FINANCIAL DEGLOBALIZATION: Resurgence of Nation States During and After the Great Recession

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I. Introduction

Since the 1980s the world economy in general—and financial markets in particular— has become increasingly more integrated. This notion of globalization has led many to believe that nation states will be marginalized.[1] The integration of financial markets with the "magnifying presence of borderless finance" (Greider 1997, 23) and the grave repercussions of the recent global financial crisis intuitively call for a view of the global economy as a totality. The Great Recession, however, reaffirmed the political capacity and analytical utility of nation states.

With immense rescue loans and guarantees for the rescue of their banks and stimulus programs for their economies, states countered the global financial crisis with broad action. Many observers have reckoned a shift of the zeitgeist away from liberal market doctrines back to nation states.[2] Cross-border capital flows continue to be 60 percent below their pre-crisis peak (McKinsey 2013), which points towards a trend of financial deglobalization or renationalization. Both aspects – stronger nation states and financial deglobalization – are closely interrelated and provide indications for the future trajectory of globalization, as well as international and transnational cooperation.

In order to examine the role of the state within the globalized financial system, I juxtapose the central arguments of the scholarly debate about globalization during the 1990s. Next, I apply these arguments to assess states' efforts to mitigate the Great Recession, with an

[1] See Strange 1996; Tabb 2001; Horsman and Marshall 1994; Greider 1997; Tanzi 1998.
[2] See Steinmo 2010; Cioffi 2010; Wilensky 2012; Martin and Swank 2012; Helleiner 2012.

emphasis on state action in the United States. Subsequently, I examine the impact of the crisis on cross-capital flows and the future international financial regulation. Finally, I summarize my findings and provide an outlook of the future trajectory of global finance.

A feasible examination of such a broad topic requires circumscriptions and generalizations. I treat "financial regulation" as a universal term despite the numerous sub-categories and differences between, for example, the trade of derivatives and equity. There will be no detailed examination of the nature of different policy responses, because not all of them were directly targeting financial issues. Furthermore, I measure the power and relevance of the nation state by its breadth of action in terms of policies, regulations, and public spending. The common question of the autonomy of the state versus the influence of interest groups will therewith be excluded.

II. Debate: The Role of the Nation State in Globalized Financial Markets

"Globalization" is a dictum that reflects the zeitgeist of the 1990s in the social sciences. In view of the end of the Cold War, leaps in communication technology, increasing trade flows across borders, and increasing importance of transnational organizations, many scholars predicted the marginalization of the nation state. The statement "the era of nation-state is over" (Horsman and Marshall 1994, 175) became a widespread slogan. The rising flow of capital across the globe, or "financial internationalization" (Haggard and Maxfield 1993, 251), was often considered to be a "central aspect […] of globalization" (Tabb 2001, 56), with the financial industry as the sector that has been affected the most by globalization (Busch 2009, 228). Finance capital – as opposed to industrial capital – was commonly at the core of this discussion because of its more transnational character (Mann 1997, 481).

Proponents of the hypothesis that the nation state was on the retreat during the 1990s argued that nation states are powerless in the face of borderless globalized economic activity. Financial markets in particular are decoupled from nation states and consequently, the divergence between these markets and the political arena of nation states grows (Tanzi 1998, 8). The rising power of these global financial market forces is mostly equated with their volume of trade (Greider 1997, 24). With finance as the “most 'globalized' component of the international economy” (Frieden 2006, 460), national regulation does not match this financial internationality and becomes ineffective (ibid., 463).

The idea of global governance – realized through institutions like the International Monetary Fund, the World Bank, and the World Trade Organization – promotes the borderless character of finance and further undermines the capacity of the nation state (Tabb 2001, 57). Post-Marxist scholars deepened this notion towards a world economic order with nation states as mere tools of a transnational collective (Potevi 2006, 420). Even Wade, who skeptically views the hypothesis that globalization disempowers nation states, suggests that borderless products like derivatives lessen “the ability of governments to manage finance” (1996, 64). Convergence in economic, political, and cultural dimensions has been suggested to be a byproduct of the process of globalization, which further erodes the state. Strange took this idea further, predicting that “Globalisation means the partial erasure of the distinctions separating national currency areas and national systems of financial regulation” (1995, 294).

