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Robert B. Packer

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CHAPTER I

Introduction

> Accustomed to presuming a state system predominantly composed of sovereign states authorized to address and cope with change, we are unlikely to inquire whether states have been weakened and their micro components strengthened, whether the nature of force, legitimacy, and authority relations has undergone meaningful redefinition, whether the state system continues to be the prime organizer of global politics, or whether another world has emerged alongside the state system as the basis for world order (Rosenau, 1990: 39-40).

In his volume *Turbulence in World Politics,* James Rosenau pointed out a number of dramatic changes in the parameters of contemporary global affairs. Most important is the observation that the capability of states and governments to provide satisfactory solutions to the major issues on their political agendas has been reduced. This occurrence is largely the result of the emergence of issues—such as the consequences of international financial integration—that are the direct products of new technologies or of the world's greater interdependence.

While most economists focus on the effects of integration on interest rate differentials (Feldstein and Horioka, 1980; Frankel, 1991; Marston, 1995), exchange rate stability and coordination (Williamson and Miller, 1987), and open economy macroeconomics (Dornbusch, 1980; 1993), scholars of international political economy in political science have focused on the effects of integration on the distribution of power between states (Keohane and Nye, 1977; Odell, 1982; Gowa, 1983) and among societal groups within states (Hawley, 1987; Frieden, 1991).

In this study, I hope to add to the literature concerning the distributional consequences of financial integration by focusing on the rise of non-state actors within a transformed international system. In it, I argue that structural change brought on by transnational production and post-industrialization has created space for non-state actors to acquire autonomy from sovereign entities. While finance is by no means the only specialized sector to achieve autonomy, it has perhaps the most immediate impact on the ability of governments to pursue policy. The ability of individual investors, pension and mutual fund managers, and foreign exchange traders to break the bounds of state direction has yielded "governmental disintermediation," as financial asset-holders remove their savings from state-regulated institutions when the direct purchase of financial claims issued by other states and non-state entities bring a higher rate of return. The ability of financial asset-holders to circumvent the political risk created by government policies is an example of what Rosenau would call a "conceptual jailbreak," in which the dominant state-centric paradigms of world politics must be challenged in order to address changed realities.

Financial asset-holders have a vested interest in maintaining and enhancing their autonomy *vis-à-vis* the state. Financial integration, in the form of both domestic regulatory reform in the financial services industry and liberalization of capital controls on transnational capital movements, grants financial asset-holders the autonomy they desire to maximize private returns. Because financial integration has transformed a formerly oligopsonistic market for financial capital to a more competitive one, governments must devise new approaches in order to induce finance capital to remain domiciled in the state.

But this sequence of events begs the following questions: Why did governments grant finance capital autonomy to begin with? And what is inhibiting governments from reimposing controls, rather than carrying out further regulatory reform and liberalization? To answer these questions requires that we address the structure of state-market relations, as well as investigate the role of finance capital's structural power in shaping governmental policy. That is, financial asset-holders are actors largely endogenous to the state political system. Because the role of government is that of intermediator among individual and group interests, the political process is one of conflict and resolution among competing resource allocation packages.

However, unlike most consumers for state services, finance asset-holders help to provide the resources that states use to distribute. Therefore, financial asset-holders are often in an enhanced position compared to other claimants to governmental services, particularly in market economies. While both states and markets allocate resources, resolving the problem of scarcity in a society, the allocative process is different. States acquire resources largely through confiscation, either from other societies via conquest or from those under its own authority through taxes and requisitions. States distribute resources based upon the political power (determined by demographic, economic, or military capabilities) of competing claimants on resources. Markets, by contrast, allocate resources based upon the independent decisions of individual producers and consumers acting in their own (perceived) best interests without central direction. To be sure, market decisions are not wholly voluntaristic, as certain market actors may possess the ability to extract rent from other actors.

