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The Old and the New Politics of International Financial Stability

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Abstract

The cross-border financial crisis that began in the United States in the summer of 2007 tested a 30-year experiment in international integration. In the background were expanding macroeconomic imbalances that leading states had neglected to address. Spawned by imprudence and regulatory failures, the crisis soon deepened and the collaborative impulse that might have prompted earlier and more fundamental macro-policy action became focused on emergency management. Ad hoc policy co-ordination ensued as liquidity was injected into turbulent markets and troubled financial intermediaries were recapitalized or reorganized. The collective performance was inelegant, not least inside the European Union. The crisis shed a harsh spotlight on the weak fiscal foundations of the Union and on the now-pressing need for collaborative adjustments in national macroeconomic policies. Since overt political innovation on such matters remains difficult, both within Europe and globally, the crisis underlined the crucial importance of much better collaborative instruments for the oversight and stabilization of integrating financial markets.

Introduction

In the immediate aftermath of a financial crisis, as the fog of war begins to lift, few things are certain. Although the global turmoil that began in the summer of 2007 continued to impose significant economic and political costs around the world, panic subsided by the middle of 2009. The capital structures of systemically significant intermediaries were bolstered either by forced mergers, injections from national treasuries or new private equity issues. Official intervention bolstered confidence in commercial and investment banks deemed too significant or too interconnected to fail. A period of extreme systemic uncertainty began moving into the realm of bad and fading memory and the global economy settled into the most serious recession of the post-1945 era. Risks were calculable again and the final questions were the ones always asked during recessions: at what level would financial losses peak in key countries and across the system, who would ultimately bear those losses and how long would it take to write them off?

It is too soon for a definitive study of lessons learned in this, the latest and most serious cross-border financial crisis since the resurrection of global finance in the early 1970s. But it is not too soon to begin assessing two key elements in the continuing evolution of political underpinnings strong enough to sustain a global economy characterized by volatile and relatively unrestrained international capital movements. This article highlights those elements and sets the stage for future research and analysis. The first points to inadequacies in cross-national macroeconomic policy co-ordination, which help inflate financial bubbles; it is a story more of continuity than of change. The second involves the collaborative development of emergency fiscal burden-sharing mechanisms to manage cross-border markets at their most vulnerable moments. It is a somewhat surprising story, filled with obscurantist noise and shrouded in hypocrisy, but a story thus far amenable to a more optimistic reading than the one most commonly presented in journalistic accounts of the crisis.

I. The Macroeconomic Foundations of Financial (In)Stability

Readers of the daily financial press are regularly reminded of looming ‘lost decades’. We are told that the financial crisis that began in the United States during the summer of 2007 looks set to usher in a global version of the abysmal Japanese economic performance in the 1990s. The historically minded observer might note that Japan is still a democracy practising its own brand of capitalism, that blood has not been running through its streets and that there remains in that country little hint of a resurgence of aggressive militarism. Such a conclusion can be extended far beyond Japan. The real ‘lost decades’ began in Germany in 1923. Hyperinflation and depression did not in themselves lead directly to world war and to Auschwitz, but they certainly did constitute important background conditions. Economic policy-makers in leading states remember their consequences, and that memory decisively shaped their decisions in 2007 and 2008.

The Bretton Woods agreement of 1944 was crafted before those very consequences entered the realm of memory. Its central commitment to expand economic openness in the post-war period reflected the deeper objective of building and sustaining a peaceful international political order. Its designers considered currency stability a necessary condition for increased trade. In other words, they saw limits on capital mobility as required to sustain a trade-promoting system of national currencies convertible at pegged exchange rates. They also considered such limits to be important in preserving national autonomy in the setting of internal interest rates. This famous multilateral policy trade-off ushered in an era of remarkable recovery and rising prosperity in much of the world. As fully elaborated, the Bretton Woods order relied on the existence of an intergovernmental referee backed by American power and charged with the task of ensuring that unfair national currency practices did not disrupt the progressive integration of national markets for goods and services. That referee, the International Monetary Fund (IMF), gradually developed a set of procedures, first for voluntary consultations with members focused narrowly on exchange rate matters and later for the mandatory surveillance of the full range of policies affecting the ebb and flow of national current accounts. The associated acceptance by member states of a duty to collaborate with others through the auspices of the Fund represented a signal change in international economic affairs. Concerning the interaction effects of macroeconomic policies still determined through national political systems, they accepted a basic accountability norm. The Fund could not force changes in those policies, but it could hold members to account in a public and legal setting (Pauly, 2008a).

Reducing the probability that imbalances in external payments would once again help destabilize world order remained a shared goal throughout the exchange rate crises that plagued the Bretton Woods system in practice. When the Articles of Agreement of the IMF were amended in the mid-1970s to legalize floating exchange rates, the accountability norm was bolstered in tandem with acceptance of an emerging norm of capital mobility. Ever since then, the price of the new and increasingly broadly shared preference for exchange rate flexibility and internal monetary autonomy was acquiescence to volatility in ever deeper and ever more open capital markets. In principle, national payments imbalances would either be financed in international capital markets or those markets would force systemically stabilizing adjustments in national macroeconomic policies. And overseeing a more complex, market-based mechanism for balance-of-payments financing and macroeconomic adjustment would be a reformed IMF.

