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Balancing Competition and Cooperation: The State's New Power in Crisis Management

Anke Hassel & Susanne Lütz

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Anke Hassel* & Susanne Lütz**

Abstract

In the aftermath of the financial crisis, governments in the western world resumed policy instruments from the immediate post-war period´s mixed economies. These instruments had all been abandoned in the liberalizing market economies of the last decades. How do we interpret these developments in the state's role in modern economies? Will we witness the return of the interventionist state or are these rather short-term measures rescuing globalized and liberal market economies? By focusing on the initial phase of crisis management between 2008 and 2010 we analyse the three most important policy tools used of the financial crisis: state ownership of banks, fiscal stimuli and the regulation of financial markets. We observe a new capacity of the nation-state to intervene, going beyond mere firefighting, but also falling short of the classic interventionist state. Under the conditions of global markets, state intervention is shaped by the logic of competition for protecting national industries and the logic of cooperation necessary to come to international agreements. For the future, we expect states will retain their newly found powers to protect national business in the global economy.

* **Hertie School of Governance, Berlin**
Address: Friedrichstrasse 180, Berlin, 10117, Germany
Email: hassel@hertie-school.org

** **Otto Suhr Institute for Political Science, Free University of Berlin**
Address: Ihnestr. 22, 14195 Berlin, Germany
Email: luetz@zedat.fu-berlin.de

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Balancing Competition and Cooperation: The State's New Power in Crisis Management

1. Introduction

As a result of the financial crisis, the state has received a new lease of life. Nationalization, fiscal stimuli, and regulations of the financial markets are policies associated with another era. They are more compatible with the Keynesian welfare state as it existed from the 1950s to 1970s, than with the market fundamentalism of the 1990s. Against the backdrop of the Great Depression, the experience of World War II and the Cold War rivalry with the Eastern Bloc, it seemed that economic stability could be best achieved with demand management, strong regulatory state intervention and governmental provision of important infrastructural services, including comprehensive social security. The concept of a 'mixed economy' (Shonfield 1984), in which the state and the market played equal roles, became the catchword of the first three postwar decades.

The winds shifted direction in the mid-1970s. All policy tools used in the mixed economy of the Keynesian welfare state were put to the test and found inadequate. Instead, privatization was thought to be the way to increase the productivity of state services. Demand management and demand-side policies were declared inflationary and replaced with supply-side economics. Restrictive monetary policy and financial markets were deregulated step by step. Together with the emerging countries and post-socialist transformation states, the Western industrial countries experienced a new thrust in economic growth under the new supply-oriented and liberalized economic model. That is, until the financial crisis hit.

Do government's answers to the financial crisis herald the coming of a new model in the state-market relationship? Does the pendulum once again swing in the other direction? Is the mixed economy of the Keynesian welfare state being rehabilitated? Several authors see the opportunity for the role of the state to become more active. In a financial crisis, the state potentially gains a new capacity to act, in that it nationalizes, regulates, and reasserts its power over the economy (Dullien et al. 2009). A similar position is by Anatole Kaletsky, who describes a new configuration between the market and the state analogous to the Golden Age that followed World War II. After the laissez-faire of the 1920s, the New Deal of the early post-war period and the market fundamentalism of the 1980s and 1990s, we are about to see the advent of Capitalism 4.0:

> Market fundamentalist assumptions are being replaced by a more pragmatic understanding of macroeconomics. Policymakers are rediscovering the use of monetary policy to manage employment as well as inflation, of public spending to create jobs, of tax incentives to encourage investment and currencies to promote export growth (Kaletsky 2010).

However, most of the voices discussing the consequences of the financial crisis for the state express far more skepticism. Many observers assume the state's new capacity to act is only due to the imperative need to save capitalism (Streeck 2010; Crouch 2009). Since the market itself cannot create the institutional foundations on which operates, it is necessary for the state to intervene time and again. It is argued that, in a crisis, governments attempt desperately to reestablish market conditions in order to restore free reign to the market and private market actors. The privatization of the economic order and polities is said to have already advanced so far that the state's primary function is to distribute the costs of finance capitalism among taxpayers and further privatize the profits. In other words, the state's new intervention directly serves private interests. This is – seemingly– reminiscent of the scope and abilities formerly ascribed to the Keynesian welfare state, though the effect is argued to be the opposite. Whereas the essence of the Keynesian welfare state was to act as the leveler among the various sectors of the population, in privatized Keynesianism (Crouch 2009), private consumption serves to re-stimulate the economy for the economic interests of proprietary classes.

In the following section we ask how the role of the state has changed in the wake of governmental reactions to the financial crisis in the initial phase between 2008 and 2010. Using the three principal avenues of intervention available to the state – nationalization, fiscal policy, and regulation – we examine the state's capability to act under the new conditions. We understand the capability to act as the capability to formulate, implement, and enforce political measures both within the state apparatus and, if necessary, against the interests of market actors. Although we are well aware the new government activities have been driven by the immediate necessity to act, we see signs indicating the adoption of a pragmatic approach toward interventionist policy tools that diminish the former ideologically colored reservations toward the state. In the course of the crisis, states have expanded their repertoire of instruments to manage the economy and, in this sense, gained 'strength'. A more pragmatic approach in the use of state instruments is shaped by two factors. First, by the imperative to safeguard investments and competitive conditions in the dominant economic sectors of national economies ('logic of competition') and second by the necessity to cooperate and coordinate actions with other governments when intervening on a major scale into the market ('logic of cooperation'). Both factors are a result of the particular kind of globalization that has emerged in the last three decades. We argue that the two factors, the logic of competition and the logic of cooperation, limit governmental action in the three areas being studied here – nationalization, fiscal policy, and regulation. In all, our argument states that new hindrances resulting from the increasingly global political economy are working against governments' attempts to manage the economy that exceeds the immediate rescue from the crisis.

