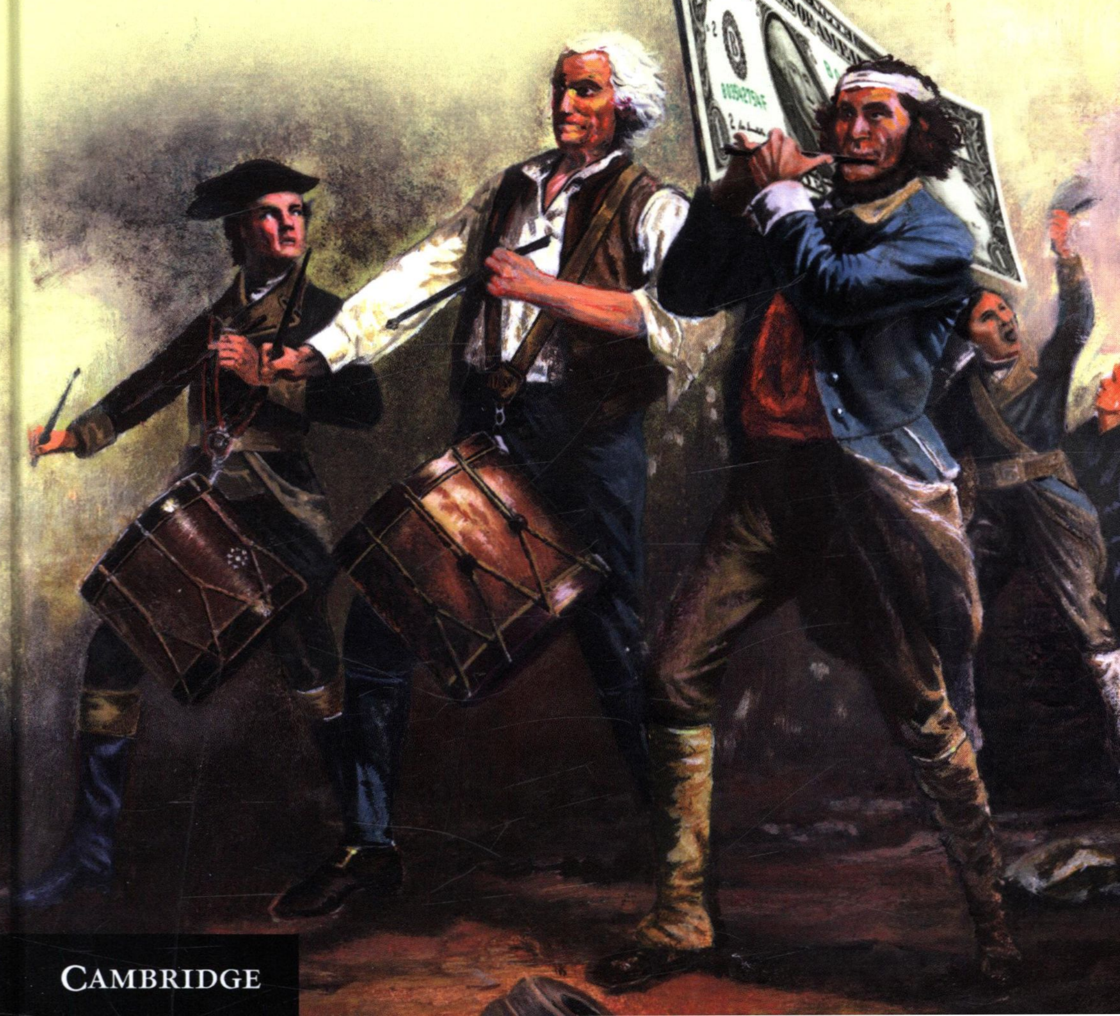
The Logic of Financial Nationalism

The Challenges of Cooperation and the Role of International Law

Federico Lupo-Pasini



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Using case studies ranging from cross-border bank resolution to sovereign debt, the author analyzes the role of international law in protecting financial sovereignty, and the risks for the global financial system posed by the lack of international cooperation. Despite the post-crisis reforms, the global financial system is still mainly based on a logic of financial nationalism. International financial law plays a major role in this regard as it still focuses more on the protection of national interests rather than the promotion of global objectives. This is an inefficient approach because it encourages bad domestic governance and reduces capital mobility. In this analysis, Lupo-Pasini discusses some of the alternatives (such as the European Banking Union, Regulatory Passports, and international financial courts), and offers a new vision for the role of international law in maintaining and fostering global financial stability. In doing so, he fills a void in the law and economics literature, and puts forward a solution to tackle the problems of international cooperation in finance based on the use of international law.

Federico Lupo-Pasini is a lecturer in international business and finance law at Queen's University Belfast School of Law. He studied at the World Trade Institute and the National University of Singapore, and previously worked at the University of New South Wales. He has been published in numerous journals in the field of international economic law, and he has served as a consultant on international finance and international trade law for the Asian Development Bank, the EU, and various governments in Asia.

