange markets increase the perceived risk of investing in corporate equity, we should expect to see investors moving funds out of stocks and into the comparative safety of government bonds. In these circumstances, it may be possible to talk of a coalition of interests between the foreign exchange and the bond markets. Yet, it is clear that such a coalition does not extend to the stock market. Quite simply, it is not possible to theorise financial capital in terms of a static and undifferentiated interest; nor, consequently, in terms of an ability to impose a logic of a similarly static and undifferentiated structural power.

It is beyond question that many sectors of British finance are deeply integrated into international circuits of capital. Yet, a history of 'financial hegemony' is less relevant to understanding the process of integration than is a history of Britain's unusual current account position. Figures for the current account record the international flows of goods and services into, and out of, a particular country. When outflows dominate inflows, the current account is in surplus; when inflows dominate outflows, the current account is in deficit. Compared with other advanced industrialised economies, Britain historically has experienced large current account deficits (Pollard 1992, 266-8).

This situation has important consequences. In order to maintain some sense of stability in the overall balance of payments position, structural deficits on the current account need to be offset by structural surpluses on the capital account. Accordingly, countries that experience persistent current account deficits also tend to be countries whose financial systems display a high degree of integration into international structures in an attempt to derive surpluses on the capital account. Long-run savings-investment correlations suggest that Britain has the highest measure of international capital mobility of any G7 economy (Sarno and Taylor 1998, 17, 24). This in turn reflects the longitudinal data that show Britain's current account position to be more deeply in deficit for a longer period of time than that of any of its peers (Hoffman 1998, 21, 33).

It would therefore seem possible to construct a simple economic rationale for Labour's discursive positioning in relation to the international financial architecture. Rather than attempt to impose increased sectoral balance onto the structures of the British economy, it has advocated an alternative 'quick-fix' solution to Britain's persistent current account deficit through the reconstitution of international financial relations. 'Sand in the wheels' reforms to the existing international financial architecture promise to introduce new forms of capital market segmentation (Frieden and Dornbusch 1993, 35). Were such circumstances to ensue, it is likely that it would become progressively more difficult for Britain to sustain the capital account position necessary to offset its historic current account deficit. Only in circumstances in which liberalising reforms constitute the basis of the international financial architecture can the British economy be expected to remain free from significant long-term balance of payments constraints.

In the hypothetical world of a truly frictionless global circuit of capital, current account imbalances simply would not matter, because it would always be possible to finance even a permanent current account deficit from a global pool of world savings (Feldstein and Horioka 1980). However, as *The Economist* has recently noted, investors continue to act in a way which suggests that current accounts do still matter. Contemporary patterns of trading imply that market sentiment will tolerate government inactivity on deficit-correction only within defined limits (*The Economist* 1999, 127). The actions of the Blair Government suggest that it agrees. Its foreign economic policy has been motivated throughout its period of office by concerns that countries adversely affected by speculative activities may reject proposals to consolidate progress towards systemic financial liberalisation (Baker 1999, 94-5; Coates and Hay 2001). In other words, New Labour's 'new Bretton Woods' discourse is animated by the fear that other countries' refusal to be bound indefinitely by liberalising norms would ensure that the correction of Britain's current account imbalance became the sole responsibility of the British government. In this sense, it is unsurprising that Labour has been at the forefront of calls to make open capital accounts a prerequisite of IMF membership; thus, removing the need for sustaining active consent to liberalising norms in the future.

In effect, the Blair Government has been attempting to harness the discipline of a new international financial architecture in order to distribute the risks of Britain's historic current account deficit around the international economic system as a whole. This certainly does not conform to the effects that economists have in mind when they talk about the risk-sharing functions of financial markets; all the same, it is a risk-sharing function of sorts.

The Social Risks of Further Financial Liberalisation

Of course, this is not the only impact on the distribution of systemic risk that Labour's proposals for international financial reform could be expected to have. Financial markets impact upon the lives of ordinary people way beyond their capacity to control events (see Strange 1998; Shiller 2000). New Labour's 'new Bretton Woods' discourse, insofar as it offers the prospect of more liberalising reforms, threatens to undermine still further society's ability to shape the distribution of risks created by excessive market volatility. Having rejected 'sand in the wheels' reforms, Labour has dismissed the possibility of developing regulatory structures which shift the management of risk back into the private sector. It now appears happy to accept a fundamental mismatch between those who create risk within the financial system (trend-chasing market actors), and those who are forced to accept the burden of risk relayed through that system (those in society least able to insure themselves against such risks).