2. The Debate about the State before the Crisis

Common to all more recent analyses of the state is the observation of a far-reaching change in the relationship between the market and the state in the last three decades. The fact itself is not contested, but rather its theoretical classification and evaluation (Grande 2008). Prior to the financial crisis, the German debate dwelt on the transformation from a democratically institutionalized interventionist state (Zürn et al. 2004) with clear functions and authority, to one assuming a new function with regard to society and the market. At the international level, the new state was described as the 'Schumpeterian Workfare State' (Jessop 2007), the 'Competition State' (Cerny 2000), or the 'Regulatory State' (Majone 1997); yet no common terminology for this new type of statehood gained a permanent foothold. Just as rare, were indications that the transformation of the state was complete or the relationship between state and market had arrived at a new equilibrium. At the point when the financial crisis occurred, the state's functions of economic regulation and responsibility were in flux.

Considerably more consensus and continuity exists concerning what had constituted the 'old' interventionist state. This interventionist state of the post-war period had many avenues to intervene. It regulated markets and production processes, created human capital, infrastructure, and public services, corrected the distribution of income and social risks, and stabilized the fiscal course of the economy (Leibfried and Pierson 1995, 454ff.). Its economic activity covered nearly 50 percent of the gross social product of developed countries.

Andrew Shonfield described postwar economies as 'mixed economies':

> A mixed economy is one in which prices and supplies of goods and services are largely determined by market processes. At the same time, the state and its agencies have a large capacity for economic intervention, which is used in an endeavor to secure objectives that the market would, it is believed, not achieve automatically or not fast enough to meet the requirements of public policy (1984, 3).

In his book Modern Capitalism – The changing balance of public and private power Shonfield maintains the state's role in 'mixed economies' exhibits the following five aspects (Shonfield 1965, 66-67): First, public authorities' influence on the management of economic systems is vastly increased. This operates differently among countries, in one country the control of the banking system is decisive; in another it is part of a wide sector of publicly controlled enterprises. Second, rising public funds are made available to spend on public welfare or on Keynesian demand management. Third, governments engage in the 'taming' of the market through public regulation and encouragement of long-range collaboration between firms. Fourth, economic policy includes an active industrial policy to promote research and development, and the training of workers. And finally, governments are open to long-range national planning, both inside government and in the private sector.

> The 'degree of mixedness' is not determined by the size of the public sector or the proportion of public expenditure to the national income. It is the function adopted by the state rather than its mass which

> counts. Governments and their agencies intervene either to accelerate a market process, or to delay it, or to bias the market in a certain direction by means of subsidies or taxes or by direct regulation. States attempt to reduce the losses of output and welfare which are caused by fluctuations in private business sentiment and activity (Shonfield 1984, 4).

Mixed economies became the leading economic-political model after World War II partly because of the experiences of the Great Depression and the macroeconomic theory of Keynesianism. They were facilitated politically by the electoral success of socialist and social democratic governments, which implemented instruments of planned economy and nationalized key industries (e.g., French steel industry, Swedish shipbuilding). They viewed planning and nationalization as means to protect and support key national industries in economically unstable times ('national champions' strategy). The growing concentration of business and the oligopolistic structures in sectors such as the chemical, electronic and steel industries favored 'mixed forums of coordination' on middle-range planning and the corporatist exchange with strong unions.

The OECD countries view of themselves as mixed economies ended with the advent of the oil crisis. Inflationary pressures could no longer be held in check by negotiated wage restraints. In the realm of economic theory, the insight became widely held that demand-side policies intensified the rise in prices, but had no effect on the production of goods or the national income. The state was classified as subsidiary and government action was said to be necessary only should markets fail completely. In short, all elements of mixed economies were discredited and successively discontinued.

In place of state ownership and to protect key national industries, there ensued the privatization and deregulation of sectors close to the state, aiming to produce profits through greater efficiency. The state pulled back from its role as provider. In many cases, this meant a renewed regulation of the sectors in which private companies were given specific access to formerly public utility companies.

Where the welfare state had once guaranteed social security, now private providers entered the area of social politics by introducing capital-covered pensions and health insurance. New welfare state philosophies proposed a greater individualization of risks, the privatization of certain aspects or even entire branches of social security, and the change from passive instruments of labor market policy to activating measures.

In fiscal policy, the predominant conviction became that a higher national income could be achieved primarily through structural reforms and improved conditions of supply. Instead of taming the market through regulation of competition and access, barriers in trade policy were dismantled and controls for the cross-border movement of capital were discontinued. It was thought that such simplification of cross-border investment would generate greater economic dynamics, which in turn would lead to a greater division of labor worldwide and to the opportunity for the specialization of national economies.

However, the forced retreat of the state was not uniform everywhere. For example, the share of public expenditures in the gross national product of most countries hardly dropped. In the twenty-five years prior to the financial crisis, the percentage of state expenditures in the gross national product in the OECD actually rose on average.[1] Despite the emphasis on supply-side economics, both private and public demand have tended to be sustained by public expenditures, tax breaks, increasing debt, and low interest rates. Even the privatization of public utility companies often did not mean a deregulation and decentralization of the market.

The transformation from a mixed economy to a selectively liberal market economy had far-reaching consequences for the function of the state. Even though the state continued to intervene during the phase of privatizing the mixed economy and used taxes, subsidies, and regulations to influence large areas of market activity, it no longer did this out of managerial interests. The state had lost any legitimacy as wanting to or being able to successfully manage the economy (Beckert 2009).

Externally, the nation-state lost sovereignty to the European Union, international economic institutions, and other regimes that hindered national measures to restrict markets. The European project was aimed at creating markets, an aim that was forced forward by the special competences of the EU in competition policy or by the prominent role of the European Court of Justice. The GATT regulations impeded national trade limitations and subsidies. Regulative measures to 'tame' market actors had to be passed at the transnational and supranational levels (e.g. the regulation of privatized sectors involving infrastructure, telecommunications and electricity; the regulation of the financial sector).

Internally, the state lost its capacity to impact market actors. Multi- and transnational enterprises used their exit options in order to avoid government policies that would increase their production costs. Under the conditions of open markets, Keynesian measures to stimulate demand did not seem practical, because they benefited foreign, instead of domestic, producers. In this respect, the maneuvering room for nation-states had already shrunk noticeably even before the financial crisis.

