The Political Economy of Global Financial Crises

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Reader's guide

The world economy today reflects an experiment involving, on the one hand, the opening and deepening of financial markets and, on the other hand, the dispersion of the political authority required to ensure the stability of those markets. The resulting governance dilemmas are nowhere clearer than in the circumstances surrounding financial crises capable of spilling more readily across national borders. In recent decades, most such crises began in emerging-market countries. In the summer of 2008, however, the experiment encountered its biggest shock when policy mistakes in the United States combined with an economic downturn to spawn a global emergency. This chapter explores the political economy of crisis prevention, management, and resolution in an increasingly decentralized system.

Introduction

Promoting interdependence among the economies of the world was a key strategic objective of the United States and its main allies after 1945. During the 1970s, the logic of interdependence...
was extended from real economies, where tangible goods are produced, to markets for capital and financial services (Helleiner, Chapter 7 in this volume, and Helleiner 1994). From that point on, crises in financial markets began to spill more readily across national borders.

The collapse of the Bretton Woods exchange rate system in the early 1970s occurred in tandem with a broadening movement toward more open financial markets around the world. In fact, financial innovation and policy change had been gradually undermining the kinds of capital controls many countries put in place during the 1930s and especially during the Second World War. Although economists still argue over the precise effects this movement had on the efficiency of real economies, its most obvious negative effect was to make it easier for intermittent financial shocks to spread misery beyond the localities where they originated. Not wanting to repeat the worst experiences of the pre-1914 era, when depressions and instability were common, but also not wanting to bear the costs of wartime controls, policy-makers in the leading states in the system engaged in simultaneously competitive and co-operative efforts to enhance both efficiency and safety in more open and interdependent markets. In other words, they sought the benefits widely associated with freedom for capital flows, while also seeking ways to limit the risks thereby incurred. A policy experiment with deregulation at the national level went hand in hand with collective efforts to liberalize financial conditions globally while encouraging prudent risk-taking by banks and other financial intermediaries. With those institutions and their clients ever more able to diversify their balance sheets internationally, and with countries across the industrial and developing worlds becoming ever more dependent on the success of the modern experiment with openness, financial crises came to demand statecraft of the highest order.

As they did during the pre-1914 era of financial market openness, financial panics recurred with some regularity after the 1970s, and they now spread rapidly across both functional and geographic borders. Markets that once again were more integrated across national boundaries exhibited the behaviour of a manic depressive. Periods of ecstatic euphoria were almost routinely followed by periods of black despair. Financial assets much in demand one day, that is, 'liquid' or easy to sell, suddenly attracted no buyers. The political consequences would be profound and would no longer easily be kept within national boundaries.

In the late 1990s, this is precisely what occurred as panic spread from stock to bond to banking markets in East Asia, and then to their counterparts in Russia, Latin America, and eventually to Wall Street. Ten years later, the same syndrome recurred, but this time it originated in American housing markets. The building blocks of the post-1945 system themselves seemed threatened as bankers and investors around the world simultaneously lost the confidence necessary to make long-term investments. Looming over economic policy-makers in the United States and elsewhere was the spectre of the terrible decade spanning the US stock market collapse in 1929 and the start of the Second World War in 1939, when economic depression brought widespread unemployment and political extremism in its wake.

Notwithstanding the post-1945 movement toward freer international capital flows, the desire to avoid a repeat of the 1930s prompted governments throughout the world to reinforce their vital national payments systems by extending implicit or explicit guarantees to banks at the core of those systems. It also focused their attention on the linkages connecting those systems to one another. Still, especially after the multilateral commitment to pegged exchange rates was finally abandoned in 1973, one cross-border crisis followed another, prompting one of the world's leading financial speculators to offer a startling diagnosis: 'Financial markets are inherently unstable; left to their own devices, they are liable to break down. More importantly, many social values are not properly represented by market forces' (Soros 1997b; see also Soros 1997a, 1998). A
former chief economist of the World Bank took the criticism further,

"While money should be flowing from the rich to the poor and risk from the poor to the rich, the global financial system is accomplishing neither. With poor countries left to bear the brunt of risk, crises have become a way of life—with more than a hundred crises in the last three decades."

(Stiglitz 2006: 246)

Even more fundamental questions about the wisdom of financial liberalization followed the crisis that began in 2007. Most remarkably, Alan Greenspan, a strong promoter of free markets who had recently retired as the head of the American central bank, conceded his 'state of shocked disbelief' that a system that for forty years had been 'working exceptionally well' came very close to collapsing (Greenspan 2008). In fact, such observations simply revived a long line of thinking inspired by the pioneering insights of John Maynard Keynes (Minsky 1986; Skidelsky 2009).

The preceding chapter set out the broad context for understanding the changing monetary dimension of our contemporary global economy. This chapter looks in depth at the political economy of recurring financial crises therein. For students of international relations and international economics, such moments in time are worth considerable attention. They open a unique window on the fragile political structures and networks that underpin globalizing markets. Those markets seem to promise prosperity and peaceful interaction among the world's still distinctive societies, but they quite obviously cannot and do not in themselves ensure such outcomes. In this regard, the early chapters of the book drew attention to the importance of collaboration among the political authorities leading that system. International financial crises demonstrate both the continuing importance of such collaboration and the profound difficulty of achieving it with a degree of certainty.

National Politics and International Markets

Financial markets exist to support the development of 'real' economies. The prices of most financial assets and liabilities continuously fluctuate. Every such price signal is meaningful to someone, somewhere. But rapid and severe fluctuations in the value of financial claims can disrupt the fundamental mechanisms through which jobs are created or destroyed and goods and services are actually produced. In the democratic systems currently lying at the heart of an integrating global economy, financial market ups and downs are typically quite constructive. When they promote growth and innovation, they stabilize underlying social and political orders, even though their specific political effects can be difficult to predict (see Hiscox, Chapter 4 in this volume). Economic resources are surely distributed and redistributed as financial prices move, but the process usually occurs in such a way that no particular group or groups with overwhelming political power become aggrieved enough to seek fundamental systemic change. In this regard, it is also worth noting that, with the exception of wartime, highly controlled financial markets tend to be associated with authoritarian governments and official corruption. Not always, but very often, this 'repression' of financial markets correlates with deepening poverty. The challenge then for those seeking to maximize the economic, social, and political benefits of financial liberalization is to find ways to limit the scope of
market instability and more fairly to share residual burdens.

Extreme instability in financial markets is socially destructive. In modern history, it is associated with man-made disasters of the first order. In fact, from the 1870s until today, the global economy has grown rapidly and consistently, except during periods characterized by financial crises and subsequent wars. On a world scale, the only significant downturns in real economic growth occurred after the financial panic of 1907, during the First World War, between 1929 and 1931, and during the Second World War (IMF 2009d: 129). Crisis conditions can engender and generalize inflation or deflation, both of which can bring spiralling declines in disposable incomes and life prospects. When panic imposes costs deemed unbearable by the politically weak, the local effects can be traumatic for all concerned. But when it brings in its wake general contractions in real economies and imposes costs deemed unbearable by the politically strong and mobilized, it can rapidly destabilize social and political orders (see Box 8.1).

**Box 8.1 The Policy Challenges of Financial Openness: The Case of Argentina**

Blessed with abundant natural resources, diversified industries, and a well-educated labour force, Argentina might have become a regional beacon of prosperity during the twentieth century. It was not to be. After decades of troubles, hyperinflation struck in 1989. In April 1991, the government embarked upon a bold policy experiment to reverse the economy’s course. The Convertibility Plan rigidly pegged the value of the peso to the US dollar and thereby constrained the ability of the central bank to print money. Simultaneously, the government announced a wide range of structural reforms to make the economy more flexible, competitive, and open. Initially, the plan achieved dramatic results. Inflation fell, international capital flowed in, and the economy grew by an average of 6 per cent through 1997. Late in 1998, however, a surprisingly severe recession began, and its effects were compounded by the unusual turbulence in global financial markets. As capital inflows dried up, some observers say the government did not react quickly enough with domestic policy adjustments. Others point to large loans from the IMF inadequately conditioned on such adjustments, and to a currency devaluation by Brazil that undercut Argentina’s export competitiveness. Still others blame the Asia-focused panic then gripping private foreign lenders and investors. In any event, bank runs, the suspension of IMF loans, and severe political and social unrest ensued. In December 2001, the country began defaulting on its international debts; the next month it abandoned its currency peg, and as the peso’s value plummeted, the value of its debt, now largely denominated in US dollars, exploded. In 2002, the economy contracted by 20 per cent and unemployment exceeded 20 per cent of the workforce.