Whether the post-Bretton Woods system 'worked' effectively or not depends upon one's perspective (Truman, 2006). As in the pre-1914 period and the turbulent decade of the 1930s, exchange rate crises receded, at least in the advanced industrial world, but banking crises once again regularly occurred (Eichengreen, 2003). Since banking increasingly involved cross-border linkages, moreover, the policy challenge of international financial stabilization also re-emerged. Nevertheless, the international economy generally grew, more countries joined it and, especially after the end of the cold war and the opening of formerly insulated economies in Russia and eastern Europe, China and India, prosperity spread more widely than ever in the history of mankind. Significantly, moreover, world war did not recur.

To be sure, the cross-border financial crises characterizing the system after 1973 did often force draconian adjustment in weaker economies across the developing world and in economies in transition from socialism. They often failed, however, to encourage serious adjustments within the most systemically significant economies. In fact, increasing imbalances in the major national current accounts provided the main stimulus for global economic growth and development. US deficits, in particular, grew extravagantly as the current account surpluses of oil exporters, Japan, smaller east Asian countries and eventually China were recycled. The overall system rested on the assumption that such imbalances would remain both financially and politically sustainable.

Within its reformed mandate, the IMF did what it could to encourage macroeconomic adjustment, but its actual influence was limited. In practice, the task of developing binding global structures for promoting 'sound' macroeconomic policies and financial stability for the long-term common good remained elusive. Various attempts to encourage leading states collaboratively to confront the systemic implications of their autonomous macroeconomic policy choices proved unsatisfactory. In this regard, the supplementary evolution of informal bodies like the Group of Seven (G7), which aimed at the same objective, often amounted to much sound and fury signifying little. Only within the European Union, with the key exception of the United Kingdom, was it seriously possible to discern deeper engagement with the fundamental political dilemma posed by the post-Bretton Woods system. Global capitalism implied continuous and fundamental adjustment across integrating markets. Only a core group within the European Union (EU) proved willing to try a novel policy trade-off to address this implication cross-nationally: irrevocably fixed exchange rates, monetary policy integration and freedom for capital movements. Even they, however, refused to confront directly the logical consequence. As we learned so painfully during the early 1930s, someone has to be in a position to bail out troubled banks that have the potential to destabilize entire markets. In national systems, national monetary and financial authorities must do so, if necessary, with fiscal resources. National economies with integrated capital markets must similarly rely on some reliable form of fiscal burden-sharing when cross-border financial institutions that cannot be allowed to fail get into difficulty.

Prior to 2007, rapid economic growth in advanced and especially emerging markets was as remarkable as it was intoxicating. But flexible exchange rates, independent monetary policies and easy borrowing from booming capital markets proved a combustible mix. Exports and inward direct investment drove that growth and debt financed it. In short, the system came to depend on ever-increasing deficits in the US current account and reciprocal surpluses in the current accounts of oil exporters, Germany, Japan and China. And within the United States, as well as within the United Kingdom and the EU as a whole, current account deficits were increasingly financed by private-sector borrowing through financial institutions now operating fluidly across national borders (FSA, 2009). The alternative was to reduce those financing requirements by reducing underlying imbalances themselves. Co-ordinated policy adjustments could have translated into reduced consumption and more saving in the United States, with the reverse combination in countries like Japan and China. For example, changes in fiscal policy can serve such objectives, just as within currency unions fiscal stabilizers can help buffer asymmetric shocks. The point is that explicitly or implicitly co-ordinated adjustments in such policies can reduce the reliance of open economies on volatile capital flows.

In 1995, after a succession of financial crises in emerging markets, the Executive Board of the IMF amended its 1977 decision on surveillance procedures designed to encourage just such system-stabilizing macroeconomic adjustments. To its traditional list of national economic symptoms requiring intensive discussions with the IMF, it added ‘unsustainable flows of private capital’. It also directed Fund staff, ‘in the context of promoting broader market liberalization, to pay increased attention to capital account issues [. . .] and to the soundness of financial systems’ (*IMF Survey*, 23 October 1995, pp. 314–15). Twelve years later, on the eve of the 2007 crisis, the Board again amended the 1977 surveillance decision to widen the scope of the Fund’s authority. To three prior basic commitments binding on Fund members – to avoid exchange rate manipulation, to intervene when necessary to counter disorderly market conditions and to take the interests of others into account during such interventions – it added a new proscription against ‘exchange rate policies that result in external instability’ (Decision on Bilateral Surveillance over Members’ Policies, 15 June 2007). The main target was widely understood to be China, which was suspected of preventing a system-stabilizing upward adjustment in the value of the renminbi.