What has happened to the state in the financial crisis? At first glance it is evident the state has again assumed many roles and functions that Shonfield described as characteristic for the post-war model of the mixed economy: the state has pursued an enormous economic stabilization program with the help of expansive monetary and fiscal policies, has nationalized banks, and intends to extensively regulate banks and financial transactions. At the same time, government economic policy takes place in the new context of a global economy and liberalized markets. The mismatch between national political institutions and global markets shape the form and pattern of state intervention. There are two overriding concerns of national governments: First, the economic base of the national political economy as presented by domestic industries. Large domestic firms and industries are not only important employers and taxpayers, but also a highly organized political actor in the domestic arena. Governments have to protect the competitiveness of domestic industries vis-à-vis global competitors. In line with both neorealists (e.g. Drezner 2006) and advocates of liberal intergovernmentalism (e.g. Moravscik 1997) we assume that governments will prioritize measures that are in line with the preferences of dominant domestic industries and call this factor the 'logic of competition'. Secondly, national policy measures are often ineffective when dealing with transnational and global business activities. Isolated national regulation can be avoided by off-shoring and national stimuli might have effects abroad but not domestically. Therefore, there is a necessity to synchronize policy making with other states and international organizations in order to cope effectively with negative externalities. Following premises of liberal institutionalists (e.g. Krasner 1983) we call this requirement the 'logic of cooperation'.

The logic of competition and the logic of cooperation introduce contradictory elements in crisis management. National stimuli can protect domestic industries but at the same time be ineffective; similarly avoiding national regulation of financial services can protect domestic industries but not address global problems. On the other hand, international agreements on banking regulation can have detrimental effects on domestic industries. Government intervention therefore has to weigh up domestic economic preferences against long term stabilization of markets and effective regulation.

However, theoretically at least, the conflict between domestic preferences and international cooperation is not automatically decided in favour of domestic producers. Rather, domestic preferences shape the interaction and thereby close some policy-avenues. As participation in supranational policy-making increasingly becomes an end in itself for protecting domestic interests, governments can be expected to compromise in exchange with participation in decision-making.

The subsequent sections will provide an analysis on the state responses in financial crisis with a particular focus on the state's strategy with regard to the ownership of banks, fiscal policy and the regulatory policy of financial market with a focus on the period up to 2010. Based on three case studies, Germany, United Kingdom and the United states, the national strategies and implemented policy tools will be compared and evaluated. This will serve as an illustration of the two logics at play.

3. The State in the Financial Crisis (I): Rescue Operation, Nationalization, and Restructuring

The new 'strength' of the state is nowhere more evident than in bank bailouts, nationalization, and the conception of restructuring measures. According to calculations of the Bank for International Settlements (BIS), the volume of the financial sector rescue programs (consisting of capital injections to strengthen banks' capital bases, debt guarantees, purchases or guarantees of distressed or illiquid assets) in eleven Western industrial countries from September 2008 to July 2009 reached the unprecedented sum of 5,000 billion euro, of which capital injections and asset purchases or guarantees 'only' account for 451 billion euro. Measured in absolute contributions, the financial rescue package, including debt guarantees, of the United States reached an unmatched sum of 2,491 billion euro (= 22.3 % of GDP), followed by Great Britain with 845 billion euro (= 54% of GDP) and Germany with 700 billion euro (= 28.1% of GDP) (BIS 2009, 13). Because the need to coordinate action with other countries was relatively low in this area, the capacity of Western governments to act was comparably larger than in other areas, such as devising new measures of financial regulation. Moreover, in the beginning, questions concerning location competition did not yet influence governments' actions. Governments intervened rather spontaneously and often under a time pressure when faced with the threat of bank failures, which in turn might cause chain reactions that would destabilize the financial sector and dry up sources of credit for business.

By the time Josef Ackermann, CEO of the Deutsche Bank, called in March 2008 for concerted action between governments, banks, and federal reserve banks saying, 'I no longer believe in the market's self-healing power' (*Spiegelonline* 18 March 2008), the state had already frequently appeared on the scene: in June 2007, the German state-owned development bank KfW and the bank federations came to the aid of the IKB, a German bank lending to small and medium-sized companies, with funds amounting to 8 billion euro. The governments of the federal states of Saxony and North Rhine-Westphalia contributed to a million-euro package to shield their state banks Sachsen LB and WestLB from risks. In February 2008, the British mortgage bank Northern Rock was nationalized, making it the first British bank to become state owned since 1975. The British state thereby assumed nearly 100 billion pounds in loans, mortgages, and guarantees (The House of Commons, 2008)) A month later, in March 2008, the US Federal Reserve Bank issued an emergency loan amounting to 29 billion dollars to the investment bank Bear Stearns through the intervention of JP Morgan. Hedge funds, other banks, and investors had emptied their Bear Stearns accounts and denied it new credit out of fear of the bank's insolvency (Felton and Reinhart 2008, 188-193)

National unilateral action to save jeopardized banks was the predominant response at the start of the crisis – a response, characterized by the motto 'each should put his own house in order' according to the then German Minister of Trade and Industry Michael Glos, confirmed at the G7 summit in September 2008 (on the general argument, see also Hodson and Quaglia 2009; *FAZ* 23 September 2008). In the subsequent course of managing the crisis, countries reacted to one another with regard to the set-up of rescue operations. Many modeled their efforts on the rescue packages designed by the United States and Great Britain (see also Quaglia 2009 on the pioneering role of Great Britain in Europe), because they had not only the largest, but also the hardest hit financial markets. The British 'Brown Plan' and the American rescue package of October 2008, each amounting to about 500 billion euro, consisted of capital injections, debt guarantees, and government investment/ownership in banks – measures that were duplicated to varying degrees in countries like Sweden, Denmark, Iceland and Benelux countries in the fall of 2008. By the time the EU finance ministers agreed to raise the legal deposit insurance from 20,000 to 50,000 euro, to support banks relevant to the entire system, and to put a time limit on the rescue operations, there already existed a patchwork rug of national measures and bailout packages. Germany in particular had rejected French demands for the establishment of a

European rescue fund amounting to 300 billion euro, out of the fear it would become the main payer for all other countries (*Handelsblatt* 25 October 2008).