The opponents of this hypothesis argue that the other side ignores historical developments and the deliberate nature of the decision by states to foster financial

liberalization and with that, financial globalization.[3] Due to the profound changes in the financial system since the 1980s, nation states face new challenges and must adjust to them without losing the general capacity to act (Sassen 1998). Although there exists a high volume of mobile capital, sheer numbers do not allow conclusions to be drawn about the "power relations" between states and financial markets (Mann 1997, 482). Alberti and Bertucci (2003) argue against the misperception of globalization as an uncontrollable and inevitable behemoth, an argument sustained by McNally (2010) and others. The integration of world markets requires complex international coordination on multiple levels. This necessity of cooperation has led many to misunderstand this process as a marginalization of the nation state, which misses the fact that nation states deliberately fostered economic liberalization in the first place and that cooperation between states "represents an exercise of state sovereignty" (Alberti and Betucci 2003, 2-3; 9).

The liberalization of capital flows and the deregulation of financial intermediaries among governments of developed countries that began in the 1980s add credence to argue that nation states consciously set the course for financial internationalization. Hence, political will among individual nation states provided for this new regulatory framework and the resulting integration of financial markets. Under the Bretton Woods system, developed countries initially turned towards a more rigorous control of capital (Ferguson 2008, 307). The subsequent abolition of the Gold Standard and the following economic turmoil of the 1970s resulted in a "reorganization of capitalist finance" (McNally 2010, 41) that is an element of what is commonly referred to as the neoliberal shift. From a historical perspective, the global economic

[3] See Boyer 1996; Wade 1996; Alberti and Bertucci 2003; Weiss 1997.

integration of the late twentieth century is not unprecedented when compared to the beginning of the century (Hirst and Thompson 1996). This recurrence of a high degree of economic integration suggests a political cyclicality, which indicates that increasing integration is reversible. During financial crises, public opinion and political will tend to shift towards tighter regulation (Wade 1996, 88). Even Tabb, who generally argues that the internationalization of finance disempowers nation states, admits this pattern of stricter regulation after economic downturns (Tabb 2001, 29).

The perceived wisdom among scholars and the public debate during the 1990s suggested an intuitive argument for the retreat of nation states. States would prove to be powerless when facing globalized finance, which would lead to the transnationalization of economic governance. This transnationalization would then almost automatically lead to the convergence of policies and, eventually, political economies at large.

III. Broad Global State Action During the Great Recession

After the Second World War, financial crises occurred less frequently compared to the previous hundred years (Reinhart and Rogoff 2010, 16). After the neoliberal shift of the 1980s, however, the trend reversed: "the three decades since the 1980s have been the most tumultuous in monetary history in terms of the number, scope, and severity of financial crises" (Kindleberger 2011, 278). As deregulation represents a sovereign state action, this positive correlation between the frequency of financial crises and financial deregulation during the 1980s and 1990s supports the hypothesis that increased power of financial markets derives from deliberate political decisions.

States responded more actively through swifter and more determinant monetary and fiscal policies to combat the effects of the Great Recession as compared to the Great Depression. Whereas the initial international ramifications of the recent crisis were graver, state action was better able to reduce the magnitude of the subsequent recession (Almunia et al. 2009, 2-3). Central banks implemented unprecedented and unconventional monetary policies by exploiting their room to maneuver in unorthodox ways, through means such as quantitative easing, credit easing, and ring-fencing. State action was therefore able to "avert a global meltdown by determined firefighting efforts" (IMF 2009, 3). In the absence of coordinated international efforts, domestic policies also caused "international spillovers" that were effective in helping to calm investors' concerns (Aït-Sahalia et al. 2012, 176). This comparative success suggests improved capacities of nation states to counter global challenges.

