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Managing Financial Emergencies in an Integrating World

Louis W. Pauly
University of Toronto

louis.pauly@utoronto.ca

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Abstract:

Financial risks as well as opportunities now flow more freely across the borders of all but the poorest countries in the world. But globalizing finance became an observable fact before fully adequate political structures were in place to steer it. The basic proposition that robust financial markets both rested on and reinforced the legitimacy of state power was decisively tested during the Great Depression. It is being tested again today. A turning away from open markets is possible. Certainly an apparent turning inward occurred as states used national fiscal resources to bail out troubled intermediaries. Strengthened home-country control of more tightly regulated financial intermediaries is more likely. But also likely is an expansion in host-state authority over the local operations of intermediaries headquartered elsewhere. In this context, both home and host states find themselves confronting the need to bolster networks of official collaboration in order to stabilize markets still significantly shaped by large, complex financial institutions. Even if direct acknowledgment by national authorities remains problematic, such collaboration now involves deeper fiscal interaction. Ironically, autonomous policy-making capacity in this most sensitive political arena cannot achieve desired objectives unless it is more intensively pooled.

Crises lay bare the nature of political systems supporting financial markets. When they are not contained and managed, they break those systems apart. When they are successfully resolved, most people can forget about the politics and get back to business. To highlight an analytical theme that stretches from Karl Marx to Susan Strange, financial crises are always symptoms of deeper contradictions. The politics that most of us can try to ignore most of the time is all about managing those contradictions.

Amartya Sen famously drew attention to the most fundamental of such contradictions today: integrative pressures from global economic and scientific transformation on the one hand, and rapidly rising expectations of individual and collective autonomy on the other (Sen 1999). This article focuses on the new politics of coping with that tension as it manifests itself in contemporary financial markets. States are challenged to manage financial emergencies involving intermediaries with very dense cross-border networks. Last-resort lending, and especially last-resort investing, operations have become more complex. Increasingly, officials reflective of those networks are engaged in coordinating the fiscal capacities of states. Integrated and stable markets with any chance of enduring can only exist in a world where fiscal autonomy is reliably transcended. Ironically, some pooling of sovereign authority now appears essential if states are to retain their effectiveness in stabilizing markets and keeping them open. Thus far in the global crisis that began in the summer of 2007, leading states appear implicitly to be acknowledging that reality as the scale and scope of transnational collaboration expands apace.

Historical Context

For a brief moment after 1919, when had finally fallen on the killing fields of Europe, it seemed that a League of Nations based on the fundamental principle of solidarity just might address problems capable of destabilizing the international system once again. In a signal case, officials of the League achieved surprising success in 1922 by assembling a support package for a financially troubled Austria. Even though the major powers of Europe were unwilling directly to assist Austria, they did in the end acquiesce in an innovative operation championed by League staff. A decade later, however, Austria was again in financial distress, and this time the League and an emergency committee of central bankers convened at Basel by the Bank for International Settlements proved incapable of stopping a cascading market collapse. The head of the League's Financial Section, Arthur Salter, later recorded the key events.

In the early summer of 1931 a director of the Credit-Anstalt of Vienna asked that its assets be revalued. . . . The financial institution most closely associated with the industrial life of Austria was revealed as insolvent. . . . The Austrian state was at once involved, because the government felt it must give its guarantee to prevent a run . . . This in turn had grave reactions on the budget and currency. . . . The consequences of the visible cracking of the structure in Austria extended rapidly over a much wider area. The world's balance of payments had for some years been maintained only by the constant renewal of large short-term advances which were liable to be called in at the first shock of confidence. . . . A run on Germany began. . . . A prime ministers' conference was called in London; and the bankers who had made the principal short-term advances to Germany made a stand-still arrangement [to February 1932]. . . . Germany's situation was relieved for the moment but obviously needed more radical action than could be immediately improvised and a Committee [of central bankers] at Basel examined the general position of her foreign obligations (Salter, 1932, pp. 42-44; also Salter, 1961).

External surveillance, as we would call it today, proved insufficient. The work of this first Basel Committee ended in failure. The following catastrophic decade witnessed the coincidence and global propagation of banking and currency crises (Simmons, 1994; Bordo and Eichengreen,

2002; Eichengreen, 2003; James, 2002; Temin, 1991), and eventually system-shattering barbarism and bloodshed.