In retrospect, it became clear that either the currency regime should have been abandoned during more halcyon days in 1996 or 1997 or that its continuation should have been supported by tighter fiscal policies, a reduction in international borrowing, and lower labour costs. At the time, neither course of action gained any political traction. Even so, according to a key IMF staffer, in 1998 “a crisis might have been avoided with good luck”—for example, had the dollar depreciated against the euro, had Brazil not been forced to devalue, or had international capital markets not deteriorated—but Argentina’s luck ran out (Alien 2003: 131; Blustein 2005).

By 2004, a distinct lack of solidarity among Argentina’s external creditors provided the policy space necessary to rekindle some domestic production. The government then took several desperate measures to stay afloat, including borrowing from Venezuela at very high interest rates and nationalizing state pension funds. Early in 2010, it engaged in a tense political struggle with its own central bank over the use of the bank’s foreign currency reserves and with recalcitrant foreign creditors who refused to accede to an IMF-sponsored plan to restructure its debts. Shut out of international capital markets for over a decade, Argentina remained a symbol of lost opportunities.
In contrast, the globalizing political economy gradually and intentionally built up after 1945 rested on the assumption of a widening circle of shared prosperity. International economic interdependence formed a core element in the strategy of systemic stabilization and development designed mainly by the United States and the United Kingdom. The central idea of a more secure world based on open-market principles was not new, but its realist architects this time tried to limit the extent to which the strategy depended on a deregulated banking industry. Certainly, they could not forget the disappointed hopes of liberals like Norman Angell, whom in the halcyon days before 1914 had famously opined:

"Commercial interdependence, which is the special mark of banking as it is the mark of no other profession or trade in quite the same degree... is surely doing a great deal to demonstrate that morality after all is not founded upon self-sacrifice, but enlightened self-interest... And such a clearer understanding is bound to improve, not merely the relationship of one group to another, but the relationship of all men to other men, to create a consciousness which must make for more efficient human co-operation, a better human society.

(Keegan 1998: 12)

Alas, the interdependence of bankers did nothing to prevent the coming war and may even have made its sequel more likely by discouraging decisive early action against fascism (Kirshner 2007). The architects of the post-1945 system did not entirely discount the strategic value of commercial liberalism, but they excluded financial activity that was not trade-related by opting for a pegged exchange rate system and for tight bank regulation at the national level. In time, we shall see, Angell’s view once again became the common wisdom, albeit with a twist born of repeated financial crises and repeated reminders that the machinery of finance capitalism required attentive political oversight.

The die was cast in favour of the gradual loosening of restrictions over banking when those same architects decided to rely on the private sector for the provision of the vast amounts of capital required to help rebuild economies broken by war and then to promote development in the rest of the world. Public funds, such as those allocated by the United States through the Marshall Plan, kick-started that process, but they were soon dwarfed by private capital flows in the form of export proceeds, foreign bank borrowing, private remittances, and foreign direct investment. By the 1970s, changing official and private preferences in advanced industrial countries lay behind a series of explicit and implicit policy choices that cumulatively pushed the system back toward freer international capital movements mediated mainly by financial institutions able to engage in a widening range of commercial and investment activities.

Within twenty years, a similar shift in preferences would be well underway in much of the developing world, notwithstanding many emergencies that reminded policy-makers and market participants of certain historical lessons. Stable, well-functioning financial markets require stable, well-functioning regulatory authority underneath them. Market actors need clear operating rules. Property rights have to be established, and adjudicated when conflicts arise. Predictable procedures have to be in place to handle inevitable bankruptcies. Someone has to provide the degree of insurance necessary to limit the chance that specific debt defaults cascade and engulf otherwise healthy borrowers and lenders. Some agency has to be entrusted with the responsibility and endowed with the capability to act as lender-of-last-resort. In light of the risk that the very existence of such ultimate insurance facilities can tempt potential beneficiaries to act imprudently, a risk that economists call ‘moral hazard’, this last-resort lending function has to be complemented by the official supervision of financial intermediaries. Finally, to deal with extreme instability, the lender-of-last-resort has to be backed by an investor-of-last-resort, an investor with unlimited access to the currency required to stop financial contagion from spreading. Despite recurrent dreams of a substitute that might limit the risk of igniting
Another great inflation, and despite the budgetary constraints faced by even the wealthiest countries, no such institution has yet been invented—except for legitimate national governments with access to fiscal accounts and printing presses.

After 1945, all advanced industrial states applied just such lessons within their national financial markets. Some gave the bulk of regulatory and supervisory responsibilities to their central banks, while some split them between central banks and other official agencies. Most initiated some kind of deposit insurance scheme to ameliorate the risk of domestic bank runs, and they all tried to leave as much scope as domestic circumstances would allow for prudent self-discipline by market actors themselves. They, nevertheless, all constructed procedures to prevent or, at worst, to resolve financial emergencies. When no one else would lend sufficiently to institutions whose survival was deemed vital to larger national interests, or in the extreme when no one else would hold their stock, some arm of the state was endowed with the mandate to do so. Across the developing world, a challenge repeatedly confronted in more recent decades has been to create similar facilities. When they could not meet that challenge, and especially when financial distress threatened global order and other states refused to provide direct assistance, the International Monetary Fund (IMF) was now available to supplement the resources of indebted and troubled member-states. Since the Fund’s underlying authority was of a limited and delegated nature, however, myriad economic and political controversies were always associated with its crisis management role.

National policies can certainly establish national regulators to govern national financial markets. When they fail to do so, it is appropriate to inquire into the reasons for internal political weaknesses or whether external political pressures were mainly to blame. But when those markets become ever more open, and ever more integrated, how can political authority and accountability be transnationalized? Deeply integrated financial markets promise no escape from the periodic necessity of reliable emergency stabilization measures. What is missing, of course, is a global polity capable of sustaining last-resort lending and investing instruments analogous to those established at the national level. Therein lies the central political dilemma posed by the contemporary move toward broader financial openness.

**Key points**

- Financial markets have always been prone to bouts of instability.
- During the twentieth century, leading states built up national regulatory and supervisory systems to limit the dangers of financial crises.
- Cross-national regulatory coordination became necessary after international capital movements accelerated in the 1970s, but remained politically difficult to sustain and expand.

**The Nature and Variety of International Financial Crises**

Financial crises commence with sharp breaks in the prices of key financial instruments. The expectations of market participants suddenly change, 'Shocks' course through markets, and participants seek to adjust their positions rapidly. Historically, the consequences of crisis moments have varied
in their severity and scope. The moments that particularly interest us here are those defined most often by plummeting prices in the value of a nation's banking assets at the core of its payments system (referred to as a 'banking crisis') and/or in the value of its currency relative to other currencies (referred to as a currency crisis).

Risk and uncertainty

Capitalist economies rest on foundations of debt. Borrowing and lending fuel economic growth. In principle, the aggregate financial claims created by the interaction of consumers, producers, savers, and investors in an economy are eminently supportable as long as expected future incomes exceed expected future debt repayments. The same logic applies internationally when once-separate economies become more integrated. At base, this involves the integration of markets for information.

Since we cannot know the future, expectations of future income flows are always doubtful. When enough borrowers and lenders share the perception that the extent of such doubts can reasonably be estimated, it becomes appropriate to speak of knowable probabilities, or risks (Knight 1921). Risks can be managed. Indeed, this is precisely what banks do when they accept deposits from savers in the short run, pool the proceeds, and make loans to borrowers in the long run. Through such activities, financial claims are generated, priced, and exchanged. The different time horizons of savers and borrowers are 'mediated'. In the absence of financial intermediaries, the ability of a particular firm, or of a particular country, to invest would be limited to the amount that firm or that country could save out of its own resources at any given moment in time.

Even when financial intermediation occurs smoothly, say through efficient and prudent banks, specific financial claims (assets from the point of view of banks, liabilities from the point of view of borrowers) become insupportable all the time. Mistakes are made, misjudgements occur, market conditions change unexpectedly. In the wake of such shocks, the expectations of creditors can shift and assets can be sold off and losses written off. If such shocks become generalized and creditors are uncertain about the limits of future losses, panic can ensue. Debtors and creditors, especially creditors late through the exit door, suffer reductions in their wealth and restraints on their economic prospects. When national markets are open, such uncertainty can easily spread like a contagious virus.