The heterogeneous impact of the global financial crisis on different regions and countries demonstrates that some states could protect their national financial systems better than could others. Asian countries reversed their financial policies towards tighter regulation based on their experiences with financial crises during the 1990s. As such, Asian financial systems in general were "carefully regulated, transparent, and sufficiently well capitalized and liquid to withstand large shocks" (Bernanke 2009), which made them less vulnerable to the financial effects of the crisis and confirms the cyclicality of financial regulation. The more severe financial ramifications of the crisis in Europe compared to Asia, exemplify that states were not helpless in the face of the crisis and had the chance to build regulatory firewalls. In other words, they had the capacities to prevent domestic financial institutions from investing in, for instance, U.S. subprime mortgages. The financial crisis originated in the United States because of major

shortcomings in financial regulation and supervision as well as mistakes in monetary policy, such as keeping the interest rate too low for too long and allowing shadow banks to leverage up their balance sheets. Thus, the series of regulatory and monetary mistakes by the state can be prevented in the future and deregulation is reversible.

The U.S. policy response to the financial crisis exemplifies the government's broad capacities and serves to augment the cyclicality hypothesis of financial regulation. With quantitative easing, credit easing, and other measures, the Federal Reserve undertook experimental monetary policies by lowering the federal interest rate to the zero bound.[4] The government acted, in conjunction with other initiatives, through the Troubled Assets Relief Program and purchased problematic assets and equity from struggling financial institutions, totaling $410 billion. Considering that the United States provided 26 percent of its GDP to rescue troubled banks (Hüfner 2010, 5), it is clear that the country took broad state action to mediate the effects of the crisis.

In 2010, after this aggressive crisis-management, U.S. Congress enacted the Dodd-Frank Act, which was considered the country's "most ambitious and far-reaching overhaul of financial regulation since the 1930s" (Acharya et al. 2010, 1;29). Combined with further regulatory reforms by the SEC, the Fed, and other U.S. regulators, the implementation of these initiatives demonstrates the political will to reverse the liberalization of the finance sector.

As part of the cyclicality of financial regulation, laxer policies informed by short-term perspectives and shifting lobbying powers during economic bonanzas have historical precedent. Like other U.S. policymakers, Ben Bernanke suffered from what has been called the "'this time

[4] For a detailed overview of the policy response by the Federal Reserve see Acharya et al. 2009, 37-39.

is different' syndrome" (Reinhart and Rogoff 2010, 29). In 2002, he argued that more sophisticated monetary capabilities have led to a "great moderation" that would make volatilities in the U.S. economy a thing of the past (Bernanke 2004, but by 2010, he expounded a markedly different message: "We should not imagine [...] that it is possible to prevent all crises" (Bernanke 2010). Hence, the crisis is also the result of intellectual failures among policy makers and scholars that have similarly emerged throughout history.

One of the main causes of the financial crisis in the United States that later became the Great Recession was the burst of a housing bubble (Acharya et al 2009, 12). The scope of the subprime sector was relatively small compared to, for example, the portfolio losses during the dotcom bubble of 1997 to 2000. The significantly larger repercussions of the decline of the U.S. housing market compared to the dotcom crisis were due to the highly leveraged bank balance sheets that held these securitized subprime mortgages (ibid., 14-15). The bust of the relatively small housing market unfolded to "a cascading vicious circle of falling asset prices, margin calls, fire sales, deleveraging, and further asset price deflation" (ibid., 2), causing an intermediation crisis and thus, a liquidity crunch across the financial system. This dynamic illustrates that the sheer volume of transactions does not indicate the respective powers of the financial sector and the state.