In the aftermath of the Second World War, efforts by the United States and its victorious allies to ensure their own internal financial stability did succeed in reducing the incidence of banking crises (Pauly, 2008a). After 1973, when the Bretton Woods pegged-exchange-rate system broke down and the scale and speed of international capital movements increased dramatically, banking crises once again became a fact of international economic life. When they finally gave up on the post-war system of pegged exchange rates in the early 1970s, leading states promoted or acquiesced in the construction of more open capital markets. They also exhibited an unwillingness to merge their associated regulatory powers together to provide a firm political foundation for those markets. Of course, capital markets are still not completely open anywhere. Despite tremendous growth in the scale of foreign asset holdings by direct as well as portfolio investor, and despite a vast expansion in the overseas operations of banks and other intermediaries, evidence remains of a home bias, especially but not only in contemporary equity markets. By most estimates, net international capital flows before the financial crises of the late 1990s did not yet exceed those characteristic of global markets in the pre-1914 period (Obstfeld and Taylor, 2004; Isard, 2005). Nevertheless, after remarkably brief pauses occasioned by crises, the broadening expansion of international capital flows has always resumed.

The contemporary emergence of global finance, or ever more open national and regional markets, is hardly the story of the inexorable progress of liberal principles or the compelling logic of individualism. It begins instead in the late eighteenth century as competitive and insecure states confronted the necessity of constituting nations. Nationalism gradually succeeded in replacing the dynastic and religious foundations of claims to political legitimacy,

first in Britain, then in the United States, and then in France. As it did so, a series of remarkable technological innovations disrupted traditional solutions to the classic economic problem of scarce resources and unlimited wants. Central to the legitimation contests that took apart old empires, reorganized dysfunctional polities, and gave us the modern nation-state was the struggle to control finance. This simple point, of course, encapsulates diverse, sometimes bloody, and always venal case histories. In the obviously successful cases, however, the growth-enhancing nationalism of competition in open markets prevailed over the depressive nationalism of market closure (Kindleberger, 1986; Minsky, 1986; Goodhart, 1988; Strange, 1988; Cerny, 1993; Helleiner, 1994; Coleman, 1996; Germain, 1997; Wray, 1998; Mosley, 2003; and Seabrooke, 2006).

Despite frequent cosmopolitan claims, the architects of modern financial markets typically focused on local interests. The markets that had a global dimension in the pre-1914 period were linked by the interests and ideological foundations of empires built around the English, French and Dutch nations. Their analogues in the late twentieth century mainly connected financial centers like New York, London, and Tokyo, but their heavy reliance on the US dollar and their support of multinational corporate investment mainly emanating from the United States suggested the earlier linkage of interest and ideology. By then, however, parochial financial policies within both the United States and Europe were giving way to the logic of confederalism, certainly in wholesale markets. In principle, this offered a model for future regulatory architecture at both regional and global levels, for decentralized solutions accommodated diverse nationalisms, did not necessarily imply a complete structural convergence, and left significant room for fiscal autonomy. Even in such contexts, however, the principal *raison d'être* for more open and competitive financial markets was to facilitate

economic growth and prosperity sufficient to sustain the claim of authority inhering in polities that were certainly more complex but not entirely dissimilar from their predecessors (Friedman, 2005; Greenfeld, 2003; Pickell and Helleiner, 2005).

The truncation of international capital flows in the 1930s taught a hard lesson (Kindleberger, 1978; Kindleberger and Laffargue, 1982), one that had been learned just as painfully in the earlier histories of large federalizing states: integrating financial markets necessitated deepening cooperation among regulators, and in the extreme, the scaling of supervisory authority to the size of the market. The development of national central banks and banking supervisors occurred in the context of lengthy political battles, often centered on the changing scale of dominant financial institutions. When the possible failure of such institutions posed larger threats, both economic and political, governments of every political stripe periodically found themselves intervening to stabilize and reorder markets. Experiences of actual crises typically ensured that such interventions would shape future market expectations and expand the scope of political obligation. Mitigating systemic risk required recourse to the public purse, which in turn spawned ‘moral hazard,’ the temptation to take excessive risks financiers supposedly faced when they believed they can ultimately count on governmental guarantees. Moral hazard, in turn, justified official supervision, which itself rested upon the ultimate power to nationalize, liquidate, or reorganize troubled institutions in order to prevent entire markets from collapsing. Central bankers, financial supervisors, finance ministers, and, in democracies, legislatures were thus becoming locked into delicate and intricate networks.

