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# General Conclusions:
## From Crisis to A Global Political Economy of Freedom

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Abstract

In this chapter I sum up the basic problems for a new theory of 21st century financial crises in light of the Asian and other subsequent crises. My conclusion is that there are indeed deep structural causes at work in the global markets that affect the political economy of countries and regions. Methodologically, new concepts, models and theories are constructed, at ;least partially, to conduct further meaningful empirical work leading to relevant policy conclusions. This book belongs to the beginning of intellectual efforts in this direction. Political economic analyses at the country level, CGE modeling within a new theoretical framework, and neural network approach to learning in a bounded rationality framework point to a role for reforms at the state, firm and regional level. A new type of institutional analysis called the 'extended panda's thumb approach' leads to the recommendation that path dependent hybrid structures need to be constructed at the local, national, regional and global level to lead to a new global financial architecture for the prevention--- and if prevention fails--- management of financial crises.

# GENERAL CONCLUSIONS: FROM CRISIS TO A GLOBAL POLITICAL ECONOMY OF FREEDOM[1]

Writing in 1926, in a biographical essay on Edgeworth, Keynes underlined some of the problems of complex human systems:

> We are faced at every turn with problems of organic unity, of discreteness, of discontinuity--- the whole is not equal to the sum of the parts, comparisons of quantity fail us, small changes produce large effects, the assumptions of a uniform and homogeneous continuum are not satisfied.[2]

If anything, the world economy today--- even more so than in the interwar years---shows the kind of complexity captured in Keynes's words above. Fortunately, systems theory and economic theory have both made some progress since those dark days. Although we are far from a genuinely complete theory of complex economic systems, efforts are underway that have already borne some interesting fruit in several limited areas. The present endeavor can be seen as a modest step towards understanding some facets of complex open economies with financial systems. I have tried to orient my study methodologically in such a way that both the possibilities of inductive logic and deductions from principles can be fully utilized. It is important to stress the "realist" methodology implicit in this effort. The concrete "facts" are understood to be theory-laden. However, correct theoretical terms are taken to be exactly those that approximately refer to the real structure and dynamics of the global economy. In causal terms, complex causal structures can be inferred to the best of our ability by using the

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[1] Forthcoming in Haider A. Khan, Global Markets and Financial Crisis: A Theory for the 21st Century Crises Based on the Asia's Mangled Miracle, Chapter 9, Macmillan/Palgrave, 2004.

[2] Keynes(1971-9), Vol. X, p. 261

conceptual, modeling and econometric techniques available to us at this moment. Given advances in theory and techniques in the future, our knowledge of the underlying causal relations can certainly improve. Thus, the results obtained in this book can only be viewed as tentative and subject to future revisions and updating. Yet, it must be said that by using a number of approaches--- historical and political economic, statistical, conceptual and formal nonlinear modeling approaches among them--- an attempt has been made to advance our knowledge of the dynamics of economies with complex financial systems as much as possible. In this final chapter I wish to sum up the most important aspects of my findings from two complementary points of view--- one positive and the other normative.

The first is the analysis of complex economic systems. Here, methods of nonlinear modeling of both decisions in a single financial entity such as a bank, and of decisions in an economy wide framework have been used. For microanalysis, neural network approach in particular would seem to hold much promise. Although not widely used in economic analysis yet, in the future, learning models that start from the assumption of bounded rationality would become more useful in analyzing complex economies. Likewise, nonlinear modeling of financial economies in an economy wide sense will also gain ground. These are hopeful predictions; but given the needs of stabilizing the global economy there is a strong case to be made for further use and development of such models.

On the other hand, the global economy is also a *political economy.* Hence the problem of global financial architecture--- to mention just one pressing global issue--- can not be simply a

problem of technical economic and econometric modelling, no matter how sophisticated and "realistic". In fact, it can be argued that a "realistic" model will have to include political economic elements--- at least implicitly. At the same time it must be recognized that the state of the art of such political economic modelling is still rather primitive. Instead of simplifying radically to fit the needs of formalization, much can also be learned from a rigorous ordinary language political economic analysis. Each of the country chapters in this book contains such analysis, as the astute reader must have noticed already. The formal modelling and rigorous ordinary language analysis are in fact complementary.[3]