The disastrous ramifications of the decline of a relatively small sector of the economy demonstrate that the role of individual financial institutions is crucial. American banks were at the core of the Great Recession and transmitted the financial crisis as a feedback to the real economy (IMF 2009). Against this background, the counterintuitive contradiction of globalized financial markets can be understood: the more integrated global financial markets become, the

more individual institutions like Lehman Brothers can pose cross-border systemic risk. Hence, as long as these institutions are subject to national supervision and regulation, the importance of nation states correlates positively with the degree of global financial integration. Moreover, most cross-border capital flows are intermediated by global banks (Committee on International Economic Policy Reform 2012, V) and are therefore detectable to the range of regulators. This poses questions about international financial regulations of financial institutions and cross-border capital flows.

IV. Globalization Revisited: International Regulation and Capital Flows

Financial globalization is not a modern phenomenon. The first wave of intercontinental financial integration occurred during the beginning of the nineteenth century (Sylla et al. 2006). Shortly after the American Financial Revolution, which occurred as early as 1803, almost half of America's federal debt was held by foreign investors (Sylla 1999, 4). As such, cross-border capital flows, a core element of financial integration, are hardly new. Wilensky soberly placed the common misperception of increased global capital flows in historical perspective: "compared to the mid twentieth century, capital has become somewhat more mobile; compared to previous 50 year periods, capital has become less mobile" (2012, 89-90). Against this background, it is not surprising that financial crises have always been contagious across borders – be it the famous and closely connected South Sea and the Mississippi bubbles in the eighteenth century in Paris and London, or the U.S. financial crisis in 1907 that originated in Italy. It is inherent in the international financial system that an economic upturn in one country will attract capital inflows from abroad or cause for variations in exchange rates, which can result in asset-price, currency, or credit bubbles (Kindleberger 2011). Thus, cross-capital flows

are the channel for global common exposure and are the transmission mechanism for global contagion. For this examination they moreover represent a valid object of study, as they mirror the degree of integration in the global financial system (McKinsey 2013).

The introduction of the Euro as the common currency of seventeen European countries may be viewed as evidence for Strange's prediction of the "erasure of the distinctions separating national currency areas" (1995, 294). Yet, on a global scale, a reduction of national currencies has not led to regional agreements. The negative examples of Argentina, England, and Mexico have led countries to abandon the approach of currency pegging, which is a form of equalizing currency areas. Currently, with the exception of China, only small economies operate within exchange rate regimes, while "all large rich economies float" (Rose 2011, 14).

During the 1980s, nation states consciously set the course for financial internationalization. Among developed countries, the liberalization of capital flows and the regulation of financial intermediaries became increasingly common. The IMF was an outspoken supporter of this development and beginning in this decade required that developing countries in need of IMF assistance institute "financial sector deregulation, the removal of controls over foreign exchange […] enhanced freedom of trade, […] the progressive elimination of capital controls, the removal of controls over interest rates, and the lifting of traditional barriers to entry into banking and other financial services" (Cable 1995, 3). The institution of this new regulatory framework required political will on the part of the individual nation states and resulted in an increase of cross-border capital flows. Due to the cyclicality of financial

regulation, the regulation of cross-capital flows has become a part of lawmakers' agendas in the wake of the Great Recession.[5]

Since 2007, the development of financial globalization reversed into financial nationalization. Eichengreen prognosticates that "the golden age of financial globalization has already passed" (2011). A recent study by the McKinsey Global Institute underscores a deglobalization of capital flows. Cross-border capital flows increased from $0.5 trillion in 1980 to $11.8 trillion in 2007. As mentioned previously, by 2012, after the global financial crisis hit, cross-border capital flows continued to be 60 percent below their pre-crisis peak.[6] The study mentions stricter regulations on capital and liquidity as well as a different mindset among shareholders and regulators who compel banks to reduce their risk exposure. As a result, banks have narrowed their geographic reach (McKinsey 2013). While it is normal that cross-border capital flows plunge during a global financial crisis, this medium-term continuity is strong evidence for a deglobalizing trend and thus, the reversibility of financial integration.