Crisis and control in integrating markets

In the years following 1945, capital mobility was limited and national banking systems were tightly regulated and insured by “home countries.” The instability of the currency system

and the intrinsically related political pressures undermining the policy intention to restrict international capital movements finally ended this era. With exchange rates among most of the world's major currencies now flexible and capital flowing more freely across national borders, the stage was set for the first great banking crisis of the new era (Pauly, 2008a). 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). With the assistance of the staff of the Bank for International Settlements, but actually led by central bankers from the United Kingdom and the United States, bank supervisors subsequently initiated regular consultations on the appropriate division of responsibilities between the home and host states of internationally engaged financial institutions, thereby initiating what was to become a potentially global network of financial system regulators. In 1975, that network began to organize itself around the terms of a grandly titled "Concordat," which provided guidelines for future collaboration, the key one of which assigned primary responsibility to home states (Kapstein, 1998).

Finance ministers and legislators became seriously interested in the dialogue of the Basel Committee on Banking Supervision after the 1982 developing-country debt crisis threatened banks at the core of national payments systems as well as smaller local banks that had ventured into international banking by taking pieces of syndicated loans (Wood, 2005). Not unlike the staff of the League of Nations in the 1920s, the IMF played a key role in that crisis but as the catalyst of inter-state collaboration, not as the lender-of-last-resort. Certainly with regard to the main debtor state like Mexico, everyone knew that the US government would have to play exactly that role if US banks, among others, were not to fail.

At the extremes of the analytical and policy debates that followed the 1982 debt crisis, it was commonplace to depict international financial markets either as poised on the brink of integration so intense that a global financial regulator backed by last-resort lending capability was now required, or so fragile that they required careful dis-integration to protect national economies. In the world of actual policy, finance ministers, central bankers, financial supervisors, and legislators encouraged the development of an awkward but politically feasible international supervisory policy regime (Porter, 2005). The core principle was home-country control of nationally regulated financial intermediaries, still mainly banks. But the regime also encompassed certain cross-national requirements both to safeguard now-interdependent payments systems and to “level the competitive playing field.” These included minimum capital requirements, the mutual recognition of other still-diverse national standards and regulatory practices, and intensified cooperation through a widening set of intergovernmental organizations, central banking, and supervisory networks. Large gray areas remained, however, remained around the operations of foreign institutions in host countries, especially in countries that would become quite dependent on those institutions. In an emergency, who would actually throw a safety net over their foreign operations? And if such an emergency actually began back in the home markets of such institutions, what would prevent them from draining capital from the host market?

The rapid expansion in cross-border capital flows after the 1980s meant that policy makers were asking themselves a basic question: 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? The question was a pressing one for many developing countries, which came to depend upon access to private capital from abroad. It

would become even more serious for countries in transition from socialism after the end of the Cold War. In certain case, like Poland and Hungary, foreign banks very soon became crucial players in quickly changing domestic markets. In principle, inward flows of privately owned capital make it possible for real economies to grow more rapidly than if they relied solely on domestic resources (Tirole, 2002). In practice, those flows are often volatile and they will respond rapidly to crises, whether homegrown or not. The extra costs associated with crisis-induced capital outflows can undermine real economies and disrupt underlying political and social orders. Those costs can be huge, their deeper effects insidious and lingering.

Nevertheless, by the 1980s it had become clear that states constructing the international economy had collectively moved away from one set of policy trade-offs and toward another. Immediately after the Second World War, they had sought to reconcile their newfound desire for exchange-rate stability with their interest in maintaining independent monetary policies; they therefore had to tolerate limits on inward and outward capital flows. Now, capital mobility and monetary autonomy were privileged, and they were willing to tolerate floating exchange rates as well as a degree of volatility in their expanding financial markets. Despite a clear trend toward capital market liberalization, however, no binding international treaty analogous to that governing trade flows has emerged to codify an underlying political understanding on the trade-offs implied by financial openness (Abdelal, 2007). The promoters of liberalization apparently hoped private and still mainly national markets on their own would provide adequate financing for both adjustment and development if countries simply pursued sound macro-economic policies. As the decade of the 1990s progressed, that very idea became contestable.

The Asian financial crises of the late 1990s highlighted the rising tensions between economic logic and political reality. Malaysia temporarily reinstated capital controls, Chile

experimented with sophisticated measures to restrain the inflow of speculative capital, and new incentives were provided for countries with surpluses in their trading accounts to hoard foreign exchange reserves. The threat to the integrative impulse at the core of the post-1945 political order was obvious. Even when calm returned and the broad movement toward capital market openness resumed, governments now refused unambiguously to embrace the principle that capital had an inviolable legal right to cross borders. They also continued to demonstrate an evident reluctance to designate an international overseer for markets more tightly linked together.