Instead of summarizing both these approaches on a chapter by chapter basis, I want to raise a more basic question here: what are the characteristics of the global financial markets that lead to repeated instabilities? Various theoretical answers to this question can be given, and many of them have been discussed in the preceding chapters. For the purpose of discussing the "complexity" approach developed in this book, several features of global financial markets are worth emphasizing. First of all, global capital and financial markets--- even more than purely domestic markets---- are characterized by serious problems of asymmetric and incomplete information. Second, these problems are faced by agents who are rational only in a bounded rationality sense. Third, the risky nature of projects can not always be completely priced even if there is no fundamental uncertainty; however, there could also be a Knightian type of uncertainty as opposed to just risk, or at least a Keynesian type of uncertainty where

[3] A more detailed methodological discussion is given in my "On Paradigms, Theories and Models", June 2002. University of Tokyo, CIRJE Discussion paper no. **2002-CF-156**

only qualitative comparisons of future states are possible. In either case, expected value maximization of portfolios is impossible, and much of the standard mean-variance or other techniques of statistical portfolio value analysis in the future becomes inapplicable.

Even without the radical characterization of the capital markets under the third point above, the increasing international exposure of both equity funds in the advanced countries and the financial systems in the newly industrializing and other developing countries has meant that in-depth information about the underlying values of the assets and liabilities are less than perfect. At the same time, the speed of shock transmission has increased because of technological advances and liberalization. This leads among other effects to a strong possibility of contagion that can be quite widespread. Another way of putting it is that contagion risk increases with financial liberalization in a world undergoing simultaneously an information technology revolution.

In the discussion on corporate governance both the seriousness of agency problems and the wider context in which we need to address these were emphasized. For bank lenders and portfolio investors, the agency problems are exacerbated because they can exercise little control over the assets and their market values. No international safeguards except implicit bailout prospects by the IFIs or governments creating moral hazard may exist. If such bailouts come at some cost---thus mitigating the moral hazard problem to some extent----then the logical loss-minimizing strategy is to avoid assets which can not be liquidated quickly if things go wrong suddenly. One logical outcome of this strategy is short-termism. The international portfolio investors and bank lenders use ‘rapid exit” as a means for dealing with

and containing downside risk. Therefore financial “quick ratios” such as the ratio of a country’s short-term foreign liabilities to central bank reserves become signals to watch. Whenever, the signal indicates downside risk and someone acts to exit, a cascading downward rush towards lowering asset values and a financial crash may start.

Another consequence of the above characteristics of the liberalization of emerging markets is that the fund managers do not see acquisition of control or even more information as a way to handle risk. Rather they seek portfolio diversification. This practice is justified by a theory that assumes a lack of covariance among the emerging market instruments so that different country risks can be played off against one another. However, this move can also lead to significant instabilities in the emerging markets, particularly when the fund managers act like a herd. It is also interesting to note that despite a large literature on equity market-based(EMS) corporate governance system, such behavior does not always result in good corporate governance. In fact, the managers of firms have strong incentives to push for short-term upward movement in stock prices. Under lax regulatory and accounting practices, these objectives can often lead to distorted information and misleading financial statements. This makes the goal of achieving a transparent and accountable financial system harder, not easier as some simplistic theories would predict.

The main overall consequence for the financial and capital markets of the above observations is a complex kind of market failure. Asset prices and interest rates do not fully reflect risk. Lenders in the domestic markets usually---- though not always--- handle this type

of failure through aggregate credit rationing. There are always potential borrowers --- even borrowers willing to pay a higher than market rate of interest---- who are refused loans. This is consistent with the particular portfolio allocation rules adopted by rational lenders in such markets. Internationally, adverse perceptions of risk by lenders that may not be connected with long-term underlying asset values can destabilize these markets. It can be shown theoretically that adverse news in a world where the shock travels in a cascading nonlinear fashion, the cumulative effect can be a complete loss of foreign capital and reserves. This is in fact, embedded in our economy wide model.

Add to this the fact that while the portfolio allocation rules in a developed country fund may be marginal adjustment overall, the emerging market part of this portfolio is far from marginal for the emerging market country. For this country--- for example Thailand in 1997--- the marginal adjustments by the developed country fund managers may lead to a huge outflow launching a full blown financial crisis. Thus unevenness of the economies has a significant role to play in explaining the capital account crises we have observed.

The volatility of the short-term capital movements in turn can have real economic consequences. The actual impact depends upon the various linkages and the strength of the capital “surges”--- both in and outflows. But overall, the mean output may fall and variances of major macroeconomic variables may increase. This makes the problem of creating more productive investment, more and better paying jobs, and social safety nets for the vulnerable groups much more difficult. Given that the capacities of many states in developing countries

are already quite weak in these respects, volatility definitely weakens these further. While we attempt to build the “missing institutions” in developing countries, the urgent problems of the weakest open economies need to be discussed also.