Financial asset-holders have been able to establish themselves as major players on the international stage due to the advent (in actuality, the reemergence) of global (financial) capital mobility. Capital mobility refers to the capacity of capital to cross borders, rather than to actual flows of money. Put differently, capital mobility refers to the relative absence of friction on financial flows across borders (Andrews, 1994: 195). Actual flows of financial capital at any given moment are contingent on profit incentives, deriving from differential rates of expected return in different states. The political effects of capital mobility are distinguished from many traditional political issues by virtue of being transnational rather than purely national or local in scope. Because international financial integration is a phenomenon not wholly within their jurisdiction, governments are hard-pressed to develop policies in response to its domestic repercussions. Because domestic policies are increasingly intertwined with significant international components, the compliance of national citizenries can no longer be taken for granted.

The extent to which domestic policy choices are constrained by international market forces and the political leverage of international finance capital interests has been an issue addressed by scholars in international political economy (Polanyi, 1944; Hawley, 1987; Haggard and Kaufman, 1992; Cerny, 1993; Andrews, 1994). Economic shocks are often cited as a principal cause of major shifts in foreign and domestic economic policies. Innovation and diffusion, the twin motors of change in economic systems, do not occur without underlying conditions making their acceptance possible. Both occur as a result of the failure of existing policies, and the perceived need among actors for change. The Great Depression of the 1930s revealed the shortcomings of the economic policymaking of that time. Governments were eventually shaken from their policy inertia and embraced innovation. But I would argue that the Keynesian macroeconomic policies that were adopted reflected the tendencies toward greater centralization and management that had been under way since the adoption of Fordist mass production techniques in the early twentieth century, and greater government involvement in economic affairs (both in developmental and social policy) which had existed since the latter half of the nineteenth century.

International economic shocks—such as the end of fixed exchange rates, commodity price volatility, balance of payments disequilibria, and the rise of offshore equity and debt financing—changed the basic policy agenda once more during the late 1970s and 1980s, forcing some policy changes directly (e.g., the decline of Keynesian demand management), and generally enhancing the political power of finance capital interests. As in the 1930s shock, the changes that revealed themselves in the 1980s had a gestation period of at least three decades. The resurrection of the world economy after the Second World War, under American leadership, led to the longest period of sustained economic growth in modern history. American leadership and Keynesian demand management went hand in hand in creating for European and Japanese national economies a permissive environment for state-guided growth. Capital market segmentation and regulation, the Depression-era state response to perceived market failure, provided incentives for adventurous financial market operators to create sovereign-free offshore markets of exchange. As Western societies grew rich, Fordist mass production techniques gave way to niche manufacturing and consumer—as opposed to producer-guided products and services. Large industrial capital interests, the privileged beneficiaries of financial repression[1] and market segmentation[2], saw their profit margins squeezed by the beginning of the 1970s as productivity gains began to lag increases in labor cost (Marglin and Schor, 1990). The lower rates of return available in regulated domestic markets provided additional incentive for finance capital interests to demand greater freedom from sovereign entities. Increased capital mobility, both permitted and uncontrolled, was to have a major constraining impact on state macroeconomic policy.

According to Haggard and Kaufman (1992), there are three distinct ways in which international factors impinge on domestic policy choices. First, developments in international goods and capital markets determine the availability of external resources, which in turn sets important limits on the range of policy options. Second, policy is influenced by international linkages: the transnational social and political networks and coalitions that link domestic and international actors. Finally, states are constrained by leverage: the financial, political, and ideological power exercised by finance capital interests, both directly and through the structure of the broad "rules of the game" (Haggard and Kaufman, 1992: 10).

The integration of financial markets, through both domestic regulatory reform[3] and the removal of restrictions on capital mobility, reduced the resources available to governments to pursue state-led strategies and increased the leverage of financial capital interests and "internationalist" political forces at home. Over time, international financial and ideological pressures also had the more profound (though difficult to measure) effect of transforming the nature of the policy debate itself. This last impact, that of ideology is an important one for it goes to the under-researched notion of the structural power of finance capital—that is, the ability to financial capital interests not merely to make demands on political actors, but to set the parameters of debate on policy.

