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The Global Financial Crisis of 2008-2009 in Context—Reflections on International Legal and Institutional Failings, "Fixes," and Fundamentals

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The Global Financial Crisis of 2008–2009 in Context— Reflections on International Legal and Institutional Failings, “Fixes,” and Fundamentals

John W. Head*

SYNOPSIS

In this contribution to the symposium on the world financial crisis, Professor Head offers his observations on several aspects of the recent financial chaos that has gripped—and partially paralyzed—the world. First, he traces how the crisis unfolded and what institutional responses it elicited, especially at the international level. In this respect he places special emphasis on the International Monetary Fund (“IMF”) and its performance and future prospects. He then proceeds to explain the broader picture of financial crises into which this one fits, by briefly surveying several twentieth-century episodes of financial chaos. On this basis he identifies several specific legal and institutional failings that the current crisis has revealed at the international level. He also discusses several “fixes” that are underway, or that might be tried, to address these failings. He closes by exploring a few “fundamentals”, particularly (i) certain fundamental changes that might (in principle) be undertaken to prevent a repeat of the 2008-2009 global financial crisis and (ii) some fundamental ideological values and human realities that will likely stand in the way of any significant reform.

TABLE OF CONTENTS

I. INTRODUCTION: WHICH “CRISIS,” AND WHY SHOULD WE STUDY IT?.....	44
A. <i>Defining the GFC 08/09</i>	45
B. <i>Why Does It Matter?</i>	47
C. <i>Why Take a Legal and Institutional Point of View?</i>	47
II. THE UNFOLDING OF THE CRISIS.....	48
A. <i>A Timeline of Turbulence</i>	48
B. <i>Underlying Causes and Specific Triggers</i>	52
C. <i>Immediate Responses in the United States</i>	55
D. <i>Damage and Control in Other Countries</i>	55

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III. THE INTERNATIONAL INSTITUTIONAL RESPONSE.....	56
A. <i>Action by the G-20</i>	56
1. <i>Financial Regulation and Fiscal Stimulus</i>	57
2. <i>Trade Liberalization</i>	59
3. <i>Reliance on a Strengthened IMF</i>	59
B. <i>The IMF: Reform and Reactivation</i>	62
1. <i>Recent IMF Reforms—1997–2008</i>	62
2. <i>The IMF “Reactivation” Starting in 2008</i>	70
C. <i>Involvement of Other International Institutions</i>	76
IV. THE GFC IN LARGER HISTORICAL AND GEOPOLITICAL CONTEXT	78
A. <i>The Early Twentieth Century</i>	78
B. <i>Currency, Debt, and Financial Crises of the 1970s and 1980s</i>	80
1. <i>Collapse of the Par Value System</i>	80
2. <i>The 1982 Debt Crisis</i>	80
3. <i>The United States Savings and Loan Crisis</i>	82
C. <i>The Troubled 1990s</i>	84
1. <i>The Mexican Peso Crisis</i>	85
2. <i>The Asian Financial Crisis</i>	87
3. <i>The Russian Debt-and-Currency Crisis</i>	89
V. THE LONGER VIEW: FAILURES, “FIXES,” AND FUNDAMENTALS.....	91
A. <i>Failures</i>	92
1. <i>The Scope and Coordination of National Financial Regulation</i>	92
2. <i>Failure of the Theory of “Self-Regulation”</i>	93
3. <i>Collapse of the “Transparency” and the “Risk-management”</i> <i>Theories</i>	95
4. <i>Inadequacies of Multilateral Institutions and Networks</i>	98
5. <i>Failure of IMF Institutional Legitimacy</i>	100
6. <i>Failure to Exercise Cultural Intelligence</i>	100
B. <i>“Fixes”</i>	104
1. <i>Strengthening Financial Regulation</i>	105
2. <i>IMF Reform Toward Crisis Prevention</i>	107
3. <i>Renewed Ideological Commitment to Multilateralism</i>	109
C. <i>Fundamentals</i>	110

I. INTRODUCTION: WHICH “CRISIS,” AND WHY SHOULD WE STUDY IT?

In this article I offer my views on the Global Financial Crisis of 2008 and 2009, as my contribution to the October 2009 Symposium sponsored by the University of the Pacific, McGeorge School of Law on the subject “Local to Global: Rethinking Spheres of Authority After a World Financial Crisis.” I am quite pleased to have been invited to participate in the symposium and to have my views published in the symposium issue of the PACIFIC MCGEORGE GLOBAL

BUSINESS & DEVELOPMENT LAW JOURNAL. In keeping with common practice for such “symposium issues” of law journals, I have, with the kind permission of the Journal’s editorial staff, structured this article more in the form of an essay, with somewhat less comprehensive citations to authority than might otherwise be provided.¹

In the remainder of this section, I wish to address three introductory questions: (a) what specifically am I referring to in speaking of the “Global Financial Crisis of 2008–2009” (which I shall usually refer to below as the “GFC 08/09”), as there might well be differing definitions of it; (b) what is to be gained by reviewing this crisis, now that it seems to be settling into some form of resolution; and (c) in particular, why might it be fruitful to take a legal and institutional perspective in reviewing the crisis?

In Section II, I offer a review of how a range of experts understands the GFC 08/09 to have emerged out of developments (some would say defects) of the past decade or so and exploded into public consciousness in 2008.

In Section III, I turn my attention to the international responses to the crisis, and particularly the legal and institutional response at the international level, including especially the Group of Twenty and the International Monetary Fund (“IMF”).

In Section IV, I widen the field of view by placing the GFC 08/09 in a larger historical context to help us consider certain aspects of the GFC 08/09 (and the international community’s response to it) in a more objective and comparative light. With that as background, I offer in Section V a series of observations about the GFC 08/09 from a “longer view.” Some of these observations take the form of questions that I believe cannot be definitively answered right now but that are central to this key issue: What steps (if any) of a legal and institutional nature can we take to prevent an even worse global financial meltdown from occurring in the future?

A. Defining the GFC 08/09

Although other definitions might well be valid for other purposes, the “Global Financial Crisis of 2008–2009” that I wish to explore here revolves

1. In particular, I have assumed that other symposium participants, and most readers, will already be generally familiar with the history, organization, and operations of the International Monetary Fund; hence I have provided relatively few explanatory or research-oriented citations regarding that institution – relying instead on some general citations to works that I and others have written on it. In this and several other respects I have tried to keep a relatively clean “story line” without the distraction of extensive background explanations or citations. I greatly appreciate the cooperation and flexibility of the editorial staff at the *Journal* in this respect and for the assistance and patience they have shown in the preparation and publishing process. I also wish to thank Ms. Heba Hazzaa (research associate at the Cairo University School of Law), Ms. Maria Neal, and Ms. Dana Watts—all of whom contributed importantly to my work in compiling this article—and to express my appreciation also to Lawrence Indyk, Lucia Orth, and my colleagues and fellow participants in the symposium for offering helpful comments and suggestions. As usual, research assistance from the University of Kansas General Research Fund is also gratefully acknowledged.

around private-sector financial institutions and public-sector regulators. This crisis featured the development of imaginative and complex new financial products, the collapse of major U.S. investment banks when those new financial products suddenly lost value, the spread of financial panic from the United States to other countries, the freezing-up of credit, the frantic efforts of national regulatory authorities around the world to stop the panic by thawing credit and saving certain large financial institutions, and the desperate collective actions taken by international authorities to prevent the crisis from leading to another Great Depression.

What this definition does *not* include is the whole range of other economic problems and traumas that resulted from these financial-sector developments. For example, although the collapse around the world in values of equities—shown most dramatically in the precipitous fall of the Dow Jones Industrial Average—is obviously of tremendous importance, I shall not attempt to give any attention to that development. Nor shall I focus on other sectors of the U.S. economy—the housing sector, for example—except to note in Section II the role that such sectors seem to have played in triggering the onset of the financial crisis.

Indeed, to the extent possible I shall avoid any U.S.-specific perspective. There is little question that the GFC 08/09 has most of its origins in the United States, and for that reason my attention will naturally be drawn to some developments in that country. However, as explained more fully below, my principal interest is in exploring the lessons we might gain for action and reform at the international level. Therefore, the details of U.S.-specific financial regulation—past or future—are of little direct interest to me here other than for illustrative purposes.

I should address another point about the definitions I use here: Is it a sign of confidence on my part that I call it “the Global Financial Crisis of 2008–2009”? That is, does this suggest that I am sure it is over? Not exactly. At least by my definition, a “crisis” cannot last more than a year or so; at some point it becomes either a recovery or a meltdown. At this point (October 2009) it seems as if a recovery has started. Events in coming months, of course, might prove this to be a false start; and even if we are in fact moving into a recovery, the distress unleashed in these two most traumatic years of 2008 and 2009 will last far into the future for many individuals and many nations.²

2. A recent IMF report is said to conclude that “on average, seven years after a bust an economy’s level of output was almost 10% below where it would have been without the crisis.” Simon Cox, *The Long Climb*, *ECONOMIST*, Oct. 3, 2009, at 3. This reduction in productivity will come on top of enormous losses in national wealth already caused by the crisis. “From the start of 2008 to the spring of [2009] the crisis knocked . . . \$11 trillion off the value of homes.” *Id.*

B. Why Does It Matter?

Given the unpleasantness of the crisis and its repercussions, we might prefer to avoid re-hashing it. Indeed, if we consider the fact that the GFC 08/09 is merely the latest in a string of global financial crises (a fact I will explore in Section IV of this article) we might well be tempted to throw up our hands in despair and jettison any hope to understand it or avoid its repetition. As I shall explain below in Section V, that conclusion strikes me as one of several reasonable conclusions. However, it is not a conclusion we can legitimately draw before at least giving serious thought to whether there is hope for preventing, or at least mitigating, another big global financial crisis that might be lurking on the horizon. Indeed, I understand the reason for this symposium in Sacramento to be precisely that—to give serious thought to the possibility of preventing future crises.

I would also offer another reason for subjecting the GFC 08/09 to our careful collective scrutiny: there should be some accounting as to where responsibility lies for a crisis that has brought such deep distress to so many people. In a companion article to this one,³ I offer some views about the causes of and responsibility for the Asian financial crisis that erupted in 1997. I would like to think that an examination of these two crises, only about a dozen years apart, can yield some useful lessons and place responsibility on some types of bad actors whose mischief can be stopped.

C. Why Take a Legal and Institutional Point of View?

Before concluding these introductory remarks, I should explain why I believe we should give special emphasis to legal and institutional matters in our assessment of the GFC 08/09. The explanation centers around the notion of financial regulation, and around how such regulation operates on two distinct levels.

I assume most people would agree that much of the responsibility for avoiding (or at least mitigating) financial crises of the sort we have just experienced (or that erupted in Asia in the late 1990s) lies with regulatory agencies, acting under national laws and procedures. In many countries, this sort of regulation lies within the authority of central banks or Ministries of Finance or other similar government authorities. The outbreak of a major crisis suggests that the regulatory action taken by such authorities has been inadequate, and therefore that the national laws under which those authorities operate are likewise inadequate. The examination of such inadequacies at the national level, and the measures taken to overcome those inadequacies, are therefore worthy of attention.

3. See John W. Head, *The Asian Financial Crisis in Retrospect—Observations on Legal and Institutional Lessons Learned after a Dozen Years*, ___ E.ASIA L. REV. ___ (2010) [hereinafter Head-2010].

What I am more interested in examining, however, is the “regulation of the regulators”—those actions taken not at the level of the national regulators but instead at the international level. After all, it is at the international level where we should expect to see some effective efforts to ensure that national laws and regulations—created and implemented by national governments—are adequate to prevent financial chaos from erupting and causing harm not only to the people to whom those governments are directly accountable, but also to other countries and the global financial system as a whole.

Much of the institutional responsibility for such “regulation of the regulators” in the sphere of financial stability rests officially with the International Monetary Fund (“IMF”), which exerts influence in a variety of ways over national economic and financial policies. In addition, since the time of the 1982 debt crisis, the IMF has generally been expected to play a key role in responding to financial crises when they do break out. The same thing occurred as the GFC 08/09 unfolded: in ways I shall explain below in subsection III(A), the Group of Twenty (“G-20”) has repeatedly referred to the important role that the IMF should play in handling the crisis. Accordingly, I shall give special attention in this article to the IMF’s response—both in terms of its operations and in terms of its structure and governance—to the GFC 08/09.

II. THE UNFOLDING OF THE CRISIS

A. *A Timeline of Turbulence*

In this section, I intend to offer a review of how informed observers understand the GFC 08/09 to have emerged out of developments (some would say defects) of the past decade or so and exploded into public consciousness in 2008. To this end, let us start with a timeline setting forth some factual highlights—dates and developments—that will serve as a background for the discussions that follow, briefly identifying underlying causes of the crisis, specific triggers of the crisis, and government responses (both in the U.S. and abroad) to the crisis.