In short, the architects of the global economy, now including not only advanced industrial states but also China, India, Mexico, Russia, Brazil, and other rising powers were unwilling to lodge ultimate political authority at the level where it logically belonged in a world of freely flowing capital. No international agency was authorized to regulate or supervise international capital movements or the mix of public and private intermediaries through which they occurred, not the International Monetary Fund, not the World Bank, and not the Bank for International Settlements. The essential fact: none had access to the resources necessary to stem a full-blown global crisis. None could serve as lender-of-last resort, except in limited cases. Most significantly, none could act as investor-of-last resort in the large, complex financial intermediaries dominating globalizing markets. Home authorities instead opted to allow the financial institutions they themselves continued to license and supervise to expand their international operations, while maintaining and expanding the transnational collaborative network of supervisory authorities begun some two decades before. For their part, host authorities continued to welcome that expansion. Their shared belief, or rationalization, was that sound macroeconomic policies would more or less automatically stabilize deepening cross-

border markets and that emergencies could be limited or managed by national regulators collaborating informally to the extent necessary and utilizing, as they themselves saw fit, nationally controlled fiscal and foreign exchange reserves (Bryant, 2003; Kapstein, 2006; Woods, 2006).

In 2006, the “Basel II agreement” negotiated by the leading industrial states allowed internationally active banks to bring supposedly sophisticated risk-management techniques into the calculation of capital requirements. In contrast to the straightforward calculations of Basel I, capital requirements were 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 states typically faced the less flexible capital requirements of Basel I. The fact that this seemed to provide a new source of competitive advantage for the largest money-center banks was not the only controversy engendered by the new accord, and work immediately began on ‘Basel III’—the search for a better middle path between the simplicity of Basel I and the theoretical rationale of Basel II.

Along with the intended stabilizing “pillar” of minimum capital requirements, the Basel II agreement stressed the importance of two additional pillars: adequate supervisory review and “market discipline.” To improve 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 judgments on their ability to meet obligations. Commentary surrounding Basel II also broached the more specific idea that banks should be forced to issue subordinated debt, which would be subject to continuous repricing in the markets and provide a signal to supervisors when early intervention might be required (Kaufman, 2002).

Basel II in practice came to be associated with the dismal failure of market discipline in 2007 and 2008. Not only did the internal risk models of systemically significant banks fail to realistically assess “tail” risks, but they also gave bank managers and regulators an unjustified sense of precision in their portfolio risk assessments. In retrospect, they provided a sophisticated cover for the strategic overleveraging many banks and, not coincidentally, for over-compensating their managers. But Basel II was really only beginning formally to come into play when the rolling crises of 2007-8 spread out from the US housing market. Its central elements, nevertheless, immediately came under critical scrutiny. Its self-regulatory aspirations were soon discredited, its capital rules proved inadequate, and its inability to address liquidity problems in complex global markets for new financial instruments immediately became clear. But an urgent issue at the core of the crises was the continuing mismatch between market scope and ultimate regulatory authority. As investment banks failed or rapidly transformed themselves into arms of commercial banks with access to emergency liquidity support from national central banks, as insurance companies required governmental bailouts, as hedge funds collapsed—national finance ministries returned to center stage. Only they had access to the kinds of fiscal resources required for final, last-line emergency defenses of institutions deemed too crucial to fail. More or less “independent” central banks could serve their traditional roles as lenders-of-last-resort, but only national treasuries could make last-ditch investments in troubled but essential financial institutions. *In extremis*, only they could nationalize them.

It would be facile, however, to conclude that the clock had simply been turned back to 1933. If states had once constructed a workable regulatory regime based on the principle of home-country control of banks continuing to expand their cross-border businesses, in 2007 and 2008 such a notion was pushed past its limits. The first draft of the US bailout plan in the fall of

2008 made US taxpayer funds available to “American” banks only. That changed within 24 hours, after the US Treasury was reminded that 25% of the US banking system was now controlled by “foreign” intermediaries. But bailouts in the United States and elsewhere could also not be limited to traditional banks, since many types of investment and financing vehicles had been permitted over time to take on various bank-like functions.

Attempting to prevent emergencies from spinning completely out of control, leading states, as well as rising states with high foreign exchange reserve balances, in fact implicitly collaborated with one another on a global scale not seen before. To be sure, the process was messy and rancorous. It was also marked by many missteps. In Ireland and Iceland, for example, panicked decision-makers tried to end bank runs with policies privileging the interests of domestic depositors and limit the liabilities of their own governments. Since their markets were intimately connected with others, especially the United Kingdom, negative knock-on effects proved immediate and costly. Policy reactions abroad were swift and ugly. Similarly, the worst fears of East European countries appeared to be realized when certain troubled LCFIs began pulling capital back from their branches and subsidiaries abroad. Various host countries reacted by trying to ring-fence the local operations of those institutions, effectively trying to separate the control of their assets from the ownership of their shareholders’ equity.