Even though the national rescue packages were neither conceived, nor primarily implemented with competition over investments in mind, the consequences of state help on competition in the financial sectors of other countries were indeed discussed. The EU Commission was also critical of any possibility that the bailouts could subsidize competition. Following considerable criticism by the member states, especially Sweden and France, of the slow pace with which billions of aid were being allocated, the Commission began to harmonize, step by step, the aid schemes for government capital injections into the banking sector. They then demanded higher interest payments from needy banks than from basically healthy banks, for whom the financial injections were only used to spur bank lending (*Handelsblatt* 9 December 2008).

The aim of the rescue packages was to re-establish trust among the banks in order to revive inter-bank trade and ensure the flow of credit to businesses. To implement the bank bailout, new institutions were created, namely: the Federal Agency for Financial Market Stabilization (Bundesanstalt für Finanzmarktstabilisierung, FMSA) in Germany in October 2008, the Public Investment Corporation in the United States in March 2009, and the UK Financial Investments Ltd in Great Britain in November 2009. The respective governments provided the seed money for these institutions, which were usually institutionally bound to their respective finance ministry, though their legal structures varied. The manner in which these funds were allocated reflects the different aims and traditions of each country: whereas the American government bailed out the banks with financial support, so that these firms would buy up beleaguered competitors and the domestic banking sector would be stabilized through mergers, the French rescue plan revealed traditions of industrial policy and investment control (*FAZ* 1 November 2008). In October 2008, the six largest French financial institutions drew 10.5 billion euro from the government's rescue funds under considerable pressure from the French government. The capital injection was granted under the condition that the volume of credit to enterprises, communities, and consumers would be increased (Xiao 2009)

The German rescue package differs from those of the United States, Great Britain and France, particularly with regard to the matter of the voluntary or obligatory acceptance of aid, as well as the willingness of the government to bail out faltering banks on the condition of receiving bank stock. In the United States, Great Britain and France, governments exerted sometimes soft and other times massive pressure to ensure that public funds were accepted by the largest bank in each country, because it was considered the most relevant to the health of the financial sector. To guard against credit risks, banks in Great Britain were required by the government to prove they had raised their core capital ratio to 9 percent; otherwise they were forced to accept government help ((IMF 2011,54, -). The United States and Great Britain actively expanded state ownership of suffering banks by purchasing non-voting preferred shares, with the view that future profits from dividend payments would eventually flow back into the state treasury and thereby to taxpayers (Tigges 2008). The Financial Market Stabilization Fund set up in Germany in October 2008, with a value of 400 billion euro, offered state aid on a voluntary basis. In principle, the money was available to every bank, not just those relevant to the entire financial system, with the aim to avoid any possible 'distortion to competition'. State investment followed in the form of non-participating shareholding, instead of share acquisition, in which the state retained a say regarding dividend payments, managerial salaries, and the business policies of the banks in question. In the public discussion, concerns about the legality of the growing state ownership in the banking sector were expressed at a point when the major financial institutions were already partly nationalized in the United States, Great Britain and the Netherlands. German banks were hesitant to take advantage of government help, and largely requested state guarantees instead of injections of capital from the rescue funds. Following the rescue of *Länder* banks, the Commerzbank was the first private big bank to apply for state funds in the form of non-participating shareholding (until January 2009 to a sum of 18.2 bn. euro), while Deutsche Bank's CEO Ackermann said "I would be ashamed if we were to take state money during this crisis" (Dempsey 2008). Germany found the issue of nationalization a more difficult one than did other countries and it was not until bankruptcy threatened the Munich real-estate financer HypoRealEstate (HRE) that the government was prepared to ignore regulatory concerns. By October 2008, it was clear that the HRE could only be saved from immediate insolvency if it was guaranteed 35 billion euro from the federal government and a loan of 15 billion euro from another financial institution. In early 2009, the nationalization of those financial institutions deemed relevant to the entire financial system seemed inevitable in view of further bank losses on their investments in the American real estate market. When the investor J. C. Flowers refused to sell his HRE shares to the federal government, the government saw itself forced to create a legal basis for expropriation. With the passage of the Financial Market Stabilization Extension Act (*Finanzmarktstabilisierungs-Ergänzungsgesetz*) by the Bundestag in the spring of 2009, expropriations with compensation were only possible in regulatory law if the stability of the financial sector could be ensured in this manner. The federal government can, in such cases, also become the majority shareholder even against the will of the of the shareholders convention (IMF 2011, 12)). Starting in mid-2009, the question of restructuring faltering banks moved into the spotlight of international debate. The discussion was sparked by the question whether, from the view of the taxpayer, it would be desirable to save precisely those banks that were said to be 'too big to fail' and whether the government, by assuming private risks, did not provide banks with new incentives to undertake moral hazards. In the meantime, the opinion in many countries was to allow banks or other enterprises to go bankrupt on the condition that the risks involved are shared by market actors and the state. An institutional innovation introduced in many countries was that of 'bad banks'. Banks transfer 'toxic' equities and thereby purge their portfolios of non-performing loans. In Germany, the passage of the 'Financial Market Stabilization Continuation Act' (*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung*) in July 2009 laid the groundwork for the establishment of bad banks. The HRE was the first German bank to avail itself of this new institution. (Kröger 2010).

In connection with the possible threat of bank insolvency, many countries are witnessing an increased willingness to grant the state far-reaching powers to intervene in the property rights of financial institutions during a crisis. In November 2010, the German parliament accepted the 'Restructuring Act' (*Restrukturierungsgesetz*) that gives financial authorities the right in an emergency to close a bank, sell and transfer parts of the bank 'too big to fail' to a state 'bridge bank' (*Brückenbank*) and to liquidate parts with greater risk exposure. The cost is to be carried by a restructuring fund that is financed by an obligatory 'bank levy', the sum of which is determined by the size of the bank and the riskiness of the types of business it does. The new fund will be managed by the 'Financial Market Stabilization Agency' (*Finanzmarktstabilisierungsanstalt* (FMSA), which also oversees the bad banks. (Kißler 2010; Bundesfinanzministerium 2010). Both in the United States and in Canada banking regulators expect the nation's largest financial firms to draw up 'living wills' showing how they would be dismantled in a crisis without the need for a government bailout. The new Dodd- Frank law gives US federal regulators new power to seize and break up faltering mega-firms that pose a threat to the stability of the entire financial system (McGrane and Zibel 2011). Through these measures the state has expanded its repertoire of actions available when dealing with the banking sector.