The vital question of whether China's mounting foreign exchange reserves were sustainable now precisely mirrored the question of whether the policies lying behind the post-1970s US current account deficit were any longer viable. As noted above, the Bretton Woods system rested on a principled commitment to economic openness, but also on the understanding that fundamental misalignments in exchange rates would not be allowed to endure. After 1976, the realization of that commitment came to depend less on acquiescence to the authority of the IMF and much more upon a willingness of all countries to follow signals sent by financial markets. By 2007, the ideal of a monitored and stable exchange rate system had in practice been replaced by imperfectly shared understandings on how such markets should work and how national authorities should respond.

Macroeconomic policy co-ordination remained both necessary in principle and elusive in practice. The assumption that integrating financial markets could induce whatever co-ordination was really necessary was now strenuously tested. Even if they sometimes did promote needed economic and political adjustments, those markets did not always work like flawless machines, especially when they ran up against resistance inside powerful countries. The crisis that began in the United States in 2007 would make that crystal clear.

II. Financial Stabilization and its Limits

The process of integrating national financial markets, accelerating and expanding around the world since the early 1970s, hit a wall in the summer of 2007. Facing financial emergencies reminiscent of the early 1930s, over the course of the next year national governments bailed out not only their own clearing banks but also a wide array of intermediaries that had long ago branded themselves as 'global'. In a number of cases, massive liquidity support by central banks proved inadequate and last-resort investing with resources drawn directly from national taxpayers proved necessary. Haphazardly, hardly elegantly, and often shrouded in opaque rhetoric, political authorities responded, in the main, effectively. Sometimes overtly but more often than not quietly and behind the scenes, they co-ordinated many of their responses across borders (Quaglia, 2009). At the technical level of central bankers and financial supervisors, they had been preparing for years. In the aftermath of the Asian crises of the late 1990s, there ensued myriad conferences, the creation of a Financial Stability Forum (FSF) for finance ministers, central bank governors and financial supervisors to bolster and broaden the work programmes of groups like the Basel Committee on Banking

Supervision and, perhaps most significantly, the building of emergency-management telecommunications linkages among national authorities. It is true that none of this effort prevented the crisis of 2007. Even collaboration on crisis management and resolution was not what it should or might have been. Nevertheless, the cynical argument that all of this prior planning signified nothing is implausible and incorrect.

To be sure, there were episodes of nationalist panic as turbulence cascaded through the system. If Icelandic, Irish, Belgian, Dutch and even American and British finance ministers could turn the clock back and rerun certain decisions taken in the heat of battle, they would likely wish to do so. In the end (by the summer of 2009, in any case), however, cross-border markets recovered. While some international intermediaries were taken apart, others grew larger and more intricate after forced or opportunistic mergers. Across the system, as they had done after every other crisis since the 1970s, leading states acknowledged their preference for not abandoning the policy trade-offs and global architecture permissive of large-scale capital movements. Even as some large banks scaled back their foreign operations, as they had also done before in the face of loan losses and capital shortages, few re-crafted their long-term strategies to focus only on their national markets. On the contrary, the politics of emergency management soon moved back on to the more certain terrain of central bank and financial supervisory co-ordination on bank capital and liquidity measures. Governments returned to long-standing technical but high-stakes policy debates on expanding and making meaningful the mandates, scope and scale of collaborative regulatory and supervisory networks. After the crisis of 2007, however, those debates could no longer downplay the underlying fiscal realities of financial integration.

Before the crisis, it had not been possible for leading states – even within the European Union – to agree on the terms under which fiscal burden-sharing would occur when nationally licensed but globally active and systemically significant intermediaries threatened to fail. During the crisis, despite journalistic accounts to the contrary, an ad hoc and implicit pooling of fiscal resources did occur. It was easier to observe co-ordinated monetary responses as central bankers simultaneously injected liquidity into fragile markets and cut interest rates. More sensitive were injections of fresh equity from national treasuries into private banks and other intermediaries. But the undeniable fact is that clumsy and politically tolerable fiscal burden-sharing did occur between 2007 and 2009.

There was nothing inevitable about that reluctant collaboration. The tolerance of taxpayers could yet be strained to the breaking point. More likely, post-mortems during calmer times will occupy regulators and legislators for years as they seek new understandings on the appropriate balance between competition and safety at national, regional and international levels. In short, as the fiscal issue demonstrated, political legitimation for the post-1970s experiment in financial integration remains weak. Notwithstanding the shortness of many memories of the sheer panic coursing through the system during 2008, the traumatic experience of the crisis placed the question of legitimacy squarely at the centre of future policy debates on the place of finance in globalizing capitalism (Jones, 2009).