Early in 2009, it was tempting to jump to the conclusion that the entire Basel process since 1975 had been futile. Home and host states could not cooperate effectively in emergencies. The idea of global markets built on the foundation of disparate local politics had come to naught. It was certainly possible that such a conclusion would be justified by coming disasters. But early in 2009, a less elegant if more hopeful interpretation of events deserved pride of place. The remarkable phenomenon was that the states at the core of the system collaborated intensely in

their policy responses and also exerted enormous pressures on others to go along. The policy networks built among national treasuries, central banks, and financial supervisors after 1975 were reinforced after each subsequent systemic crisis, including the crisis that began in the summer of 2007. Harmony would hardly characterize the operation of those networks.

Defensiveness, testiness, and recrimination would come closer. But through those networks an inelegant pastiche of burden-sharing measures was put in place, and throughout the crisis one could observe a continuing shared commitment to the idea of open markets, to the regulatory principle of reciprocal national treatment, and to the practice of better, more effective supervision.

What leading states did not do was tip decisively in the direction of deep political innovation, which one might have imagined by this time in history to have entailed supranational regulation and supervision. Are the seeds now sown for such a move? Perhaps in Europe, where the idea remained intensely controversial but was at least up for explicit discussion. In short, it took the form of proposals for reliable *ex ante* agreements on burden sharing in the context of cross-border financial emergencies (Goodhart and Schoenmaker 2006). 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, whether they shared the same risk cultures, and whether they were guided by similar regulatory approaches. In the event, all that actually proved possible thus far were *ad hoc* understandings reluctantly reached at the moment of crisis itself.

The nationalizations of mainly national institutions were hardly surprising, and their cross-border effects were typically limited. More interesting were the bailouts of relatively new transnational intermediaries like the Franco-Belgian bank Dexia and the even more complicated

Fortis. In September 2008, the governments of Belgium, France, and Luxembourg pledged 6.4 billion euros to save Dexia, and they then moved to carve up its operations. Similarly, later that month Fortis was effectively split into pieces when the Belgian, Dutch and Luxembourg governments took 49% 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% 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 transnational operations of BNP-Paribas. What it did not do was to unleash cascading defaults and the demolition of Europe's cross-national payment and investment systems.

Not entirely dissimilar processes of *ad hoc* collaboration have been evident throughout post-war European history. In fact, this kind of crisis-induced policy coordination worked opaquely but well enough within a highly decentralized Germany after 1945 (for more detail, see Pauly, 2008b). A similar process has been widely recognized as having opened the political space for maneuver (and for complex bargaining) across various issues among post-war West Germany and its partners in the European Union. Although Germany itself appeared to take the most truculent positions in the bailouts and fiscal experiments undertaken in response to financial emergencies within Europe during 2007 and 2008, it would be a mistake to interpret its positions as anti-integrationist. More plausibly, it simply sought as usual to reduce the scale of its ultimate financial liabilities in the context of a continuing, if fractious, *Gemeinschaft*. To have expected open-ended *ex ante* agreements on burden sharing in a now-enlarged and variegated union would presume faster transformation in deep political and ideological structures

than is yet realistic. Germany did not, however, move away from its longer term interests in promoting more integrated and more resilient European capital markets. This would suggest looking more at what it does than what it says on the complexities of preventing and managing future financial crises. The same goes for its key partners in the broader European Union, especially France and the United Kingdom, which both demonstrated the political utility of hypocrisy and of pragmatism when markets seemed most fragile.

Early in 2009, it seemed more obvious that testy but durable political collaboration was hard-wired into European and wider global markets (Grande and Pauly, 2005). States had resigned themselves collectively to mitigating and resolving cross-border emergencies, mainly by intervening to save their particular pieces of markets deeply linked internationally. Despite the now-evident risks, they took few serious measures to disentangle themselves from financial networks they themselves had spent a half century constructing. As soon as the most intense local political heat was reduced, finance ministers appeared likely to turn one again to collaborative working groups aimed at providing better supervision for LCFIs, which in turned look set to be fewer in number but even larger in scope.