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Using case studies ranging from cross-border bank resolution to sovereign debt, the author analyzes the role of international law in protecting financial sovereignty, and the risks for the global financial system posed by the lack of international cooperation. Despite the post-crisis reforms, the global financial system is still mainly based on a logic of financial nationalism. International financial law plays a major role in this regard as it still focuses more on the protection of national interests rather than the promotion of global objectives. This is an inefficient approach because it encourages bad domestic governance and reduces capital mobility. In this analysis, Lupo-Pasini discusses some of the alternatives (such as the European Banking Union, Regulatory Passports, and international financial courts), and offers a new vision for the role of international law in maintaining and fostering global financial stability. In doing so, he fills a void in the law and economics literature, and puts forward a solution to tackle the problems of international cooperation in finance based on the use of international law.

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Acknowledgments

This book is the result of my professional and academic journey into the fascinating field of international economic law. I started my career as an international trade policy advisor in South East Asia, and I have progressively switched my interests toward law and economics and financial regulation, which are now my main areas of research. The book reflects this trajectory as it combines my interest for the problems international finance, my appreciation for the analytical insights of economics, and a desire to investigate the political economy dynamics of international law.

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This book is partially based on my PhD dissertation, defended at the National University of Singapore in 2015. My deepest gratitude goes to my supervisor, Professor Jiangyu Wang, for his useful advices and the constant support throughout the entire PhD period. His suggestions and critiques were of fundamental importance for the development of the argument. I also appreciated the support of Professor Charles Adams, who acted as co-supervisor for the economic side during part of my PhD tenure, and

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Finally, I would like to dedicate this book to Thuy, my parents and family in Bergamo, for their love, dedication, and constant support.

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FINANCIAL INTEGRATION AND INSTABILITY

At the outset of the catastrophic East Asian financial crisis of 1997, Jagdish Bhagwati challenged, in a highly influential essay, the economic wisdom of free capital mobility at the core of the Washington Consensus' agenda for financial globalization.[1] As he succinctly pointed out in the title of his essay, trading in widgets and trading in dollars cannot be considered the same. While the benefits of the former have remained unchallenged for the last 200 years – supported by strong economic evidences – the virtues of the latter are questionable at best. From a purely historical viewpoint, it is difficult to challenge Bhagwati's view. The history of finance and the recurring financial crises unquestionably demonstrate that financial globalization exposes domestic economies to far more dangerous risks than free trade.

Eleven years later, indeed, the global financial system was embroiled in two even more destructive crises in the United States and Europe. Both events had major international repercussions and forced regulators and scholars to question once again how to reconcile the benefits of an integrated international financial market with the need to control its stability. As a lawyer, it is not my role to comment on whether financial globalization shall be maintained or dismantled in favor of a return to a situation of financial autarchy. I take financial globalization as a fact. For me, the question is how to manage it. In this regard, the discipline of law and economics offers very good insights on the power and limits of the law in addressing social problems. It shows how to use incentives and punishments to modify the behavior of individuals, companies, or states toward a desired outcome. It helps in understanding when and

[1] Jagdish Bhagwati, "The Capital Myth: The Difference between Trading in Widgets and Trading in Dollars," 77 *Foreign Affairs* 7 (1998).

to whom rights shall be allocated so that they can be used more efficiently. My contribution to the analysis of the difficult relationship between financial globalization and financial stability therefore looks at the role of international law in addressing the problem of global instability. It discusses whether the current international law of finance is actually efficient in reducing global spillovers and, if not, how it shall be changed.

Modern financial systems are structured as networks made by a constellation of diverse entities – banks, funds, traders, central banks, clearinghouses, and other intermediaries. The reason being that financial institutions are, for a variety of reasons, highly interdependent; they borrow, lend, and invest in various forms in each other. Their creditors too are subject to the same mood swings and, often, they influence each other. This means that a problem in one node of the financial network can easily transmit instability to others and therefore endanger the entire financial system; in financial jargon, we say that it can create *systemic risk*. Regulation plays a fundamental role in containing systemic risks.

In modern times, different solutions have been put forward to reduce the systemic impact of financial crises, from high capital requirements, to licensing rules, to concentration limits. Irrespective of their technical differences, these regulatory strategies rest on a common and simple principle – to participate in a common and interconnected financial system, financial institutions must internalize the social costs of their actions. The rationale behind this principle is to reduce the incentive that firms have in taking socially excessive risks, by imposing on them a price for participating in the financial system: a necessary sacrifice in terms of reduced freedom of action and potential earnings. I define this rationale as the *logic of externality*. The law plays a fundamental role in this regard, because by prohibiting financial market participants from engaging in risky (albeit lucrative) activities – such as the use of excessively high leverage – it can modify the behavior of individual financial institutions toward the socially optimal, and therefore minimize the risk of instability.