The history of capitalism is replete with such financial shocks. As Kindleberger put it in the title of a famous book, manias, panics, and crashes are endemic in a private market-based system (Kindleberger 1978). Few close observers deny that modern financial markets can sometimes be excessively volatile. Nevertheless, few participants are prepared to concede that alternative non-market or public allocation mechanisms in complex social systems are feasible. The massive human failures associated with planned economies in the twentieth century are not easy to forget.

The theoretical debate over whether the financial crises associated with market capitalism are self-correcting is a perennial one. Since the 1930s, however, the Keynesian side has apparently proved irresistible to policy-makers, except, as we shall see below, at one crucial moment in 2008. The near disaster that followed reinforced the Keynesian position. A financial crisis widely perceived to be severe simply requires some kind of decisive leadership if it is to be managed and resolved with the least possible social damage. In short, someone widely perceived to be acting with authority must administer a counter-shock capable of bringing market makers psychologically out of the realm of uncertainty and back into the realm of risk. Early on in the post-1945 period, the United States was the obvious leader. As the financial integration project proceeded and American economic power waned, more intense collaboration among diverse national and regional authorities were required. Questions concerning the reliability of such collaboration, moreover, rose in tandem with doubts
about the distributive justice of a system that ever more tightly linked financial markets across rich and poor countries (Sen 2009).

Notwithstanding the difficulty of imagining radically different financial systems conducive to truly global prosperity in the long run, contemporary history highlights two crucial facts. First, financial crises, and especially banking crises, remain recurrent, their only reliable predictor an increasingly shared sense that they will not recur because 'this time is different' (Reinhart and Rogoff 2009). Second, when financial markets cross legal and political borders, the probability of crisis increases as the information embedded in prices becomes less readily accessible for all market participants. In the deep structure of contemporary financial markets, the information asymmetries analyzed by economists and the power asymmetries analyzed by political scientists overlap.

Incidence of international financial crises

Economic historians commonly depict the period 1870 to 1914 as the first to witness the rapid expansion of cross-border financial markets (Flandreau and Zumer 2004). Although few countries were involved, by some measures the scale of international financial intermediation far exceeded anything that has developed since then. A golden age only for some, the purchase and sale of financial claims to foreigners boomed, albeit only at various points during this period. So, too, did defaults, especially around 1875, and then again when the world began marching toward what became known as the Great War. In an era when the values of the main currencies were meant to be firmly pegged to one another (recall the discussion in the previous chapter of the gold standard, which itself never worked perfectly), such defaults often translated into bank failures. After 1919, the incidence of banking crises escalated, but so, too, did currency crises when reperged exchange rates would not hold. The disastrous decade commencing in 1929 was characterized by the awful coincidence and global explosion of banking and currency crises (Kindleberger 1973).

Currency crises continued to plague the system that eventually emerged from the ashes of the Second World War. Efforts by the United States and its victorious allies to ensure internal financial stability did succeed in reducing the incidence of banking crises in the decades immediately following the war. But even after 1945, recurrent currency crises strained efforts to restore a stable exchange rate system reminiscent of the pre-1914 gold standard era. Those efforts failed in the early 1970s, when the link between the world’s leading currency and the price of gold was decisively broken. After 1973, banking crises once again became a fact of international economic life; so, too, did their coincidence with currency crises mainly in the developing world. As we shall see, a powerful reminder that advanced industrial countries remained far from immune to twin crises came in 2008.

Key points

| The most damaging financial crises occur when banking markets and currency markets simultaneously come under pressure. |
| After the breakdown of the Bretton Woods exchange rate system in the early 1970s and before the cross-border crisis of 2007, banking and currency crises occurred with most frequency in emerging market countries. |
The Changing Global Context

In 1974, the failure of a German bank, Bankhaus I. D. Herstatt, to honour its foreign exchange contracts had knock-on effects globally, which ultimately even caused the Franklin National Bank of New York to fail as well (Spero 1980). Long memories recalled the collapse of the Credit-Anstalt Bank in Austria in 1931 and the contagion it spread through world markets (Schubert 1992). The post-1945 international economic system as a whole, however, did not revert to depression, and lessons for avoiding systemic crises were certainly learned in the years after the Bretton Woods exchange rate system collapsed. We return to them below.

Banks based in advanced industrial countries rapidly expanded their international lending operations throughout the 1970s, and multinational corporations diversified their investment activities. Gradually, individual investors expanded their appetites and capacities for buying bonds and other financial instruments issued by governments and firms in certain developing countries, mainly in Central and South America. Some associated capital flows were trade related, some investment related, and some simply reflected the kind of financial speculation inherent in a capitalist system now becoming more global. An explosion of international financial intermediation after the 1980s brought in its train financial crises with cross-border effects (Martinez-Diaz 2009). For policy-makers in relatively poor and rich countries alike, the main political question became both obvious and difficult to answer: When real economic growth rates were sought in excess of those capable of being generated by domestic savings, how were the benefits and costs of financial openness to be distributed?

In principle, inward flows of privately owned capital make it possible for real economies to grow more rapidly than if they rely solely on domestic resources. In practice, the extra costs associated with crisis-induced capital outflows, bank bailouts, and the lost confidence of investors occasionally threatens to undermine real economies, set back the process of industrialization, and disrupt underlying political and social orders. Behind the immediate economic costs of financial crises, for example, in terms of lost economic output, lies a human story repeated time and again. It is the story of unemployment, increasing tax burdens, personal despair and hopelessness, family breakdown, and rising crime rates. In developing countries, it is the story of deepening poverty, coups d'état, and military dictatorship. Who would deny that it is best to avoid such outcomes? But their very possibility is inherent in the macro-policy choices both leading states and those aspiring to their level of prosperity made in the post-1945 period. With the final collapse in 1989 of the only alternative system once attractive to some, that of state socialism and central planning, financial openness apparently marked the only feasible road to the future. To be sure, nevertheless, all but the most dependent states retained the ability to determine the speed with which they went down that road, and all but the weakest retained levers of power sufficient to influence the internal distribution of the benefits and costs thereby incurred.

National policy reform, international systemic consequences

In essence, by the 1980s, it had become clear that states constituting the international economy had collectively moved away from one set of policy trade-offs and toward another. Immediately after the Second World War, they sought to reconcile their newfound desire for exchange rate stability with their interest in maintaining independent monetary policies. Both as a matter of logic and of policy, they therefore had to tolerate limits on inward and outward capital flows—the ‘ unholy trinity’ idea discussed in Helleiner, Chapter 7 in
as a whole. In practice, the stronger the country—that is, the more it was capable of generating and retaining its own domestic savings and/or the more it was capable of attracting foreign capital flows—despite its pursuit of fiscal and monetary policies that might, in principle, be expected to have the opposite consequence—the lower such disciplinary effects turned out to be. In any event, through such macro-policy choices, industrialized economies constructed a system that relied on the possibility of sharp reversals in capital flows to force on themselves and others that modicum of co-ordination required for the interdependence of real economies to deepen.

Partly in reaction, as Helleiner notes in the previous chapter, European states sought to restore internal discipline through the establishment of a regional currency union. Moreover, especially in the aftermath of the Asian crisis of the late 1990s, China and other states with robust export sectors sought to build a buffer against externally generated financial shocks through building high levels of foreign exchange reserves. Still, the system as a whole increasingly relied on more open financial markets to promote the cross-border policy adjustments entailed by deepening economic interdependence (Abdelal 2007).