Thus before going any further a detour to view the problems of poverty alleviation in these countries may throw some light on how different sets of economies must be dealt with differently in an uneven world. Thus for the poorer countries opening up should be accompanied by a flow of official and NGO aid with the condition that governance should be improved. New aid and investment policies must be connected to a new trade policy . Liberalizing the Generalized System of Preferences (GSP) under which the industrialized countries would exempt imports from these countries while maintaining tariffs on imports from other countries, is an urgent task. The U.S. can take a bold step by unilaterally liberalizing its GSP towards indebted poorer countries. This will generate not only the moral pressure for the other G-7 countries to follow but will in the meantime confer an advantage to U.S. firms trading and investing in these countries. Even a gradual liberalizing would help enormously, although progress will be slower than in the case of immediate liberalization.The economic assistance policy needs also to be geared towards helping the small producers through providing funds and expertise .On the technological front, the G-7 countries and the multilateral aid agencies can help by financing and arranging for granting the poorer countries access to the global communications networks.

To some extent, these problems are faced by other developing countries also, but not as severely. What happened during the Asian and Argentine financial crises was that many middle class people also faced the threat of sudden poverty. Creation of a safety net for these people in such (relatively more affluent ) economies is also an urgent task. Since the private sector is not entrusted with this task, at least in the short and intermediate terms, other actors have to step in. It should be recognized that poverty alleviation has been embraced as the major goal by the multilateral banks. Therefore, it is natual to expect them to play a leading role in this respect. To the extent, an increse in their capital base is necessary for this purpose, this should be accepted as a global responsibility.

The prospects of global financing bring us back to the problems of the unevenness and other failures of global capital markets. In the discussion of global financial architecture, I emphasized the role a hybrid structure can play. I also emphasized the following two principles:

1. *The principle of symmetry,* i.e., the surplus and deficit countries should be treated equally. However, it was not realized in the past; nor is it likely to be realized in the near future. However, there are various ways to pursue this as a goal even under the current set up of the IMF. If serious efforts are made to follow this principle by a reformed IMF, that will be an important step towards a new and better GFA.

2. *The principle of burden-sharing,* i.e., during episodes of crisis management the IMF will share the management burden with the RFAs and through them also with the affected countries and their neighbors.

It should be kept in mind that in keeping with the "extended panda's thumb" argument both the principles recognize the practical impossibility of the IMF being transformed into a global central bank in the near future. What the IMF cannot do now and will not be able to do in the foreseeable future is to follow Bagehot's dictum to lend freely against good collateral at a high interest rate in time of crisis. Unless SDRs become the commonly accepted and easily expandable means of settlement, this role will remain foreclosed. It is unlikely that the principal shareholders of the IMF will allow such a change to occur.[4] Also, compared to a national central bank dealing with a problematic domestic financial institution the IMF has a limited ability to force corrective action. Yet, there will clearly be a role for IMF lending, and the consequent moral hazard will need to be recognized. But just as the moral hazard from having fire fighters ready to fight fires does not compel thoughtful communities to abolish fire stations, the global community also cannot abolish the IMF, or reduce its resources simply because there is a moral hazard problem associated with such institutions. The second principle above, the principle of burden sharing with the RFAs, national governments and the private sectors should go some distance towards both increasing the overall resources available, and mitigating the moral hazard.

It has also been pointed out that while the Fund can not now, or even in the near future be expected to act as a global central banker, pressures for increasing the net supply and poor country allocations of SDR could have beneficial effects. Even if the increases are not significant in the short run, the tendency will keep alive the eventual goal of forming a global central bank, as Keynes had envisioned. More practically, putting pressures on the IMF to emit new SDRs in order to finance the stabilization of primary ( and perhaps other) commodity prices will lead to benefits for both the developing and the developed countries in the intermediate run. The stabilization of these prices will help many developing countries avert BOP disasters. Furthermore, to the extent that the unusual price increases, such as the oil price increase in the 70s, create general inflationary pressures such pressures can also be averted. A smooth international transactions pattern will thus be consistent with domestic price stabilization as well.

I also emphasized that in addition, the Fund could make a concerted effort to manage the private creditors. Most important from the point of view of managing crises will be the incorporation of new provisions on loan contracts so that orderly work out procedures become feasible. The Fund can also lend into arrears as a means to provide debtor-in-possession financing. Such a provision, along with more direct measures vis-à-vis the creditors, can help to bring the creditors to the bargaining table during a crisis.

