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Why finance will not be unfettered

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The liberation of finance is one of the most significant transformations brought about by today's era of globalisation. The scale of cross-border flows, the extent of financial innovation and the size of the fortunes made in financial activities are among the most noteworthy features of our age. Yet the survival of unchained financial capitalism cannot be taken for granted. It will endure only if a sizeable portion of humanity decides that it serves their interests. That is far from certain, as the current backlash against private equity, on both sides of the Atlantic, demonstrates.

The explosion of financial activity is remarkable. According to the McKinsey Global Institute, the ratio of global financial assets to world output soared from 109 per cent in 1980 to 316 per cent in 2005. The value of the global stock of equities and bonds reached about $140,000bn by the latter year. On top of this mountain is piled yet another, made of derivatives, whose face value reached $286,000bn in 2006, up from a mere $3,450bn in 1990.

Along with the new instruments have emerged clever new players. Hedge funds and private equity are among the most visible. The business of these new actors is seeking out pockets of undervaluation anywhere in the world. In the process, they eliminate the opportunities, spreading common financial practices and valuations not only across all assets, but also across the globe.

This is more than just the globalisation of finance, though it is that. It is also the globalisation of the maximisation of shareholder value. As both valuations and principles of corporate governance converge, the economy in which we all live is becoming ever more global.

The globalisation of finance is capable of bringing huge benefits: it eliminates much inefficiency; it applies capital wherever it brings the highest returns; it disciplines lazy management; and it offers far better opportunities for managing risks. But the complexity and scale of the emerging financial system also brings huge challenges. What then needs to be done by practitioners, regulators and policymakers if the promise of financial globalisation is to be fulfilled?

First, at the core of the financial system remain the big banks, which are insured, explicitly and implicitly, by governments. Regulators have to ensure that excessive risk-taking is not going on, with the gains once again privatised and the losses shifted on to taxpayers.

Second, central banks have to understand how the new financial system responds to monetary policy. It seems to have an extraordinary capacity to create credit. The question is whether central bankers are taking this development fully into account in their policies.

Third, democracy rests on the perception of fair treatment of its citizens. Most people accept the wealth earned by successful business activity. Far less acceptable, however, is the ability of the rich to avoid almost all taxation. The case for a neutral tax system, with few loopholes, is stronger than ever.

Fourth, regulation must be global. Moreover, such regulation must include taxation. As finance goes global, so must the depth of co-operation among fiscal authorities. A world in which a global plutocratic class pays little or no tax, while benefiting from the stability generated by taxes imposed on the "little people", will prove unsustainable.

We must never forget the political reality of economic globalisation. However global finance may become, politics is national and, in the world's richest countries, democratic. Financiers do not live on another planet. They depend on those who govern their places of business to provide the regulatory and legal regimes they depend on. A political backlash is already now visible. In the next downturn it is sure to grow. It is one the financiers themselves must not ignore. Ultimately, after all, even they operate at the pleasure of politics.