Since 1945, in fact, the preference for competition in open markets has prevailed over the depressive nationalism of market closure (Kindleberger, 1986; Minsky, 1986; Goodhart, 1988; Strange, 1988; Helleiner, 1994; Wray, 1998; Pickell and Helleiner, 2005). We remain, however, in a world where nationalism retains its primacy as the key ideology providing legitimation for the wielding of state power. When combined with constitutionalism and a commitment to the rule of law, nationalism has most reliably been tamed. But its darker side – suggesting a radical separation between 'us' and 'them' – lurks in the shadows, behind even the most liberal state authorities. Nationalism continues to influence even the most cosmopolitan structures of regional governance. Nothing fundamental changed in this regard when after 1973 the shared preference for openness began to encompass markets for capital as well as for good and services. As in 2007 and 2008, we see its face most clearly during financial emergencies requiring fiscal responses. At that very point, the persistent human question 'who is "us"?' demands a non-evasive answer.

The evolution of financial markets and the evolution of the underlying authority to supervise them are, so to speak, two sides of the same coin. The development of national central banks and banking supervisors occurred in the context of lengthy political battles, often closely related to the changing scale and scope of financial intermediation. When the possible failure of important and/or politically connected intermediaries posed larger threats, both economic and political, governments found themselves intervening to stabilize and restructure markets (Kindleberger, 1978; Kindleberger and Laffargue, 1982). Associated crises either expanded the scope of political obligation underpinning actual markets, or led to their disintegration. The power to nationalize troubled intermediaries during emergencies entailed the power to supervise them in more pacific circumstances.

As noted above, the experience of the Great Depression and subsequent world war pushed the United States and its allies eventually and decisively to embrace economic interdependence. To be sure, that the United States itself would often be relatively less dependent in the post-war system translated into the power to lead, and sometimes to force others into accepting that embrace. But the system it led after 1945 did persist, despite many turbulent periods and despite US policy actions that could sometimes plausibly be interpreted as self-regarding or inept. Again, its first phase ended when a pegged exchange rate system proved unworkable and international capital movements became key drivers for a more integrated structure of financing and adjustment. In retrospect, strategic acquiescence in the decisions giving impetus to such a market-centred system locked central bankers, financial supervisors, finance ministers and, in democracies, legislatures into delicate, intricate and difficult-to-manage policy networks.

III. Managing Cross-Border Financial Crises

In 1975, following the collapse of Franklin National Bank of New York, leading central bankers and bank supervisors reached a basic consensus at the level of principle, which took the form of voluntary guidelines for future collaboration, the key one of which clarified the primary bail-out and supervisory responsibilities of the home states of cross-border banks.[1] Finance ministers and legislators re-engaged with the technical dialogue of the Basel Committee on Banking Supervision after the 1982 developing-country debt crisis threatened many of the world's large financial intermediaries. Home-country control remained the guiding principle, and everyone understood that banks requiring emergency assistance would look first to their national authorities. In 1988, this principle was complemented by the Basel I agreement, setting out minimum capital requirements for internationally active banks.

The evolving regime meant to guide the continued opening of banking markets was marked not only by the exigencies of crisis management, but mainly by the politics of competition policy in a sector deemed promising in basic economic terms (Kapstein, 1998). Light-touch regulation in small islands, and even in big ones like the United Kingdom (Hodson and Mabbett, 2009) could be construed as industrial policy by another name. The challenge of safeguarding interdependent payments systems was therefore caught up in the game of levelling national 'playing fields'. Understandings reached in such forums as the Basel Committee on minimum capital requirements, the mutual recognition of other still-diverse national standards and regulatory practices, and even nascent plans for information-sharing during emergencies needed to be viewed in this light. Not coincidentally, the so-called Basel I agreement left large grey areas around the operations of foreign banks in host

[1] This section updates and develops parts of Pauly (2008b) and Pauly (2009). It links to a continuing research programme on the theme of globalization and autonomy supported by the Social Sciences and Humanities Research Council of Canada. See Coleman and Pauly (2008). Also see Clark *et al.* (2009).

countries. Answers to such vital questions as who would actually intervene in emergencies involving small branches or subsidiaries of large, complex financial institutions and who would prevent them from suddenly transferring resources from host to home markets remained opaque.

Nevertheless, the post-1982 consensus was fundamentally shaped by a shared belief, certainly among the technical policy specialists charged with financial regulation and supervision, that more open national markets would reliably provide financing for both gradual adjustment and durable development as long as governments and central banks pursued sound macroeconomic policies. The idea of more intensive and collaborative oversight of large cross-border financial institutions (LCFIs) was regularly raised in official circles, but just as regularly sidestepped. Emerging cross-border markets found their normative grounding mainly on Anglo-American understandings of how they ought to work (Abdelal, 2007). Because this accommodated the deeply held assumption that home states would and should principally be in a position to act decisively in emergencies, national authorities sceptical of liberal or cosmopolitan ideologies went along. Not coincidentally, their own champions aggressively sought profitable opportunities abroad, even if, as in the cases of Switzerland, Austria, Italy and Spain, they soon stretched the credibility of implicit home-state guarantees to the limit. For their part, host authorities continued to welcome foreign capital and the expertise coming with it. Certainly, many central and eastern European countries seized the moment after the end of the cold war and looked to foreign banks to help reconstruct and modernize their economies.