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[4] However, this should not be ruled out completely. Pressures for increased supply of SDRs will be beneficial in specific ways as argued below.

But the major emphasis in terms of the proposal for a hybrid GFA has been on the role the regional financial architectures---if they were to be created--- could play in the future. Here it may be instructive to reconsider the Asian case.From the policy perspective, it is important to know if the existence of an Asian RFA would have helped in any way during the AFC. This is really a counterfactual question which asks: suppose there existed an RFA for Asia during the AFC, how would it have responded to the crisis that would have been different?

In contrast with the behavior of the IMF, within the proposed hybrid GFA,a regional financial architecture, had it been present could have done at least the following on the basis of applying an evolutionary theory of financial instabilities under globalization:

1.Through constant regional monitoring it would have sensed the danger ahead of time. Even a regional monitoring unit alone would have been able to do better than the IMF team in Asia.

2.Through constant formal and informal contact with the officials in member governments and the private sector, it would have sized up the possible extent of the problem earlier and better than did the IMF.

3.Through prompt and early action it would have provided liquidity to the system, and punished bad management in coordinated measures with the national governments.

4.It would have been able to start regional discussions about bankruptcy and work out procedures by keeping in close touch with the history and legal issues facing particular countries.

5.It would have been in a position to use both moral suasion and toughness to keep both regional creditors and debtors in line.

The fundamental requirement for this, however, was an actually existing RFA with enough liquidity and technical expertise. The Asian Development Bank provided quite a bit of liquidity to Korea in particular, but did not even have a monitoring unit when the crisis broke out. Furthermore, the autonomy and integrity of any future RFA, in Asia and elsewhere are issues that need discussion. The relationship between the RFAs and the IMF also needs to be further specified. These are matters that are of necessity evolutionary by nature.

What is important to realize is that the root causes of crises were not prevented from being actualized by the Washington consensus policies in effect. Accelerated financial liberalization, exchange rate anchoring, and encouraging private portfolio capital inflow did not lead to the desired growth and stability. To be sure, there may be short-term gains. But these gains can exacerbate herd behavior and problems arising from such behavior. Once the macroeconomic balances are obtained via structural adjustment and inflation is under control, market liberalization may bring in both financing for real sector projects and hot money. If all the main short-term indicators turn positive for a while investors tend to ignore some fluctuations. For example, large current account deficits--- Thailand readily comes to mind--- may be seen as really the simple algebraic counterpart to a positive capital account balance. Thus, an accounting, or at best a result of equilibrium in BOP is taken as a causal evidence for success in attracting foreign investment. By the same token--- as the chapter on corporate governance issues showed in detail---- corporate debt and high leveraging may be construed as global financial diversification. In retrospect, we can see that it requires much close analysis to determine whether the external deficit reflects a private savings-investment gap and rational decisions about intertemporal consumption smoothing. Private sector decisions have turned out to be much more myopic than assumed by the received doctrines.

Our approach of boundedly rational agents teaches us to take myopic behavior seriously, and asks under what kind of environment caqn agents learn not to be myopic?

Another failure has been that of the private credit rating agencies. These agencies failed to predict the collapse in both Mexico and Asia. Apart from problems with techniques that are backward-looking, there are deeper issues at stake here. The use of information by the rating agencies seems deficient. The tendency is to interpret matters in such a way as not to destabilize the market in a good equilibrium. But in a bad equilibrium the rating agencies also engage in herd behavior and rapid nonlinear downgrading can occur. There is also the question of how the ratings are used and the consequences following; but this is a systemic problem rather than that of the credit agencies.

Because credit rating and its use are systemic issues, competent international bodies can play a stabilizing role here. In the hybrid global financial architecture propsed in this book, such public-private hybridity can also be helpful. In addition to investigating what role the IMF, possible RFAs and other international public bodies can play, we can also explore the prospects of using bodies such as the International Association for Insurance Supervisors(IAIS) and International Organization of Securities Commissions(IOSCO).[5]

Related to such hybrid structures are possible extension of bank supervision capabilities outside of G-10. The publication of the Basle Committee's "Core Principles for Effective Banking Supervision" establishing best practices has been a good step forward. Supervision of cross-border banking is another area of concern. The report on off-shore banking and "the Supervision of Cross-border Banking" received the endorsement of banking supervisors from 140 countries in the International Conference of Banking supervisors in Stockholm. Although these are encouraging steps, much remains to be done. Also, much depends on the sharing

of information and cooperation across borders among the supervisors. Regulatory forebearance is another problem that is relevant for both state-owned financial institutions and privately owned ones in many countries.