The actual leverage of finance capital interests is not grounded solely on the role of domestic politics; countervailing international factors also enhance influence. These include the "high" political interests of governments[4], the difficulties in orchestrating a transnational capital control regime, and a number of peculiar features associated with the nature of international financial markets that make enforcement of capital controls difficult. One reason for enhanced leverage of finance capital interests is that potential enforcers of a capital control regime—governments—have multiple and conflicting goals *vis-à-vis* finance capital. The concern to attract capital for growth purposes, leading to the liberalization of existing domestic regulatory frameworks, can easily override the interest in enforcing an international capital control regime. This, in turn, can undermine efforts to coordinate transnational capital flows and produce quite perverse incentives. Where governments are already committed to fiscal rectitude and current account surplus—such as Germany and Japan—additional finance may strengthen the national currency, though such an event was likely to occur anyway. When nonconditional resources are made available to deficit countries —such as the United States—finance allows the government to procrastinate, rather than pursue needed adjustment.[5]

The depiction of financial asset-holders in the 1960s and 1970s as actors in pursuit of escaping the bounds of sovereign-based entities (i.e., states) is an important one. In the study of world politics, states are accorded a privileged position among actors in the global arena. To be sure, states have resources—particularly military ones—that are unmatched by non-state actors. International law further codifies the position of sovereign-based actors through its many norms and conventions. If one accepts, however, the proposition that the sovereignty of actors may constrain as well as enhance their actions and effectiveness—in the sense that it imposes responsibilities and obligations which must be met in order to preserve their authority and which can thus divert resources and energy from the service of other goals—then it is not so great a leap of faith to accept the proposition that those actors who lack sovereignty may therefore be freer to exercise the full measure of their capabilities on behalf of goals. That is, while individual governments and the sovereign state system must operate with agendas open to a broad range of issues, non-state ("sovereign-free") actors with narrow agendas are receptive to only selected types of issues and can concentrate resources in pursuit of achieving goals. When the policy issue is considered complex and demanding of special information, policymakers are more likely to defer to epistemic communities of "issue authorities," particularly in times of great change and uncertainty. It is this asymmetry of attention and expertise attached to the issue of international financial integration by state and non-state actors that has simultaneously reduced state effectiveness and enhanced that of finance capital interests.

FINANCE AND GOVERNMENTS

The changed relationship between finance capital and state officials is most graphically illustrated by the difficulties faced by politically Left-oriented governments in carrying out their preferred policies of state intervention and income redistribution. Through the threat or actuality of capital flight and investment strikes, finance capital interests can have a decided influence over the policies of state officials. If free movement of financial capital is allowed, domestic interest rates are tied, via Eurocurrency markets, to the "world" rate of interest (Glyn, 1986: 37). Moreover, if the future of the exchange rate is in doubt, interest rates have to exceed world nominal rates by the discount on the forward rate, which will widen as confidence declines. This confidence factor is the mechanism by which the pressure of international finance capital is channelled against the implementation of policies that challenge prevailing financial orthodoxy. Harold Wilson, Labor party prime minister of Britain in the 1960s and 1970s, recorded how this pressure was exercised during his tenure in office:

> That night we had our most desperate meeting with the Governor of the Bank. Claiming that our failure to act in accordance with his advice had precipitated the crisis, he was now demanding all-round cuts in expenditure, regardless of social or even economic priorities, and fundamental changes in some of the Chancellor's economic announcements. . . . [W]e had now reached a situation where a newly-elected government with a mandate from the people was being told . . . by international speculators that the policies on which we had fought the election could not be implemented (Wilson, 1971: 37).