If they could, some host states built up foreign currency reserves to buffer their economies in the event of future systemic financial shocks (Bryant, 2003; Kapstein, 2006). In east Asia in particular, the regional crises of the late 1990s obviously bolstered the dual and partly contradictory impulses of openness and caution. As China and other new entrants followed along lines pioneered by Germany, France, Japan, and smaller east Asian countries, financial mercantilism became harder to differentiate from prudent conservatism. As in Keynes' famous analogy between financial markets and beauty pageants, diverse national authorities could see one reality but believe that others were seeing quite another (Keynes, 1936, ch. 12).

Once again seeking to recalibrate the balance between competition and safety, and surely under pressure from rapidly expanding financial intermediaries, in 2006 leading states modified their mutual understanding on the capital adequacy of banks and on systemic risk management. The Basel II agreement allowed internationally active banks to bring complicated models for measuring their risks into the calculation of their capital requirements. In contrast to the straightforward standards of Basel I, capital requirements were now calibrated with the risk profiles of different kinds of banking assets and with diverse portfolio choices. For the largest banks, heavy reliance was now placed on internal value-at-risk models maintained by the banks themselves. Under the terms of Basel II, smaller banks and banks not based in advanced industrial countries typically faced the less flexible capital requirements of Basel I.

In the end, Basel II rested on capital requirements keyed on credit risks, adequate supervisory review and 'market discipline'. To enhance the latter, the agreement recommended various mechanisms for increasing the disclosure of information by banks, information that would allow credit rating agencies and others to render judgements on their ability to meet obligations. Ironically, after the debacle following the summer of 2007 Basel II is now associated with an absence of discipline in markets lacking in transparency. Not only did the internal risk models of systemically significant banks fail to assess realistically the risks of low-probability but high-cost events, but they also gave bank managers and regulators an unjustified sense of precision in their performance assessments. In retrospect, they provided a sophisticated cover for strategic over-leveraging in many commercial and investment banks, for misguided 'innovation' involving the securitization of debt claims, for the expansion of inadequately regulated investment vehicles and, surely not coincidentally, for overcompensating the managers of banks and their new competitors (Carmassi, Gros and Micossi, 2009).

Although Basel II was not yet fully implemented by the summer of 2007, its normative aspirations immediately came under critical scrutiny as a crisis-driven rush for liquidity spread around the world. A postmodern bank run had begun, but this time not in the periphery of the system. The idea of self-regulation was discredited, at least for a time. Available bank capital often proved inadequate as securitized risks migrated back to bank balance sheets. A mismatch between market scope and ultimate regulatory authority became undeniable. As investment banks failed or rapidly transformed themselves into bank holding companies with access to liquidity support from national central banks, as systemically significant insurance companies received bail-outs, as hedge funds collapsed – financial supervisors went to ground and national finance ministries returned reluctantly to centre stage.

The history of modern central banking and financial supervision is the history of masking, buffering and providing scapegoats for those authorized to gather, safeguard and spend state revenues. Placing banks and other financial institutions at arm's length from finance ministries has simply turned out to be good politics and wise policy, even across widely differing national systems. Under the elastic concept of liquidity management, central banks can do a great deal to stabilize financial markets in emergencies. In extreme circumstances, however, only finance ministries have access to the kinds of fiscal resources required for final, last-line defences of institutions deemed too crucial to fail. In most countries, only national treasuries can make last-ditch equity investments in troubled but arguably essential financial institutions or encourage other institutions to make such investments.[2] Since such measures are bound to be controversial and subject to unintended consequences, wise finance ministers try to keep the spotlight on central banks and financial supervisors, even during crises. When emergencies nevertheless shift the spotlight their way, they do what is necessary and then seek the shadows again as quickly as possible.

Future historians may well emphasize the irony that a quarter-century of effort to craft reliably collaborative supervisory foundations for global financial institutions almost ended in 2008 with a replay of the drama of 1931. But the past did not in fact repeat itself, either as farce or as tragedy, precisely because the lessons of the Depression were so widely and convincingly learned. It is true that Basel I and its central notion of home-country control was pushed to its limits. It is also true that Basel II now needs fundamental rethinking. But hints of deeper recalibrations in financial crisis management policies should not be missed. In 2008 and 2009, finance ministers often did more than they might have initially desired and they did so quite mindful of what their counterparts were doing around the world. The nationalist poses some of them occasionally struck must be interpreted carefully. Especially in democracies, they could hardly be expected to behave as cosmopolitan liberals in the midst of emergencies. Their constituents were both traumatized and angry. In retrospect, however, it seems that excessively nationalist policy actions tended to backfire, especially when no *ex ante* backstopping facilities existed to save finance ministers from suffering the consequences of folly. Future research can be more definitive, but for the present a couple of other examples are suggestive of the new and subtle politics of financial stabilization in the more complex system evolving in the aftermath of 2007.