Whether all these add up to an adequate framework for financial stability is the crucial question. The BIS now has an expanded membership. But the BIS itself has no regulatory functions as such, and seems reluctant to play a more active role. The US treasury also does not seem particularly willing to cede authority of cross-border intervention to a body it does not control. In effect, the G-7 countries themselves may not be able to agree on the role of BIS. Partly as a result of this, the US seems more content with the IMF expanding its regular article IV consultations with the member countries to examine the quality of domestic banking supervision. In a way, the IMFs move towards pressuring for capital account liberalization can be seen as a tactic to enhance its capacity to control the financial policies of the less powerful member countries. Reforming the IMF constitution in this direction will create additional risks from capital flow surges globally. The argument in this book has been that a hybrid structure that respects the practical policy issues arising from unevenness will be more stable than a sudden move towards uniform capital account liberalization. This conclusion seems to have been borne out by the facts of global financial instability even from such moves for a subset of developing and newly industrializing economies.

While this book endorses the positive good that can come from enhanced cooperation discussed above, and from enhanced “mutual recognition agreements” there are problems that should not be overlooked. The US supported mutual recognition agreements, in particular, can become a form of disguised protection for the US banks and financial services institutions. At the same time such extension of mutual recognition would surely increase the extraterritorial powers of the US regulators such as the SEC and the Fed. Legally, it may also expose the US authorities to claims from the US investors if there were to be crises in

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[5] In fact the Bank for International settlements(BIS) bid successfully to host IAIS in 1996. If BIS--- with cooperation from the US--- can become more capable of helping in the supervision of non-bank financial

markets outside of the US whose regulatory system has been certified by the US through a mutual recognition system. But as I have emphasized, used with care--- keeping the above and other possible problems in mind--- these type of bilateral arrangements can also be a part of the hybrid system.

There are other proposals such as the international credit insurance corporation that do not seem viable at the moment. Because of contagion risk, the pooling of risks necessary for any insurance scheme to work may be difficult if not impossible. Problems of moral hazard and adverse selection will arise more frequently and massively requiring premiums that may indeed be prohibitive.

Once again, however, the prospects for funding this with new issues of SDRs is not without merit. Availability of a fund like this could mean conditional lending of last resort. Such lending could also happen more quickly than in the past cases. Having a large amount of international liquidity would also lessen the risk of a major asset deflation during crisis. After crisis, in order to mitigate any possible inflationary impact, the loans could be paid back quickly by the borrowing countries, or in some cases, long-term bonds could be issued.

From the above discussion it should be clear that the creation of a new hybrid GFA is the supreme political task of creating a new global political economy amidst the ruins of financial and real economic crises. The Asian financial crisis and the Argentine crisis both showed specific institutional features. They also showed the failures of the so-called "developmenmtal states'. The truth about these crises are that these are largely private sector problems in a lax national and global regulatory environment. Excessive lending beyond the dictates of prudential regulations, had they existed internationally or enforced properly, by private banks and non-bank financial intermediaries in developed countries to private banks and corporations in developing countries was at the core of the crises. Since this was not a

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institutions, that will be a significant step towards global stability.

sovereign debt problem, the usual intergovernmental or IMF prescription was not likely to work and in fact did not work.[6] Another characteristic was the credit rationing in the global capital markets. It was the decisions of the lenders that dictated the capital flows. Hence, the so-called "developmental state" had in fact little to do with the heydays of success, or the bleak days of failure that followed. The only difference was that the bleak postcrisis days showed up the real weaknesses of these styates in the global political economy.

Finally, the studies of the political economy of capital flows should pay close attention to the problems related to the lenders since these really are the key actors. The key problem faced by the lenders is that of managing risk by whatever means. Sometimes this may be consistent with a stab;e and orderly market---- the key goal of the national governments and the international authorities. But quite often as shown both empirically and theoretically, the private sector actions can be destabilizing. A deeper look at the problem really shows that a proper economic and political economy analysis both point to the problem of missing institutions. The foregoing analysis of crises largely underlined four types of missing institutions.

First, there is the lack of a global central bank. This missing institution means that the job of providing enough liquidity, particularly during crisis can not be done adequately. As a result, illiquid, but not insolvent banks and financial institutions, as well as other productive enterprises may go bankrupt. As pointed out, the IMF is not up to this task now and may not be for some time. A hybrid structure with regional provision of liquidity is therefore an urgent reformist and new institution-building task.