A chronology of key events in the unfolding of the GFC 08/09 would surely include these features, most of which occurred in the United States⁴:

- February 27, 2007: The Federal Home Loan Mortgage Corporation (Freddie Mac) announces that it will no longer buy the most risky subprime mortgages and mortgage-related securities.

4. This timeline draws heavily on (and in many cases uses terminology and entries from) THE FEDERAL RESERVE BANK OF ST. LOUIS, *THE FINANCIAL CRISIS: A TIMELINE OF EVENTS AND POLICY ACTIONS*, 1-28, <http://timeline.stlouisfed.org/pdf/CrisisTimeline.pdf> (last visited Mar. 6, 2010) [hereinafter *CRISIS TIMELINE*]. Although the timeline published by the Federal Reserve Bank extends up to February 2010, the excerpts I have provided here extend only up to June 2009.

- April 2, 2007: New Century Financial Corporation, a leading subprime mortgage lender, files for Chapter 11 bankruptcy protection. . . .
- July 31, 2007: Bear Stearns liquidates two hedge funds that invested in various types of mortgage-backed securities.
- August 6, 2007: American Home Mortgage Investment Corporation files for Chapter 11 bankruptcy protection. . . .
- August 9, 2007: BNP Paribas, France's largest bank, halts redemptions on three investment funds. . . .
- September 14, 2007: The Chancellor of the Exchequer authorizes the Bank of England to provide liquidity support for Northern Rock, the United Kingdom's fifth-largest mortgage lender. . . .
- February 13, 2008: [U.S.] President [George W.] Bush signs the Economic Stimulus Act of 2008 (Public Law 110-185) into law.
- February 17, 2008: Northern Rock is taken into state ownership by the Treasury of the United Kingdom.
- July 13, 2008: The Federal Reserve Board authorizes the Federal Reserve Bank of New York to lend to the Federal National Mortgage Association (Fannie Mae) and . . . Freddie Mac, should such lending prove necessary. . . .
- July 30, 2008: President Bush signs into law the Housing and Economic Recovery Act of 2008 (Public Law 110-289), which among other provisions, authorizes the Treasury to purchase [Government Sponsored Enterprise] (GSE) obligations and reforms the regulatory supervision of the GSEs under a new Federal Housing Finance Agency. . . .
- September 7, 2008: The Federal Housing Finance Agency (FHFA) places Fannie Mae and Freddie Mac in government conservatorship. . . .
- September 15, 2008: Lehman Brothers Holdings Incorporated files for Chapter 11 bankruptcy protection.
- September 16, 2008: The Federal Reserve Board authorizes the Federal Reserve Bank of New York to lend up to [US]\$85 billion to the American International Group (AIG) under Section 13(3) of the Federal Reserve Act. . . .
- September 17, 2008: The [Securities and Exchange Commission] (SEC) announces a temporary emergency ban on short selling in the stocks of all companies in the financial sector.
- September 18, 2008: The [Federal Open Market Committee of the Federal Reserve Board] (FOMC) expands existing swap lines by

[US]\$180 billion and authorizes new swap lines with the Bank of Japan, Bank of England, and Bank of Canada. . . .

- September 24, 2008: The FOMC establishes new swap lines with the Reserve Bank of Australia and the Sveriges Riksbank for up to [US]\$10 billion each and with the Danmarks Nationalbank and the Norges Bank for up to [US]\$5 billion each. . . .
- October 3, 2008: [U.S.] Congress passes and President Bush signs into law the Emergency Economic Stabilization Act of 2008 (Public Law 110-343), which establishes the [US]\$700 billion Troubled Asset Relief Program (TARP). . . .⁵
- October 29, 2008: The [IMF] announces the creation of a short-term liquidity facility for market-access countries. . . .⁶
- November 18, 2008: Executives of Ford, General Motors, and Chrysler testify before Congress, requesting access to the TARP [funding]. . . .
- December 12, 2008: The U.S. Treasury Department purchases a total of [US]\$6.25 billion in preferred stock in 28 U.S. banks under the Capital Purchase Program. . . . [This is the first of several such purchases.]
- December 19, 2008: The U.S. Treasury Department authorizes loans of up to [US]\$13.4 billion for General Motors and [US]\$4.0 billion for Chrysler from the TARP. . . .
- February 6, 2009: The Federal Reserve Board releases additional terms and conditions of the Term Asset-Backed Securities Loan Facility (TALF). Under the TALF, the Federal Reserve Bank of New York will lend up to [US]\$200 billion to eligible owners of certain AAA-rated asset-backed securities backed by newly and recently originated auto loans, credit card loans, student loans and [Small Business Administration]-guaranteed small business loans. . . .
- February 17, 2009: President [Barack] Obama signs into law the “American Recovery and Reinvestment Act of 2009”, which includes a variety of spending measures and tax cuts intended to promote economic recovery. . . .
- February 18, 2009: President Obama announces The Homeowner Affordability and Stability Plan. The plan includes a program to

5. *Id.*

6. *Id.*; See also Int’l Monetary Fund [IMF], IMF Survey Magazine: Policy, *IMF to Launch New Facility for Emerging Markets Hit by Crisis*, <http://www.imf.org/external/pubs/ft/survey/so/2008/POL102908A.htm> (Oct. 29, 2008). This Short Term Liquidity Facility was discontinued about half a year later when the IMF created the Flexible Credit Line. See Press Release, IMF, *IMF Overhauls Lending Framework*, No. 09/85 (Mar. 24, 2009), available at <http://www.imf.org/external/np/sec/pr/2009/pr0985.htm> [hereinafter IMF Overhaul].

permit the refinancing of [certain] conforming home mortgages owned or guaranteed by Fannie Mae or Freddie Mac In addition, the U.S. Treasury Department will increase its preferred stock purchase agreements with Fannie Mae and Freddie Mac to [US]\$200 billion, and increase the limits on the size of Fannie Mae and Freddie Mac's portfolios to [US]\$900 billion. . . .

- February 25, 2009: The Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision announce that they will conduct forward-looking economic assessments or “stress tests” of eligible U.S. bank holding companies with assets exceeding [US]\$100 billion [to determine their ability to absorb likely] losses over a two-year period. . . .
- March 19, 2009: The U.S. Department of the Treasury announces an Auto Supplier Support Program that will provide up to [US]\$5 billion in financing to the automotive industry. . . .⁷
- March 24, 2009: The IMF announces an overhaul of its lending framework, including these key components⁸:
 - Modernizing IMF conditionality;
 - Introducing a flexible credit line;
 - Enhancing the flexibility of the regular stand-by lending arrangement;
 - Doubling access limits for member countries' use of IMF funds;
 - Adapting and structures of cost and maturity for its lending; and
 - Eliminating certain lending programs that were seldom used.
- March 31, 2009: The U.S. Treasury Department announces an extension of its temporary Money Market Funds Guarantee Program through September 18, 2009 . . . [to] continue to provide coverage to shareholders up to the amount held in participating money market funds as of the close of business on September 19, 2008. . . .
- April 24, 2009: The Federal Reserve Board publishes a white paper describing the process and methodologies employed by federal banking supervisory authorities in their . . . “stress test” of large U.S. bank holding companies. . . .
- May 20, 2009: President Obama signs the Helping Families Save Their Homes Act of 2009, which temporarily raises [coverage under the Federal Deposit Insurance Corporation] from [US]\$100,000 per depositor to [US]\$250,000 per depositor. . . .

7. CRISIS TIMELINE, *supra* note 4.

8. IMF Overhaul, *supra* note 6.

- May 21, 2009: Standard and Poor’s Ratings Services [(S&P)] lowers its outlook on the United Kingdom government debt from stable to negative because of the estimated fiscal cost of supporting the nation’s banking system. S&P estimates that this cost could double the government’s debt burden to about 100 percent of [Gross Domestic Product] by 2013. . . .
- June 1, 2009: As part of a new restructuring agreement with the U.S. Treasury and the governments of Canada and Ontario, General Motors Corporation and three domestic subsidiaries announce that they have filed for relief under Chapter 11 of the U.S. Bankruptcy Code.⁹

B. Underlying Causes and Specific Triggers

Having provided the timeline above—enumerating some specific dates and developments as the GFC 08/09 unfolded—I turn now from bare facts to a summary analysis of three points. First, in this subsection, I report on what are commonly identified as the underlying causes and the specific triggers of the crisis. Then, in subsection C, I draw attention to some highlights of the U.S. government’s response to the crisis. Lastly, in subsection D, I offer illustrations of how the crisis spread to other countries, and the efforts of governments in those other countries to handle the chaos it brought.

The underlying causes of the GFC 08/09, according to a variety of experts, center around such matters as the U.S. housing bubble, inappropriate U.S. monetary policy, under-regulation of U.S. and international financial markets, and over-sophistication of relatively new types of financial instruments. The claim that a U.S. housing bubble is to blame relies on the following logic.¹⁰ To begin with, too many new homes were built, creating an oversupply of housing. To sell these houses, banks and other lenders were willing to do “subprime” lending—that is, to lend money to persons who did not qualify for Fannie Mae or Freddie Mac programs. These highly leveraged borrowers defaulted when their circumstances changed. Banks “attempted to resell the houses, exacerbating the oversupply of housing.”¹¹ Home values, which had long been thought to move in only one direction—up—began to come down. By October 2008, the average home price had fallen twenty percent from its 2006 peak.¹²

9. CRISIS TIMELINE, *supra* note 4.

10. Except as otherwise noted, the details set forth in this paragraph and the following paragraph are drawn largely from DAVID A. WESTBROOK, *OUT OF CRISIS: RETHINKING OUR FINANCIAL MARKETS* 19, 24 (2010).

11. *Id.*

12. See *A Helping Hand to Homeowners*, *ECONOMIST*, Oct. 23, 2008, fig. Falling off the property ladder.

One of the reasons U.S. home prices tended to increase in earlier years can be found in the process of securitization. In this process, banks and other mortgage lenders bundled their home loans and sold them to special purpose entities, which transformed them into securities that were then sold to investors both in the United States and abroad. This process allowed banks to recoup their investments much more quickly than waiting to be paid back by the borrowers over 30 years; therefore, it gave the banks more capital to make loans, which in turn made it easier for consumers to get loans. Moreover, because the lenders intended to sell the loans soon after they made them, they cared less and less about their borrowers' financial solidity and prospects.

A second alleged cause cited for the outbreak of the crisis is poor monetary policy. Critics point to the fact that the U.S. Federal Reserve Board repeatedly lowered interest rates. For example, between June 28, 2007, and October 29, 2008, the so-called "federal funds" rate dropped from 5.25% to 1.00%.¹³ The easy financing led to higher amounts of consumer debt.¹⁴ In the United States, household debt rose to 127% of annual disposable personal income in 2008 versus just 77% in 1990.¹⁵ Another alleged monetary-policy fault was the Federal Reserve Board's policy of believing its prime task was to keep inflation low and stable, instead of attending to systemic risk.¹⁶

A third suspected cause of the financial crisis was overly lax regulation of the financial markets, particularly in the United States. "In this view, . . . [t]he oversight of the SEC, as exemplified by its failure to [discover and shut down] Bernard Madoff's Ponzi scheme was simply inadequate for the task of regulating the largest financial markets in the world."¹⁷ Two of the reasons for the lack of sufficient supervision were "fragmented regulatory structures and legal constraints on information sharing."¹⁸ Problems such as this became apparent both within borders and internationally.¹⁹ Furthermore, regulation did not keep pace with the growing importance of the shadow banking system (which includes investment banks and hedge funds), the markets in derivatives, and off-balance-sheet financing. As a result of this laxity or absence of regulation, investors continued taking on more risk than they understood.²⁰

13. See CRISIS TIMELINE, *supra* note 4, at 1, 11.

14. See WESTBROOK, *supra* note 10, at 24.

15. *The End of the Affair: America's Return to Thrift Presages a Long and Deep Recession*, ECONOMIST, Nov. 20, 2008.

16. See *Jackson's Holes*, ECONOMIST, Aug. 20, 2009, at 68. For further observations about certain elements of macroeconomic policy that could have contributed to the GFC 08/09, see IMF, Research Department, *Lessons of the Global Crisis for Macroeconomic Policy* (Feb. 19, 2009), available at <https://www.imf.org/external/np/pp/eng/2009/021909.pdf>.

17. See WESTBROOK, *supra* note 10, at 22.

18. IMF, Monetary and Capital Markets Department, *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management*, at 3 (Feb. 4, 2009), available at <http://www.imf.org/external/np/pp/eng/2009/020409.pdf> [hereinafter *IMF Regulation Lessons*].