When we move to the role of international law in the international financial system, however, the music changes. From the great depression in the 1930s until a few decades ago, financial systems were predominantly national, with only limited cross-border interconnectedness between foreign financial intermediaries. In this situation, regulators largely developed their own national supervisory rules for financial institutions; they decided how to resolve them in the event of a crisis, and the level of protection accorded to depositors; and, crucially, they managed independently their monetary and macroeconomic policies. Since the 1970s, financial systems have progressively internationalized and become interdependent to the point that a problem in one country can now easily be transmitted across the global financial system and affect other states. The push for deeper integration was not, however, always accompanied by a parallel push for real international policy coordination. True, since the creation of the Basel Committee on Banking Supervision in 1974, regulators have increasingly engaged in regulatory cooperation through the various Transnational Regulatory Networks. Yet, in various circumstances, cooperation was not possible or did not lead to actual policy convergence. At times, cooperation failures actually increased global instability.

In an interconnected global financial system, one would expect international law to require states to take into account the global implications of their policies, and internalize the social costs of their actions. Surprisingly, however, the logic of externality does not fully apply to states. The very foundation of international law is based on the idea that states are sovereign in their territories. In principle, they do not need to answer to anyone for their policies, except their citizens. For instance, states can take up as much external debt as they want. They can, in principle, decide the rules that their banks will follow and how to restructure them.

More generally, states can decide their economic policies and legitimately refuse to coordinate them with other states. Even when states have agreed to reduce their sovereignty in favor of a more coordinated approach, they are, nonetheless, protected by various legal doctrines that have the ultimate goal of protecting the strict bond between the regulators and their citizens. For instance, most of the international rules on regulatory cooperation are in the form of soft laws. This means that, ultimately, states can renounce them at any time if they consider it necessary to protect their own political interests. Regulators cannot resort to international law to challenge another regulator's failure or refusal to cooperate, thus leaving the solution of regulatory disputes to pure power politics. In the few cases in which rules are binding, international law sometimes dispenses states with their obedience whenever doing so would impair an essential state interest. In sum, in the international law of finance what really matters is not the protection of social goals, but rather the safeguarding of national interests. In other words, in international finance, the logic of stability often gives way to its opposite: the *logic of financial nationalism*.

The goal of this book is to analyze the rationale underlying financial nationalism by looking at the economic and legal incentives that national regulators have to protect their own interests even when this is inefficient from a global perspective. In doing so, I will examine various policy areas, from bank supervision to derivatives regulation. I will show that financial nationalism is, ultimately, a very inefficient regulatory strategy in the long term. Over time, the interconnectedness between national financial systems has increased exponentially, and with it, the risk that wrong or otherwise socially suboptimal domestic policies in one country might impair the financial stability of others. This book argues that in an interconnected financial system, the protection of financial nationalism contributes to the creation of global systemic risk and, therefore, it is an unsustainable way to regulate global finance. It incentivizes states to adopt unsustainable domestic policies, and it transfers to the wrong side the costs of maintaining a stable global financial system.

This book also shows that, under the right circumstances, coordination is possible. The quest for a stable global financial system requires, however, a fundamental change in philosophy with regard to the way in which international law addresses financial stability. Addressing the moral hazard of nation states is no different from addressing that of individual financial institutions in a domestic financial system. In both instances, the law must force those subjects to internalize the costs of their actions and price correctly their participation into an integrated financial network. International financial law must therefore move from the logic of financial nationalism toward the logic of externality. What does that mean, precisely? In essence, an international law of externality focuses on addressing the social costs of stability policies, rather than simply enabling their adoption. On the one hand, the law must enable states to enjoy the benefits of market expansion, but on the other hand, it must also take into account the role of integration as a vehicle for global instability. Thus, it shall price adequately the externalities of economic sovereignty by making states wishing to participate in a truly integrating economic system responsible for the external effects of their domestic economic policies.

Most of the solutions proposed by the literature to the challenges of global financial stability focus either on a reduction in the level of financial integration, or on the entire dismantling of financial sovereignty in favor of a centralized international regulator. In contradistinction to these solutions, the strategy that I am proposing focuses on the role of (binding) international law and the correct attribution of rights and obligations among states, firms, and creditors. First, I argue that international agreements should increase the power of foreign stakeholders in driving international financial policymaking – for instance, by giving them rights and standing in international courts, similar to what international law does already in international trade or investment agreements. This should be complemented by the establishment of dispute settlement mechanisms to adjudicate or mediate financial disputes between regulators. Second, I propose to change the political economy bargain at the basis of financial integration in favor of a system that grants market access to foreign firms only when their home states agree to a binding code of conduct that