The first draft of the US bail-out plan in the autumn of 2008 promised to make US taxpayer funds available only to ‘a financial institution having its headquarters in the United States’ (US Treasury, 2008). That changed within 24 hours, after the Treasury was apparently reminded that nearly 25 per cent of the US domestic financial system was now managed by foreign-headquartered intermediaries. The final version of the Emergency Economic

[2] In the recent crisis, the most inventive and surprising developments in this regard occurred in the United States. Based on an obscure provision in a 1991 law reforming the Federal Deposit Insurance Corporation, the US Federal Reserve conveniently remembered that it had all the authority it needed to intervene not only to save regulated commercial banks, but also investment banks like Bear Stearns. The idea that this authority was invoked with the understanding of the US Treasury is more than plausible (see *Washington Post*, 30 May 2009, p. 1).

Stabilization Act passed by Congress on 3 October 2008 specified in section 3.5 that the bail-out programme covered 'institutions with significant operations in the United States, excluding foreign central banks or institutions owned by foreign governments' (US Congress, 2008). Unlike previous episodes of financial instability when congressional action focused on banks, the term 'institutions' had been carefully chosen. In this crisis, problematic intermediaries posing systemic risks now included not only commercial and investment banks, but also insurance companies like AIG and other highly leveraged non-bank investment and financing vehicles. In the fullness of time, moreover, it became clear that the AIG bail-out covered a full range of domestic and foreign bank counterparties, who were ultimately able to unwind associated contracts at par, that is, without a discount. The goal may have been system stabilization, even if actual transactions could be interpreted as evidence of regulatory capture. But the fact is that when they were done and when they were disclosed, they proved to be politically tolerable.

Similarly attempting to prevent emergencies from spinning completely out of control, leading states, as well as rising states with high foreign exchange reserve balances, sought common ground in 2008 and 2009. To be sure, the process was messy and rancorous. It was also marked by many missteps. In Iceland and Ireland, for example, panicked decision-makers tried to end bank runs with policies blatantly privileging the interests of domestic depositors and limiting the liabilities of their own governments (Mayes, 2009). Since their markets were intimately connected with others, especially in those two cases with the United Kingdom, negative knock-on effects proved immediate and costly. Policy reactions abroad were swift and ugly. In the end, however, only non-EU member Iceland was left completely bereft, for Ireland was able to benefit from liquidity injections from the European Central Bank (ECB) and implicit financial support from stronger partners within the Union. Indeed, in the aftermath of catastrophe and facing few alternatives to draconian fiscal cutbacks, a long-standing debate on joining the EU was re-energized.

During the crisis, some central and eastern European countries, long worried about the extent of their dependence on foreign providers of capital, feared that troubled LCFIs would begin pulling resources back home. Host countries reacted by trying to ring-fence the local operations of those institutions, effectively attempting to separate the control of their assets from the ownership of their shareholders' equity. Earlier incidents in the Baltics and elsewhere had highlighted the potential implications of the Basel I idea of home-country control, but the basic dilemma facing European countries not already in the monetary union had long been obvious. What alternative did they have? As the situation of central and eastern European countries developed throughout 2009, it became clearer that the real question was whether certain home countries – like Sweden, Austria, Belgium and Italy – could themselves count on support from other west European governments, either directly or indirectly through regional institutions (IMF, 2009, p. 14). In that regard, little in the post-1950s history of European integration justified pessimism. At the same time, much in that same history suggested opacity, reluctance, controversy and much grumbling whenever such support turns out to be required (Verdun, 2000; Beck and Grande, 2007; Quaglia, 2008; Schmidt, 2006, Sapir, 2007). More difficult to deny after the crisis of 2007, however, is the wisdom of better regional programmes to complement IMF facilities available to counter future financial shocks.

Although the division of responsibilities between home and host supervisors will again be a focal point in post-crisis debates, more challenging issues became clearer during the course of the actual bail-outs of relatively new transnational intermediaries like the Franco-Belgian bank Dexia and the even more complicated Benelux institution, Fortis. In September 2008, the governments of Belgium, France and Luxembourg pledged €6.4 billion to save Dexia and they then moved to carve up its operations along national lines. Similarly, later that month Fortis was fundamentally reorganized when the Belgian, Dutch and Luxembourg governments took 49 per cent positions in the bank's businesses in their three still-linked markets. The majority of the Belgian and a minority of the Luxembourg shares were soon sold to the French bank BNP Paribas in a complex transaction that left the Belgian government with a 25 per cent stake in BNP Paribas itself. The deal was later amended after protests from the Dutch shareholders of Fortis, but it essentially left national demarcations more starkly drawn within Fortis while broadening the potential transnational operations of BNP Paribas (ECB, 2009, pp. 41–2). What neither the Dexia nor Fortis debacles did accomplish, however, was to undermine Europe's cross-national payment and investment systems. One year earlier, Jean-Claude Trichet, head of the European Central Bank, had foreshadowed the political limits surrounding a potentially more elegant and more certain burden-sharing mechanism underneath those systems. 'We encourage intimate co-operation between all banking authorities. We also insist on flexibility.'[3] During the following two years, flexibility is what Europe got.