19. *Id.*

20. One source, focusing on derivatives markets, expressed it this way: "The multitrillion-dollar market

A fourth problem thought to have led to the crisis was the increased use of complex financial products. These products involved, among other things, the bundling of subprime mortgages into mortgage-backed securities or collateralized debt obligations (which included debt other than mortgages, such as car and student loans) and the use of credit default swaps (a form of credit insurance).²¹

With the array of ailments reflected in the foregoing (partial) list of underlying causes,²² it is perhaps no wonder the GFC 08/09 could explode with the spark of one or more specific triggering events. As indicated in the timeline appearing in subsection A above, several such triggers in fact occurred, thereby transforming potential chaos into actual chaos. But perhaps the most visible and catastrophic single event was the collapse of Lehman Brothers in mid-September 2008. One observer has characterized that event as follows:

In the early hours of Monday, 15 September, the 185-year-old Wall Street institution [Lehman Brothers] officially declared itself insolvent with a filing for chapter 11 protection against its creditors. It was a very public bankruptcy—all weekend, television crews had stationed themselves outside Lehman’s office, snatching footage of downcast employees emerging with boxes full of personal belongings. The event brought out attention-seekers—one man stationed himself outside Lehman’s building with a red flag, shouting: “The capitalist order is in freefall collapse!”

It was well known that Lehman, an Alabama cotton trader turned banking behemoth, was the biggest bankruptcy in US history. But nobody anticipated quite what would follow—a week that has become known on Wall Street as the great panic of 2008.²³

in derivatives was a major catalyst of the financial crisis. Derivatives are supposed to help investors and businesses manage risk, but after a 2000 law largely deregulated them, they also became tools for vast speculation, creating and amplifying risk instead of reducing it.” Editorial, *Reforming the Financial System*, N.Y. TIMES, Sep. 14, 2009, at A20.

21. These are discussed more fully in subsection V(A), below. See *infra* text accompanying note 182.

22. For another brief enumeration of underlying causes of the GFC 08/09, including several of the elements noted above, see C. Fred Bergsten, *The Dollar and the Deficits: How Washington Can Prevent the Next Crisis*, 88 FOREIGN AFFAIRS 20 (2009) (asserting that the role of the US dollar “as the dominant international currency has made it much easier for the United States to finance, and thus run up, large trade and current account deficits . . . [creating] huge inflows of foreign capital . . . [that] turned out to be an important cause of the current economic crisis, because they contributed to the low interest rates, excessive liquidity, and loose monetary policies that—in combination with lax financial supervision—brought on the overleveraging and underpricing of risk that produced the meltdown.”).

23. Andrew Clark, *How the Collapse of Lehman Brothers Pushed Capitalism to the Brink*, THE GUARDIAN, Sept. 4, 2009, <http://www.guardian.co.uk/business/2009/sep/04/lehman-brothers-aftershocks-28-days>; see also *The Long Climb*, *supra* note 2, at 4 (noting that “the day Lehman Brothers filed for bankruptcy, the world economy fell off a precipice.”).

Another account paints an equally grim picture of the consequences of Lehman Brothers' collapse in September 2008:

Lehman's failure created enormous pain. It spawned a panic in the commercial-paper, credit-derivatives and bank-funding markets that dramatically worsened banks' liquidity. Capital and trade flows collapsed. A vicious spiral of credit withdrawal, weakening growth and debt impairment ensued. In July 2008 the IMF thought the world economy would grow by 3.9% in 2009. [But as of September 2009, the IMF] thinks it will shrink by 1.4%.²⁴

C. Immediate Responses in the United States

As shown in the above timeline, there have been several key points at which the U.S. government has taken specific action in response to the GFC 08/09. Perhaps the three most significant ones are: (i) the July 2008 Federal Reserve Board's authorization of the Federal Reserve Bank of New York to lend to Fanny Mae and Freddy Mac; (ii) the September 2008 move to bail out AIG; and (iii) the October 2008 establishment of the Troubled Asset Relief Program.

The first of these, the announcement of backing for Fanny Mae and Freddy Mac, was intended to show government support of the two agencies. Only a few weeks later, these two agencies were placed in government conservatorship.²⁵

In establishing the TARP, Congress authorized the purchase of 700 billion dollars worth of troubled assets. In November 2008, Ford, General Motors ("GM"), and Chrysler asked for TARP loans. The U.S. Treasury authorized loans of up to US\$13.4 billion for GM and US\$4.0 billion for Chrysler in December.²⁶

D. Damage and Control in Other Countries

As the crisis unfolded in the United States, governments in some other parts of the world also witnessed their financial systems in chaos and tried to take protective measures in response.²⁷ In February 2008, Northern Rock, the United Kingdom's fifth-largest mortgage lender, was taken into state ownership. The collapse of all three of Iceland's major banks has made the banking crisis in that country the largest in economic history. In annualized terms, Japan's GDP fell 15.2% in the first quarter of 2009. In the world's Arab countries, the worst is possibly still yet to come. Arab banks have reported almost US\$4 billion in

24. *What If*, *ECONOMIST*, Sept. 12, 2009, at 86.

25. See *CRISIS TIMELINE*, *supra* note 4, at 6.

26. *Id.* at 9, 12, 14.

27. Except as otherwise noted, the information presented in this paragraph is drawn from Wikipedia, *Financial Crisis of 2007-2010*, http://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932010 (last visited Nov. 1, 2009).

losses due to the crisis,²⁸ and unemployment rates are projected to go as high as 17%.²⁹

In a great many countries around the world, governments made unprecedented volumes of public funds available to shore up financial institutions. According to one estimate, “[b]y the spring of [2009] the world’s governments had injected [US]\$432 billion of capital into their banks . . . and guaranteed bank debts worth [US]\$4.65 trillion.”³⁰

III. THE INTERNATIONAL INSTITUTIONAL RESPONSE

The brief account of the GFC 08/09 I have offered above in Section II highlights some of the key responses made by the government in the birthplace of the crisis—the United States—and by governments in other countries affected most directly by the crisis. In addition to these responses by national governments, however, responses also emerged from international institutions. I examine those responses in this Section. In doing so, I divide the account into three segments: (i) the response by the G-20; (ii) the response by the IMF; and (iii) the response by a few other international institutions, including the World Bank, the Asian Development Bank, and the European Central Bank.

A. *Action by the G-20*

For many years, the Group of Seven (comprising the United States, the United Kingdom, France, Germany, Japan, Canada, and Italy) has served as an informal but powerful forum for economic and financial decision-making.³¹ It appears that the GFC 08/09 might mark the eclipsing of the G-7 (or its partial successor, the G-8, including Russia) in favor of the G-20, which was originally set up in September 1999.³² Indeed, the primacy of the G-20 as “the premier forum for [our] international economic co-operation” was announced at the gathering of G-20 leaders in September 2009.³³ Whether this shift in influence is

28. Doron Peskin, *Recession Costs Arab Banks \$4B*, INFO-PROD RESEARCH (MIDDLE EAST) LTD., Sep. 25, 2009, <http://www.infoprod.co.il/article/2/295>.

29. See Doron Peskin, *Unemployment in Arab World a ‘Time Bomb’*, INFO-PROD RESEARCH (MIDDLE EAST) LTD., Apr. 10, 2009, <http://infoprod.co.il/main/siteNew/index.php?langId=1&mod=article&action=article&Admin=qwas&stId=251>.

30. *Gandhian Banking*, ECONOMIST, Oct. 3, 2009, at 20.

31. For an interesting account of the various groupings of countries that have arisen over the years, see Alan S. Alexandroff, *G-8? G-20? G-x?: The Library Group Grows Up*, COURIER, Summer 2009, at 8, available at <http://www.stanleyfoundation.org/articles.cfm?id=580>.

32. IMF *Regulation Lessons*, *supra* note 18, at 7. The G-20 was established in the wake of the Asian financial crisis to provide “a permanent forum for broadening the dialogue on issues of international financial stability between advanced and major emerging economies. Its membership consists of 19 systemically important countries and the European Union, which together account for two-thirds of the world’s population and nine-tenths of the global gross national product.” *Id.* (footnote omitted)

33. Richard Wray, *World Leaders Relaunch G20 as Top Economic Forum*, THE GUARDIAN, Sept. 25,

permanent or not, the fact remains that the G-20 has taken a lead role in coordinating efforts at the national level to address international aspects of the GFC 08/09.

The following paragraphs highlight three specific aspects of the G-20's work in this regard: (i) instructions issued by the G-20 to national authorities in terms of fiscal stimulus and financial regulation; (ii) instructions issued by the G-20 to national authorities in terms of resisting protectionist temptations and pressures; and (iii) instructions issued by the G-20 to the IMF regarding its role in the containment of, and recovery from, the crisis.³⁴

1. Financial Regulation and Fiscal Stimulus

On November 15, 2008, at its summit in Washington, D.C., the G-20 called on national governments to take these steps relating to the provision of fiscal stimulus and to the regulation of financial institutions within their jurisdictions:³⁵

- Request their finance ministers to review accounting standards, executive compensation, financial risk management, the systemic risk of credit derivatives, the mandates/governance/resources of the IMF and other international financial institutions, and to report back with additional recommendations;
- Improve accounting (valuation) and disclosure standards, especially for complex financial instruments, and to require enhanced disclosure of risks on a timely basis from financial institutions;
- Undertake a financial sector assessment program and report its results;
- Review their bankruptcy systems to ensure adequacy for winding down large multinational financial firms;
- Strengthen their capital requirements for financial institutions;
- Improve their mechanisms for international cooperation and information-sharing among their national regulators; and
- Create “supervisory colleges” to meet regularly, supervise, and discuss risks with “all major cross-border financial institutions.”

2009, available at <http://www.guardian.co.uk/world/2009/sep/25/g20-reform-pittsburg-developing-nations>.

34. For further details on G-20 initiatives on some of these points, see IMF *Regulation Lessons*, *supra* note 18, at 7.

35. The following list is drawn from the declaration emerging from the G-20 meeting in Washington. The Group of Twenty Finance Ministers and Central Bank Governors [G-20], *Declaration: Summit on Financial Markets and the World Economy* (Nov. 15, 2008), available at http://www.g20.org/Documents/g20_summit_declaration.pdf [hereinafter *G-20 Washington Declaration*].

On April 2, 2009, at its London summit, the G-20 called on national governments to take these additional steps relating to the provision of fiscal stimulus and to the regulation of financial institutions within their jurisdictions:³⁶

- Ensure the strength of their domestic regulatory systems and establish greater regulatory consistency and cooperation with each other;
- Extend regulation and oversight to the shadow-banking sector (that is, “all systemically important financial institutions, instruments and markets”), explicitly including hedge funds;
- “[E]xtend regulatory oversight . . . to Credit Rating Agencies;”
- Improve the capital in the banking system and limit excessive leverage, as well to agree to a single set of global accounting standards; and
- Take action and deploy sanctions against non-cooperative jurisdictions and tax havens.

On September 25, 2009, at the Pittsburgh summit, the G-20 requested national governments to take these further actions regarding fiscal stimulus and financial regulation:³⁷

- Pledge to avoid prematurely ending stimulus and to withdraw extraordinary support in a coordinated way;
- Commit to developing international rules to raise capital standards and discourage excessive leverage by the end of 2010, with implementation phased in by the end of 2012;
- Commit all major financial centers to adopting the Basel II Capital Framework by 2011;
- Require that all standardized over-the-counter derivatives be traded on exchanges/electronic platforms, cleared through central counterparties, and reported to central repositories by the end of 2012, with non-standardized ones subject to higher capital requirements;
- Call on international accounting bodies to produce a single set of global accounting standards by June 2011; and

36. The following list is drawn from: G-20, London Communiqué, *The Global Plan for Recovery and Reform* (Apr. 2, 2009), available at <http://www.g20.org/Documents/final-communication.pdf> [hereinafter *G-20 London Communiqué*].

37. The following list is drawn from the declaration emerging from the G-20 meeting in Pittsburgh. G-20, *Leaders' Statement: The Pittsburgh Summit*, (Sept. 24–25, 2009), available at http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf [hereinafter *G-20 Pittsburgh Statement*].

- Phase out and rationalize inefficient fossil fuel subsidies, and to report implementation strategies for this at the next G-20 meeting.

2. *Trade Liberalization*

In addition to pressing their governments to take decisive action in the areas of financial regulation and fiscal stimulus, the G-20 leaders have, in all three of the G-20 crisis-period summits, warned against the dangers of protectionism, especially in the area of trade and investment. For example, at its November 2008 summit in Washington, D.C., the G-20 called on national governments to take these steps³⁸:

- Commit not to raise new barriers to investment or trade, new export restrictions, or WTO-inconsistent measures to boost exports, for the next twelve months; and
- “Strive to reach agreement this year on modalities that leads to a successful conclusion” of the Doha Round.