No institutional architecture becomes established unless there is a political coalition capable of sustaining the social settlement which that architecture shapes. Any framework of institutions should therefore be seen as a statement of public aspiration. New Labour's 'new Bretton Woods' discourse is no different in this respect. Quite clearly, it represents more than an articulation of merely technical economic concerns relating to the stability of the international financial system. It is also a comment on the government's wider political intent. The technical economic concerns may constitute little more than a legitimising backdrop to what is essentially a new politics of redistribution. This is a two-way redistribution: put simply, wealth flows from society to financial markets at the same time as risk flows from financial markets to society.

As Ulrich Beck argues in his seminal study of the ‘risk society’, there tends to be a distinctive social distribution of risk conforming to more or less regular patterns (Beck 1992, 22-6). Certain groups are systematically more likely to be affected than others by an overall increase in risk levels. Moreover, the social distribution of risk and the social distribution of wealth are intimately linked. Those with limited access to wealth repeatedly find it more difficult to insure themselves against exposure to risk.

This is particularly evident in relation to the risks induced by excessive volatility on international financial markets. As Susan Strange argues, “ordinary people ... have never been asked if they wanted to gamble their jobs, their savings, their income in [a] casino form of capitalism” (Strange 1998, 3-4). Yet, this is precisely the kind of effects that they have to endure as a progressively liberalised financial architecture facilitates ever greater market ‘runs’ and ever greater social consequences of such ‘runs’.

The effects of the Asian financial crisis are an extreme, yet by no means atypical, case in point. The management of the social consequences of that crisis by the international community revealed a marked asymmetry in the distribution of the burden of the systemic risks that the crisis exposed. Asian populations paid the costs of adjustment to the crisis in terms of lost jobs, lost savings and lower living standards. At the same time, the international investors whose actions created the speculative bubble that led to the crisis in the first place were able to rely on international institutional guarantees that default was not an option for the afflicted countries to minimise their risk exposures arising from the crisis (see, for instance, Radelet and Sachs 1998; Bello 1998; Lee 1998).

Such outcomes suggest that some have greater means than others to insure themselves against systemic risks emanating from international financial markets. Indeed, it is necessary to question whether most citizens have the ability to insure themselves *at all*. Returning to Beck's analysis of the 'risk society', he argues that, typically, it *is* possible to secure against risk (Beck 1992, 20). For, risks tend to be willingly accepted on the expectation that some future reward will be forthcoming to more than compensate for the present risk position. It then becomes a matter of personal choice to what extent those risks are allowed to remain uncovered. The greater the coverage taken out, the less will be the potential long-run gain, but the greater will be the short-term security.

However, it is questionable whether this scenario applies to the risks which originate in, and are diffused by, international financial markets. As the above analysis has shown, the dominant mood of the market is now created endogenously by predominantly speculative dynamics. This means that individual citizens have become ever more susceptible to the destabilising effects of market bubbles, and these are quite clearly effects over which they have no control. In a highly deregulated international financial environment, not only are individual citizens increasingly powerless to insure themselves when the consequences of excessive financial volatility impact upon the real economy. Governments are also increasingly powerless to provide collective insurance for their citizens by influencing the dominant mood of the market through exogenous intervention.

In such circumstances, it is clear that any attempt to reconstitute the burden of financial risk management must first entail a fundamental reorganisation of power and authority within society. Yet, during its first five years in government, New Labour's economic policy (in both its domestic and international orientation) has repeatedly demonstrated that it has few intentions to impose fundamental change onto the existing structure of social power. Indeed, in terms of its proposals for the international financial architecture, it would appear to be advocating the further institutionalisation of both the current distribution of risk positions within the international economic system and also the current international structure of social power.

Conclusion

In his speech to the party's centenary anniversary conference, Tony Blair suggested that if the underlying philosophy of New Labour could be summed up in one word, that word would be 'progress'. "We are Labour," he argued, "because in the great historical debate we side with the progressives not the conservatives. We are reformers: those who want to change the world not preserve it. Those who know that no change benefits those who hold power, and change helps those without it" (Blair 2000b). As was required at such an occasion, these were evocative words. But the question remains: to what extent is it possible to accept this simple conflation of ‘reform’ and ‘progressive’ in order to imply that all reform must necessarily be progressive in nature?