Second, the need for international prudential regulation of financial services. As shown here, the Basle system is far from adequate. Again, a hybrid form with national and perhaps

[6] Of course, questions can be raised as to whether the IMF recipe worked even in the sovereign debt case. For a review of the pro and contra literature on this, and some novel theoretical arguments and empirical results in the

regional components may be the best realistic response that the global system can make at this time.

Third, many capital and financial markets—for example long-term bond markets--- are themselves missing. If not altogether missing, they are so thin that no real capital accumulation can occur through their marginal functionings. In developed countries this problem is addressed by the existence of market makers. In fact, these are considered so crucial that some theorists with in-depth knowledghe of real financial institutions, make the study of market making the starting point of their analysis. This is the approach followed, for example, by Charles Goodhart in his path-breaking study of monetary economics. The crucial point to recognize is that such market makers do not exist in most global financial markets. We do not know if and when they will emerge. We also do not know how their activities might be coordinated once they do emerge. In the mean time, no international body seems to be ready or capable of discharging the task of market makers. Here is a palpable concrete example of how complex developed financial economies really are.

Fourth, as the chapter and particularly section on corporate governance and legal structures showed, transaction costs are indeed high without a smoothly functioning adequate legal system. While no unique system may be optimal--- the difference between the Common Law and the Continental Legal Systems shows this--- a certain degree of integrity in dispute settlement mechanisms including bankruptcy and orderly work out procedures may be essential. Without these, the rule for both foreign investors and domestic companies may be quick returns and capital flight in times of trouble. In a hybrid system, some degree of capital control and building of domestic legal institutions may be a prelude to creating a more appropriate body of regional and international dispute settlement mechanisms.

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African context, see Khan (1997c).

Although we have not arrived at a complete theory of the new capital account type of financial crisis, the main outline is by now clear. Open capital account and weak banking and financial sectors are a combustible mix. In the presence of nonlinear, complex interrelations, discontinuities, uncertainty the behavior of boundedly rational agents may tend towards cascading herd behavior. Likewise, governments may also panic. Thus, on this “complexity” view of capital account crises, there is no magic formula short of complete autarky to prevent capital account crises. However, even under autarky there could be financial fragility arising from purely domestic factors. Such fragility could also result in a financial crisis. Given the benefits of openness, autarky is really a counsel of despair. What is important to realize is the need to have a coupling of domestic policies and regulatory environment with the regional and global financial architecture. However, we must now, at the end of our endeavor turn from issues of pure finance to the broader question of the implications of sound finance for well-being.

Sound Finance and economic growth may go together under an appropriately designed global economic regime. However, the results of growth must still be evaluated from the point of view of human well-being. In the standard utilitarian approach this can be done by choosing an appropriate social welfare function(SWF) where both levels of income and the distribution of income are arguments. Given a preference for equality at a given level of income, technically certain SWFs are the only admissible ones.[7]

A more elaborate evaluation of well-being has been proposed by various theorists drawing upon the insights of Adam Smith. Sen is the originator of this “capabilities approach” in recent times. The theoretical criticisms of the utilitarian approach by Sen Nussbaum and others that this approach reduces all qualities into quanta of utilities is a serious one. Nussbaum gives a graphic example of this by

[7] For example, Schur-concave SWFs are such “equality preferring” SWFs.

quoting the exchange between Mr. Gradgrind, economist and grief-stricken father, and his pupil Bitzer. Bitzer outdoes his mentor by adhering to a strict code of utilitarian rationality that cannot comprehend a father's grief. I have pursued a similar line of criticism in a number of recent papers. And my book "Technology, Development and Democracy. This approach makes the capabilities explicitly social and asks: what concatenation of economic (real and financial ) and other (e.g., political, social etc.) institutions will allow capabilities to be both increase steadily on the average and tend to equalize them among diverse individuals? In effect, as the following discussion makes clear, we are asking: how can we increase and equalize real, positive freedom for individuals?

In discussing the well-being implications of sound global finance, therefore, I wish to take a version of the social capabilities approach. The institutional reforms and changes proposed here, and by scholars who suggest alternative structures , must be proven to be capability enhancing, or at least not to be capability-reducing..But first we still need to ask: What is meant by capabilities both abstractly and concretely?