This situation is a far cry from that envisioned by John Maynard Keynes and the other founders of the Bretton Woods international monetary regime. Keynes, whose thinking was shaped by the Depression, wanted the new regime to allow state officials the freedom to pursue policies of demand management, which would have a countercyclical effect on national economies. Capital mobility, which allows financial market operators to ship funds out of a state whose government's policies they did not like, would frustrate demand management. The industrial countries, thus, emerged from the Second World War with controls on virtually all types of international transactions. Many currencies were not even convertible. In such cases, all currency transactions, including those involving international trade, had to be settled through special clearing facilities. In the two decades following the war, the industrial countries began to ease restrictions on the convertibility of currencies and to liberalize international trade in goods. It was only in the 1970s, however, that the liberalization of international capital flows became a major goal. Even then, many industrial countries continued to maintain controls on capital flows. At various times in the last two decades, firms found themselves paying widely differing rates for national and international loans even when the loans were in the same currency (Marston, 1995: 1).

With international financial integration and the enhanced power of financial asset-holders, the main aims of governments changed dramatically in the 1980s. Replacing the goal of full employment, the pursuit of redistribution, and expansion of public sector transfers, the main aims of most Western governments in 1980s were to curb inflation, improve competitiveness, and to spur economic growth (Fagerberg and Skarstein, 1990: 76). In pursuit of these goals, it was deemed necessary to reduce growth in public spending, to cut taxes for higher-income households and the business sector, and to deregulate markets, especially in the strongly regulated area of finance. The argument rested on New Classical[6] logic, with a strong emphasis on supply factors. Reduced growth in government spending was assumed to have a positive impact on inflation, while at the same time making tax cuts possible. Tax cuts, in turn, would increase the incentives for work and investment, and weaken claims for higher wages. These effects, together with greater efficiency allowed by market deregulation, would boost productivity and competitiveness and curb inflation.

The essence of New Classical policies towards the financial system was to repeal some direct regulations on private bank practices (such as interest rate ceilings on deposits and restrictions on lending in certain market segments), the elimination of the oligopolistic market in the securities brokerage industry (such as the end of fix commissions on trading), as well as the elimination of restrictions on transnational capital flows and private ownership of certain classes of financial assets.

GROWTH OF INTERNATIONAL FINANCIAL TRANSACTIONS

Since 1975, international financial capital flows have grown at phenomenal rates. Cross-border transactions between U.S. residents and others, for example, have risen from 4.2 percent of GDP in 1975 to 36.4 percent in 1985, to 92.1 percent in 1990, and 134.9 percent in 1993 (BIS, 1994: 175). In the case of Japan, the growth in cross-border flows is even more dramatic: from 1.5 percent of GDP in 1975 to 121.0 percent in 1990, before ebbing with the Tokyo stockmarket crash. In Germany, international portfolio transactions grew from 5.1 percent of GDP in 1975 to 54.9 percent in 1990 (the year of reunification), and 169.6 percent in 1993. In Britain, home of the largest offshore equity and bond markets, cross-border transactions reached 1,015.8 percent of GDP in 1991.

Despite these rapid increases in the size of transnational capital flows, however, the stock of cross-border holdings remain a small fraction of total assets outstanding. This is the conclusion of a study of international portfolio diversification conducted by French and Poterba (1991). They found that investors in each of the national home markets of the Group of Five (G-5)—the United States, Japan, Germany, France, and Britain—have a significant "home bias," which limits their investment in foreign markets to less than ten percent of their assets.[7] The domestic ownership shares of the world's five largest stock markets are: United States, 92.2 percent; Japan, 95.7 percent; United Kingdom, 92 percent; Germany, 79 percent; and France, 89.4 percent (French and Poterba, 1991: 222). In a different study, however, Tesar and Werner (1992) point out that estimates of portfolio holdings are unlikely to be completely accurate because they are based on benchmark surveys that in the case of the United States are over 40 years old. Even with this *caveat*, the initial conclusion they also reach is that, despite the growth in cross-border transactions, international diversification appears to be limited. So it remains to be seen how well integrated financial markets have become.