Similar pleas were made (with time horizons extended each time) at the London and Pittsburgh summits,³⁹ and another related element—to agree to minimize negative effects on trade by fiscal policies and financial sector supports—was added at the London summit.⁴⁰

3. *Reliance on a Strengthened IMF*

The attention of the G-20 leaders was directed not only at national authorities but also at other international institutions, and especially at the IMF. At each of the three G-20 crisis-period summits, the IMF was called upon to take measures that would assist national governments in fighting the crisis, and also to take steps that would strengthen the legitimacy and effectiveness of the IMF itself.

For example, at the November 2008 G-20 summit in Washington, the leaders announced that it had done the following:

- Requested that the IMF provide recommendations to mitigate pro-cyclicality, including a review of the effects of policies regarding leverage, capital requirements, executive compensation, etc.;
- Asked the IMF to improve its cooperation with the Financial Stability Forum,⁴¹ to better integrate regulatory responses and economic surveillance;

38. See *G-20 Washington Declaration*, *supra* note 35.

39. See *G-20 London Communiqué*, *supra* note 36, *G-20 Pittsburgh Statement*, *supra* note 37.

40. See *G-20 London Communiqué*, *supra* note 36.

41. The Financial Stability Forum (“FSF”) was convened in April 1999 “to promote international

- Requested that the IMF take a lead role in drawing lessons from the crisis;
- Undertook a review of the adequacy of financial support for the IMF and other international financial institutions, looking towards increasing it where necessary;
- Called on the IMF to conduct vigorous surveillance reviews of countries, to integrate these with the IMF-World Bank joint reviews of countries' financial sectors, and to provide capacity-building programs to aid developing countries in formulating and implementing new regulations; and
- Called for the reform of the IMF and other Bretton Woods institutions to reflect changing economic weights and to give more voice to developing countries.⁴²

Likewise, at the April 2009 London summit, the G-20 focused attention on the IMF's role in handling the GFC 08/09. In that case, issues of financing and legitimacy took center stage, as the G-20 announced that it had taken these steps:

- Agreed to measures that would result in a tripling of resources available to the IMF in the form of immediate financing from members (up to US\$750 billion), via expanded New Arrangements to Borrow;
- Agreed to support a new SDR allocation (that is, creating additional quantities of Special Drawing Rights, the IMF's reserve "currency") amounting to the equivalent of US\$250 billion;
- Urged the IMF to use additional resources from a previously-planned sale of IMF gold holdings to provide US\$6 billion in concessional lending to the poorest countries;
- Pledged to support "candid, even-handed, and independent" IMF surveillance of members' economies, financial sectors, and policy impacts on other countries, as well as of global economic risks;
- Asked the IMF, along with the newly-formed Financial Stability Board, to provide "early warning" of macroeconomic and financial risks, and to prescribe the policies needed to address them;

financial stability through information exchange and international co-operation in financial supervision and surveillance." *IMF Regulation Lessons*, *supra* note 18, at 6. The FSF "brings together finance ministries, central banks, regulators and supervisory authorities from major financial centres." *Id.* In October 2007 the FSF established a senior working group to examine the causes and weaknesses that produced what became the GFC 08/09; and in April 2008 the FSF set out an agenda for regulatory reforms that focused on strengthening prudential oversight, capital and liquidity standards, the use of credit ratings, and other points. *Id.* For further details on the FSF – and on its successor, the Financial Stability Board ("FSB")—see also *infra* notes 193, 218, and accompanying text.

42. See *G-20 Washington Declaration*, *supra* note 35.

- Asked the IMF to implement the reforms regarding quotas and “voice” for member countries, as agreed upon in April 2008, and to complete the next IMF quota review by January 2011;
- Agreed to “give consideration” to greater involvement of IMF governors in providing the IMF direction and accountability; and
- Agreed that the top leadership of the IMF, along with that of other international financial institutions, should be selected through an “open, transparent, and merit-based” process.⁴³

The G-20 leaders gave further attention to IMF-related matters when they gathered in Pittsburgh for the September 2009 summit. The statement issued at the conclusion of that meeting reported that the G-20 had taken these additional steps:

- Committed to a shift in IMF quotas of at least five percent from currently over-represented to under-represented countries;
- Asked the IMF to assist G-20 members in developing mutual forward-looking assessments of whether G-20 countries’ individual policies are collectively consistent with one another and with sustainable, balanced economic growth;
- Asked the IMF to report regularly to both the G-20 and the IMF’s own International Monetary and Finance Committee on global economic developments, global patterns of growth, and suggested policy adjustments;
- Tasked the IMF with providing a report at the next G-20 meeting regarding options for requiring the financial sector to contribute toward paying the burden of government interventions in order to repair the banking system.⁴⁴

I would offer this summary of the role and initiatives of the G-20 in addressing the GFC 08/09: In three main respects, the G-20 took dramatic steps, thereby asserting its prominent role in international economic cooperation going forward. First, it pressed its member governments to use robust and coordinated fiscal and regulatory initiatives to arrest the chaos being caused by the crisis and to set the stage for a recovery. Second, it reasserted the importance of taking such measures without resorting to protectionism—especially trade protectionism of a sort that would spell the end of efforts to complete the Doha round of negotiations. Third, the G-20 breathed new life and purpose into the IMF, simultaneously vesting in the IMF broad responsibilities for collaborative action and greatly enhanced lending activity, and insisting on prompt completion of

43. See *G-20 London Communiqué*, *supra* note 36.

44. See *G-20 Pittsburgh Statement*, *supra* note 37.

substantial reforms in governance and participation within the organization. Let us now examine how the IMF has responded to the new challenges issued to it—not only those coming from the G-20 in recent months, but those coming from other sources as well.

B. The IMF: Reform and Reactivation

As I indicated at the beginning of this article, a key aim of this subsection on the “international institutional response” to the GFC 08/09 is to discern and assess how the IMF, which by anyone’s estimation surely plays a key role in international economic management, has responded to the crisis. To do this, I look first at a number of the recent reforms undertaken by the IMF in the dozen years since the Asian financial crisis erupted in 1997, and then I describe some new reforms now underway.

1. Recent IMF Reforms—1997–2008

In subsection III(C)(2) below, I offer a brief account of the Asian financial crisis, which serves as the most recent precedent for the GFC 08/09. I shall not preempt that discussion here, but I do wish to highlight the significance of the Asian financial crisis in concentrating an enormous amount of attention on the IMF. As I have explained more fully in a companion article to this one,⁴⁵ the increased scrutiny of the IMF in the late 1990s resulted in four particular criticisms (among others, of course), which may be stated generally as follows:

- *Bad Medicine.* “The IMF prescribes economic and financial policies that fail to cure, and that indeed often make sicker, its borrowing member countries and the entire world economy.”
- *Distributional and Social Injustice.* “The economic and financial policies that the IMF insists on create distributional inequities and ignore the social aspects of a country’s well-being.”
- *IMF Secrecy and Opaqueness.* “The IMF is a closed, non-transparent organization that operates in secret, despite its insistence on transparency in the governments of its members.”
- *The IMF Democracy Deficit.* “Controlled by a handful of rich countries, the IMF is an unaccountable autocracy in which the people most affected by its operations have far too little chance to participate or exert influence.”⁴⁶

45. Head-2010, *supra* note 3.

46. This enumeration of criticisms draws from a book I wrote in 2008. See JOHN W. HEAD, *LOSING THE GLOBAL DEVELOPMENT WAR: A CONTEMPORARY CRITIQUE OF THE IMF, THE WORLD BANK, AND THE WTO* (2008) [hereinafter HEAD-2008]. I examined these four criticisms of the IMF, together with numerous other

By examining how the IMF has responded to these four criticisms in the dozen years since the Asian financial crisis occurred, perhaps we can gauge to what extent the IMF was in some “state of readiness” to address the GFC 08/09 when it erupted in 2008. My own assessment is that the reforms made during that time did, in fact, help prepare the IMF for this new challenge.

The reforms I refer to can be divided into: (i) reforms in IMF operations; and (ii) reforms in IMF accountability and governance. The following paragraphs identify several major operational reforms.

One change in IMF operations—designed specifically to address the sort of “contagion” issues that arose so dangerously in the context of the Asian financial crisis—is the establishment in 1999 of a new source of financing called the Contingent Credit Line (“CCL”). The CCL was designed to provide “a means by which the IMF could provide . . . a member country that is pursuing strong economic policies [an opportunity] to obtain financing on a short-term basis when faced by a sudden and disruptive loss of market confidence because of contagion from difficulties in other countries.”⁴⁷ Although the CCL expired in 2003, a new instrument designed to serve similar purposes was recently established. That facility, called the Flexible Credit Line (“FCL”), also aims to help countries with very strong fundamentals, policies, and track records of policy implementation; like the CCL, the FCL is particularly useful for crisis prevention purposes. Access to financing under the FCL “is determined on a case-by-case basis, is not subject to the normal access limits, and is available in a single up-front disbursement rather than phased.”⁴⁸ In addition, disbursements under the FCL are not made conditional upon the borrower’s implementation of prescribed policy commitments, as is the case under certain other types of IMF financing. Moreover, “[t]here is flexibility to draw on the credit line at the time it is approved,” or the country may treat it as precautionary.⁴⁹ In short, the IMF has created new forms of lending that can guard against some of the worst aspects of financial crises.

Another change in IMF operations came in 2005 when the IMF introduced “a new kind of instrument—Policy Support Instrument—designed for low-income countries that do not currently need or want IMF financing but do wish to have

criticisms of that institution and other international economic institutions in that 2008 book as well as in a 2005 book that I wrote for an academic and research audience. See JOHN W. HEAD, *THE FUTURE OF THE GLOBAL ECONOMIC ORGANIZATIONS: AN EVALUATION OF CRITICISMS LEVELED AT THE IMF, THE MULTILATERAL DEVELOPMENT BANKS, AND THE WTO* (Series on Int’l Law & Dev., 2005) [hereinafter HEAD-2005]. Various other criticisms that I identified in those earlier two works do not, in my experience, appear as frequently in the literature regarding the IMF’s handling of the Asian financial crisis as do the four criticisms referred to above.

47. See HEAD-2008, *supra* note 46, at 108; see also HEAD-2005, *supra* note 46, at 24-25.

48. IMF, Factsheet: *IMF Lending* (Sept. 9, 2009), <http://www.imf.org/external/np/exr/facts/howlend.htm>.

49. *Id.* For example, Mexico entered into an FCL arrangement in April 2009 and announced at the time that it intended to treat the arrangement as precautionary and did not intend to draw on the line of credit. See Press Release, IMF, *IMF Executive Board Approves US\$47 Billion Arrangement for Mexico Under the Flexible Credit Line*, No. 09/130 (Apr. 17, 2009), available at <http://www.imf.org/external/np/sec/pr/2009/pr09130.htm>.

IMF endorsement of their economic and financial policies, and to provide advice and monitoring in connection with those policies.”⁵⁰ A country’s agreement with the IMF on such a Policy Support Instrument signals potential donors and financial markets that the “country’s policies have been discussed with the IMF; this can, in turn, help a country boost its international reputation for financial prudence[,]” and hence its ability to attract financing on attractive terms.⁵¹

Related to these initiatives aimed specifically at crisis prevention are two other recent operational changes undertaken by the IMF. In 2006, the IMF began engaging in multilateral consultations—the first one involved the Euro Area, Japan, Saudi Arabia, and the United States—focusing on how global imbalances can be addressed while maintaining robust global growth.⁵² More fundamentally, changes were put in place in 2006 for more intensive economic surveillance at both the country level and the regional level. As components of the new “Medium-Term Strategy” introduced by former Managing Director Rodrigo de Rato, these changes are aimed at doing more to identify and promote effective responses to threats to economic stability. “Moreover, a new model, the “Global Economy Model”” was developed and launched by the IMF in 2004 to provide a better instrument for evaluating the effectiveness of various national economic and financial policies.”⁵³

Another major change in IMF operations came in 2002 with the adoption of new guidelines on conditionality. The new guidelines on conditionality, replacing a set that had been in place since 1979, were designed to reflect four principles: (i) the need to enhance the borrowing country’s “ownership” of the policy reforms; (ii) the need to reduce the number of conditions; (iii) the need to tailor the policy programs (and hence the content of the conditionalities) more closely to the borrowing country’s circumstances; and (iv) the need to improve clarity in the specification of conditions.⁵⁴

50. HEAD-2008, *supra* note 46, at 113.

51. HEAD-2008, *supra* note 46, at 113; *see also* IMF, Factsheet: *The Policy Support Instrument* (Nov. 2008), available at <http://www.imf.org/external/np/exr/facts/psi.htm>.