Political sovereignty and economic interdependence

During periods of euphoria in financial markets, participants tend to forget historical lessons. When a fund manager is earning 5 per cent a year for a client, it is difficult to stay employed when colleagues elsewhere are earning 20 per cent for theirs. But only the most ideological of participants in global markets choose entirely to ignore the past. Perhaps this helps explain why, despite their new-found preference for financial openness, no governments have unambiguously embraced the principle that capital has an inviolable legal right to cross borders. In this regard, their evident reluctance clearly to match global treaties
on trade with robust agreements on capital movements or to designate an international overseer for systemically significant cross-border financial intermediaries is telling. The architects of the post-1973 order will simply not lodge ultimate political authority over international financial markets at the level where it logically belongs. No international agency has been authorized to regulate or supervise international capital flows, not the International Monetary Fund, not the World Bank, and not the Bank for International Settlements (BIS). None has been provided with the resources necessary to act as true lender-of-last-resort. States have instead opted to allow the financial institutions they themselves continue to license and supervise to expand their international operations on the understanding that national regulators would informally co-ordinate their supervisory policies and emergency practices to the extent necessary. At moments of confidence-withering crises, who would ultimately be responsible for bailing out financial institutions confronting the prospect of collapse? In the wake of actual financial crises in the decades following the breakdown of the Bretton Woods exchange rate system, the answer became clearer and clearer (Kapstein 1994). Last-resort facilities remain under the exclusive purview of individual states themselves, and the home states of financial intermediaries therefore bear primary regulatory and supervisory responsibilities. At most, pre-emptive or precautionary credit is made available to others by key states acting jointly through treaty-based intergovernmental organizations like the International Monetary Fund or through less formal regional understandings and bilateral reserve-swap arrangements (Henning 2002). In any event, trust between home and host states remains both crucial and tenuous. Every cross-border financial crisis therefore refocuses attention on the systemic risk and the ultimate fragility of the post-1970s policy experiment in financial openness (see Box 8.2).

Box 8.2 The Global Financial Panic of the Late 1990s

In the mid 1990s, interest rates fell and stock markets boomed in North America and Western Europe. Banks and portfolio investors, including rapidly expanding mutual funds and so-called 'hedge' funds that pooled the capital of institutional and wealthy investors, increasingly looked abroad for higher returns. With those higher returns came higher risks. At the same time, Japanese banks, confronting stagnant demand in a slumping home market, sought the higher earnings promised in neighbouring countries. Both public sector and private sector borrowers in emerging markets suddenly found new and ready sources of funds, and they borrowed heavily.

In Thailand, much of this new debt was denominated in the local currency, which the Thai government valued at a pegged, not floating rate. By buying Thai debt, investors and creditors, in essence, bet that the baht would hold its value. Early in 1997, however, Japanese banks, which then held about half of the country's foreign debt, began to lose confidence. They sought to reduce their exposures in Thailand as well as in a number of neighbouring countries. Their pullback prompted a regional liquidity crunch. Soon, generalized fears of a devaluation of the baht became self-fulfilling, and other Asian nations needed to defend the competitive edges of their own exporting industries by allowing their own currencies to depreciate.

Capital suddenly flew out of South Korea, Indonesia, and Malaysia, a phenomenon now exacerbated by the panicked reactions of hedge fund investors globally. Just as a bank hit by a run of depositors is forced hurriedly to raise cash by calling in loans, these hedge funds had to meet demands for withdrawals by liquidating their assets. As their Thai assets declined in redeemable value, they withdrew what they could as quickly as possible from their Asian portfolios. Liquidity dried up across the region, and very quickly the solvency of local banks recently considered sound came into question.
The policy landscape of global financial crises

The government in Malaysia tried to stem the panic and also developed the robust, strong markets. The recovery began in the region. The government in Malaysia tried to stem the panic and also developed the robust, strong markets. The recovery began in the region. The government in Malaysia tried to stem the panic and also developed the robust, strong markets. The recovery began in the region. The government in Malaysia tried to stem the panic and also developed the robust, strong markets. The recovery began in the region.
Figure 8.1 Net capital inflows to developing countries (US$ bn)

Source: Data in World Bank (1999a, 2002a, 2009a)

Figure 8.2 Composition of net private capital inflows to developing countries (US$ bn)

Source: Data in World Bank (1999a, 2002a, 2009a)
Table 8.1 Net Capital Inflows to Developing Regions, 2005–8

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<thead>
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Note: e = estimate  
Source: World Bank (2009a, 40)

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**Key points**

- Financial crises have generated policy innovations inside and among industrial states; the pattern repeated itself in many emerging-market states.
- Sovereignty remains an important legal doctrine in a globalizing economy, but in practical policy terms it is under rising pressure as border-spanning risks become ever more obvious.

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**Crisis Prevention**

No modern financial market exists for long without common standards understood by all participants. At the most basic level, financial information must be expressed in an understandable form. Accounting, auditing, and licensing rules form the bedrock. In all but the most limited local markets, or in all but the most libertarian utopias, such rules have not been spontaneously generated. Some actor must provide the collective goods of standard setting, adjudication, reform, and, ultimately, enforcement. Even illegal markets, if they are to persist, require someone to provide those minimal requirements. In legal markets, by definition, such collective goods are provided by the final maker of binding laws. To be sure, ultimate authorities can and do delegate the responsibility to define and promote technical standards in many of the world’s financial markets. But all contemporary markets that are legal rest on standards and enforcement procedures associated with governmental authority in one form or another. Even central banks that we now conventionally label ‘independent’, like the European Central Bank, derive their authority from constitutional arrangements or interstate treaties. Crisis prevention begins here. It is built on confidence in the long-term resilience of orderly markets.
Defining and defending public interests

Moments of financial crisis have tested this reasoning, even in recent times. International financial crises expose jurisdictional ambiguities and overlaps. But they are typically followed by new preventive measures, directly or indirectly supported by political authorities. However, they have not yet been followed by the establishment of an unambiguous global standard-setter or a global agency capable of final enforcement. The frontier of markets integrating themselves across political and legal boundaries therefore remains characterized in the final analysis by intergovernmental bodies charged with negotiating common cross-border understandings on appropriate standards and their enforcement (Bryant 2003). This is not to suggest that organizations created by private sector actors have been absent. For example, standard-setting bodies set up by accounting and other types of firms or private associations are increasingly common. In the United States, the United Kingdom, and elsewhere, governments have often been willing to let market participants attempt to reach agreement among themselves on best practices. When such attempts fail and markets are threatened with disruption, however, governments and central banks come out of the shadows.

Contemplating the ever-present possibility that a bank they regulated could fail and thereby compromise the financial system as a whole (called systemic risk), governments retained the ability either to dip into national treasuries to save it or to allow it to be liquidated in an orderly fashion. As banks expanded their international operations, regulators necessarily had to begin working with their foreign counterparts on common standards for prudential supervision and common approaches to the management of emergencies.

Over time, other kinds of financial intermediaries, like investment funds and trust companies, found ways to provide analogous services more cheaply. With the emergence of lightly regulated non-bank financial institutions in domestic and international markets in the 1960s and 1970s, the very same logic of international collaboration on standard setting and enforcement therefore spread beyond the banking sector. The provision of insurance, stock underwriting and sales, and pooled investing services had by the 1990s clearly become global businesses. To some extent, most firms in these businesses remained supervised in some measure in their home markets, but the governmental agencies licensing and overseeing them often expressly tried to limit their own responsibility for bailing them out in an emergency. That is, their licensing authorities attempted to limit the risk that firms would make imprudent judgments and take excessive risks in the knowledge that they would not be allowed to fail. As in the banking sector though, setting standards, defining enforcement responsibilities, and preventing official liabilities became more complicated as functional and geographical barriers were permitted to erode throughout the post-1970s era. Drawing a clear dividing line between public interests and private risks would rarely be a straightforward task any more (Pauly 2009).

Incipient co-ordination of regulatory and supervisory policies

Well into the 1980s, the main arenas within which financial regulators sought to co-ordinate their standard-setting and enforcement activities were easy to identify. Bilateral negotiations between national regulators and central banks were nothing new. After the fallout from the Herstatt failure spread globally through foreign exchange markets, such interaction became multilateralized through a central bankers’ club organized under the institutional auspices of the Bank for International Settlements (BIS). The Basel Committee on Banking Supervision associated with the BIS (see Box 8.3) technically reports to the governors of the world’s leading central banks (the so-called G10, which actually now includes more than ten members), but it continues to be the key standard-setting forum for the largest financial institutions operating across
had 1970s, the proliferation of international financial institutions and the growth of international finance made it necessary for countries to cooperate in regulating international financial activities. The Basel Committee on Banking Supervision, established in 1974, became the primary forum for regulators to coordinate supervision of banks operating across national borders, institutions that still typically have a bank at the core of complicated conglomerate structures. The prevention of future international financial crises defines the core mandate of the Basel Committee. This has led it to experiment with protocols for minimum standards for back-up capital reserves to be held by banks, and to work with other national and regional bodies to bolster the transparency and effectiveness of prudential supervision within and beyond the banking sector narrowly defined. In 2006, the most extensive and detailed effort to ensure capital adequacy came in an accord commonly dubbed Basel II. Under its terms, international lenders were encouraged to bring sophisticated risk-management techniques into the core of their internal decision-making procedures and calculations of adequate capital. The fact that this seemed to provide a new source of competitive advantage for the largest money-centre banks was not the only controversy engendered by the new accord. Some observers also feared that Basel II capital requirements could be "pro-cyclical," that is, that they could encourage banks excessively to restrict lending during recessions and imprudently to expand lending during booms. As we shall see, that fear would be justified even before the new agreement was finally implemented by key countries.