Why the hopefulness thereby implied, given the undeniable historical fact that even hard wires can be cut if the wire-cutter is big enough? Because financial crisis management is ultimately all about fiscal burden-sharing, and in 2007 and 2008 we witnessed states collectively passing a difficult test in this regard. To be sure, the process was not smooth. Decisions on bailouts and on the division of associated costs were always made grudgingly. In many cases, they were arguably made ineptly and therefore entailed even larger future costs. Across all cases where cross-border effects were plausible, “cooperation” entailed the joint deployment of state power and the acquiescence of taxpayers fearful of the consequences if that deployment did not

occur. (The two US House of Representatives votes in the autumn of 2008 on a staggering \$700 billion bailout package—the first against and the second reluctantly for the package, together with convergent actions elsewhere around the same time, exemplified the process with stunning clarity.) At the start of 2009, nevertheless, states still appeared unwilling to contemplate either a collective return to an international regime of pegged exchange rates or permanent and enforceable limits on international capital movements. They instead joined in effectively coordinated taxpayer-funded financial bailouts, the scope and implications of which clearly did not stop at the water's edge. Whether acknowledged or not, a fiscal element was added to the sometimes fractious but now routine dialogue occurring within the transnational collaborative network of state officials. Communications lines across leading finance ministries, the most internally oriented node in the network, were open and now paralleled the deeper lines connecting central banks and financial supervisors ever since 1975. Policy responses that potentially could hurt the citizens of other countries became immediate focal points for public grievance and negotiation—bilaterally or multilaterally in fora like the G-20, the European Council, and the IMF. In sum, neither the idea nor much of the practice of global finance fell apart (Wolf, 2008).

To the contrary, a pooling of formerly quite autonomous policymaking capacities occurred in a concentrated effort to stabilize markets and keep them open. Fiscal interventions were now clearly part of the mix, and if they were to succeed, home and host states had to accommodate one another. At the level of newspaper headlines, it appeared that economic nationalism trumped all whenever finance ministers and national legislatures felt compelled to act. But behind the scenes, the transnational network of state officials—from finance ministries to central banks to financial supervisors--expanded their collaborative work. (On the broader

context of transnational networks and the disaggregation of the state, see Slaughter, 2005). To be sure, contrary reactions were predictable, especially after public announcements of the details of bailout funds flowing through firms like AIG to foreign bank counterparties. Also predictable was a homeward pull, at least for a time, on most intermediaries' foreign operations.

Whenever the crisis that began in 2007 ends, the most likely outlook included a number of key elements: larger and still complex cross-border firms, less opaque planning for systemic fiscal backstops, efforts to make official commitments to specific intermediaries once more constructively ambiguous, a new emphasis on reforming national regulatory and supervisory systems, and an increased reliance on national bankruptcy and unwinding regimes. It will also likely include revised capital adequacy and other institutional operating standards for internationally active banks, intensifying collaboration among central banks and the IMF (all of whom will have more macro-prudential responsibilities), and a clarification and re-assignment of micro-prudential supervisory authority between home and host states. In this latter area, we will likely see the further evolution of a European system of financial supervision, and if so it will have likely interact in a more disciplined fashion with counterparts in the United States, the United Kingdom, Japan, and elsewhere (FSA, 2009; Larosière, 2009). Most significantly, we have just been vividly reminded of the ultimate role of national finance ministries in crisis management. If we are lucky, the long-run implication will be deeper collaboration aimed at fairer burden-sharing among polities now sovereign in legal principle only (Cohen, 1998; Beck, 1999; Alexander, Dhumale, and Eatwell, 2006). That such collaboration will be shrouded in technical detail and obfuscating language should not confuse careful observers about its political significance.

Financial globalization, fiscal autonomy, and the future of political authority

In *The Sovereign State and its Competitors*, Hendrik Spruyt argued quite convincingly that there was nothing inevitable about the nation-state form of political authority. But like Hayek, Braudel and other seminal thinkers before him, he also argued that there was nothing particularly voluntary about it either. It emerged instead from a series of unintended consequences to policy decisions taken in Europe during the 14th and 15th centuries. It solved certain collective action problems—mainly fiscal and military in nature--better than its competitors, city-leagues and city-states, and it inherited by accident certain distributive functions that were once managed within imperial formations. Then certain nation-states began joining together in concert, again to address whatever problems happened to confront them at the time. This in turn effectively constructed an inter-state system, which ultimately helped drive out of existence alternative forms of polity. Note that nothing in this convincing argument suggested that the state form itself was immutable. Indeed, quite the contrary.

