Globalization and autonomy: embedded liberalism in the post-financial crisis economic order

Globalização e autonomia: o liberalismo embutido na ordem pós-crise financeira e econômica

Diogo Ramos Coelho*

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The study of regime theory is familiar to any student of International Relations. Since the publication of a collection of articles in the 36th volume of the academic journal *International Organization* – in which distinguished specialists thoroughly explored the concept of international regimes –, almost every study on the subject quoted Stephen Krasner's definition: international regimes are implicit or explicit "principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations" (1982, p. 1).

Oran R. Young (1982, p. 277) also defined International Regimes as "social institutions governing the actions of those interested in specifiable activities." International regimes are possible to recognize not only by their descriptive account, but also by the "underlying principles of order and meaning that shape the manner of their formation and transformation" (Ruggie, 1982, p. 196).

Since those basic concepts were outlined, studies have multiplied to address how international regimes have been created or transformed in areas such as the economy, the environment and international security. In 1982, John Gerard Ruggie, a well-known International Relations scholar, wrote an article to analyze the formation and transformation of the international regimes on money and trade after World War II.[1] He introduced the term "embedded liberalism" to describe the underlying structure of the postwar economic order.

According to Ruggie, this order was constructed on a broad international consensus: intergovernmental collaboration and market integration were necessary to promote balance of payments equilibrium in a multilateral environment – but States should retain sufficient autonomy to pursue domestic economic stability, such as full employment policies. States should cooperate in devising and implementing international economic institutions. Nevertheless, governments also sought to maintain autonomy to pursue production strategies, employment policies and social welfare protection. Embedded liberalism thus signified a compromise between excessive free markets and excessive protectionism. It implied that the postwar economic order reflected a consensus upon core social values, ideas, and objectives – which, in turn, were reflected in the rules and decision-making procedures that were established to make such consensus work.

Ruggie's concept of embedded liberalism also implied concerns about the means by which this compromise could be, or has been, altered or jeopardized. He acknowledged the significance of power as a potential source of change, but stressed the "shared social purpose" as the more significant determinant. In the author's perspective, significant changes in the international macroeconomic order stems more from changing social ideas and ideology than from external economic dynamics and shifts in the international distribution of power. The concept of embedded liberalism challenged alternative explanations for the creation and sustaining of the international regimes on money

* Diplomat. Master in Diplomacy by the Rio Branco Institute – IRBR (diogo.coelho@me.com).

1 The article was also published in the 36th volume of the academic journal *International Organization*

and trade, particularly by those that emphasized the role of American leadership and power. For the author, there was a fundamental difference between changes in the principles and norms (normative framework) and changes in rules and procedures (instruments). In this sense, the normative framework of the monetary and trade regime would not necessarily be jeopardized by what many perceived to be the decline of American power after the Bretton Woods system collapsed in the early 1970s.

Ruggie suggested that, after the breakdown of the system of fixed exchange rates, many of the changes that have occurred in the regimes for money and trade have been norm-governed changes instead of reflecting radical transformations in the social purpose of those regimes. Yet there were huge debates about how the new international monetary and financial structures would restore the balance between market integration and national independence in macroeconomic policies. Such debates are still recurrent in international affairs. But they become more relevant for political leaders after severe economic crises, like the one that hit the U.S. and the world economy in 2008.

After the financial crisis, what have been the consequences for the embedded liberalism compromise and for the global economic governance? Is it possible now to track only changes in economic dynamics and shifts in the international distribution of power or also changing social ideas and ideologies?

The end of the postwar macroeconomic order

The postwar monetary system of fixed exchange rates, which lasted until the early 1970s, was designed to provide both domestic policy autonomy and international monetary stability (Rieden & Broz, 2001). The system was based on the following principles: fixed or pegged exchange rates along with sufficient flexibility to enable individual States to deal with extraordinary situations (including the pursuit of full employment policies). The member countries agreed to peg their currencies to the dollar – which, in turn, was pegged to the gold. The IMF was responsible for managing the system through approval of exchange rates adjustments and could also make its monetary reserves available to countries in economic trouble. The World Bank was also created to promote foreign investments.