In addition to strict controls on capital flows, since the Depression official regulations and non-official market conventions had limited the degree of competition in most national financial markets. There existed in these markets both "market segmentation" and "financial repression." Market segmentation refers to the emplacement of "fire-walls" between providers of different types of financial services. Most famous is the American Glass-Steagal Act, which separates the activities of commercial banks (which accept deposits and make loans) from those of investment banks (which underwrite securities to finance new capital investments). Financial repression refers to interest rate ceilings on deposits and loans. Such ceilings had two uses: first, to discourage competition among depository institutions for customers; and second, to ensure market access to preferred borrowers. Since 1980, many national financial markets have undergone significant regulatory reform, commonly termed "deregulation." In some countries regulatory reform was initiated by explicit government programs, while in others deregulation was spurred on by competition from new financial instruments like certificates of deposits and commercial paper.

The liberalization of international capital flows also played a role in the regulatory reform process in national markets. Liberalization opened the national markets to the intense competitive pressures of the Eurocurrency markets and other international markets. Firms denied competitive pricing for loans at home could easily turn to Eurocurrency loans or to medium-term international bonds. Similarly, investors who were denied market rates of return at home could seek them in Eurocurrency deposits or other international instruments (Marston, 1995: 3).

By the end of the 1980s, it became generally accepted that international financial markets had become more open than at any time since the end of World War II—indeed, since the pre-1914 gold standard era. The post-Depression capital control regime had collapsed. Domestic financial markets were undergoing varying degrees of regulatory reform. Interest rates on many short-term national instruments became indistinguishable from those on Eurocurrency deposits and loans in the same currency. During the decade of the 1980s, secondary-trading values in the international equity market surged from less than $100 billion in 1980 to over $1.6 billion in 1989. According to Salomon Brothers, gross cross-border equity flows among the United States, Japan, Britain, and Europe totaled $776 billion in 1989 (Ziegler, 1990: 7).

Following extensive financial liberalization and market regulatory reform over the past decade or so, international capital movements have increased enormously and now dwarf transactions on current account. One indicator of the vastly increased scale of capital movements is that gross capital outflows from the main industrial countries (excluding official and short-term banking transactions) came to about $850 billion in 1993. Such flows averaged around $500 billion during the 1985-93 period as a whole, compared to only about $100 billion a year in the first half of the 1980s (BIS, 1994: 147). The freedom of financial market operators to transact international financial business, though not entirely unprecedented, has never been experienced to the present degree, even before the First World War (BIS, 1994: 147). Indeed, in some respects it is entirely novel, in that the whole pace and complexity of international capital transactions have been transformed by data-processing and communications technology, and by the financial innovation which that has facilitated.

The ramifications of liberalization and regulatory reform have spawned new systemic dangers in the increasingly integrated financial markets. Prior to the 1980s, interest rates in some key national markets remained regulated and shielded from international competition. The financial services industry has been revolutionized by competition in formerly segmented markets. It is important to realize how different markets today are from those of just a few years ago. Following the huge flows of international money are financial services firms that have been rebuilt to thrive upon volatility and risk (Ziegler, 1990: 28). As profit margins narrow, these firms have sought higher returns from trading on their own account, seeking to profit from short-term moves in interest rates and currencies. For traders, markets are most profitable when they are most volatile. As transactions costs come down, those with a vested interest in volatility can leap in and out of markets more easily. This process lies behind much of the great boom in the trading of securities during the 1980s. The task that lies ahead for sovereign state regulators is an unenviable one. It is to ensure that competition on a global scale does not endanger the capital-raising abilities of international capital markets.

PAST AS PRELUDE

In an integrated financial market, there should be no significant gap between national interest rates and Eurocurrency interest rates in the same currency. So it is possible to speak of the dollar financial market or the yen financial market as a unified whole without specifying whether financial instruments are national or international in origin. In such a world, relative financing costs are governed primarily by currency factors rather than by the peculiar characteristics of each national market (Marston, 1995: 3).

In recent years world capital markets have become more integrated than at any time since the pre-1914 gold standard period. Indeed a comparison with that period serves to bring certain aspects of recent experience into sharper focus. In a study directly comparing the integration of financial markets in the 1980s with those of the pre-1914 period, Zevin (1992) found the latter more integrated, based upon two key measures: the size of the net investment position and the percentage of foreign equities traded in major financial bourses. Zevin found that Britain's net foreign-investment position relative to GNP in 1913 was 153 percent.[8] Schwartz (1994: 152) noted that by 1913, for every £2 Britain had invested in its domestic economy it had £1 invested overseas. Zevin cited data provided by Morgenstern (1959), which revealed that 59 percent of shares traded in London in 1900 were of foreign origin, compared to 20 percent in 1987.