During the current crisis, we have been reminded that the nation-state form is resilient, that when they choose to do so states can still design and implement policies in response to emergencies (Gelpert, 2009), that such policies can only be effective at a tolerable cost to the system as a whole if they are coordinated, even if in an *ad hoc* fashion, and that key policymakers charged with designing and implementing such policies have learned one lesson above all others. It is the lesson of the early 1930s: never let your clearing banks fail, for the destabilization of governments themselves may follow. There were new extensions of the lesson. Let central banks undertake active liquidity support operations, even for investment banks and insurance companies if their potential failures might cascade into core payments systems. If this is not enough, then re-capitalize clearing banks with national fiscal resources,

and nationalize them if necessary. That logic now extended one step further, borne of pragmatic necessity and not perfectly or elegantly incorporated into policy. Act in concert with other states to the extent required by the new complexity of integrating markets. In practice, since there existed no single fiscal account across even the European states enveloped in monetary union, this meant improvisatory, protracted, difficult, and deliberately opaque negotiations on fiscal burden-sharing to support large, complex financial institutions with key national payments' functions and significant cross-border operations (Pauly, 2008 and 2009).

Might these lessons prefigure a new chapter in the migration and reformation of political authority? Although experimentation with new forms of polity may now effectively be underway, in the contemporary period grudging acknowledgment is limited to Europe (Verdun, 2000; Beck and Grande, 2007; Hedetoft, 2008). Even there, however, the fiscal autonomy even of the member-states of European monetary union remains jealously guarded. Talk of federalism, and even the hint of confederation in fiscal terms remains suppressed. But the need to find a new balance between the rising pressures of financial integration and traditional demands for maximum feasible degrees of fiscal autonomy can't be ignored, either in Europe or globally. In practice, contemporary political exigencies suggest both an implicit commitment to policy coordination and burden sharing and an explicit denial of the same (Best, 2005). No wonder then that the key institutional feature of nascent efforts to create new governing mechanisms for financial markets at the system level is *increasing complexity*.

The building up, breaking down, and building up again of organizations and less institutionalized networks for coordinating the actions of states is certainly part of the long story of systemic integration and rationalization, despite the often overly simplified functionalist logic and assumption of inevitability associated with much related analysis. In this regard, one thinks

again of the League of Nations, of monetary unions, and of political federations that have come and gone. Even in cases where reform has actually been achieved, erosion and constant adaptation seem more common than stability. The trend is clearly evident in the monetary and financial institutions established by the victorious allies after World War II. The most recent traumas associated with financial globalization promise deeper and more profound changes in the relationships constitutive of institutions and networks needed for authoritative social ordering (Sassen, 2007).

As in the past, there is nothing inevitable about the creation of structures to sustain what is best in those relationships or to ameliorate their negative consequences. Reshaping old institutions and fostering new ones require basic agreement on principles and norms and the willingness of leaders and followers to make trade-offs among those that are contradictory. The transformative processes of globalization do not make it any easier to achieve such agreements or engineer such tradeoffs. In fact, by making increasingly visible the increasing multipolarity of the present world system, they render more and more inconceivable a world where institutions are designed, adapted and led by the leaders of the post-1945 system alone. In such a context, the multi-faceted concept of autonomy and the essential question of whose autonomy is most immediately accommodated become ever more important.

The world's most prosperous societies have to the present point in time managed to benefit from economies of scale and scope without bearing an unacceptable loss in autonomy, defined in either collective and individual terms. Although there is no single model of a perfectly balanced society, the various societies comprising the advanced industrial world today, along with growing parts of the emerging industrial world, exemplify ever more urgent struggles to attain and maintain a delicate balance. They seek stable points of equilibrium among the prosperity

produced by integrated markets, the legitimate social ordering created by a sense of collective belonging, and the fulfillment associated with the freedom both to escape wants and to make choices. The important point for present purposes, however, is that even in those lucky countries cross-border financial disturbances increasingly disrupt that stability. Ever more forcefully, they call for decisive choices between turning back from economic integration or acknowledging the necessity of serious burden sharing across traditional borders.

Where should we look for a positive response? The most obvious places are inside the post-1945 political institutions constructed precisely to facilitate policy coordination (Pauly and Coleman, 2008). We should see adaptation occurring in the successor agencies to the League of Nations--IMF, the World Bank, the UN—as well as in the Bank for International Settlements. We should also see serious reform occurring in the institutions designed to promote regional integration in Europe, and lately East Asia and North America. We might expect to see a proliferation of new formal and informal institutions designed actually to resolve pressing policy challenges and not simply to talk about them. Most crucially in the policy arena covered in this article, we should see externally-oriented adjustments in traditional domestically-focused practices within central banks, finance ministries, legislative committees, and national courts. Here is a rich research agenda. The mistake would be to close it off by taking too seriously the pronouncements of political leaders that they would never compromise the fiscal autonomy of their states or the narrow interests of national taxpayers.