Although this system functioned well for almost thirty years, in the early 1970s the increasing dollar's lost of value became a central issue in the world economy. The Vietnam War and the launching of the Great Society Program by the Johnson Administration (1963-1969) augmented the global rate of inflation and thus jeopardized the value of the dollar (Gilpin, 2001). In the following years, irregular American macroeconomic policies led to the devaluation of the dollar and to the subsequent collapse of the Bretton Woods agreements in 1971 – when the dollar became no longer pegged to the gold and currencies became free to float. The system had thus changed from one based on fixed exchange rates to one based on flexible rates.

The end of the Bretton Woods' monetary agreement changed the rules and decision-making procedures of the international regimes on money and trade – but did not modify their social purpose. The embedded liberalism compromise continued to prevail, but under a different structure. Rules and procedures had changed – but not principles. The balance between market integration and domestic autonomy had to be restored in a new equilibrium.

After the end of the Bretton Woods' fixed exchange rates system, the embedded liberalism compromise was adapted to a new framework. Globalization was in the making. On one hand, freeing financial markets facilitated reorganization and transformation of international business. It also increased international interdependence through capital mobility, trade flows, globally-integrated corporate ownership, and foreign investments. On the other, the integration of national capital markets made it possible for developing countries to borrow funds abroad to invest domestically and thus increase their governments' capabilities to promote growth. The floating exchange rate system also represented the triumph of the Central Banks as the main authorities of the international monetary regime.

The Bretton Woods rule-based international monetary system was politically replaced by an informal political agreement among the dominant economic powers (G-7). The new monetary structure was based on cooperative, and sometimes not so cooperative, efforts of central bankers and finance ministers to stabilize currency values. But the new equilibrium between free markets and national autonomy also proved to be unstable. The international financial revolution that promoted market integration was inherently unsteady and subject to serious crises. The volatility of capital flows and the debt problems of many less developed countries in the 1970s and early 1980s created many financial crises and macroeconomic imbalances – which shaped the dynamics that led to the financial crisis of 2007-2009.

The roots of the 2008 financial crisis

Any clear-cut explanation of the financial crisis of 2008 would be too simplistic. Nevertheless, it is possible to outline the major trends behind the events that led to the financial breakdown of 2008 – especially those accounting to global macroeconomic imbalances that were developed in the world economy since the 1970s.

My story of the crisis starts with a simple lesson of international macroeconomics: an international monetary regime must determine the method by which national economies will restore equilibrium (i.e., reduce a deficit or a surplus) in their international accounts (balance of payments). Every adjustment policy results in economic costs, and some methods of adjustment are considerably more costly for individual economies and for the overall world economy than are others. But the bottom line is simple: if some countries generate surplus, others must run huge deficits. With few exceptions, a deficit country cannot continue drawing down its reserves for very long, and eventually the debtor country must take measures to eliminate the cause of the imbalance – and pay its debt.

If debts are to exist, some sectors of a national economy must spend more than their incomes. This is intuitively obvious: if a collection of people spend more than their income on goods and services, they must be receiving loans or investments from elsewhere to finance the excess of their imports over their exports. This was the reality for many developing countries after the financial revolution of the 1970s. The emergence of an international financial market accelerated deregulation of domestic financial systems, removal of capital controls in a number of countries, and greatly increased size and velocity of global financial flows. It enabled developing countries to borrow funds for economic development – or, more specifically, to adjust their balance of payment deficits. But it made those countries vulnerable to external shocks and to sudden swings in investor's preferences.