### Box 8.3 Institutions for Collaboration on International Financial Policies and Practices

- **Bank for International Settlements (BIS)** Established in 1930 to oversee Germany's war reparation payments. After the Second World War, this institution based in Basel, Switzerland, assisted European governments in their monetary and financial interactions. After the 1960s, its role in facilitating a multilateral payments system in Europe made it an obvious venue for intensifying dialogue among central bankers, now including the United States and other non-European countries, on a broad range of regulatory and supervisory issues. Today, the BIS provides a meeting venue and secretariat for several collaborative committees, including the Basel Committee on Banking Supervision.

- **Basel Committee on Banking Supervision** Provides a forum to stimulate collaborative approaches on issues of common concern among its members, which now include Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. The Committee has developed international standards on capital adequacy for banks and core principles for effective supervision of cross-border banking. Among other activities, it promotes its standards globally through a biennial International Conference of Banking Supervisors. The Committee also works with IOSCO and the IAIS (see below) on issues related to the supervision of financial conglomerates, including the division of responsibilities between home and host states.

- **Financial Action Task Force** Initiated at the 1989 summit meeting of the G7 to combat money laundering. A small secretariat based in the OECD, but not technically part of that organization, it co-ordinates national efforts, now also aimed at disrupting the financing of terrorism in a world of more open markets.

- **Financial Stability Board (FSB)** Following the international financial crises of the late 1990s, the G7 finance ministers and central bank governors brought together national financial regulators from a wide range of countries hosting important international financial centres, together with international organizations involved in financial policy matters. The Financial Stability Forum (FSF) began meeting in April 1999 and maintained a small secretariat at the BIS. In April 2009, the G20 expanded its membership to include Spain and the European Commission and transformed it into a more ambitious effort with the mandate of fostering "macro-prudential" collaboration among central banks and financial supervisors, that is, on ensuring that the oversight of financial institutions included not only analysis of the effects of institutional failure on the system as a whole but also rigorous assessment of the effects of systemic shocks on the institutions themselves. The FSB, with a slightly expanded but still modest secretariat comprised of two secretaries, was to be a vehicle for consultation...
across various standard-setting groups and organizations. It was to country-level link its work to the Financial Sector Assessment Programs of the World Bank and the IMF and to the Fund’s surveillance operations. Particular emphasis was placed on issues related to the regulation of cross-border financial institutions, including the division of the responsibilities between home and host states.

G7/G8/G20 Dating back to informal meetings of European finance ministers after the collapse of the Bretton Woods exchange rate arrangements, regular annual meetings of financial officials and heads of government now occur under these rubrics. Originally including five members—the United States, France, Britain, Germany, Japan, Canada, and Italy—in recent years also met with Russia and the European Union. The G20, which includes leading emerging market-countries like China, India, Brazil, and South Africa is set to overshadow smaller groups in the future. Meetings often involve the confidential sharing of information on financial and economic policies. Personal relationships thereby developed and reinforced can be useful when it comes to co-ordinating national policies rapidly in the face of international financial crises. There is no secretariat.

International Accounting Standards Board (IASB) and International Federation of Accountants Private sector bodies organized by professional accounting associations to encourage international standardization of accounting principles and auditing practices. Activities intensified during the 1970s and came to prominence in the 1990s after a series of accounting scandals in the United States and other major markets.

International Association of Insurance Supervisors (IAIS) Established in 1992 to encourage co-operation among regulators and supervisors of insurance companies. Since 1998, its secretariat has been housed in Basel, Switzerland, where it receives technical assistance from the BIS.

International Bank for Reconstruction and Development (World Bank) Also originally created at Bretton Woods (see Wade, Chapter 12, and Phillips, Chapter 13 in this volume).

International Monetary Fund (IMF) Designed at the Bretton Woods Conference, July 1944. (For details on its subsequent evolution, see Helleiner, Chapter 1 in this volume.)

International Organization of Securities Commissions (IOSCO) With a secretariat based in Montreal, Canada, IOSCO sponsors conferences, and other linkages among the regulators of national stock and other securities markets. Designed to facilitate the sharing of information and best practices, it developed during the 1970s as buyers and sellers of securities increasingly moved their funds across national borders.

Organization for Economic Co-operation and Development (OECD) Evolved out of efforts after the Second World War to facilitate the use of Marshall Plan resources. Often now considered a think tank for industrial countries contemplating various forms of economic policy co-ordination.

Regional Development Banks With local mandates akin to the global development mandate of the World Bank, these multilateral organizations are now involved in providing technical advice for financial market deepening, regulation, and supervision in Africa, Latin America, East Asia, Eastern Europe, and Central Europe.

United Nations (UN) Various UN commissions, agencies, and departments, such as the Department of Economic and Social Affairs in the New York-based secretariat, have mandates to review international financial developments and seek to promote understanding among member states on issues of equity and efficiency in the global economy. In recent years, its focus has shifted to ensuring the availability of adequate financing for developing countries and to promoting internationally agreed Millennium Development Goals for poverty reduction and sustainable development (the ‘Monterrey Consensus’).

World Trade Organization (WTO) Having grown out of the General Agreement on Tariffs and Trade (GATT), under which national trade policies have been liberalized on a multilateral basis ever since 1948, the WTO now has growing responsibilities for trade in various services, including a widening range of financial services (see Winham, Chapter 5 in this volume).
The broader macroeconomic policy context

Ultimately, mutually sustainable fiscal and monetary policies in the United States are required for international financial stability. Stabilizing fiscal policies in the United States, in turn, depend on the United States' ability to sustain the post-1985 recovery while maintaining low inflation and a low interest rate environment. These measures were implemented by a coalition of central bankers, developing country authorities, and policymakers, who agreed on a coordinated strategy to stabilize the global economy.

However, the crisis of 1997-98 exposed the limits of this approach. The crisis was driven by a sharp appreciation of the yen and the dollar against the currencies of emerging market economies. This led to a sharp decline in capital inflows to the crisis countries, which, in turn, led to a sharp decline in domestic demand and output. The crisis highlighted the importance of macroeconomic policy coordination and the need for a more robust international financial architecture.

To address these challenges, the G-7 and the International Monetary Fund (IMF) agreed on a set of principles and policies to promote stability and openness in the global economy. These principles include: (1) enhancing transparency and accountability in the conduct of monetary and fiscal policies, (2) promoting financial sector development, (3) improving the resilience of the financial system, and (4) facilitating international cooperation.

The G-20, established in 2009, has played a crucial role in promoting these principles and policies. The G-20 has become a key forum for policy coordination among major economies, and its agenda reflects the need for sustained growth and employment, financial stability, and promotion of trade and investment.

In conclusion, the crises of the 1990s underscored the importance of macroeconomic policy coordination and the need for a robust international financial architecture. The G-20 has played a key role in promoting these principles and policies, and its agenda reflects the need for sustained growth and employment, financial stability, and promotion of trade and investment.
not in emerging markets, but in the housing market of the United States. Early on, even the most pessimistic observers expected a version of the 'savings and loan' crisis of the late 1980s, which, though severe, proved containable within the domestic US economy. But this particular financial crisis soon went viral, and it nearly tipped the global economy into the second Great Depression (see Box 8.4).

### Box 8.4 Timeline for the Crisis of 2008

- **17 May 2007** Following months of rising turbulence in US housing markets, combined with mounting scandals involving Fannie Mae and Freddie Mac, agencies with implicit US government backing that guarantee $5 trillion in mortgages, including many considered 'subprime', Federal Reserve Chairman Ben Bernanke states that a growing number of housing related defaults will not seriously harm the US economy.