4. The State in the Financial Crisis (II): Fiscal Stimuli and Budget Policy

Following the immediate action to combat the financial crisis, fiscal policy became the second area in which the state intervened in the economy on a massive scale. The threat of banks folding reduced the flow of credit to private firms, unnerved the market players and led directly to drops in private demand. The governments of the OECD countries reacted to this primarily with fiscal programs designed to hold overall steady demand. These measures came in the form of tax breaks, subsidies for employees and companies, investment programs and the strengthening of automatic stabilizers. In monetary policy, the central banks stimulated the overall economic demand by increasing the amount of money in circulation and lowering prime interest rates.

Compared with the guarantees made by the state to save the banks, the fiscal programs put into place were modest: the German stimulus plans I and II totaled about 60 billion euro, representing less than 10 percent of the funds used to bail out the banking sector. The German FMSA had 480 billion euro compared with the barely 60 billion euro that made up the fiscal stimulus packages I and II. According to estimates included in the joint fiscal analysis and prognosis by leading German economic research institutes, the sum of all fiscal policy measures for 2009 totaled about 1.3 percent of gross domestic product (GDP) and 1.8 percent in 2010 (Roos 2009, 400).

In the area of fiscal policy, the United States also stands out ahead, both in absolute and relative terms. In 2008, the US Congress passed a fiscal stimulus program amounting to 100 billion euro. Immediately following his election, US President Obama issued the American Recovery and Reinvestment Act, which contained fiscal policy measures worth more than 600 billion euro, (*Spiegelonline* 10 February 2009) followed by another 100 billion euro stimulus program in the fall of 2010 (*Financial Times* 8 September 2010). Great Britain, however, implemented a stimulus package equaling 1.9 percent of its GDP, which places it behind the German package of 3.2 percent of GDP. Germany's contribution also puts it in the middle field among OECD countries.

The importance of fiscal policy measures is indeed controversial. Although there was consensus concerning the necessity of initial measures to stabilize demand, today the debate in nearly all countries foreshadows budget consolidation.[2] In light of the fact that national debt is skyrocketing to levels previously reached only during military conflict and is projected to reach thoroughly unprecedented levels in the future, the leeway open to governments to stimulate demand is limited by the negative effects of potential over-indebtedness. It is estimated that the debt level of most OECD countries has risen by a third in the course of the financial crisis and, on average, already equals 100 percent of the GDP (ECB 2010, *Financial Times* 23 September 2009). The commitments of the German federal government to save the banks and the expenditures for the fiscal stimulus program, when combined, equal just about 30 percent of the German national debt, which stands currently at 1.7 trillion euro. The latitude to act available to the state is primarily determined by the pull between stimulating demand and the conditions to refinance, specifically, the necessity to consolidate the budget.[3]

Beyond this fundamental debate over stimulation versus consolidation, it becomes evident in fiscal policy how the state's new role is influenced by competition over investments and the necessity to cooperate. Both directly linked to one another. Since the about-face in economic policy by the Mitterrand government in 1982, it has been apparent that fiscal programs cannot be limited to national economies, in a world where the economy is global (Hall 1986). Whether governments increase overall demand directly via state spending or indirectly through tax breaks or tax bonuses, both can lead to a demand for products from abroad and thereby stimulate production in other countries. Thus, fiscal programs to overcome global recessions have a free rider problem. Small open economies profit from fiscal policy measures less than large economies and therefore have a smaller interest in fiscal stimuli. Since fiscal programs should be both fast and large, according to the consensus among economists (Roos 2009), there is a need to coordinate fiscal policy particularly among smaller countries, so that the impact of the measures will be a great as possible. Thus, cooperation is not a condition for the implementation of fiscal policy measures, but certainly a factor influencing their effectiveness.

Additionally, national governments are tempted to support the competitive advantage of their own economies through various other measures in order to use the crisis to better position their competitive sectors on the world markets. As a result, tensions arise for governments between the need to coordinate efforts in fiscal policy and the hesitancy to pursue a fiscal policy that benefits their trade partners.

These limitations are visible in the reactions of governments to the financial crisis. The Bush administration reacted to the looming recession in February 2008 by issuing consumer bonuses totaling 75 billion euro (Politi 2008). The British government presented a 20 billion pound fiscal stimulus package on

25 November 2008 (Bertrand, Hall, and Pickard 2008) and Presidential candidate Obama called in the fall of 2008 for a fiscal stimulus program of over 500 billion euro. The economic performance of both countries was immediately affected by the crash of the financial sector. Since the imminent recession was a global one, the British and American governments assumed the effects of stimulation would be all the greater with the number of countries that followed their lead.

However, the view outside the financial centers was a different one. The German economy was hit by the crisis relatively late. The economic prognoses still remained optimistic until the fall of 2008. The German Council of Economic Experts had forecast a growth of 1.8 percent for 2008 and stagnation for 2009 (SVR 2008). This supported Finance Minister Steinbrück's conclusion that the crisis was an American problem. If no economic crisis hit Germany, no German fiscal stimulus program would be necessary. However, in the final quarter of 2008, the German economy began to shrink. In early 2009, first exports and then the economic output of producing industries dropped massively. Thus, it became clear the recession had reached Germany by way of the sudden collapse in demand from abroad. In 2009, the German economy shrunk more than that of the Anglo-Saxon countries, which were considered the perpetrators of the crisis. Despite the warnings from other countries and the international calls for action, the German federal government had only acted the moment the crisis reached German soil. From then on, the government passed two fiscal stimulus packages, the first on 5 November 2008 for 11.8 billion euro and the second on 27 January 2009 for nearly 50 billion euro.