The erratic behavior of global capital markets and the risky policies undertaken by governments of developing countries resulted in many financial crises: the Latin American debt crisis of the early 1980s; the Tequila Crisis, which started in Mexico in 1994-95 and spread elsewhere in Latin America; and, mostly important of all, the "rolling crisis" that started in Thailand in June 1997 and immediately spread to East Asia, and then to Russia and Brazil, in 1998 and 1999 (Wolf, 2010). What made these systemic crises so important were their long-term effects and a new adjustment in the emerging world growth model. After such crises, the developing economies effectively said "enough" and ever since, in the aggregate, have been running current account surplus and accumulating international reserves. "Export to grow" became the new rule.

In the 1990s, the plentiful surplus savings of the developing world – soon to be augmented by the surpluses of Germany and the oil-rich countries – was available to fund spending for someone else. According to Raghuran Rajan, professor of finance in the University of Chicago and former chief economist of the IMF, that "someone else" was corporations in industrial countries that were on an investment spree, especially in the areas of information technology and communications (Rajan, 2010). This boom in investment – now called the dot-com bubble – came to an end in the early 2000s, when these corporations scaled back dramatically on investment because of losses they endured after the bubble burst. As a result, the U.S. economy slowed and new incentives had to be created to stimulate an economic recovery.

Professor Rajan (2010, p. 5) stressed that the Federal Reserve (Fed) had to cut interest rates sharply to energize activities in sectors of the economy that were interest sensitive. According to him, as the corporations had invested too much during the dot-com bubble years, they had little incentive to do so again. Instead, the low interest rates prompted U.S. consumers to buy houses, which raised house prices and led to another surge of investments in the real estate market. The U.S. financial sector stepped in to create financial instruments that could bridge the gap between an overstimulated United States and the rest of the world. New credit was made available for the so-called subprime segments and consumption boomed. A new investment bubble was then created, but this time in the housing market. New housing construction and existing housing sales provided jobs and served as the necessary guarantee for new financial investments, especially for subprime mortgages. Rising house prices provided the capital to refinance old loans and to finance new consumption. Foreign countries also took their share in this euphoria. They could emerge from their economic slump by exporting to the apparently insatiable U.S. consumer, while also lending the United States the money to pay for those imports.

The rest of story is well-known: when the Fed raised interest rates and halted the house price rise, bad debt started to show, risky investments started to be priced again, and worries about funding leveraged institutions started to spread. The stage was set for panic, and in the end that was what hit, starting in the summer of 2007 and reaching its peak in the autumn of 2008, when three of the largest U.S. investment banks either went bankrupt (Lehman Brothers) or were sold at fire sale prices to other banks (Bear Stearns and Merrill Lynch).

Has the system failed?

What have been the consequences of such developments for the embedded liberalism compromise? First of all, it is important to acknowledge that such compromise has not been abandoned, of course. It is the balance between more market integration and more national autonomy that continues to shift – and now more drastically.

The age of financial liberalization was, in short, an age of crises. Freedom of capital movements has complicated, and some believe, reduced macroeconomic policy autonomy and the ability of individual governments to control their own economies. International financial flows have also become an important determinant of exchange rates and a cause of erratic movements in currency values. Many developing countries believed that they needed to restore more capital controls and shield themselves from external shocks through enormous reserve accumulations. They started to advocate regulatory mechanisms for international finance movements. Mostly important: they refused to allow substantial private capital inflows to shift them from their determination to run very large current account surpluses. But the development of international finance has also increased interdependence of trade, monetary, and others aspects of the international economy. The "export to grow" model chosen by many developing countries is not so autonomous, after all. They have become much dependent on consumption elsewhere.

Emerging economies, developed countries like Germany and Japan, oil-rich countries, they all created a very efficient export-oriented manufacturing sector. Government intervention and artificially competitive exchange rates have guaranteed the necessary support for their companies' success in foreign markets. But also in many of those countries, domestic-oriented sectors managed to limit external competition. As a result, low domestic demand from those exporting countries puts pressure on other countries to step up spending. According to Rajan (2010, p. 10), "because the exporters have excess goods to supply, countries like Spain, the United Kingdom, and the United States – which ignore growing household indebtedness and even actively encourage it – and countries like Greece – which lack the political will to control government populism and union demands – tend to get a long rope."