- **June 2007** Two highly leveraged ('hedge') funds owned by the investment bank, Bear Stearns, which had large holdings of subprime mortgages, report large losses and are forced to begin selling assets at distressed prices. The trouble spreads to major Wall Street firms such as Merrill Lynch, JPMorgan Chase, Citigroup, and Goldman Sachs, which have lent the funds money. Similar problems emerge in the United Kingdom.

- **August 2007** Early in the month, US stock markets fall sharply. 'Credit crunch' spreads around the world as subprime mortgage-backed securities are disclosed in portfolios of banks from BNP Paribas to Bank of China. To provide market liquidity, the Fed cuts inter-bank interest rates and injects nearly $100 billion into the US banking system. The European Central Bank and the central banks of Japan, England, Canada, and Australia make co-ordinated moves to provide liquidity in their own markets.

- **16 August 2007** Stricken by losses in investments related to US subprime mortgages, the German regional bank, SachsenLB, is rapidly sold to Germany's biggest regional bank, Landesbank Baden-Württemberg. The same day, Countrywide Financial Corporation, the biggest US mortgage lender, narrowly avoids bankruptcy by taking out an emergency loan of $11 billion from a group of banks. Shortly thereafter, the UK bank, Northern Rock, admits similar difficulties and requests Bank of England assistance in the face of a run by depositors.

- **18 September 2007** The Fed starts cutting broader interest rates, and will continue doing so at seven straight monthly meetings, and one unscheduled emergency meeting. It also agrees to start loaning money directly to Wall Street firms, rather than to commercial banks alone, and to accept troubled mortgage-backed securities as collateral.

- **30 September 2007** Affected by the spiraling mortgage and credit crises, Internet banking pioneer, NetBank, declares bankruptcy, and the Union Bank of Switzerland announces a loss of US$690 million in the third quarter. Six days later, US investment firm, Merrill Lynch, reports losses of $5.5 billion, which will mount to $8 billion within the next month.

- **2 November 2007** The US Treasury announces its long-delayed final implementation of the Basel II Accord negotiated by the Basel Committee on Banking Supervision. The aim was to set an agreed standard for risk-weighted capital requirements to offset various risks threats to bank solvency. The gathering crisis was already underlining the important risks not adequately covered by the Accord, especially the risk that extreme market conditions would limit access to normal operating liquidity. Two weeks later, the US Financial Accounting Standards Board (FASB) announces new standards for 'Fair Value Measurements' on bank balance sheets. By requiring mark-to-market accounting during a crisis, the controversial standards increase the risk that bank losses will be exaggerated.

- **12 December 2007** The Federal Reserve's Open Market Committee negotiates swap lines with the European Central Bank and the Swiss National Bank for up to $20 billion and $4 billion, respectively. Similar facilities, designed to assist one another in the provision of liquidity to local markets, will be extended and expanded repeatedly over the next year. Eventually, central banks from around the world, including many emerging-market countries, will participate in this evolving system.

- **11 January 2008** Bank of America pays $4 billion for failing Countrywide Financial, the country's biggest mortgage...
originator and, soon, the subject of a rising scandal involving the provision of financial favours to prominent politicians, including the chair of the Senate Banking Committee and the head of Fannie Mae.

28 January 2008 Four days after the first nationwide decline in housing prices since the 1930s is announced, the Economic Stimulus Act of 2008 is proposed in the US Congress. The next day, the House of Representatives passes a $146 billion aid package to speed up tax rebates to most taxpayers. The Senate increases the package and the legislation is sent to the President on 7 February. Six days later, Northern Rock is nationalized by the UK government.

15 March 2008 In an extraordinarily rare weekend move, the Fed provides cash, not only to commercial banks at the heart of the national payments system, but to investment banks as well. The next day, JPMorgan Chase & Co. acquires troubled Wall Street firm Bear Stearns, in a deal engineered and backed by the Fed. Soon thereafter, the IMF projects $945 billion in global losses from the financial crisis, and G7 finance ministers launch a review of the global financial regulatory system.

16 June 2008 The New York investment bank, Lehman Brothers, reports a loss of $2.2 billion in the second quarter. Within the firm, funds begin to flow from units overseas back to New York, a development that will cause host countries to raise serious objections. Three days later, ex-Bear Stearns fund managers are arrested by the FBI for allegedly misrepresenting the fiscal health of their funds heavily invested in subprime mortgages.

31 August 2008 German Commerzbank AG takes over Dresdner Kleinwort investment bank. Seven days later, US Treasury Secretary Henry Paulson announces a public 'conservatorship' for cash-starved Fannie Mae and Freddie Mac.

14 September 2008 Lehman Brothers, burdened by $60 billion in soured real-estate holdings, files a Chapter 11 bankruptcy petition after official attempts to arrange a rescue for the 158-year-old firm fail, and the US Treasury and Fed apparently decide that the knock-on effects will be manageable. The next day, under pressure from government officials, Bank of America acquires Merrill Lynch. The same day, New York State authorizes insurance giant, American International Group (AIG), which provides insurance for many of the securities comprised of bundled subprime mortgages, to use $20 billion from its own insurance subsidiaries for liquidity purposes.

16 September 2008 In co-ordinated operations, central banks around the world pump billions of dollars into money markets. Supposedly very safe money market investment funds shock increasingly illiquid markets when they are forced to pay clients redeeming their investments less than those clients paid in. Panic ensues, and the US government announces an unprecedented blanket guarantee for money market funds. The same day the Fed lends AIG $85 billion in exchange for nearly 80 per cent of its stock; the decision generates intense controversy from its inception, with the Fed and Treasury claiming its necessity to prevent a depression and critics seeing an ill-negotiated transfer of wealth from taxpayers to financial intermediaries. The price of gold soars by over 8 per cent, equity markets continue a broad global retreat, and governments around the world begin moving to ban the speculative short-selling of financial stocks.

21 September 2008 Goldman Sachs and Morgan Stanley, the two remaining giants in US investment banking markets, change their legal charters to become bank holding companies, thus gaining access to the emergency liquidity facilities of the Fed. Three days later, in the largest bank failure in US history, Washington Mutual collapses and with government support is sold to JPMorgan Chase.

29 September 2008 The US Senate rejects a $700 billion plan to bail out the US financial system. Bradford & Bingley of the UK is nationalized and sold to the Spanish bank, Santander. Hypo Real Estate is bailed out by banks and the government in Germany. Fortis Bank in Belgium is bailed out and then effectively taken apart by Netherlands, Belgium, and Luxembourg, and the next day, its main competitor, Dexia, is taken over by France, Belgium, and Luxembourg. Iceland begins nationalizing its biggest banks. In the US, Citigroup announces the government-backed takeover of Wachovia Bank. The Fed continues supporting markets with massive liquidity operations, while the Securities and Exchange Commission and the Financial Accounting Standards Board announce moves to relax 'mark-to-market' accounting rules. The next day, spreads on short-term inter-bank lending in global markets, normally quite low, spike to 7 per cent, their highest levels ever.
1 October 2008 The US Senate reverses itself and two days later, President Bush signs the $700 billion Emergency Economic Stabilization Act into law. Three days later, EU leaders travel to Paris for an emergency summit. During the next week, stock markets around the world record their worst week since the early 1930s. Iceland’s banking system collapses, with immediate consequences for British Internet-banking depositors. Major British banks are partly nationalized; Germany, France, and other EU countries prepare decisive measures to stabilize failing local banks. Fearing a global economic collapse, central banks simultaneously slash interest rates. The fever of the crisis begins to break.

20 October 2008 G7 finance ministers and central bank governors meet in Washington and agree to co-ordinate monetary and fiscal actions to prevent the credit crisis from throwing the world into depression. Citing provisions of anti-terrorist laws, the UK government freezes Icelandic assets in a bid to force the country to compensate British depositors. Four days later, the US Treasury announces its intention to take $250 billion from the $700 billion package authorized by Congress to purchase troubled assets from US banks and the US operations of foreign banks.

22 October 2008 The House Oversight and Government Reform Committee grills executives from the country’s leading credit-rating companies, who had privately acknowledged for more than a year that conflicts of interest contributed to excessively favourable ratings of mortgage-backed securities. One day later, former Federal Reserve Chairman Alan Greenspan, whose easy-money policies are now seen as sowing the seeds for the crisis, says that the inability of financial markets to correct themselves has left him in a ‘state of shocked disbelief’.