Capabilities can be construed as general powers of human body and mind that can be acquired, maintained, nurtured and developed. They can also (under circumstances such as malnutrition or severe confinement) be diminished and even completely lost. I have emphasized elsewhere the irreducibly social (not merely biological) character of these human capabilities. Sen himself emphasizes "a certain sort of possibility or opportunity for functioning.

In order to assess financial reforms and structures from a capabilities perspective we need to go further and try to describe more concretely what some of the basic capabilities may be. David Crocker has given an admirable summary of both Nussbaum's and Sen's approach to capabilities in a recent essay.

Mainly relying on Nussbaum but also on other sources (shown below), he has compiled a list that is worth reproducing here:

Basic Human Functional Capabilities (N and S stand for "Nussbaum" and "Sen", respectively; the quoted items come from Nussbaum unless otherwise noted).

1. Capabilities in Relation to Mortality
   1.1. N and S: "Being able to live to the end of a complete human life, so far as is possible
   1.2. 1.2. N: Being able to be courageous
2. Bodily Capabilities
   2.1. N and S: "Being able to have good health.
   2.2. 2.2. N and S: "Being able to be adequately nourished.
   2.3. N and S: "Being able to have adequate shelter
   2.4. 2.4. N: "Being able to have opportunities for sexual satisfaction"
   2.5. N and S: "Being able to move about from place to place
3. Pleasure
   3.1. N and S: "Being able to avoid unnecessary and non-useful pain and to have pleasurable experiences

4. Cognitive Virtues
   4.1. N: "Being able to use the five senses"
   4.2. N: "Being able to imagine"
   4.3. N: "Being able to think and reason"
   4.4. N and S: "Being acceptably well-informed'

5. Affiliation I (Compassion)
   5.1. N: "Being able to have attachments to things and persons outside ourselves"
   5.2. N: "Being able to love, grieve, to feel longing and gratitude"

6. Virtue of Practical Reason (Agency)
   6.1. N: "Being able to form a conception of the good
   S: "Capability to choose; "ability to form goals, commitments, values
   6.2. N and S: "Being able to engage in critical reflection about the planning of one's own life"

7. Affiliation II (Friendship and Justice)
   7.1. N: "Being able to live for and to others, to recognize and show concern for other human beings, to engage in various forms of familial and social interaction"
      7.1.1. N: Being capable of friendship
      S: Being able to visit and entertain friends
      7.1.2. S: Being able to participate in the community

7.1.3. N: Being able to participate politically and being capable of justice

8. Ecological Virtue
   8.1. N: "Being able to live with concern for and in relation to animals, plants and the world of nature"

9. Leisure
   9.1. N: "Being able to laugh, to play, to enjoy recreational activities"

10. Separateness
   10.1. N: "Being able to live one's own life and nobody else's
   10.2. N: "Being able to live in one's very own surroundings and context"

11. Self-respect
   11.1. S: "Capability to have self-respect"
   11.2. S: "Capability of appearing in public without shame"

12. Human Flourishing
   12.1. N: "Capability to live a rich and fully human life, up to the limit permitted by natural possibilities"
   12.2. S: "Ability to achieve valuable functionings"

To facilitate this ordering, it might be better for practical rationality and affiliation to "infuse" but not "organize" the other virtues. Crocker contrasts Nussbaum's approach with Sen's. Sen's and Nussbaum's lists differ at a few points. For Sen, the bodily capabilities and functionings (2) are intrinsically good and not, as they are in some dualistic theories of the good life, merely instrumental means to other (higher) goods. In interpreting Aristotle, Nussbaum distinguishes between bodily functionings that are chosen and intentional, for instance, "chosen self-nutritive and reproductive activities that form part of a reason-guided life" and those that are non-intentional, such as digestion and other "functioning of the bodily system in sleep" (forthcoming). She may want to say that intentional bodily actions that lead to being well-nourished and healthy are intrinsically good, but that being healthy or having good digestion are not functionings (because not intentional) and are valuable only because of what they enable us to do. Another option open to her would be to adopt Sen's view that bodily states and processes, whether

intentional or not, both as intrinsically and instrumentally good but as less valuable than other inherently good capabilities/functionings.