However, this shift will not precipitate more coordinated international financial regulation. Whereas the IMF has been arguably the most important voice against the control of capital flows, its position changed remarkably in the wake of the recent crisis. In an extensive study, the IMF found that countries that used capital controls were less affected by the crisis than those that relied on this mechanism to a more abbreviated extent. This marks an intellectual "U-turn" (Financial Times 2012), as the fund now sees capital controls as "a

[5] It is important to note that the Great Recession originated in the U.S. because of domestic policies and oversight failures. The connection to globalized financial markets thus had no direct impact on the beginning of this Great Recession. Eichengreen argued that capital flows into the U.S. had an insignificant impact (2010, 2).
[6] These figures include foreign direct investment (FDI) in addition to portfolio investment ("hot money"). It is interesting to note that FDI has recovered faster than portfolio investment, and thus its share of cross-capital flows has increased.

legitimate part of the toolkit to manage capital inflows" (Ostry et al. 2010). However, this change in position is unlikely to result in a shift in international financial regulation, and will likely be translated into merely "another code of conduct" (Eichengreen 2011, 7).

One may assume that the lessons learned from the Great Recession would ignite willingness towards more international coordination in regulatory matters, considering how policymakers congratulated each other for cooperatively responding to the crisis (Helleiner 2012, 65). However, Helleiner states that the crisis exacerbated future efforts to regulate finance internationally, with the expectation of a "more decentralized regulatory order, [and] more autonomy to national and regional authorities" (ibid., 84). Since nation states assumed a stronger role in the course of the crisis, their different economic philosophies and views on financial regulation became more pronounced. Iversen and Soskice as well as Eichengreen agree with this outlook and argue that divergence between nations and between regions will remain and thus result in a deglobalization (Iversen and Soskice 2012; Eichengreen 2010). In view of this decentralizing impact of the Great Recession vis-à-vis financial regulation, capital flows and exchange rates will also continue to be regulated and managed at the national level (Eichengreen 2011, 2).

Aside from political will, the absence of transnationalized financial regulation are due to coordinative difficulties based on regulatory differences among national jurisdictions (Acharya et al. 2009, 365) and the high transaction costs inherent in changes of institutions and regulatory approaches (Busch 2009, 227). Also, there is no consensus about best practices, which has led some to characterize the situation as one without a model (ibid., 240).Supervisory structures of banking sectors have also remained diverse and nationally

peculiar. These findings counter the 1990s hypothesis of an automatic convergence mechanism that is inherent in globalization. Transnational organizations have not taken over the control of financial policy and nation states remain the source and enforcer of financial regulation and supervision.

V. Conclusions and Outlook

Robert Gilpin suggested that "interdependence is a phenomenon to be studied, not a ready-made set of conclusions" (2001, 18). This proves to be a wise observation, since the predictions surrounding globalization in the 1990s have not materialized. Nation states made deliberate choices to deregulate their financial systems and increase their common exposure. In the wake of a global financial crisis, they reversed this path.

In the absence of transnational coordination, nation states mitigated the crisis with unprecedented effectiveness and boldness. As nation states assumed a stronger role in the course of the crisis, their different economic philosophies and views on financial regulation became more pronounced as well. This will lead to more nationally oriented financial regulation and a deglobalization of finance. Such a changed self-understanding of states is likely to have an effect on other policy realms as well, which will exacerbate transnational and international coordination efforts. This shift has already led to stricter capital requirements and control of global financial institutions by states, as well as more regulated cross-capital flows. The dispute between the Federal Reserve and the EU Commission about U.S. plans to apply more stringent capital requirements on subsidiaries of large foreign banks is one of the first signs of this development (Financial Times 2013).

After the Great Depression, it took the "this time is different syndrome" about five decades to resurface. It remains to be seen how long the lessons of the Great Recession will last. The notion that nation states become helpless in the face of uncontrollable globalized financial forces will certainly remain a myth.

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