The financial crisis of 2008 revealed how fragile the world economic equilibrium was. Excess savings were only possible for some countries because others were running excessive spending. The crisis also affected what Martin Wolf, chief editor of *Financial Times*, has called "the deal": the post-second-world-war political/economic settlement which, in the United States, was centered on full employment and high individual consumption; and, in Europe, was centered on state-provided welfare.[21]

The financial crisis also affected the "export to grow" model that so successfully has been applied in developing countries. What is more: it affected the embedded liberalism compromise. On one hand, there's a call for the reduction of government intervention and for fiscal austerity in developed countries. On the other, many developing countries struggle to keep the export-led growth model intact. And such a battle has been taken to the governance of the world economy.

Changes in the global economic governance: from multilateralism to multipolarity in the G-20

After the financial collapse of 2008, a collective international effort was set to stimulate domestic demand and to constraint governments from resorting to protectionism and currency devaluations to alleviate a nation's economic difficulties at the expense of other countries. In November 2008, the leaders of the world's largest economies met in Washington and designated their group, the G-20, as the primary forum for global economic cooperation. The leaders of the G-20 imposed themselves the task to develop a coordinated fiscal and monetary stimulus in response to the crisis. It was crucial to include emerging economies in the discussions, since the G-7 leaders needed them to be part of the compromises that would be settled to address the financial crisis.

When the world economy had hit rock bottom after the financial crisis, there was an urgent need to inject demand into the world economy through fiscal and monetary stimulus. The G-20 meetings can rightfully be credited with having facilitated a more coordinated global fiscal expansion, with countries such as Japan and Germany, reluctant at first, joining the United States and China in what ended up as a simultaneous and strong worldwide expansionary fiscal and monetary policy (Bradford & Lim, 2011). The firsts meetings, held in Washington in November 2008 and London in April 2009, produced "an agreement on joint monetary and fiscal expansion, increased funding for the IMF, and set new rules for financial institutions" (Bremmer & Roubini, 2011). Those agreements came mainly because there was a shared feeling that the harsh effects of the crisis needed to be addressed immediately – and that no country was safe and sound from them.

The balance then looked to be leaning more towards markets integration. Governments seemed to be willing to cooperate, instead of resorting to claims for more autonomy in macroeconomic affairs. But as the economic recovery began, the sense of crisis abated in some countries. The Toronto summit, held in June 2010, highlighted the first tensions between the G-20 members. The agenda was filled with divisions among them, including a growing divide on the question of global or national economic regulation. The United States and Europe also could not agree on whether to focus on stimulus spending or deficit reduction strategies. Greece's sovereign debt crisis had forced Europeans to focus on deficit reduction as a way to ensure market confidence. The U.S. administration remained concerned about jobs and growth.

It didn't take long for other conflicts start to emerge. Ian Bremmer and Nouriel Roubini (2011) pointed out, in an article in *Foreign Affairs* magazine, that "conflicts over trade liberalization have recently pitted the United States, the European Union, Brazil, China, India, and other emerging economies against one another as each government looked to protect its own workers and industries, often at the expense of outsiders." Similar commercial conflicts have stalled the Doha negotiation talks. Before the G-20 summit in Seoul, a "currency war" broke out. The U.S. policy of monetary expansionism – also called "quantitative easing" – resulted in an outflow of dollars to emerging markets, causing currency appreciation in developing countries and thus harming their exports.[3] China was also

2 Available at: <http://www.ft.com/intl/cms/s/0/39c67712-8eb1-11df-8a67-00144feab49a.html#axzz1lkycGSWo>. Access on January 23, 2012.