Conclusion

The fragility of integrating financial markets in a system of dispersed political authority became increasingly obvious in recent decades. In the cascading crises that began in the summer of 2007, risk management within large financial institutions reached obvious limits. Central

banks and finance ministries intervened repeatedly to bolster confidence in markets that now spanned national borders in more complex and intimate ways. Some movement back from global to national occurred as market players and policy makers sought to minimize future losses. But behind the scenes, collaborative crisis management became the compelling order of the day. Central banks coordinated their liquidity operations to safeguard money markets now deeply linked across national borders. Moreover, fiscal burden sharing implicitly occurred not so much through newly constituted regional or global funding mechanisms, but through simultaneous national interventions targeted at the local operations of national and international intermediaries. It might have been better, and certainly more elegant, if joint support operations had simply flowed from *ex ante* inter-state agreements on crisis management and resolution. Such agreements had even been proposed in the wake of previous crises, especially in Europe. But they have thus far proved politically infeasible. *Ad hoc* collaboration nevertheless did occur in 2007 and 2008. It signified a marked improvement over the experience of the 1930s, when—despite rising pressure from bankers--states insisted on their autonomy in the face of stark systemic challenges that actually required a pooling of sovereign authority for the common good (Kirshner, 2007).

When more open markets are calm, authoritative overseers, lenders-of-last-resort, and especially investors-of-last-resort fade into the background, where they certainly should but do not always quietly encourage improved risk management practices by intermediaries, investors, and savers. When those markets are not so calm, official actors come back to the fore, and if they do not cooperate effectively enough, markets and the private institutions mainly comprising them simply fail. The inherent fragility of those markets has been exposed once again, and so too has the increasingly collaborative politics upon which they ultimately rest.

Coda

No shortage exists of proposals to reduce this fragility, even if few close observers believe that financial crises can ever be completely prevented. Like Keynes in his famous despairing moment, many focus on the idea that finance is unlike trade and longer-term investment and must be “home-spun”—permanently relegated to the national realm. More balanced views along this line follow a later Keynes, still cautious but more realistic about the costs and the practical difficulties of de-linkage. As Robert Skidelsky (2009), the distinguished biographer of Keynes, recently put it:

When the crunch came, we discovered that national taxpayers still stand behind banks, and national insolvency regimes matter. A more rules-based exchange rate system is not inconceivable. This might seek to put some curbs on capital movements—especially at times of economic stress.

Indeed, that very hymn has been sung during every crisis since 1945. Like believers in the “original intent” of the American founders, however, consistent policies have always proved impossible to implement. Skidelsky knows it, for he continues:

In this new climate, national politicians are likely to reach for ideas and influences that until recently would have seemed exotic. The idea, for example, that economic growth does not, beyond a certain point, make people happier. . . . Rich countries could probably abandon the globalist project without much damage to their material standards and with possible gain to their quality of life. Rejecting the inevitability of market-based globalisation would not necessarily be harmful—especially if it were accompanied by a reassertion of democracy at a national level.

The thought is noble, but the immediate consequences of implementation are all too easy to imagine counterfactually. Would Germany and Japan have been reconciled to world order after 1945 in the absence of rapid economic growth? Would the Soviet tyranny have collapsed and the Chinese system begun a difficult process of reform in a less interdependent world focused on raising measurable living standards? Would the less than adequate level of assistance flowing

from industrial to developing countries be increased in a low-growth environment? To be sure, “our” environmental challenges might now be less ominous, but would “their” environmental situations be more tolerable?

We certainly got carried away in the finance-centered cult of economic growth that typified the past twenty years. A wise critic like Skidelsky--and Keynes before him--aspires to the restoration of a moral balance. Unless we can imagine a plausible alternative, however, a reversal of supraterritorial economic and political ambitions is not easily defensible. Most of us all knew the extreme behavior of investment bankers and financial “innovators” would end in tears. Most of us with any sense of history or human nature knew that financial markets could never be self-regulating. But with an understandable sense of revulsion now inspiring policy reactions around the world, we now risk falling into the trap of hypocrisy.

Everyone else should stop growing, but we—the lucky few—should keep our prosperity and our democratic constitutions. Economic growth and the wealth it generates have proven empirically to be a necessary condition for the sustainability of individual and collective (national) autonomy. And sustainable growth now seems conditioned on transformative technological innovation, the fruits of which must rapidly be shared across the system. The truly sufficient condition, however, must be the wisdom to extend outward the boundaries around our political lives—to provide a secure foundation of legitimacy for the collaborative regulatory networks vital to systemic stability and openness.

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