At the same time, fiscal policy was also conducted as industrial policy. Unlike the liberal Anglo-Saxon countries, the German manufacturing sector is based on specifically qualified skilled workers. The drop in business in the manufacturing industries would have led to massive layoffs, but these could be avoided by extending and broadening the short-time allowance (at a cost of 6 billion euro). In addition to tax relief, increases in current transfer payments, numerous write-offs, state investment and special measures were enacted to support the automobile industry: car tax was lowered and the scrapping premium created a direct demand for new, if not exclusively German-produced, cars. The scrapping premium was so popular that its total budget was expanded in April 2009 from 1.5 to 5 billion euro (Deggerich et al. 2009). In July 2009, a similar yet smaller scrapping premium, 'Cash for Clunkers' was introduced in the United States with the aim of supporting the American automobile industry (Economic Report of the President 2010, 54).

More extensive consumption-oriented measures, such as consumer bonuses or the reduction of the value-added tax for a limited period, found no advocates in rather consumption-weak Germany. However, in Great Britain, it is estimated that the reduction of the value-added tax had an impact, gauged by additional turnover in the retail business, totaling more than 2 billion pounds. In Germany, relief measures were geared a far greater degree toward the need and interests of the manufacturing industries and their employees.

Immediately following the passage of the German stimulus package, the federal government once again hit the brakes. In preparation for the G20 summit held in London in early April 2009, the United States advocated additional coordinated fiscal programs and was backed by the British government. In the Financial Times, Obama's chief economic advisor, Larry Summers, called for a continued worldwide stimulation of the economy (Freeland and Luce 2009). His call was answered with a clear refusal by Europeans at the EU summit in late March 2009 (*Spiegelonlin*e 9 March 2009). Governments could not agree on a common course of action at the global or

European level. At the Pittsburg summit in September 2009, the G20 nations agreed to the following statement:

> We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a cooperative and coordinated way, maintaining our commitment to fiscal responsibility (Wolf 2010).

However, since the middle of 2009 the debate has increasingly shifted away from the topic of stimulation to that of consolidation. In the statement issued at the G20 summit in Toronto, governments committed themselves to cut their deficits by half by 2013 and to reduce, or at least stabilize, the debt share of their national incomes by 2016.

The change of government in Great Britain in May 2010 led to the implementation of a radical austerity program, which prescribed cutbacks of 25 percent until 2014 in most ministerial portfolios (Giles and Pimlott 2010). In Germany, the grand coalition resorted as early as May 2009 to the 'debt brake' as an institutional mechanism to avoid further debt. In this context, the German federal government announced in the summer of 2010 its plan to implement a comprehensive austerity package equaling 80 billion euro, in light of robust export figures and unexpectedly high growth rates (Theodoropoulou and Watt 2011, 15).

In the United States the focus remained on fiscal stimulation until the mid-term elections in November 2010, which was mainly due to the persisting poor economic performance. Since then, pressure towards budget consolidation has been on the top of the political agenda. In spring 2011, the government had to find political support for the decision to raise the debt ceiling of 14.3 trillion US dollar. The negotiations laid open deep and intensified political and ideological conflicts over the size of government and fiscal policy (Calmes 2011).

It thus becomes clear, like fiscal stimuli, budget consolidation policy is subject to free rider problems. The process of reducing debt burden in one country affects other countries' economies. Moreover, in the Eurozone there is the added factor that in the past, economically weak and indebted countries have profited from the solvency of competitive regions. In order to distribute the burden of consolidation on all shoulders, more efforts towards cooperation are expected.

5. The State in the Financial Crisis (III): Financial Regulation

The financial sector was not unregulated terrain before the financial crisis. With the breakdown of the Bretton Woods system and the globalization of the finance business in the 1980s, however, a type of dialectic process took place involving market development, bank collapse or regional crises (e.g., debt crisis in Latin America in the 1980s, the Asian crisis of 1998/99), and subsequent re-regulation. The crises came about not the least because banks exploited loopholes in the regulatory net (sometimes with the quiet toleration of politics). Countries reacted by pursing multilateral cooperation to expand the range of risk-limiting regulation and thereby deprive banks of ways to escape regulatory constraints. Hence, compared with the fields of rescue operations or fiscal stimuli, states exhibited a substantial amount of intergovernmental collaboration in financial regulation since the mid-1970s. After the bankruptcy of the Herstatt Bank and the closure of the Franklin National Bank in 1974, institutions and instruments of finance market regulation at the national, European and global levels were expanded after every major financial crisis (for a historical overview, see Lütz 2009). Even before the current crisis, the ability of nation-states to regulate financial markets was determined chiefly by the need to coordinate regulatory standards with other states. Matters involving regulation had always broadened out beyond the banking sector to include securities and insurance businesses, as well as, issues concerning international payment transactions, accounting standards and corporate governance.

Prior to the current crisis, finance market regulation was discussed in an international, institutionally fragmented, yet exclusive, network made up of international organizations (IMF, World Bank), nation-state representatives (G7 finance ministers, regulatory authorities, central bank governors) and an increasing number of international peak organizations and actors who 'interface' between the national, European and global levels (e.g. Financial Stability Forum, FSF) (see also Helleiner and Pagliari 2010). The regulations developing out of this network were primarily of a 'soft law' character, meaning that their effectiveness depended on the transposition into national or European law. Simultaneously – and this highlights a key dilemma in this area – the international negotiations on security standards always expressed policy preferences regarding the protection of national firms. Every government sought to avoid strengthening regulatory constraints that would put its own national finance sector at a disadvantage in international competition. As a result, the standards agreed upon reflect a consensus based on the 'smallest common denominator' and often represent the success of national or international bank lobbying (e.g., the G30 or the Institute of International Finance (IIF). Therefore it is not surprising to find that in the last ten to fifteen years regulatory tasks have increasingly been delegated to private market actors – visible in the regulation of derivatives, hedge funds, rating agencies, accounting standards and especially the setting of capital adequacy standards for banks (Basel II). Regulatory jurisdiction has been turned over to private bodies (e.g. accounting) and regulation has occurred through nonbinding 'codes of best practices' (hedge funds, derivatives, rating agencies). Also the content of regulation (such as the calculation of and safeguarding against credit risk) were defined by the banks and the supervision left essentially to market mechanisms (Basel II). All in all, it is the concurrency of cooperation logic and location logic that definitively limits the ability of each individual nation-state to take action in this area. As will be shown, this has not changed in the current financial crisis. Two trends characterize current regulation activity: first, the content of regulation is being expanded and combined with public jurisdiction in areas that were previously regulated privately or not at all; second, the institutional architecture of financial oversight is being strengthened, which is the manifestation of a new regulation philosophy and is associated with the reorganization of the regulatory structure.