52. *See* IMF, *The Multilateral Consultation on Global Imbalances*, Apr. 2007, <http://www.imf.org/external/np/exr/ib/2007/041807.htm>.

53. *See* HEAD-2008, *supra* note 46, at 180; *see generally* IMF, Research Department, *GEM: A New International Macroeconomic Model* (Jan. 2004), available at <http://www.imf.org/external/np/res/gem/2004/eng/012304.pdf> (providing reasons for the creation of the Global Economy Model, including detailed analysis of its features).

54. *See* IMF, Legal and Policy Development and Review Departments, *Guidelines on Conditionality* (Sept. 25, 2002), available at <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm>. The changes in the IMF conditionality guidelines were praised by Allan Meltzer, the chairman of the commission that in 2000 voiced strenuous criticisms at the IMF. *See* Allan H. Meltzer, *The IFIAC Report: Comments on the Critics*, in *THE IMF AND ITS CRITICS: REFORM OF GLOBAL FINANCIAL ARCHITECTURE* 122 (David Vines & Christopher L. Gilbert, eds., 2004).

Another form of operational reform in the IMF—this one responding to the “distributional and social injustice” criticism summarized above⁵⁵—revolves around a set of steps the IMF has taken in recent years to give special attention to the social aspects of a country’s well-being. In urging governments to provide such protections, the IMF has advanced the view (in one of its numerous “social dimensions” publications) that one of the elements in a strategy of high-quality growth for a country is “sound social policies, including social safety nets to protect the poor during the period of economic reform, cost-effective basic social expenditures, and employment-generating labor market policies.”⁵⁶ Likewise, in its 2003 annual report, the IMF offered this description of how social issues bear on its operations:

The IMF is committed to integrating poverty and social impact analysis in programs supported by lending under the [IMF’s Poverty Reduction and Growth Facility]. The purpose of this analysis is to assess the implications of key policy measures on the well-being of different social groups, especially the vulnerable and the poor.

When analysis indicates that a particular measure (for example, currency devaluation) may harm the poor, the impact is addressed through the choice or timing of policies, the development of countervailing measures, or social safety nets.⁵⁷

That same report listed some of the safety nets built into IMF-supported programs: “subsidies or cash compensation for particularly vulnerable groups; improved distribution of essential commodities, such as medicines; temporary

55. See *supra* text accompanying note 46.

56. IMF, IMF Pamphlet Series No. 47, *Social Dimensions of the IMF’s Policy Dialogue* 1 (Mar. 6-12, 1995), available at <http://www.imf.org/external/pubs/ft/pam/pam47/pam47sum.htm>.

57. IMF, *Annual Report of the Executive Board for the Financial Year Ended April 30, 2003*, 44 (2003) [hereinafter *IMF Annual Report 2003*], available at <http://www.imf.org/external/pubs/ft/ar/2003/eng/index.htm>. The report goes on to list some of the safety nets built into IMF-supported programs: “subsidies or cash compensation for particularly vulnerable groups; improved distribution of essential commodities, such as medicines; temporary price controls on some essential commodities; severance pay and retraining for public sector employees who have lost their jobs; and employment through public works programs.” *Id.* For a couple of decades, “numerous IMF-supported programs have been designed to provide specific protections for the poorest consumers and workers in borrowing member countries.” Details on these are available in numerous IMF publications and website entries, as well as in HEAD-2005, *supra* note 46, at 82. For further information about IMF policies in this regard, see generally IMF, Factsheet: *Poverty and Social Impact Analysis of Economic Policies* (Apr. 2008), available at <http://www.imf.org/external/np/exr/facts/sia.htm>; IMF, Factsheet: *Social Dimensions of the IMF’s Policy Dialogue* (Mar. 2001), available at <http://www.imf.org/external/np/exr/facts/social.htm>. For a discussion of issues relating to distributional justice, undertaken immediately after the outbreak of the Asian financial crisis, see generally IMF, IMF Fiscal Affairs Department, *Should Equity Be A Goal of Economic Policy?*, JAN. 1999, available at <http://www.imf.org/external/pubs/ft/issues/issues16/index.htm>. It is perhaps worth noting that IMF attention to such issues dates back even a decade earlier. See generally Peter S. Heller, A. Lans Bovenberg, Thanos Catsambas, Ke-Young Chu, and Parthasarathi Shome, IMF Occasional Paper Series No. 58, *The Implications of Fund-Supported Adjustment Programs for Poverty* (May, 1988).

price controls on some essential commodities; severance pay and retraining for public sector employees who have lost their jobs; and employment through public works programs.”⁵⁸

The IMF’s several lending mechanisms that aim directly at economically disadvantaged countries further demonstrate the attention the IMF now pays to social issues and distributional fairness. Just after the Asian financial crisis, the IMF’s Poverty Reduction and Growth Facility (“PRGF”), designed to provide low-cost loans to poor countries, was created (from older programs created after the 1982 debt crisis), and was later supplemented in 2005 with the Exogenous Shocks Facility (“ESF”)—also aimed expressly at low-income countries. These two facilities can be summarized in this way:

- *Poverty Reduction and Growth Facility (1999)*. Provides longer-term assistance for deep-seated, structural balance of payments difficulties; aims at sustained, poverty-reducing growth. . . .
- *Exogenous Shocks Facility (2005)*. . . . to provide policy support and finance assistance to low-income countries facing exogenous shocks (commodity price changes, trade disruptions from neighboring country, etc.); available to countries eligible for the PRGF but without a PRGF-supported program in place.⁵⁹

In 2009 the IMF announced that these two facilities would be further enhanced to provide additional support for low-income member countries. I explain these very recent changes below, in subsection B(2), discussing the “reactivation” of the IMF.

In yet another operational change designed to address the “distributional and social injustice” criticism—in addition, that is, to these funding techniques established to provide special favorable terms for low-income borrowing countries—the IMF has also helped create and implement the Multilateral Debt Relief Initiative aimed at canceling debt claims that the IMF holds on certain countries. As of 2006, the IMF had already canceled the debts owed to it by nineteen poor countries.⁶⁰ Another special program for poor countries is the Heavily Indebted Poor Countries (“HIPC”) initiative, under which the international financial community reduces the overall external debt of poor countries in the most debt.⁶¹

58. IMF *Annual Report 2003*, *supra* note 57, at 44.

59. This summary is drawn from HEAD-2008, *supra* note 46, at 110. See also IMF, *Factsheet: IMF Lending* (Sept. 9, 2009), available at <http://www.imf.org/external/np/exr/facts/howlend.htm>.

60. See HEAD-2008, *supra* note 46, at 116. The figure as of mid-2009 is 26 poor countries. See IMF, *Factsheet: The Multilateral Debt Relief Initiative (MDRI)* (June 2009), <http://www.imf.org/external/np/exr/facts/mdri.htm>.

61. See IMF, *Factsheet: Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative* (Sept. 22, 2009, <http://www.imf.org/external/np/exr/facts/hipc.htm>). The HIPC was created in 1996. *Id.*

In sum, in the dozen years since the Asian financial crisis erupted, the IMF has implemented an impressive array of major reforms that increase its capacity to respond to crisis situations in a way that takes social and distributional justice issues into account.⁶²

Another reform in IMF operations warrants some mention. This reform responds to the “secrecy and opaqueness” criticism mentioned above.⁶³ Especially in the last decade, the IMF has undertaken an impressive campaign to provide more information on its operations.⁶⁴ Now the IMF regularly posts on its website the reports of Article IV consultations—that is, the consultations the IMF holds annually (under the auspices of Article IV of the IMF Charter) with each of its member countries regarding economic and financial developments. The IMF website also provide the letters of intent and associated documentation relating to standby arrangements and other IMF lending operations, as well as information about each member’s financial position with the IMF and a range of details about the IMF’s own financial position. Indeed, according to a recent entry on the IMF’s website, ninety-five percent of members now choose to release their letters to the IMF regarding their requests for use of IMF resources. Similarly, three-quarters of all stand-alone reports on IMF-supported programs were published in the half-decade starting in 2001, with the pace of those releases increasing over time. The IMF now posts information on its website about each member’s financial position with the IMF, quarterly IMF financial statements, and other information about administrative and operational aspects of the IMF.

Having summarized several *operational* reforms undertaken by the IMF in recent years, let me turn now to some reforms in the IMF’s *accountability and governance* that had already been undertaken before the GFC 08/09 erupted. These reforms reflect the IMF’s response to the “democracy deficit” criticism summarized above.⁶⁵

A first initiative in this respect is the IMF’s establishment in July 2001 of an Independent Evaluation Office (“IEO”) in order “to conduct objective and independent assessments of issues of relevance to the mandate of the IMF.”⁶⁶ The

62. There is, however, more that could be done. In another context I have offered specific suggestions that would, if adopted by the IMF, give it a wider role in insisting that its member countries recognize and protect human rights. See HEAD-2008, *supra* note 46, at 203, 297 (urging linkage of IMF operations with obligations of its members to implement certain treaties, including human rights treaties).

63. See *supra* text accompanying note 46.

64. Details in the remainder of this paragraph are drawn from HEAD-2005, *supra* note 46, at 76-77; HEAD-2008, *supra* note 46, at 229.

65. See *supra* text accompanying note 46.

66. IMF *Annual Report 2003*, *supra* note 57, at 60; see generally IMF, Independent Evaluation Office of the IMF, About IEO, <http://www.ieo-imf.org/about/> (last visited Mar. 7, 2010) (providing further information about the IEO’s history, purpose, structure, and operations, including its official terms of reference, including IEO annual reports). For some views on the IEO, see generally four short articles by (respectively) an academic, two former IMF Executive Directors, and a senior official of the NGO Friends of the Earth: Peter B. Kenen, *Appraising the IMF’s Performance: A Review of the First Three Studies by the New Independent Evaluation Office*, 41 FIN. & DEV. 41 (2004); Karin Lissakers, *Blunt Approach Does the Trick*, 41 FIN. & DEV. 46 (2004);

IEO has already undertaken several evaluation projects, including assessments of: (i) the IMF's role in the economic crises in Brazil, Indonesia, and Korea; (ii) the IMF's role in Argentina; (iii) the effectiveness of the IMF's Poverty Reduction and Growth Facility (by which it makes low-cost loans to poor countries); (iv) IMF technical assistance; (v) the IMF's approach to capital account liberalization; and (vi) IMF initiatives in the area of corporate governance. One of its most recent evaluation efforts focuses on the governance of the IMF—a matter that I shall elaborate on below. In 2006, the IMF's Executive Board reviewed an external assessment of the IEO itself (a so-called “evaluation of the evaluators”) and decided to continue the IEO in operation with no major changes.

Although it is too early to assess the long-term impact of the IEO's work, its very creation does signal a willingness on the part of the IMF to provide increased public accountability. In its current formulation, the IEO is largely an internal organ of the IMF, given the fact that the Director of the IEO is appointed by the IMF Executive Board, may be dismissed at any time by the Executive Board, hires other IEO officers on terms and conditions determined by the Board, depends on the Executive Board for budgetary funding, and reports to the Board. Although the IEO's terms of reference call for it to “be independent of Fund management and staff”—a requirement that is given some force by (1) requiring that a majority of IEO personnel come from outside the IMF and (2) prohibiting the IEO Director from being appointed to a regular IMF staff position at the end of his or her term of office—the IEO, nevertheless, falls short of being an external organ broadly representative in character, empowered to exercise a fully objective review of IMF operations and to issue binding orders if it judges those operations to be improper or *ultra vires*.⁶⁷

It is, however, a start toward some sort of “judicial review” of IMF operations.

“A second recent IMF initiative—or, more precisely, a cluster of related initiatives—to increase the institution's accountability to the citizens of IMF

Jean-Claude Milleron, *Enhancing the Learning Culture*, 41 FIN. & DEV. 48 (2004); Carol Welch, *Credible Start, Untested Impact*, 41 FIN. & DEV. 50 (2004), available at <http://www.imf.org/external/pubs/ft/fandd/2004/03/pdf/kenen.pdf>. Some of the IEO's reports have criticized IMF operations. IMF, Independent Evaluation Office, *The IMF and Aid to Sub-Saharan Africa* (Mar. 2007), available at <http://www.imf.org/external/np/ieo/2007/ssa/eng/pdf/report.pdf> (finding “ambiguity and confusion” about the IMF's policies and practices in its work in sub-Saharan Africa); IMF, *Progress Report on the Activities of the Independent Evaluation Office (IEO)* (Oct. 2, 2009), available at <http://www.imf.org/external/np/pp/eng/2009/100209.pdf> (criticizing IMF operations and finding that the IMF needed to “play a larger and more considered role” in three areas: whether and how countries should liberalize trade in financial services, the systemic implications of the proliferation of preferential trade agreements, and the global effects of trade policies in systemically important countries).