10 November 2008 China announces a $585 billion stimulus package, the largest in the country’s history. The US Treasury expands the bailout package for troubled insurer, AIG, to $150 billion and allows direct government investment in the company. Two days later, the Treasury loosens itsstructure on purchasing troubled assets and says that the bailout programme will be adapted to bolster financial intermediaries as needed.

28 November 2008 The Basel Committee on Banking Supervision provides new guidance on the valuation of assets at fair market prices, while the World Bank launches a Debt Management Facility to help developing countries prevent debt problems in the future. Meanwhile, the IMF is busy in central and eastern Europe negotiating standby arrangements with vulnerable countries from Latvia to Belarus.

1 December 2008 The US National Bureau of Economic Research announces that the economy entered a recession in December 2007. A few days later, as global investors seek the relative safety of US government debt, the yield on three-month Treasury bills briefly falls into negative territory for the first time ever. Two days later, former NASDAQ stock exchange chairman, Bernard Madoff, is charged with running a fraudulent investment business that lost at least $50 billion.

17 December 2008 The Fed lowers its base interest rates near 0 per cent and begins planning for highly unusual new measures (quantitative easing) to bolster market liquidity. Similar moves are underway at central banks in Canada, Europe, Asia, and in emerging-market nations. Two days later, President Bush announces plans to lend General Motors and Chrysler $17.4 billion to prevent their collapse.

9 January 2009 The German government takes a 25 per cent stake in Commerzbank through a €10 billion capital injection in an effort to help Commerzbank acquire Dresdner Bank. Ireland bails out Anglo-Irish Bank. A few days later, Standard & Poor’s cuts the credit rating of debt issued by Greece, while Portugal, Spain, and Ireland are put on watch lists.

20 January 2009 Barack Obama is sworn in as the forty-fourth president of the United States. IMF projects world economic growth to fall to just 0.5 per cent this year, its lowest rate since the Second World War.

10 February 2009 The US Treasury announces a Financial Stability Plan involving purchases of convertible preferred stock in eligible banks. The creation of a Public-Private Investment Fund to acquire troubled assets from financial institutions, expansion to $1 billion of the Fed’s Term Asset-Backed Securities Loan Facility, and new initiatives to stem residential mortgage foreclosures. One week later, a new $787 billion fiscal stimulus plan, the American Recovery and Reinvestment Act of 2009, is signed into law.
1 March 2009 The Fed and the US Treasury provide $30 billion in capital to AIG and take over two divisions of the company after it announces a $61.7 billion loss, the largest in US corporate history. Debate heats up on the effective use of US taxpayer dollars to pay AIG’s obligations in full to major counterparties, including Goldman Sachs and a number of large foreign banks.

2 April 2009 G20 leaders meet in London, where they agree to convert the Financial Stability Forum (FSF), born after the Asia crisis, to the Financial Stability Board (FSB) (see Box 8.3). The heads of the FSB and the IMF are mandated to report jointly to the International Monetary and Financial Committee that brings together the finance ministers and central bank governors of all Fund members. The same day, the Financial Accounting Standards Board relaxes mark-to-market financial rules.

1 June 2009 General Motors declares bankruptcy. Many countries are by now deep in recession, and global trade flows are in decline. The Fed outlines new supervisory criteria for banks seeking to return loans and capital injections from the Treasury. President Obama proposes a massive legislative and regulatory overhaul.


9 December 2009 Finance ministers of the UK and France plan tax on windfall bonuses paid to bank executives. US Congress begins work that culminates in the sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act on 21 July 2010.

11 January 2010 Fed records $46 billion profit for 2009, mainly reflecting interest payments and gains on securities purchased during the crisis. The highest earnings ever in its history are turned over to the US Treasury. Two days later, the Financial Crisis Inquiry Commission, established by the US Congress to examine the causes of the financial meltdown, holds its first public hearings. Pressure mounts for more extensive international co-ordination to reduce sovereign debts built up during the recent crisis.

Key points

- Since the collapse of the Bretton Woods exchange-rate regime, governments have attempted to cooperate more intensively to prevent financial crises.
- Fundamental macroeconomic policy choices usually condition the flow of capital across national borders, but capital flight can sometimes occur unexpectedly.
- Policy collaboration to reduce the chances that a localized financial crisis will spread has often involved talk about joint moves in fiscal and monetary policy making, but substantive movement to render global markets more resilient has occurred mainly in regulatory and supervisory arenas. The results have been mixed, and significant challenges remain.

Crisis Management and Resolution

Debt rescheduling and restructuring

When the financial obligations of a business firm become unsustainable given available resources, the classic question is whether the underlying problem is one of illiquidity or insolvency. The distinction is rarely clear-cut in practice, and one problem can easily slide into the other. In the typical case of
illiquidity, creditors or investors in the firm might judge that a short-term loan or capital injection will get it through a payments crisis and enable it to find solid footing once again. In the case of insolvency, they would judge that it is no longer a going concern and that further lending would be worse than useless. One of two options might then be chosen. The firm could be taken over by its creditors and its balance sheet reorganized in an attempt to recreate some kind of viable business, or the firm’s assets could be liquidated to retire as many of its liabilities as possible before finally closing its doors. In advanced capitalist systems, national bankruptcy laws exist to guide these procedures, and courts are often required to make the ultimate decisions. If Schumpeter was right and processes of creative destruction are the essence of modern capitalism, national governments use bankruptcy to clear their economic systems and enable those processes to repeat themselves. In the end, they no longer send failed entrepreneurs to debtors’ prison but instead give them another chance.

Countries facing currency crises in an interdependent system are in a somewhat analogous position to a firm unable to meet its obligations. Aggregate debts become unsustainable, creditors demand repayment, and the resources available to settle accounts deteriorate in value. The national balance sheet requires adjustment. Crisis conditions may be generated by government overspending, by excessive imports, or by the building up of private-sector debt that cannot be financed domestically. Any of these situations might motivate the government to increase the rate of production of its monetary printing press. Inflation would normally be the consequence, and if the fundamental problem is one of temporary illiquidity this might provide the necessary space for internal adjustments to occur. If much of a country’s debt is owed to foreigners and is denominated in foreign currency, however, such a policy may quickly deepen the problem and easily turn it into one akin to the insolvency of a business firm. Inflation in the local currency by definition pushes up the value of foreign currency liabilities. Expecting further declines in the purchasing power of the local currency, domestic as well as foreign creditors and investors rush to preserve their capital, and even to get it out of the country. A deteriorating real exchange rate makes debt repayment more costly, imported goods required to facilitate revenue-generating production become more expensive, and potential investors in future production lose confidence. The debtor government can default on its loans, or try to allow private firms under its purview to default with impunity, but then it risks cutting its economy off from future capital inflows that have no domestic substitute. The country becomes caught in the downward, vicious economic syndrome of deflation and depression. The situation in Argentina in 2001 provided a vivid example.

Obviously missing in such a scenario is a mechanism for the orderly bankruptcy of a national economy. Absent is a lender-of-last-resort, internationally agreed liquidation procedures, and a final court to replace managers and supervise the forced adjustment of the national balance sheet. This is, of course, no accident. In the conceptual extreme, the sovereignty of a state implies the absolute right both to resort to war and to default on debts. As a classic realist might argue, the ability in practice to claim such a right is in the final analysis a function of the raw power a state has in its possession to enforce its decision. In the real world, the sovereignty of particular states is compromised all the time (Krasner 1999). Unilateral defaults, payment moratoria, or standstills can be, and often are, declared by debtors. On the other hand, national assets can sometimes be unilaterally seized by aggrieved creditors.

The architects of the post-1945 system deemed economic instability to be the handmaidens of war. At Bretton Woods, therefore, they took the first steps in designing mechanisms that would limit the extent to which sovereign participants in the system would find themselves pushed to default on their debts. Time and again, from 1945 until the present moment, the main creditor states and the private financial institutions they license and regulate found themselves designing and redesigning substitutes for gunboat diplomacy, namely programmes that
provide certain debtor states with the functional equivalent of last-resort lending facilities or of debt-restructuring services loosely analogous to those found in domestic bankruptcy courts. Sovereign debt reschedulings and restructurings have been common since the 1980s. International banks as well as official agencies providing export credits informally organized themselves into negotiating groups (the so-called London Club and Paris Club, respectively) to manage such arrangements. Frequently, however, the threat of default has drawn attention from creditor governments themselves.