What leading European states did not get in the midst of systemic crisis was the courage to move decisively in the direction of deep political innovation, which one might have imagined by this time in history to have entailed both supranational regulation and supervision of key financial institutions and

[3] *Financial Times*, 17 September 2007.

binding arrangements for macroeconomic policy collaboration. Are the seeds now sown for such moves? Perhaps not, but continuing debate will remain ever more deeply shaped by proposals for reliable *ex ante* agreements on fiscal burden-sharing in the face of cross-border financial emergencies (Goodhart and Schoenmaker, 2006; Schoenmaker and Oosterloo, 2005). Such proposals begged the questions, for example, of whether the constituent members of the monetary union in Europe were fundamentally obliged to assist one another in an emergency, whether they could trust one another to minimize financial losses and whether they could now share the same culture at least on the issue of systemic risk. Perhaps all that really remained feasible for the moment were ad hoc understandings reluctantly reached at the moment of emergency itself. But the political implication of even such understandings, now reinforced by painful experience, should not be underestimated.

To have expected open-ended *ex ante* agreements on burden-sharing in a now-enlarged and variegated European Union would have presumed faster transformation in deep political and ideological structures than was yet realistic. In the event, however, Germany did not move decisively away from its longer-term policy of promoting more integrated and more resilient European capital markets. Its own largest banks, moreover, proved to be more vulnerable than many had imagined in 2007 (Hardie and Howarth, 2009). They needed foreign markets and access to foreign capital, so Germany had even more reason to stay committed to the larger systemic project of financial integration. In this regard, note that even Deutsche Bank turned out to be a key beneficiary of the US bail-out of AIG. For their part, German policy-makers tried to minimize the exposure of German taxpayers to the costs of system maintenance, both regionally and globally. This would suggest looking more at what they actually did than what they said on the complexities of preventing and managing future financial crises. The same goes for their key partners in the broader European Union, especially France and the United Kingdom, which both demonstrated considerable pragmatism when markets seemed especially vulnerable. Société Générale and BNP Paribas both grew more complex in the wake of the crisis and by its end a somewhat chastened City of London stood poised to resume its role as a crossroads for global finance.

Certainly in mid-2009, testy but seemingly durable political collaboration of a minimal but historically significant sort remains apparent in European and global markets (Grande and Pauly, 2005). Leading states are behaving as if they have resigned themselves collectively to mitigating and resolving future cross-border emergencies. Contagion from contrary actions undertaken in panic by certain governments proved limited. Despite now more evident systemic risks, few contemplated serious measures to disentangle themselves from financial networks they themselves spent half a century constructing. Calls to take apart financial behemoths and render them 'small-enough-to-fail' rang hollow. As soon as the most intense local political heat was reduced, finance ministers, central bankers and supervisors turned once again to collaborative working groups aimed at providing better oversight for LCFIs, which in turn looked set to be fewer in number but larger in scope (Larosière, 2009; FSA, 2009). At the same time, quiet burden-sharing continued, for example, through reduced profits flowing from central banks back to national treasuries, through the balance sheets of multilateral financial institutions and through regional payments facilities.[4] More broadly, attention returned to the threats posed by underlying macroeconomic imbalances, which financial deregulatory moves during previous decades had only obscured and not resolved.

At their high-profile London summit meeting in April 2009, the traumatized leaders of the Group of Twenty (G20) declared themselves ready to strengthen the global financial system and return to the issue of macroeconomic fundamentals (G20, 2009). Aside from making predictable promises to 'assess', 'study' and 'monitor' more effectively, their declaration signified no binding commitments to co-ordinate key macroeconomic policies. They did, however, agree to change the FSF into the Financial Stability Board (FSB) and expand its membership to include all of the G20, Spain and the European Commission. They underlined the 'macro-prudential' role of the Board, thus acknowledging the connection between financial market fragility and the ultimate interaction of national macroeconomies. As its chairman noted, 'We all share the same goals: an open international financial system based on market principles, sound regulation, adherence to standards and stability-oriented policies' (Draghi, 2009).

In practice, the Board is to be a vehicle for consultation across various standard-setting groups and organizations, like the Basel Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors. Encouraging improved and collaborative oversight especially of systemically significant financial intermediaries, it embodies a network approach to prudential supervision and crisis management. In the wake of the crisis of 2007, nevertheless, it may in time push beyond non-binding resolutions and informal consultations. At the London

[4] Burden-sharing through central bank operations is worth more detailed empirical research. The case of the ECB seems particularly interesting. Although statutorily more autonomous than other central banks by virtue of its Treaty base, it remains operationally the creature of national central banks. Net financial returns on its operations redound to them. In principle, therefore, the costs of the Bank's liquidity support activities are borne collectively by them. To the extent particular national central banks pass their own earnings on to national treasuries, there will be evident fiscal implications.