67. For specific citations to sources relied on in this paragraph, including pertinent provisions in the regulations governing the IEO, see HEAD-2005, *supra* note 46, at 86-87.

consumer countries centers on the notion of ‘voice.’”⁶⁸ In order to increase the “voice” (notwithstanding the tiny voting strengths) of many member governments in IMF deliberations steps were taken in 1999 to give broader authority to the IMF’s International Monetary and Financial Committee, which is a group of twenty-four Governors that gather twice a year to provide policy oversight to the Executive Board. The aim of establishing this group was to provide “greater direct involvement of governments in the policy-making process within the Fund.”⁶⁹

In a similar effort to strengthen the “voice” of developing countries, as well as non-government entities and individuals within those countries, the IMF’s Executive Board continues to develop the IMF’s Poverty Reduction Strategy Paper (“PRSP”) process, introduced in 1999, by which written plans for reducing poverty are prepared by low-income countries through a participatory process involving domestic stakeholders and external development partners. Moreover, as yet another effort to strengthen the “voice” of the most thinly-represented countries, the IMF’s Executive Board is undertaking efforts to address staffing and technological constraints of the two sub-Saharan African constituencies on the Executive Board.

In addition to these various initiatives to increase the “voice” of some of its smaller member countries, the IMF has also begun to make changes in the distribution of voting power. Although the weighted voting system itself is still in place, a first round of adjustments was made in 2006 to increase, on an *ad hoc* basis, the quotas (and therefore voting power) of four member countries: China, Korea, Mexico, and Turkey.⁷⁰

68. The account in this paragraph and the following paragraph is drawn from HEAD-2008, *supra* note 46, at 237-38.

69. François Gianviti, *The Reform of the International Monetary Fund (Conditionality and Surveillance)*, 34 INT’L LAW 107, 115 (2000).

70. An IMF “Factsheet” issued in August 2009 (and available on the IMF website) reports as follows regarding the portion of the Medium-Term Strategy that relates to quotas and voting power:

On April 28, 2008, a large-scale quota and voice reform in the making for nearly two years was adopted by a large margin by the Board of Governors of the IMF. It aims to make quotas more responsive to economic realities by increasing the representation of fast-growing economies and at the same time giving low-income countries more say in the IMF’s decision making. The reform builds on an initial step agreed by the IMF’s membership in September 2006 to have ad hoc quota increases for four countries—China, Korea, Mexico, and Turkey.

See IMF, Factsheet: *IMF Quotas* (Aug. 31, 2009), <http://www.imf.org/external/np/exr/facts/quotas.htm>. For information on the Board of Governors resolution of April 2007 requesting work on a Charter amendment, see Press Release, IMF, IMF Board of Governors Approves Quota and Related Governance Reforms, No. 06/205 (Sep. 18, 2006), available at <http://www.imf.org/external/np/sec/pr/2006/pr06205.htm>.; IMF, IMF in Focus, *Setting a New Course*, (Sep. 2006, at 7), available at <http://www.imf.org/external/pubs/ft/survey/2006/090106.pdf> for a summary of the IMF’s Medium-Term Strategy. For details about the charter amendment currently under consideration, see *infra* note 86 and accompanying text.

2. *The IMF “Reactivation” Starting in 2008*

Above, I have offered some details about reforms the IMF has undertaken in recent years—in terms of both the IMF’s operations and its accountability and governance—in order to gauge to what extent the IMF was in some “state of readiness” to address the GFC 08/09 when it erupted in 2008. After all, it is clear from various G-20 actions and communiqués that the IMF has been called on to take a leading role in addressing the crisis, nurturing a recovery, and reducing the chances of a recurrence.⁷¹ I refer to this as the “reactivation” of the IMF.

It is worth noting that this “reactivation” has come on the heels of a period in which the IMF had become substantially less active—so much so that it was scrambling as recently as the beginning of 2007 to find means of generating income to cover its operating expenses in the wake of a substantial drop in its lending volumes.⁷² Now, the IMF’s lending volumes have shot skyward again. For example, the loans made available to members out of the IMF’s General Resources Account increased from about SDR1 billion in 2007 to over SDR13 billion in 2008, and already stood at nearly SDR17.7 billion for just the first three quarters of 2009.⁷³ Large (sometimes massive) IMF loan commitments have been made since November 2008 to Iceland, Hungary, Mexico, Bosnia & Herzegovina, Serbia, Romania, Pakistan, Ukraine, Sri Lanka, Latvia, Belarus, and Colombia.⁷⁴

It seems that the IMF intends for this increased lending volume to continue; in April 2009, for example, the IMF doubled the “access limits”—that is, the amount of funds a country can borrow from the IMF—for its poorest member countries.⁷⁵ Indeed, an extensive reformulation and expansion of IMF lending to low-income countries planned for implementation in late 2009 has been undertaken in response to the GFC 08/09. The changes involve the use of a trust—the Poverty Reduction and Growth Trust—which itself will have three facilities. The new regime has been described this way:

To make its financial support more flexible and tailored to the diversity of low-income countries, the IMF has established a new Poverty

71. See subsection IIIA3, *supra*; see also IMF, IMF Survey Magazine, *G-20 Reaffirms IMF’s Central Role in Combating Crisis* (Apr. 3, 2009), available at <http://www.imf.org/external/pubs/ft/survey/so/2009/NEW040309A.htm>.

72. See HEAD-2008, *supra* note 46, at 116 (explaining that the drop in lending necessitated a call for proposals from a “Committee of Eminent Persons” as to how the IMF could meet its institutional funding needs).

73. See IMF, *IMF Financial Activities—Update December 31, 2008* tbl.1, available at <http://www.imf.org/external/np/tre/activity/2008/123108.htm>; IMF, *IMF Financial Activities—Update October 1, 2009* tbl.1, available at <http://www.imf.org/external/np/tre/activity/2009/100109.htm#tbl>.

74. For information on current IMF lending, see IMF, *IMF Lending at a Glance*, available at <http://www.imf.org/external/np/exr/map/lending/index.htm>.

75. See Press Release, IMF, IMF Executive Board Approves Doubling of Borrowing Limits for Poorest Countries, No. 09/138 (Apr. 23, 2009), available at <http://www.imf.org/external/np/sec/pr/2009/pr09138.htm>.

Reduction and Growth Trust, which has three new lending windows. The new windows, which are expected to become effective later in 2009 when donor countries have given their final consent, are

The Extended Credit Facility (ECF), which replaces the Poverty Reduction and Growth Facility (PRGF). The ECF

- Provides sustained engagement in case of medium-term balance of payments needs

- Should be based on a country's own poverty reduction strategy, and

- Offers more flexible timing requirements than the PRGF for countries to produce a formal poverty reduction strategy document.

The Standby Credit Facility (SCF) , replacing the Exogenous Shocks Facility's High Access Component, is similar to the Stand-By Arrangement for middle-income countries. The SCF

- Provides flexible support to low-income countries with short-term financing and adjustment needs caused by domestic or external shocks, or policy slippages

- Targets countries that no longer face protracted balance of payments problems but may need help from time to time, and

- Can also be used on a precautionary basis to provide insurance.

The Rapid Credit Facility (RCF) , which

- Provides limited financial support in a single, up-front payout for low-income countries facing urgent financing needs

- Substitutes for a regular IMF loan when use of the other two facilities, which involve one-to three-year policy programs, is either not necessary or not possible, and

- Offers highly flexible financing that provides single-use loans that replace the Exogenous Shocks Facility's Rapid Access Component and the subsidized Emergency Natural Disaster Assistance; and offers successive drawings for countries in post-conflict or other fragile situations, replacing and expanding subsidized Emergency Post-Conflict Assistance.

For policy advice and signaling to donors, countries can request non-financial assistance under the existing Policy Support Instrument (PSI), which

- Supports low-income countries that have secured macroeconomic stability and thus do not need IMF financial assistance, and

- Can provide accelerated access to the new SCF in case of subsequent financial needs.

Low-income countries will receive exceptional forgiveness through end-2011 on all interest payments due to the IMF under its concessional lending instruments.

Increased IMF financial support for low-income countries has been joined by changes in the design and assembly of the agreed policy packages—called programs—that accompany IMF loans. These changes aim to

Strengthen the focus on supporting poverty alleviation and growth, for all these programs

Protect public spending even as economic downswings cut revenues

Prioritize national budgets in the direction of spending targeted at the poor, and

Focus loan conditions on critical areas, such as transparent management of public resources.⁷⁶

These changes aimed at low-income countries supplement a major overhaul of the IMF's lending practices announced in April 2009, that also include these other elements:

- Making further changes to IMF conditionality, to depart from the old practice, under which the IMF now says loans “often had too many conditions that were insufficiently focused on core objectives”;
- Introducing of the Flexible Credit Line described above, thereby giving qualified countries access to IMF funding with “[n]o hard cap on access to [IMF] resources” and with longer repayment periods than in the earlier Supplemental Reserve Facility;
- Enhancing the flexibility of the IMF's regular standby arrangements, by permitting more front-end access to funds and reducing the frequency of reviews of a country's performance;
- Continuing to allow countries to exceed the regular access limits—even after the doubling of the access limits noted above—under so-called Exceptional Access procedures; and
- Eliminating the “time-based repurchase expectations policy” under which countries were requested to make repayment before actually being required to do so—with the ultimate effect of lengthening grace periods applicable to certain IMF loans.⁷⁷

76. IMF, Factsheet: *IMF Support for Low-Income Countries* (July 29, 2009), available at <http://www.imf.org/external/np/exr/facts/poor.htm>.

77. See IMF, *IMF Implements Major Lending Policy Improvements* (Mar. 24, 2009), available at <http://www.imf.org/external/np/pdr/fac/2009/032409.htm> [hereinafter *IMF Lending Improvements*]. All quoted passages in the following bullet-points are drawn from that source.

In order to attain the increased lending volume that these various reforms envision, of course, the IMF has had to find new resources. As noted above, the G-20 called for a tripling of the IMF's borrowed resources.⁷⁸ Moreover, in September 2009, the People's Republic of China agreed to purchase IMF notes in an amount of US\$50 billion to expand the IMF's lending capacity.⁷⁹ This came after an agreement that the IMF concluded with Japan in February 2009 under which Japan made a commitment to lend the IMF up to US\$100 billion in an effort to overcome the global financial crisis.⁸⁰ The European Union also has committed 75 billion for this purpose.⁸¹

In addition, the IMF responded to the G-20's call to create another \$250 billion in SDRs.⁸² The IMF allocated these in August 2009.⁸³

With such a dramatic "reactivation" as this, the effectiveness of the IMF will turn on its "state of readiness," which I believe turns in part on how well it has responded to the criticisms leveled at it in the past. Particularly significant in this regard is the issue of legitimacy. Above, I have summarized certain changes made in recent years in IMF accountability and governance, including the recent increase in voting power of China, Korea, Mexico, and Turkey. Even more significant change in the distribution of votes is currently in process.

The following list shows the "top ten winners" and the "top ten losers" of voting power following a proposed second round of *ad hoc* adjustments:

Increased

China	...	increase by 0.88 percentage points, to a 3.81% share of total voting power
Korea	...	increase by 0.61 percentage points, to a 1.36% share of total voting power
India	...	increase by 0.42 percentage points, to a 2.34% share of total voting power
Brazil	...	increase by 0.31 percentage points, to a 1.72% share of total voting power
Mexico	...	increase by 0.27 percentage points, to a 1.47% share of total voting power
Spain	...	increase by 0.22 percentage points, to a 1.63% share of total voting power

78. See *supra* text accompanying note 43.

79. See Press Release, IMF, IMF Signs US \$50 Billion Note Purchase Agreement with China, No. 09/293 (Sep. 2, 2009), available at <http://www.imf.org/external/np/sec/pr/2009/pr09293.htm>.

80. See IMF, Factsheet: *How to Increase the IMF's Lendable Resources* (Apr. 2009), available at <http://www.imf.org/external/np/ext/facts/imfresources.htm>.