3 Bremmer & Roubini, *A G-Zero World* (Foreign Affairs Magazine, vol. 90, n. 2).

manipulating the value of its currency to artificially devaluated levels to keep its "export to grow" model from damages.[4] Many countries deemed those practices "unfair" and even "clueless".[5]

Despite such conflicts, the emergence of the G-20 can be seen as a defining moment in the development of global governance towards looser and more informal cooperation frameworks (Jokela, 2011, p. 7-8). The group can be described as the main current guardian of the embedded liberalism compromise. And indeed it is.

The formation of the G20 and its achievements – governance reforms at the World Bank and the IMF; new global rules on banking supervision, known as Basel III; coordinated stimulus packages, and many others – suggest a real expansion of multilateral cooperation and political coordination among key actors. But several obstacles remain for a strong international compromise on macroeconomic adjustment. It was very easy to get politicians together in the face of a crisis and to get governments to ease on fiscal and monetary policies. The real difficulties emerge when countries need to undertake politically painful reforms that might even seem to be more oriented towards helping other countries in the short run at the expense of some domestic groups.

Those difficulties have been vast. According to Bremmer and Roubini (2011):

> Today, the United States lacks the resources to continue as the primary provider of global public goods. Europe is fully occupied for the moment with saving the eurozone. Japan is likewise tied down with complex political and economic problems at home. None of these powers' governments has the time, resources, or domestic political capital needed for a new bout of international heavy lifting. Meanwhile, there are no credible answers to transnational challenges without the direct involvement of emerging powers such as Brazil, China, and India. Yet these countries are far too focused on domestic development to welcome the burdens that come with new responsibilities abroad.

The outcome of this new cooperation agreement may be a multipolarity system without multilateralism, as the main powers and the newly empowered States go their own way – and as macroeconomic adjustment gets harder to achieve.

Conclusions

Ruggie asserted that the embedded liberalism compromise was a central feature of the postwar international regimes on money and trade. It continues to be. There has been no rupture within the ideational framework of such regimes. Rules and procedures (instruments) have changed, but principles and norms (normative framework) have not. Presumably, the new instruments that have emerged would be better adapted to the new power situation. Unfortunately, such new instruments have proven to be not enough to respond to the challenges imposed by global imbalances.

Working out the distribution of the costs of adjustment among deficit and surplus countries is at the heart of solving the adjustment problems. But we are very early at developing a functioning global economic order that can promote such outcome. The rules of the game are not clear at all. When does a macroeconomic policy of a country create global harm? As Professor Rajan (2010, p. 211) asked, "when the Fed cuts interest rates and thus sets off a global wave of risk taking, do countries elsewhere have the right to protest? Could the Fed not say it focused only on U.S. economic conditions, in accordance to its primary responsibility? When China imposes controls over capital flows and intervenes in exchange markets to keep its currency from appreciating, should it be considered an unfair competitive advantage?" In other words: how to impose sanctions on countries that rely on greater autonomy in

4 See note 3 above.

5 See note 3 above.

macroeconomic policies? How to balance then the equilibrium between market integration and national autonomy? How to manage the embedded liberalism compromise?

The birth of the G-20 reflected the emergence of a multipolar order as well as the recognition of increasing interdependence among developed and developing countries. Nevertheless, politics have always been a local business – and there's no constituency for the global economy. There are currently no great political ambitions to bolster the global economy by taking painful domestic reforms that would promote stability internationally. What still prevails is the embedded liberalism compromise – under a new structure, and threatened by new global imbalances.

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Abstract

In 1982, John Gerard Ruggie published a study of the international trade and monetary regimes in which he introduced the concept of "embedded liberalism". This article describes how the concept of embedded liberalism has been altered or jeopardized after the 2007-2009 financial crisis.

Resumo

Em 1982, John Gerard Ruggie publicou um estudo dos regimes monetário e comercial internacionais em que ele introduziu o conceito de "liberalismo embutido". Esse artigo descreve como o conceito de Ruggie tem sido alterado ou comprometido depois da crise financeira de 2007-2009.

Key words: Embedded liberalism; Financial crisis; Political economy.

Palavras-chave: Liberalismo embutido; Crise financeira; Economia política.

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