Since the fall of 2008, the progress in regulating financial markets has been essentially determined by the decisions reached at G20 summits, which have replaced the G7 summits as the platform for international cooperation (Alexandroff and Kirton 2010). The network of states and domain experts, which had previously focused on the circle of Western industrial countries, has been broadened during the course of dealing with the crisis to include the 'emerging markets' (especially China, India, and Brazil, BRIC). This development reflects the changed power relations within the global economy. Basic guidelines for regulating financial markets are now decided at G20 summits; the translation of these guidelines into specific technical formulations is then delegated to expert panels (such as the Basel Committee on Banking Supervision, also expanded to include representatives from emerging markets), the International Organization of Securities Commissions (IOSCO) as the international association of organizations regulating securities, and especially the Financial Stability Board (FSB, previously known as the Financial Stability Forum) as a body at the interface of oversight agencies and international organizations. At the first crisis summit in November 2008, the G20 pledged to continue to open capital markets and trade relations; though, it was also stated that the group aimed to ensure the regulation of 'every market, every market participant and every financial product". As far as the details of the reform proposals are concerned, the G20 at first pursued a 'roadmap' worked out by the FSB, based on the work of other regulatory bodies. The main topics on the list of sixty recommended actions were the regulation of derivatives, hedge funds, rating agencies, and especially the reform of capital adequacy standards for banks (Basel II) with the goal to increase fundamentally the capital cushion and to protect capital by basing it less on market and risks and thereby making it procyclical (Helleiner and Pagliari 2009, 7-8).

Before the financial crisis, derivatives were considered in the United States to be financial innovations that expressed the securitization of financial relations, made the relations between lenders and borrowers tradable in obligatory law, and thereby dispersed risk among many market actors. The lack of transparency surrounding complexly intermingled products with unclear risks and unknown implications for other market actors was underscored over the course of the crisis. In the United States, the regulation of the derivative business became one of the first topics tackled by the Obama administration in May 2009. The United States and the EU decided to subject the trade in derivatives to government oversight (performed in the EU by the new European Securities and Market Authority, ESMA) and to move the so-called 'over-the-counter' (OTC) business back to organized markets like stock exchanges and registered trading platforms. A type of clearinghouse is to act as a 'counterparty' and thus as a mediator between buyers and sellers (Helleiner and Pagliari 2010; Grant 2010).

Proposals put forth by Germany, France and the EU Commission on the regulation of hedge funds had been rejected by the United States and Great Britain, the key centers of this financial business. Now there is growing discussion on the systemic character and the procyclical-leaning, crisis-enhancing effect of the hedge fund business. In the meantime, it has been decided in the United States and the EU to regulate this field in the sense of registering and publicizing business information, a task for which supervisory bodies are responsible. However, conflict arose between Great Britain, the United States and the rest of the EU over the use of the EU 'Alternative Investment Fund Managers Directive' (AIFM), which member states agreed upon in the spring of 2010 against the wishes of Great Britain. Hedge funds originating in third countries are only allowed to do business in the EU if they have an 'EU passport' that requires them to uphold European regulations. This is interpreted by the United States as a potentially protectionist measure that represents a de facto market ban for American funds (Peel 2010).

With regard to the regulation of rating agencies, the United States proves to be much more hesitant than the EU, probably because the leading agencies worldwide have the bulk of their business in the United States. The EU was determined to regulate in 2009; in the wake of the imminent bankruptcy of Greece and the role that ratings of Greek government bonds were thought to play in heating up the crisis, further steps were taken in June 2010. It was planned to subordinate rating agencies to the supervision of the new institution ESMA, which has more responsibilities than registration alone. Additionally, this regulatory authority should have the power to issue monetary penalties, demand business records and conduct interrogations (Kafsack 2010a).

The so-called Basel Capital Adequacy Standard represents one of the most important regulations to contain financial risks. Since the 1980s, the standard has been the focus of negotiations among central bank governors and regulators in the Basel Committee, which is affiliated with the Bank for International Settlements (BIS). The Basel II standard, valid prior to the crisis, allows banks to calculate risks and the amount of capital they must place in reserve on the basis of their own models of calculation or ratings. In addition, Basel II was not implemented by American investment banks. Criticism of the standard arose fairly quickly and charged that it was procyclical in nature and that the equity ratio of the standard was too low overall (Porter 2010, 64-65). In September 2010, the Basel Committee agreed on the new Basel III standard, which was ratified by the member countries of the G20 in Seoul in November 2010. According to this standard, the minimum requirement for common equity will be raised considerably and will be further expanded by the introduction of new capital buffers. The common equity should only be made up of shares and retained earnings, while the non-participating shareholding so important in Germany, or public funds, will become less important for securing against risk (BIS 2010). It is not surprising that Germany views these rules as disadvantageous for its own banking system and opposed them to the very end. It was decided to grant a long transition phase (until 2019) to give banks the chance to cover their capital needs (*Handelsblatt* 7 September 2010; Frühauf 2010; Enrich and Paletta 2010). In contrast, no consensus exists at the G20 level on the issues of introducing a financial market transaction tax and a bank levy, neither of which could be implemented due to the resistance of Canada and the BRIC countries, among others (Beattie 2010). Even though the international community is still far from attaining the goal of creating a security net without loopholes, there are indications that regulatory progress is being made in many key issues, due primarily to the change in preferences expressed by the United States and Great Britain.