81. See *IMF Lending Improvements*, *supra* note 77.

82. See *supra* text accompanying note 43.

83. See Bergsten, *supra* note 22, at 27. Bergsten states that "[t]his took SDRs' share of global reserves from a previous level of under one percent to about five percent." *Id.*

2010 / *The Global Financial Crisis of 2008–2009*

Singapore	...	increase by 0.18 percentage points, to a 0.59% share of total voting
Turkey	...	increase by 0.15 percentage points, to a 0.61% share of total voting power
Ireland	...	increase by 0.13 percentage points, to a 0.53% share of total voting power
Japan	...	increase by 0.12 percentage points, to a 6.23% share of total voting power

Decreased

United Kingdom	...	decrease by 0.64 percentage points, to a 4.29% share of total voting power
France	...	decrease by 0.64 percentage points, to a 4.29% share of total voting power
Saudi Arabia	...	decrease by 0.41 percentage points, to a 2.80% share of total voting power
Canada	...	decrease by 0.37 percentage points, to a 2.56% share of total voting power
Russia	...	decrease by 0.35 percentage points, to a 2.39% share of total voting power
Netherlands	...	decrease by 0.30 percentage points, to a 2.08% share of total voting power
USA	...	decrease by 0.29 percentage points, to a 16.73% share of total voting power
Belgium	...	decrease by 0.26 percentage points, to a 1.86% share of total voting power
Switzerland	...	decrease by 0.19 percentage points, to a 1.40% share of total voting power
Australia	...	decrease by 0.18 percentage points, to a 1.31% share of total voting power ⁸⁴

Another proposed move is to increase the number of “basic votes” for all member countries, so as to increase the relative voting power of the IMF’s smaller members.⁸⁵ This will require an amendment to the IMF Charter and is currently underway.⁸⁶ Indeed, as of late February 2010, sixty-three member

84. See Press Release, IMF, IMF Executive Board Recommends Reforms to Overhaul Quota and Voice, No. 08/64 (Mar. 28, 2008), available at <http://www.imf.org/external/np/sec/pr/2008/pr0864.htm> [hereinafter Quota Recommendation]. In describing this second round of adjustments, the IMF explained that its goal was “to enhance representation for dynamic economies, many of which are emerging market economies, whose weight and role in the global economy have increased.” *Id.*

85. *Id.* For an explanation of “basic votes” and the effect of increasing them—a move that several observers have urged for years—see HEAD-2005, *supra* note 46, at 89.

86. The text of the proposed amendment itself can be found in Attachment II to the pertinent report of

countries—including all of the G-7 countries—had already voted in favor of this Charter amendment.⁸⁷ The amendment would also authorize “an Executive Director elected by more than a specified number of members to appoint two Alternates.”⁸⁸ The immediate (and intended) effect of this latter change would be to increase the “voice” of the two Executive Directors’ offices representing African constituencies.⁸⁹

The same trajectory of change—designed to respond to the “democracy deficit” criticism—is evident in another important area as well: selection of the IMF Managing Director. In a 2008 report acknowledging that the gradual reforms that have taken place in the governance of the IMF “have not kept pace with changes in the environment in which it operates”;⁹⁰ the IEO recommended that “[t]he selection process for the Managing Director should be reformed Candidates’ qualifications and likely effectiveness should be the main criteria used in the selection, and the competition should be open to candidates of all nationalities.”⁹¹ Similarly, a 2009 report of a Committee on IMF Governance Reform—an external group of experts appointed by the IMF Managing Director—called for “[t]he introduction of an open, transparent and merit-based system for the appointment of the Managing Director and Deputy Managing Directors.”⁹²

It is worth noting that the 2008 and 2009 reports and recommendations go much further than recommending a change in the process for selection of the Managing Director. Both reports also urge sweeping changes in other aspects of IMF governance as well. These include (i) the activation of the Council of Ministers (as provided for in the IMF Charter but not used yet) “as the ultimate decision-making body for [the IMF,]” (ii) the reorientation of “the Executive Board’s activities away from executive day-to-day operational activities towards a supervisory role[,]” and (iii) “the lowering of the voting threshold on critical decisions from 85 percent to 70-75 percent, and consideration given to extending

the IMF Executive Board to the IMF Board of Governors. See IMF, *Reform of Quota and Voice in the International Monetary Fund—Report of the Executive Board to the Board of Governors* 23 (Mar. 28, 2008), available at <http://www.imf.org/external/np/pp/eng/2008/032108.pdf> [hereinafter *Reform of Quota and Voice*]. The modified Charter provision on basic votes is formulated in a way that will permit basic votes to be increased as overall quote increases occur in the future, by prescribing that “[t]he basic votes of each member shall be the number of votes that results from the equal distribution among all the members of 5.502 percent of the aggregate sum of the total voting power of all the members, provided that there shall be no fractional basic votes.” *Id.*

87. See IMF, *Consents to the Proposed Amendments of the Articles of Agreement* (Feb. 25, 2010), available at <http://www.imf.org/external/np/sec/misc/consents.htm> [hereinafter *IMF Consents to Agreement*].

88. *Reform of Quota and Voice*, *supra* note 86, at 23.

89. See Quota Recommendation, *supra* note 84.

90. Independent Evaluation Office of the IMF, *Governance of the IMF: An Evaluation* 1 (2008), available at http://www.ieo-imf.org/eval/complete/eval_05212008.html [hereinafter *IEO Governance Report*].

91. *Id.* at 22.

92. IMF, Committee on IMF Governance Reform, *Final Report* 4 (March 24, 2009), available at <http://www.imf.org/external/np/omd/2009/govref/032409.pdf> [hereinafter *Experts Governance Report*].

double majorities to a wider range of decisions” so as to ensure support of those decisions by most members.⁹³

The precise outcome of these initiatives, which have been strongly urged but not yet set in stone, will reveal how serious the IMF—or more precisely, the handful of most powerful IMF members—really is about responding to the “democracy deficit” criticism and thereby gaining legitimacy to help the IMF meet the challenges that have been given to it in the context of the GFC 08/09. My own impression is that substantial changes are sure to be made. Whether they prove adequate or not remains to be seen.

C. Involvement of Other International Institutions

Subsections A and B, above, highlight how the G-20 and the IMF have responded to the GFC 08/09. Of these two entities, the IMF is the pivotal one in addressing the many detailed efforts that the crisis indicates need to be made. However, the IMF is part of a larger system of international financial institutions that have been developed over the past several decades to deal with international economic relations. Some of those other international financial institutions have also taken new initiatives in response to the GFC 08/09. Several of these are enumerated below.

Key initiatives taken by the World Bank Group (the IMF’s sister Bretton Woods institution) in response to the global financial crisis include the following:⁹⁴

- Providing loans for infrastructure projects both to enable countries to implement economic stimulus plans and to promote long-term economic growth;
- Providing loans to help to ensure that banks have adequate levels of capital and liquidity, to enable them (1) to promote public confidence in the banking sector, (2) to prevent unhealthy slowdowns in credit growth, and (3) to help counter non-performing assets resulting from the global financial crisis;
- Providing support for fiscal reforms to ensure long-run fiscal and macroeconomic stability;
- Providing loans to increase investing in social safety nets; and
- Providing loans aimed to increase financing to small businesses and microfinance institutions.

93. The first two of these recommendations appear in the IEO Governance Report, *supra* note 90, at vii. All three appear in the Experts Governance Report, *supra* note 92, at 3–4.

94. The information in this paragraph and the next draws generally from various pages on the website of the World Bank, <http://www.worldbank.org>, and in particular <http://www.worldbank.org/financialcrisis/> (both last visited October 2, 2009).

In addition to these steps, the World Bank also approved US\$2.6 billion in loans in 2009 to support healthy financial and investment climates in middle-income countries, and tripled investment in safety nets and social protection up to US\$12 billion over the next two years.

Key initiatives taken by the Asian Development Bank, one of the four main regional development banks, include the following:⁹⁵

- Establishing a three billion dollar Countercyclical Support Facility (“CSF”) which will supply stimulus financing to its developing member countries in the form of short-term, fast-disbursing loans;
- Approving additional liquidity of US\$400 million for member countries borrowing from the Asian Development Fund (“ADF”), the low-cost lending window of the Asian Development Bank) and adding the option to front-load the 2009-2010 biennial allocations for ADF borrowers;
- Adjusting pre-crisis loans in light of current financial and economic needs of borrowers.

Key initiatives taken by the European Central Bank in response to the GFC 08/09 include the following:⁹⁶

- Following a new fixed rate full allotment tender procedure to ensure sufficient liquidity;
- Accepting a wider range of securities, including a wider range of private securities, as collateral in order to ease liquidity restraints and encourage banks to roll over maturing loans and extend new credit; and
- Offering refinancing to a large number of counterparties to ensure public confidence that intermediaries will have sufficient liquidity.

In short, several other international financial institutions have undertaken initiatives designed, like those of the IMF, to provide resources necessary for

95. The information in this paragraph draws generally from various pages on the website of the Asian Development Bank, <http://www.adb.org>, and in particular <http://www.adb.org/Economic-Crisis/default.asp> (both last visited October 2, 2009).

96. The information in this paragraph draws generally from various pages on the website of the European Central Bank, especially: Press Release, European Central Bank, ECB and other Central Banks decide to continue Conducting US Dollar Liquidity-Providing Operations (Sept. 24, 2009), http://www.ecb.int/press/pr/date/2009/html/pr090924_2.en.html; Press Release, European Central Bank, ECB Activates the Swap Line with Sveriges Riksbank (June 10, 2009), <http://www.ecb.int/press/pr/date/2009/html/pr090610.en.html>; Press Release, European Central Bank, Measures Designed to Address Elevated Pressures in the Short-Term US Dollar Funding Markets (Sept. 26, 2008), www.ecb.int/press/pr/date/2008/html/pr080926.en.html; Press Release, European Central Bank, Swiss National Bank and European Central Bank Cooperation to provide Swiss Franc Liquidity (Oct. 15, 2008), http://www.ecb.int/press/pr/date/2008/html/pr081015_1.en.html.

governments to carry out economic stimulus programs and bring stability to the financial institutions in their states.

IV. THE GFC IN LARGER HISTORICAL AND GEOPOLITICAL CONTEXT

Having sketched out the general contours of (i) the causes and repercussions of the GFC 08/09, and (ii) the international institutional response to the crisis, with particular attention to the IMF, let us now widen our field of view to consider how the GFC fits into a larger landscape of developments. In the following paragraphs I offer a thumbnail sketch of several instances of financial and monetary crisis in the 20th century. I suspect that with the exception of the Asian financial crisis that erupted in 1997, most of these instances would be disregarded as ancient history (if they are known about at all) by many observers. Taken together, however, these crises impress me as forming a pattern into which the GFC 08/09 fits quite naturally (unfortunately). I hope by examining that pattern of crisis, we might gain a useful perspective on the challenge we face today in considering what can be done (if anything) to avoid the distress of yet another crisis.

A. *The Early Twentieth Century*

First, it is worth remembering that the Great Depression that started in the United States and then spread to much of the rest of the world in the 1930s was, in substantial part, a financial crisis.⁹⁷ It started in the 1920s with fluctuating commodities prices, but achieved its most visible form as a financial crisis with the stock market crash of 1929. On October 29, 1929, also known as “Black Friday,” stocks lost roughly forty percent of their value. By 1933, these stocks had lost eighty percent of their pre-Black-Friday value. Many people lost their life savings. Banks were strained, especially those whose depositors, having lost confidence in the market and banking systems, tried to withdraw all their money at once. Banks were not able to meet this demand for cash, and they started calling in loans. As prices and incomes plunged by as much as fifty percent, these debts became harder and harder to pay. In the year after Black Friday, 744 U.S. banks failed. A total of 11,000 of the 25,000 U.S. banks would fail by the end of the Great Depression.

My father’s father was the president of a small bank in a northeast Missouri town at the time this financial crisis was unfolding. His was among many banks, large and small, that closed their doors and never opened them again. For those that did re-open, of course, a heavy load of regulation—from both state and federal sources—was put in place; with that regulation came a promise of

97. The information in this paragraph and the next paragraph is drawn largely from Modern American Poetry, *About the Great Depression*, <http://www.english.illinois.edu/maps/depression/about.htm> (last visited Nov. 1, 2009).

support, especially in the form of deposit insurance provided by the federal authorities via the Federal Deposit Insurance Corporation. Similar forms of support, signaling an acknowledgment that the government has a special role to play in the health and safety of financial institutions, were developed over later years in the United States and were put in place in countries all around the world.

Those efforts helped create some safety and stabilization, but they did not create economic growth adequate to pull the United States and the rest of the world out of the Great Depression. By many accounts, it was World War II, and particularly the dramatic increase in U.S. industrial and economic activity to arm the Allied countries to fight the war, that overcame the Great Depression. Then, as the war was winding down, economic and political leaders in the Allied powers identified two dangerous national economic policy trends that they thought would have to be reversed in order to prevent the world from descending again into economic distress—and possibly into another war.

Those two national economic policy trends were forms of protectionism that developed in the years between World War I and World War II.⁹⁸ “First, the major states engaged in competitive raising of tariff barriers, seeking economic gains at the expense of their trading partners”⁹⁹ These high tariffs tended to stifle international trade. Second, some states also engaged in another national economic policy: competitive devaluations of national currencies. “Official measures by a national government to reduce the value of that [country’s] currency against the currencies of other countries typically have the effect of (i) making imported items more expensive for the residents of the devaluing state, and (ii) making items exported from that state more attractively priced for residents of other states against whose currencies the exporting state’s currency has been devalued.”¹⁰⁰ In the 1930s, several states engaged in the practice of currency devaluation to gain these short-term advantages in the terms of trade with other countries. Such currency practices, and others, provided a drag on trade among states.