Zevin (1992), while claiming that the degree of international financial openness has yet to match that of the pre-1914 period, nevertheless admits to the increase in openness over the past two decades. The persistence of such sizable capital flows since the 1970s has resulted in a sharp rebound in the proportion of financial assets held by non-residents. According to one calculation, non-resident holdings now amount to around 20-25 percent of total outstanding government bonds in the Group of Ten countries other than Japan (BIS, 1994: 146). While the recent period of increased international capital mobility can be characterized as a return to historical norms there are three aspects of the contemporary liberalization effort, cited by the Bank for International Settlements, that set it apart from the pre-1914 period: the monetary and exchange-rate regime, the range of financial assets, and the role of institutional investors.

The first and perhaps biggest, difference is in that exchange rates are more flexible today than they were then. Unlike the fixed exchange-rate system of the gold standard, exchange rates today are set by market supply and demand conditions. Under conditions of capital mobility, states with financial assets offering higher-than-average real rates of return are likely to encounter large capital inflows, while states with financial assets offering lower-than-average real returns will encounter capital outflows. In current circumstances, the liberalization of capital flows has constrained the ability of national policymakers to peg the exchange rate to a fixed value, as the recent 1992-93 collapse of the European Union's exchange-rate mechanism (ERM) has shown. But more than exchange-rate stability is compromised by capital flows. The heavy capital flows of the pre-1914 period did not upset fixed exchange rates because there was much greater credibility in the gold standard commitment. Governments readily sacrificed other goals (e.g., full domestic employment) in order to maintain long-term payments balance. Because of policy credibility, only small interest rate differentials were required to finance current account imbalances:

highly interest-rate elastic capital flows thus supported the fixed exchange rate (BIS, 1994: 147). In such a situation, capital mobility helps to stabilize a fixed exchange rate regime as capital smoothly finance *ex ante* balance-of-payments imbalances.

The second difference from the pre-1914 period is the much wider range of financial assets that can be readily traded nowadays—in domestic as well as in international markets. Moreover, such assets (notably in different currencies) have yielded much more divergent real returns than during the gold standard period. Then, there was less of a need for the financial diversification and risk-hedging which lies behind the high turnover in modern securities markets. Total international securities transactions in the six Group of Seven countries that compile such data amounted to $6 trillion per quarter in the second half of 1993—about five to six times the value of international trade (BIS, 1994: 147). As a result, portfolio-related transactions in the foreign exchange market now dominate trade-related transactions. In the United States, Japan, and Britain this change had already occurred about a decade ago; in continental Europe, it has been more recent. This increased volume of portfolio capital movements has made foreign exchange markets much more sensitive to changes in sentiment in financial markets, an important factor behind the volatility in currency values.

A third difference is the much greater weight of institutional investors: insurance companies, mutual funds and pension funds. It was the diversification of institutional investors' portfolios that was a major driving force of capital flows in the 1980s. Institutional investors' holdings of foreign securities increased in Japan from eight percent in 1980 to 40 percent in 1990. In the United States, however, investment by residents in foreign securities remained relatively small, reaching only 15 percent of mutual and pension fund assets in 1993 (BIS, 1994: 147). But this figure represents a dramatic increase since the 1980s. Such holdings are sensitive to shifts of sentiment in international financial markets. As will be detailed later, enhanced capital mobility combined with flexible exchange rates to once more subject national economic policies—in particular attempts to maintain misaligned exchange rates or macroeconomic policies at variance with neoliberal precepts—to the sanction of finance capital interests. The Bretton Woods experiment with government-determined prices for financial assets has ended, and global neoliberalism has returned. The interaction of a changing international financial landscape with the distribution of