As was the case in earlier crises, the expansion of the architecture of financial institutions is part of the crisis management. Once again, the United States and Great Britain have assumed a pioneering function. The reorganization of regulatory responsibilities is highly influenced by a new philosophy of regulation, which no longer places the job of securing against risk solely at the microlevel of each individual bank but seeks to scrutinize more closely the interactions between various market sectors and financial institutions, and, in turn, the system risks ('macro-prudential regulation'). This is linked to the expansion and transfer of supervisory functions to the central banks and to the establishment of new coordinating bodies to deal with systemic risks at the European level (European Systemic Risk Board, ESRB) and at the global level (transformation of the Financial Stability Forum into the Financial Stability Board, FSB). In June 2010, Great Britain transferred not only the oversight of systemic financial risks to the Bank of England, but also the responsibility for the regulation of the City of London (*Handelsblatt* 23 June 2010).

In the United States, the job of regulating systemic risks was given to the Financial Stability Oversight Council (FSOC), which was created by the Dodd-Franck Act of July 2010 and is made up of representatives from the most important regulatory bodies and located and chaired by the Treasury Department. In addition to concerns over systemic risks, consumer protection issues moved to the center of finance market regulations. Both the United States and Great Britain have established new consumer protection agencies that assume some of the tasks of the previous banking authority, or like the American Consumer Financial Protection Bureau, deal specifically with controlling the mortgage markets. Institutionally, new ground is being broken in the United States because the new authorities are not subordinate to an independent regulatory agency like the SEC or to the Executive branch, but answer instead to the US Federal Reserve Bank (Wallison 2010). In Germany, the introduction of a new consumer protection agency is not officially being discussed; however, demands by consumer organizations for the right to appeal to the financial regulatory authorities, and by investor associations for the creation of a '*FinanzTÜV*' (government-issued certification) for all financial products shows the increased importance of investor protection after the crisis. In sum, much speaks for the emergence of a new trend to separate supervision and control over the behavior of market actors (conduct regulation) from the classic oversight over financial institutions and their risk portfolios (prudential regulation) (Masters and Parker 2010).

At the European level it is becoming evident that a supranationalization of regulatory responsibilities over the financial markets is taking hold, as was long and repeatedly rejected especially by Germany and Great Britain. In September 2010, EU member states agreed to set up three European regulatory agencies, one for banks (EBA), one for securities and stock exchanges (ESMA) and one for insurances (EIOPA). These build on the three existing European expert committees and commenced their work in January 2011. The new agencies are not to replace national oversight, but they do have the right to intervene in conflicts between national bodies, directly enact standards for credit institutions and markets and ban risky financial products. In cooperation with the European Systemic Risk Board (ESRB), that represents the ECB and the presidents of the twenty-seven national central banks, the new regulatory agencies are to set up an 'early warning system' for systemic dangers (Kafsack 2010b). Though the process of institution building is certainly incomplete, the number of new regulatory responsibilities indicates, of all institutions involved, the central banks are clearly the winners of the crisis. At least on the national level, their importance has increased at the cost of the disempowerment of pre-existing banking regulatory bodies. They had to relinquish some responsibilities to the European level and some to the new consumer protection authorities, making these regulatory bodies the apparent losers of the crisis. The one certain winner is expert bureaucracy as a whole.

6. The State in Global Capitalism

The rescue of capitalism in the financial crisis has placed the state once again at the hub of economic policy management. In the Western industrial countries, the state demonstrated power and the ability to act. Governments passed legislation, sometimes using fast-track procedures that had extraordinary consequences for their national budgets, intervened in the property rights of banks and other firms and completely reorganized financial regulations. The acceleration of decision making processes was usually accompanied by a strengthening of the executive branch of government. In all Western industrial countries, new institutions (regulatory authorities, bank-rescue and restructuring funds) were established and the bureaucracy involved in regulating financial markets was expanded during the course of the crisis. It remains to be seen whether the strengthening of the state apparatus will continue to reinforce the top-heaviness of the decision making process favoring executive branch of government, as was evident in the crisis management, or whether, over time, this will once again give way to established modes of politics and policy.

An important finding of our analysis is that Germany, found it exceptionally difficult to recognize the necessity of economic policy action in the crisis. The United States and Great Britain were more willing to intervene faster and deeper into the market and property rights of investors and enterprises. The deeply rooted tradition of ordo-liberalism in German ministerial bureaucracy (evident in the hesitation of the state to invest in failing banks or in the voluntary acceptance of rescue funds) as well as a restrictive fiscal and monetary policy could hardly be reconciled with the intervention in the market economy necessary in the crisis.

By opening the toolbox and applying the 'mixed economy' tools found inside– namely, nationalization, fiscal policy and market-limiting regulation – nation-states today have expanded their repertoire of management tools compared to the period of market liberalization. Ideological taboos were broken and dogmas seemingly fortified by academically backed economics were weakened. The necessity of government oversight and management in essential economic areas is once again no longer questioned. The state after the financial crisis is no longer the same as it was before the crisis. However, the conditions framing government action today are fundamentally different from those existing in the heyday of the mixed economy. In all of the policy fields we examined, there was a close relationship between the logic of competition and the logic of cooperation. Nation-states in global capitalism are subjected to overwhelming constraints. Their interventions in the economy influence the investment decisions of firms and thus the competitiveness of their own economies. At the same time, many measures can no longer be implemented by a single government; instead, regulations and stimulus programs are dependent on the decisions made in other countries. As a result, economic and regulative interdependence are the essential conditions of government action. Precisely because the economic interdependence of government action is limited, it is possible the state will retain the recently obtained tools as means to implement economic policy.

[1] Data from the OECD shows the share of government expenditure in most countries has stagnated, but not that it has been reduced to any great degree (Schäfer 2009).

[2] High debt levels prevent the effective implementation of fiscal policy instruments, or more specifically, they increase future costs. The uncertainties over the creditworthiness of governments then replace the uncertainty over the liquidity of banks on the part of market players. There is a danger that the long-term interest for government bonds will rise if private investors judge the risk of insolvency to be greater. In particular, the assumption of economists pertaining to the expected growth rates of the developing countries and the trust of investors in the budget policy of the OECD countries determine the various positions. Financial Times, IMF Warns on Global Recovery, 8 July 2010. See also Reinhardt and Rogoff (2010) and Blanchard et al. (2010).

[3] On the discussion about the impact of over-indebtedness on limiting the state's ability to act for the United States, see Hacker and Pierson (2006), and for Germany, Streeck (2010) and Streeck and Mertens (2010).

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Houghton Street
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