The rise of emerging markets and their special needs

In the early post-war decades, the main economic imbalances capable of derailing the system as a whole occurred in industrial countries. They typically manifested themselves as currency crises (typically when governments sought to defend the par value of their currencies while running substantial trade deficits), so it was no coincidence that the International Monetary Fund was often enlisted either to help resolve them or retroactively to bless new currency pegs or unorthodox financial arrangements. During the 1980s and 1990s, the main crises capable of derailing the system occurred in emerging markets, and more often than not, the IMF again found itself at the centre of efforts to chart that middle path between financial anarchy and global governance. Many other institutions were eventually involved one way or another (Box 8.3). At moments of systemic danger centered on emerging markets in the 1980s and 1990s, the main creditor states shared the management burden by working through the IMF on currency crises and through the Basel Committee and ad hoc networks of central banks and finance ministries on banking crises.

The immediate objective of the IMF at such moments was to help break the psychology of fear and mistrust among its members and in the markets. Its ultimate mission, however, was to assist in stabilizing the financial underpinnings necessary for real national economies to become more deeply interdependent and more reliably prosperous through expanded trade and investment. That the IMF was not dissolved after 1973, when its members could not agree on a new exchange rate regime, reflected much more than bureaucratic inertia. Most importantly, the Fund’s balance of payments financing facilities, which had grown over time in both size and flexibility, proved to be extremely convenient to its major member states. In effect, they mainly provided a mechanism for creditor states to share the burden of providing emergency financial assistance to debtors. Through the conditions attached to the use of such facilities, they could exert pressure on borrowers in a manner that would be politically difficult for individual creditor states. Moreover, the Fund’s annual national and global surveillance activities offered the promise of holding all members accountable for the external consequences of their economic policy choices (Pauly 1997).

In retrospect, it is not surprising that the Fund evolved into the central crisis manager for emerging markets in a system that moved over time from one based on the interdependence of national exchange rate policies and underlying macroeconomic choices, toward one involving the deepening interaction of trade, investment, and financial policies. In this context, the leading states in the system confronted three basic choices every time one country or another found that it could not pay its bills to external customers or service its debts to external creditors:

1. They could do nothing, and risk the crisis spilling over to other countries and perhaps into their own domestic systems as well.
2. They could intervene directly by providing adequate financing from their own resources to the troubled country, and work directly with it to address the fundamental causes of the problem.
3. Or they could do the same indirectly, collectively, and more cheaply through the Fund and other collaborative institutions.
In practice, the third option often proved to be the least unattractive of the three, except for cases involving the weakest and most isolated developing countries. For countries whose periodic debt problems were widely perceived to be capable of seriously disrupting the system as a whole, the option of doing nothing, and of thereby letting markets attempt to force necessary adjustments, seldom seemed wise to actual policy-makers charged with making such a decision. Moreover, the option of exposing their own taxpayers to the unmediated hazards of crisis resolution has typically proven itself to be almost as unpalatable as bearing the political costs of unilaterally trying to impose conditions on recalcitrant debtors. The third option, therefore, nearly always found a sufficient number of advocates, in both creditor and debtor countries alike.

A New Global Architecture?

Perhaps there was a moment in time, just after the Second World War, when one could sense a window opening on a world where states would actually delegate a coherent piece of their monetary, if not fiscal, sovereignty to a technical agency with a binding, enforceable mandate. By 1973, the member states of the IMF had obviously conceded that the co-ordination of national fiscal and monetary policies could only be voluntary. How then could a reliable foundation for globalizing capitalism be constructed? If deeper financial integration remained a collective goal even as fiscal and monetary sovereignty remained sacrosanct, then those same states confronted the logically alternative necessity of co-ordinating their more technical policies and instruments aiming at preventing or, at worst, managing and resolving future financial crises. The prospect of future joint gains from routine macroeconomic policy co-ordination was not often a successful motivator. On the other hand, the prospect of catastrophic national and systemic losses did concentrate minds and held the promise of a modicum of policy collaboration (see Aggarwal and Dupont, Chapter 3 in this volume).

Key policy debates after the crises of the late 1990s revolved around the theory and practice of crisis management and resolution in emerging markets and especially around reducing the exposure of the most needy countries to excessively volatile capital flows (Eichengreen 2003; Roubini and Setser 2004). Serious reform proposals were conventionally grouped into three main categories: the unilateral, the multilateral, and the supranational (Eichengreen 2002; Bryant 2003; Woods 2006; Truman 2006).

In the first category, both conservative believers in the virtues of unfettered markets and the defenders of absolute sovereignty in developing countries join in a common cause. Crises, when they occur, are to be managed by unlucky or unwise external investors taking their lumps, and by debtor governments reverting to defaults and/or capital controls with attendant risks to their future access to external financing. In less extreme circumstances, private creditors and debtors would be left to their own devices to work out debt restructuring arrangements and to encourage reforms in national exchange rate regimes.

At the other end of the imagined policy spectrum were global institutions that would come closer to serving as the functional equivalents of domestic emergency-lending, bankruptcy, and liquidation arrangements. Two successive deputy managing directors of the IMF made such proposals, one for the Fund to be legally empowered to play the role of lender-of-last-resort and the next for the Fund to serve as a kind of ultimate bankruptcy court by overseeing a Sovereign Debt Restructuring Mechanism.
industrial states had also quite likely transformed a short-term banking crisis into a long-term fiscal problem, with negative consequences for their currencies and future living standards if official indebtedness could not soon be reined in. Moreover, although large foreign exchange reserves built-up after the late 1990s had now apparently buffered China and neighbouring East Asian states from financial meltdown, the ultimate costs of that buffering could only be estimated after taking into account the political effects of fiscal stress and unemployment on the global trading system as a whole.

Like other financial crises in the post-1970s period, the recent crisis revealed the macroeconomic and macropolitical foundations of the experiment in financial market integration. In the end, the idea of cross-border financial intermediation through nationally licensed and regulated private institutions was not repudiated. The crisis therefore starkly underlined the importance of ensuring effective cross-border political collaboration and eventually of rendering such collaboration legitimate. Easier for political leaders to contemplate after the crisis were marginal adjustments in technical policies aimed mainly at prevention. This explains the new focus on the Financial Stability Board (FSB), the enhancement of the IMF’s role in monitoring systemic risks and assisting weaker states, and the bolstering of bank capital adequacy and liquidity requirements in the Basel III agreement announced in September 2010.

Promoting a stable modus vivendi between national and regional impulses of competition and cooperation was a difficult task after 1945, when the United States, guided by a vision of freer trade and tightly regulated financial markets, clearly occupied the position of system leader. It is more difficult now, when raw economic and financial power is dispersing across the Americas, Europe, and Asia. The extent to which that power remains harnessed to a common purpose will be tested in the years ahead. Not coincidentally, responses to crises in financial markets will signal the answer.
Key points

- International financial crises are usually more difficult to manage than domestic crises because of jurisdictional ambiguities.
- Some basic level of cross-national co-ordination is required in crisis management and resolution; intergovernmental institutions can play a supportive role, but their main missions have typically focused on preventing the next crisis.
- Central bank networks among advanced industrial countries operated effectively during the crisis of 2008, but unilateral fiscal actions by national governments were often required to resolve the crisis. Fiscal burden-sharing occurred to a limited degree, but it remains politically quite sensitive.
- Emerging-market countries, not least, China, look set to exercise a more direct and determinative influence on the future of global financial integration.

Questions

1. What causes financial crises, and why do some quickly spread globally?
2. What special risks are associated with cross-border finance, and how have regulators tried to respond?
3. What measures hold promise for preventing future financial crises?
4. How can international financial crises be more effectively managed?
5. How durable are any limits on crisis management and resolution?
6. How should we evaluate issues of distributive justice raised by financial market openness, both for the system as a whole and for specific countries?

Further reading


Strange, S. (1998), Mad Money: When Markets Outgrow Governments (Ann Arbor, MI: University of Michigan Press). The late, great international political economist provides a rousing and contentious introduction to the policy and technical innovations that dramatically increased the volume and volatility of global financial flows.