Summit, its mission was explicitly linked to the Financial Sector Assessment Programmes of the World Bank and the IMF and to the Fund's efforts, born of its surveillance mandate, to devise an early warning system for problems likely to destabilize global markets in the years ahead. In this regard, the heads of the FSB and the IMF were charged with making joint presentations to the International Monetary and Financial Committee which brings together the world's leading finance ministers and central bank governors in the ultimate governing structures of the Fund itself. Once again, the vital linkage was highlighted between financial stability and mutually sustainable macroeconomic policies.

The test will be whether such stated objectives are soon reflected both in more resilient capital markets and in less extreme imbalances in the current accounts of key states. Growth in countries like China and Japan, for example, should become less dependent on exports to the United States. In turn, the United States should import less as it eventually confronts the necessity of fiscal austerity. Overall, commitments to a more balanced system dating back to 1973 should move beyond routine communiqués issued after summit meetings.

In Europe, movement toward a more cohesive, if still complex, system of financial supervision looked possible in the aftermath of crisis, even if explicit and binding burden-sharing arrangements remained elusive. Although the prospects for profound policy reform were hardly certain in either Europe or the United States, few officials across the Atlantic would likely forget any time soon that macroeconomic and regulatory missteps had preceded a near-catastrophic global emergency, the successful management of which had depended on the joint deployment of the fiscal power of the state, the acquiescence of national taxpayers fearful of the consequences if such deployment did not occur and the improving quality of technical networks organized around central banks and financial supervisors. Across the Pacific, a key question remained whether the emergency would perversely encourage the building up of reserves, rendering more difficult the challenge of collaborative and politically sustainable macroeconomic adjustment and heightening the risk that the next financial crisis would be even more severe.

Conclusion

During the crisis of 2007, leading states proved to be strongly motivated by the dynamics of financial stabilization and, once again, only weakly drawn to the co-ordination of macroeconomic policies in the search for enduring, shared prosperity. They remained unwilling to contemplate either a collective return to an international regime of pegged exchange rates or to a system of enforceable limits on international capital movements. They instead joined in loosely connected and nationally funded financial bail-outs, the scope and implications of which clearly did not stop at national frontiers. Whether acknowledged or not, a fiscal element was now clearly injected into renewed dialogue inside transnational policy networks. The idea of globalizing finance did not collapse, but neither was it vindicated. The most that can be said was that a reluctant and ad hoc pooling of sensitive national policy-making capacities occurred in a concentrated effort to stabilize more integrated markets and keep them open. At the level of newspaper headlines, it appeared that economic nationalism had trumped all whenever finance ministers and national legislatures felt compelled to act. But behind the scenes, networks of state officials – from finance ministries to central banks to financial supervisors – expanded their collaborative, if hardly harmonious, work.

The future global financial environment looked set to include a number of vital elements: larger and still complex cross-border firms, implicitly co-ordinated fiscal backstops, regulatory systems still decisively shaped by national bankruptcy and unwinding regimes but perhaps better linked through shared standards (Véron, 2006), and intensified collaboration among central banks and supervisory authorities. In states particularly dependent on foreign banks and non-bank financial intermediaries, there may also be heightened insistence on new rules to prevent or forestall capital flight during emergencies, including the requirement that foreign firms take the form of fully capitalized subsidiaries subject to greater host-country control.

The nation-state remains resilient and states can still design and implement policies responsive to emergencies (Gelpern, forthcoming). Still, the shadow of the Great Depression continues to loom large over key policymakers. A dramatic retrenchment of LCFIs in the immediate wake of the crisis was obvious after 2007, but so too was the refusal of leading states to back decisively away from the very idea of capital market integration. The resulting policy challenge is now an old one, but a new politics engages it.

After each succeeding systemic financial crisis in the post-1970s period, governments promised deeper co-ordination of their macroeconomic policies in an effort to contain cross-border financial risks. Thus far, they failed to take the promise seriously, either in the context of agreed IMF procedures or in less formal consultative forums like the G7 or G20. The question remains whether better structures and practices of emergency crisis management can be counted on to compensate for that failure. Europe is now grappling internally with the same question, and with its underlying fiscal dimension. Worth more systematic and extensive study in this regard is the evolving role of the

ECB, of quietly co-ordinated interaction between the ECB and the Bank of England and of the new work programmes of specialized financial supervisors. Behind the screen of their technical work, could finance ministers still be attempting to reinvigorate more open, more resilient and ultimately more integrated regional financial markets? Certainly the experience of the recent crisis suggests that observers should be wary of solemn declarations of the inviolability of national fiscal sovereignty, for repeated fiscal actions of an ad hoc and loosely co-ordinated character give rise to quite plausible expectations that they will ever more reliably be deployed to stabilize those markets. Since the challenge of negotiating macroeconomic policy adjustments globally similarly impinges on the larger experiment in systemic financial integration, the rest of the world has more reason than ever to pay attention to the European experience.

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