Furthermore, Nussbaum has included items 5 and 8-10, for which Sen has no counterparts. These items are welcome features. Item 8, which I have called "ecological virtue", is an especially important recent addition to Nussbaum's outlook. In a period when many are exploring ways of effecting a convergence between environmental ethics and development ethics, it is important that an essentially anthropocentric ethic "make room" for respect for other species and for ecological systems. Worth considering is whether Nussbaum's "ecological virtue" is strong enough. Perhaps it should be formulated to read: "Being able to live with concern for and in relation to animals, plants, and nature as intrinsically valuable." Item 9 injects some appealing playfulness in a list otherwise marked by the "spirit of seriousness." What explains the presence of these items on Nussbaum's list, their absence on Sen's list, and, more generally, the more concrete texture often displayed in Nussbaum's descriptions? One hypothesis is that the differences are due to Nussbaum's greater attention, in her Level 1, to the limits, vulnerabilities, and needs of human existence. Further, it may be that Nussbaum's richer conception of human beings derives from making use of the story-telling imagination far more than the scientific intellect."[43/] On the other hand, Sen helpfully includes the good of self-respect, a virtue that enables him to find common ground with Rawls and to establish links with the Kantian ethical tradition, in which moral agents have the obligation to respect all persons, including themselves, as ends-in-themselves[/]

Both Sen and Nussbaum agree, however, that these capabilities are distinct and of central importance. One cannot easily trade off one dimension of capability against another. At most, one can do so in a very limited way. They cannot be reduced to a common measure such as utility.

As Crocker points out, "capability ethic" has implications for freedom, rights and justice going far beyond simple distribution of income considerations. If one accepts the capability approach as a serious foundation for human development, then it follows that going beyond distributive justice is necessary for a complete evaluation of the impact of economic policies.

In evaluating international financial regimes and national economic policies from this perspective not only do we wish to pose the question of efficiency but also the whole set of questions regarding human freedom. In particular, the positive human freedom to be or to do certain things. Thus, creation of markets and efficient production by itself would mean very little if it led to a lopsided distribution of benefits. Worse yet, if markets and other institutions led to phenomena such as reduced life expectancy, increased unemployment, reduced consumption levels for many and deprivation for certain groups such as women and minorities then they will not even be weakly equitable global economic structure. On the contrary, under such circumstances, the global markets and other financial institutions will be strongly inequitable from the capability perspective.

It is because of this perspective that the earlier positive analysis of the problems of global financial markets and institutions need to be put in a completely transparent "social capabilities" framework. Such a framework is openly normative and makes a strong ethical case for helping the disadvantaged increase their capabilities towards achieving equality of capabilities. Thus poorer nations and poor people in the global economy deserve a special ethical attention within any proposed global financial architecture. As Khan(1998) shows in the context of adopting innovation structures leading to increased productivities, ultimately the aim of any increase in productivity needs to be the increase of freedom. Such freedom, as Sen (1999) points out has both

an instrumental value and an ultimate value. Instrumentally, freedom as social capabilities can lead to a further increase in productivity. Thus even a hard-nosed, efficiency driven analysis must address this aspect as an empirically relevant issue.

The thrust of the previous chapters has been to show how bad theories—- regardless of their ideological leanings, left, right or center—- can lead to bad policies. Likewise, a refusal to face up to serious ethical issues of equity and well-being for all can also lead to a troubled society. As we move towards the creation of a global society where individuality and rich diversity reflected in differences of cultures and social practices leading to well-being are equally respected, we can do no less than a genuine attempt to approach the reforming of old financial structures and building new financial institutions with a clear ethical perspective of global citizenship. Efficiency and equity are both important and sometimes can be achieved together. At other times at least short run trade offs must be considered carefully. Here, the advances in economic theory -— both positive and normative-— can play a modest but useful role. Therefore, In the realm of crisis prevention and crisis management, the minimization of costs and the maximization of the benefits from any financial system must be guided by advances in both positive economic theories and in economic ethics.

If the main argument advanced in this book is correct, the global financial markets need monitoring and a proper global financial architecture needs to be erected for both efficiency and equity reasons. From the efficiency side the argument -—- in a world of undiversifiable systemic risks-—- has been quite clearly one of exercising prudence through appropriate national and international institutional arrangements that can formulate and implement policies better than in the past. On the equity side, the foregoing argument would lead towards creating institutions and policies that protect not just creditors, but also the ordinary citizens. In particular careful attention must be paid to the problems of the disadvantaged and the vulnerable groups. Adequate social safety nets must be in place before the crisis, and swift response after the crisis to meet their urgent needs must be ensured. A more democratic decision making before the crisis could better realize such administrative structures. Once again, good governance at all levels is essential. If the 21st century is to be safer with a more civilized global society then these democratic imperatives must be heeded along with the technical advice that economists can at times give.

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