In terms of New Labour’s proposals for a ‘new Bretton Woods’, there can be no question that the Blair Government supports reform to the financial regime. However, the most likely outcomes of its proposed reforms are more progressive in some areas than others and, on the whole, the progressiveness of its overall reform package remains in doubt.

Gordon Brown in particular has been at the forefront of attempts to build an international consensus for alleviating the debt burdens of the most heavily indebted poor countries (see Brown 2000c, 2000d, 2001; see also Blair 2000a), and he has led the way in this respect by committing Britain to a programme through which the British Government unilaterally retires those countries’ debts that it holds. Such measures undoubtedly deserve to be seen as progressive. Yet, how do they fit in with the Government’s broader liberalising goals? Are they any more than a means of securing a suitable basis for imposing liberalisation on the Third World? Even if Labour does not see debt cancellation directly in terms of facilitating efficient liberalisation, it is clear that the Government’s concerns for retiring debt are secondary to its concerns for promoting further financial liberalisation. It is in terms of this latter goal that the progressive nature of Labour’s reforms must be adjudicated.

Stephen Byers has argued that the first priority for any institution of global economic governance must be to embed “a culture of responsible risk-taking” (Byers 1999a). However, Labour’s liberalising reforms to the international financial architecture would seem more likely to trigger greater rather than less market volatility. The

Government's transparency codes will make it much easier for individual market actors to identify the dominant mood of the market. This in turn will increase the incentives for such actors to take positions within the market which bear no relation to underlying economic fundamentals, so long as their actions harden the prevailing market trend. As a consequence, we can expect New Labour's 'new Bretton Woods' to create a context in which financial markets operate ever further from equilibrium.

Where would this leave Byers' 'culture of responsible risk-taking'? Should financial market movements become entirely autonomous of fundamentals, swings in market sentiment are likely to have an increasingly adverse effect on those whose personal economic well-being is dependent on the reproduction of a stable economy. Such circumstances would entail a distinctive shift in the pattern of risk relayed through the international financial system. For those within the markets, further financial liberalisation reduces the exposure to systemic risk, certainly insofar as market trends which are easier to spot lower the chances of being caught out on the wrong side of the market. By contrast, for those outside the markets, further financial liberalisation increases the exposure to systemic risk. Recent experiences of speculative bubbles which suddenly burst suggest that costs of adjustment to changes in the market mood are born just as much in terms of jobs as falling portfolio value. What would be progressive about reform proposals which served to 'oil the wheels' of international finance and, as a consequence, induced a further shift in risk burdens from those who create the risk to those who are merely innocent victims of it?

Of course, any advocate of 'oiling the wheels' reforms is likely to be able to enlist the support of some economist who will argue that international financial markets do not act any more independently of fundamentals today than they have at any previous time. Two responses are appropriate. The first is to suggest that such an argument can only be constructed on the basis of bad economics and, in particular, a tendency to elevate market ideology above the findings of empirical research into the microstructure of actually existing markets. The second is to suggest that, even if such an argument were to be grounded in rather better economics, it still misses the point. Even if it can be proved beyond doubt that all speculation is a purely rational reflection of information about fundamentals, this does not invalidate the case for 'throwing sand in the wheels' of international finance. The technical economic aspect of the debate about the international financial architecture should always remain secondary to its normative socio-economic aspect. In order to sustain the case for 'sand in the wheels', it is only necessary to show that the social consequences of current patterns of speculation are inimical to a truly progressive politics. This is relatively straightforward to do; so much so, that serious questions remain about the precise meaning of progress which New Labour has in mind when it outlines its proposals for a 'new Bretton Woods'.

Notes

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them of any potential blame; no-one other than myself can be held responsible for the opinions that appear in this article.

[1] This sentiment was first expressed explicitly in his statement to the House of Commons on the World Economy, 02.11.98.

[2] I am indebted to one of the *BJPIR*'s anonymous referees for reminding me of this fact.

[3] On the need to protect the price mechanism from shocks which emerge from the external and, in particular, the policy environment, see the following contribution to the academic literature made by Ed Balls, then Economic Advisor to the Chancellor of the Exchequer, Gordon Brown (Balls 1998). Note especially the length to which Balls feels compelled to go in order to explain the 'necessity' for governments to pre-commit monetary policy as a means of making credible policy pledges not to inject destabilising tendencies into the price mechanism.

[4] Creditors, of course, being those for whom the immediate task is to make a saving decision; debtors being those for whom the immediate task is to make an investment decision. Each class of market actor can typically be assumed to want to make the decision which minimises the risk that it is necessary to bear at any given level of return.