By the 1940s, both of these economic policy trends that emerged in the inter-war years—competitive raising of tariff barriers and competitive devaluations of currencies—were regarded by many economic and political leaders as dangerous to world economic stability and, therefore, to the peace that was to be sought after World War II. They saw two necessities: (i) to encourage international trade by reducing tariff levels and other trade barriers; and (ii) to encourage international trade also by stabilizing and regulating national currency values.

It was the second of these two perceived necessities that led to the creation of the IMF. The new organization would prescribe and enforce rules to stabilize currency rates and encourage currency convertibility among states. Hence, at the Bretton Woods conference in New Hampshire in the summer of 1944, the IMF

98. The following account is drawn from HEAD-2008, *supra* note 46, at 97-100.

99. *Id.* at 97.

100. *Id.*

Charter was finalized; and in December 1945 the Charter came into effect, thereby creating the “par value system” that lasted for twenty-five years. In order to make this “par value” system work, the IMF Charter authorized the IMF to make short-term loans available to member countries having temporary balance-of-payments difficulties as could occur when a bad crop year reduced a country’s export revenues.

B. Currency, Debt, and Financial Crises of the 1970s and 1980s

1. Collapse of the Par Value System

Let us fast-forward now to the early 1970s. As participants in this symposium know, the par value system of fixed exchange rates broke down in the early 1970s, when the U.S. government announced it would no longer abide by some of its IMF Charter obligations on currency convertibility. This collapse followed a period of currency chaos, in which several countries manipulated their currency values in circumvention of the par-value-system restrictions; these measures, in turn, precipitated further currency chaos.¹⁰¹

In these chaotic circumstances, the par value system ultimately was recognized as having been overwhelmed by new conditions and the IMF’s members radically amended the IMF Charter accordingly, in the form of the Second Amendment.¹⁰² As a result, the IMF’s operations were correspondingly reduced: instead of being responsible for both (i) managing the par value system and (ii) conducting surveillance of the international monetary system, the IMF now retained only the second of those major functions.

2. The 1982 Debt Crisis

However, when the 1982 debt crisis broke out upon announcements by Mexico and Brazil that they would no longer be able to service their commercial debt obligations, the IMF took a lead role that set the stage for its operations ever since. The 1982 debt crisis posed an enormous risk to the international financial

101. For a summary description of the collapse of the par value system, see generally Eric Dorkin, *Development, the IMF, & Institutional Investors: The Mexican Financial Crisis*, UNIV. OF IOWA CENTER FOR INT’L FIN. & DEV., available at <http://www.uiowa.edu/ifu/ebook/ebook2/contents/part3-III.shtml>. For a more extensive treatment, see generally STEVEN M. SURANOVIC, *INTERNATIONAL FINANCE THEORY AND POLICY: THE BREAKUP OF BRETTON-WOODS* Chapter 100, available at <http://internationalecon.com/Finance/Fch100/F100-1.php>.

102. Perhaps the most important change appeared in Article IV of the Charter. In its original formulation, Article IV provided for the establishment of a par value (expressed in terms of gold or US dollars) for each member country’s currency and prohibited a country from changing or departing from such par value by more than 1% (in most cases) without IMF approval. After the amendments of the late 1970s, Article IV permitted each member country to establish exchange arrangements of its choice and merely required a member country to notify the IMF of its decision in that regard.

system, so it is worth examining as we paint this broad “landscape” of financial crises of the twentieth century.

The starting point for the debt crisis of 1982 was the global oil crisis of 1973.¹⁰³ Oil prices, which were as low as US\$1.30 per barrel in 1970, more than doubled to US\$2.70 per barrel in 1973. This was partly a result of the newly formed cartel operated by the Organization of Petroleum Exporting Countries (“OPEC”). By 1974, oil prices had reached a whopping US\$10.00 per barrel. A second global oil crisis began in 1979. In 1978, Saudi crude oil cost US\$13.00 per barrel. By 1981, Saudi crude had risen to US\$32.50 per barrel. Naturally, countries that relied on imported oil had to spend much more money to meet their oil needs. Developing countries resorted to foreign borrowing to pay the increased oil costs. Because much of the surplus money from oil exporting countries was saved in western banks, these banks had plenty of money to lend to developing countries. As a result, the current accounts deficit of developing countries rose from US\$11 billion in 1973 to US\$46 billion in 1975.

The rising price of oil alone did not lead to the debt crisis of 1982; falling commodity prices also contributed. Many developing countries exported commodities. However, as the industrial countries slowed production, the demand for commodities lessened. The year 1975 saw a nineteen percent drop in demand for commodities. Developing countries paid more for oil and received less for the commodities they exported. At the same time, the U.S. dollar was appreciating. This meant that loan repayments, which were to be made in dollars, cost more in terms of local currency.

Increased interest rates contributed to the debt crisis as well. Lenders made their loans subject to variable interest rates, pegging those rates above inflation to ensure that they were adequately compensated. As interest rates in the United States surged in the 1970s, so did interest rates on loans that had been made to the developing countries. Because of the rising prices of oil and the falling prices of commodities, many developing countries had to take out new loans to service their old loans.¹⁰⁴ In some cases, the new loans covered only the interest of the old loans.¹⁰⁵

All of these factors—the rise in oil prices, the collapse of commodity prices, the appreciation of the U.S. dollar, and the increase in interest rates on loans—contributed to Mexico’s declaration in 1982 that it could no longer service its debt.¹⁰⁶ In August 1982, Mexican officials flew to Washington D.C. to inform the

103. Except as otherwise indicated, all information in this account of the 1982 debt crisis is drawn from P. Kalonga Stambuli, *Causes and Consequences of the 1982 Third World Debt Crisis*, (Oct. 1998) (Pre-Doctoral Research Paper, University of Surrey), available at <http://129.3.20.41/eps/if/papers/0211/0211005.pdf>.

104. *Id.* at 2.

105. *Id.* at 12.

106. See John W. Head, *Suspension of Debtor Countries’ Voting Rights in the IMF: An Assessment of the Third Amendment to the IMF Charter*, 33 VA. J. INT’L L. 591, 597 n.19 (1993) [hereinafter Head-1993]. For a detailed account of the 1982 debt crisis, see Federal Deposit Insurance Corporation [FDIC], *The LDC Debt Crisis*, in AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S 191 (1997), available at

U.S. Treasury Secretary that Mexico was defaulting on its international financial obligations.¹⁰⁷ After Mexico's default, most banks stopped lending to developing countries. Because these countries had been relying on new debt to service old debt, they began defaulting on their loans. As these countries attempted to pay back their debt, the capital outflow depreciated exchange rates and thereby raised the real interest rate. In per capita terms, real GDP growth for Latin America was a negative nine percent between 1980 and 1985.

These economic repercussions that occurred at the national level as a result of the 1982 debt crisis had dramatic results at the international level, especially for the IMF. As I have described elsewhere, the severe strain that the crisis placed on the international financial system prompted U.S. government officials and other world leaders to turn to the IMF to help manage the crisis, ultimately leading to an enormous increase in the volume of IMF lending.¹⁰⁸

3. *The United States Savings and Loan Crisis*

The debt crisis that began in 1982, and that had international implications for several years thereafter, was paralleled in the U.S. financial system by another crisis that stretched through much of the 1980s—the “savings and loan crisis.” That crisis followed a familiar pattern that involved lax regulation, “bubble” enthusiasm, and collapse.

The crisis could be summarized as follows: In an effort to salvage the floundering savings and loan (“S&L”) industry in the early 1980s, the U.S. government deregulated the industry and expanded the lending capabilities of the S&Ls. Also known as “thrifts,” the S&Ls are specialized banking institutions that use savings deposit accounts to fund mortgages and other loans. Deregulation of the S&L industry coupled with federal insurance of savings deposits—especially in conjunction with a period of volatile, high interest rates and a real estate bubble—fostered unsustainable, high-risk lending that eventually drove many S&Ls to insolvency. Mass insolvency of S&Ls, in turn, drove the Federal Savings and Loan Insurance Corporation (“FSLIC”), which insured S&L savings deposits, into insolvency. The S&L crisis culminated at the end of the decade with a federal bailout of FSLIC and the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), which restructured regulation in the S&L industry and established the Resolution Trust Corporation for the purpose of closing failed S&Ls. The effects of the crisis were felt well into the next decade.

www.fdic.gov/bank/historical/history/191_210.pdf.

107. Guillermo Emiliano del Toro, *Foreign Direct Investment in Mexico and the 1994 Crisis: A Legal Perspective*, 20 HOUS. J. INT'L L. 1, 15 (1997).

108. See generally Head-1993, *supra* note 106.

Some elements of that brief narrative warrant expansion, in part because they resemble elements in the GFC 08/09. Here is a slightly more detailed chronological account of the S&L crisis:

- Between 1966 and 1979, interest rates were volatile. In 1979, oil prices doubled, and the Federal Reserve Board restricted the money supply. Inflation and short-term interest rates rose drastically.¹⁰⁹
- Because of ceilings placed on interest rates that S&Ls could offer on savings held with them, the rise of interest rates available in other investments created liquidity problems for S&Ls; and in response, the Financial Institutions Regulatory and Interest Rate Control Act of 1978 was enacted to allow S&Ls to invest certain amounts of their assets in land development, construction, and education loans.¹¹⁰
- From 1981 to 1982, the S&L industry reported losses of nearly US\$9 billion.¹¹¹
- In 1980 and 1982, in an effort to boost the S&L industry into profitability, the U.S. Congress deregulated the industry and further expanded the lending authority of S&Ls. Specifically, new laws removed the interest rate ceiling on deposit accounts as well as the limit on the amount of brokered deposits that an S&L could hold. Congress also raised the deposit insurance limit from US\$40,000 to US\$100,000 and reduced the net worth requirements for insured S&Ls.¹¹²
- In September of 1981, the Federal Home Loan Bank Board (FHLBB) issued “income capital certificates” which were purchased by the FSLIC and effectively allowed insolvent S&Ls to masquerade as solvent.¹¹³
- The Tax Reform Act of 1981 provided tax incentives for real estate investors, contributing to a real estate bubble and over-building.¹¹⁴

109. See Bert Ely, *Savings and Loan Crisis*, LIBR. OF ECON. & LIBERTY (2008), available at <http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html>; FDIC, *The S&L Crisis: A Chrono-Bibliography* (2002), available at <http://www.fdic.gov/bank/historical/s&l/> [hereinafter Chrono-Bibliography].

110. See Chrono-Bibliography, *supra* note 109.

111. See Ely, *supra* note 109.

112. See Chrono-Bibliography, *supra* note 109. See also Michelle Minton, *Community Reinvestment Act's Harmful Legacy: How It Hampers Access to Credit*, COMPETITIVE ENTERPRISE INST.: ONPOINT, Mar. 20, 2008, at 2, available at <http://cei.org/on-point/2008/03/20/community-reinvestment-act%E2%80%99s-harmful-legacy>.

113. See Chrono-Bibliography, *supra* note 109.

114. *Id.*

- In response to the real estate boom and relaxation of FHLBB supervision, S&Ls increased lending, with industry assets jumping fifty-six percent between 1982 and 1985.¹¹⁵
- Deregulation led to increased competition, driving up interest rates paid by S&Ls to depositors and encouraging risky lending.¹¹⁶
- The Tax Reform Act of 1986 removed many real estate tax shelters, causing real estate values to fall.¹¹⁷
- In the decade following 1986, 1,043 S&L institutions failed, and the total number of S&L institutions dropped by about half.¹¹⁸
- By 1987, FSLIC had become insolvent, and by 1989, Congress stepped in and bailed out the S&Ls.¹¹⁹
- The FIRREA, enacted in 1989, restructured federal regulation of the S&L industry.¹²⁰ Specifically:
 - The Resolution Trust Corporation (“RTC”) was created for the purpose of disposing of insolvent S&Ls;
 - The Office of Thrift Supervision replaced the FHLBB as the agency empowered to regulate S&Ls; and
 - The Savings Association Insurance Fund (“SAIF”) replaced the FSLIC as the agency empowered to provide ongoing insurance to S&Ls.

C. *The Troubled 1990s*

The financial crises of the 1980s that I have recounted briefly above—the international debt crisis that erupted in 1982 and the US S&L crisis—were echoed in the next decade. Indeed, Professor Douglas Arner of Hong Kong University has observed that “[i]n many ways, financial crises were a defining feature of the last decade of the twentieth century.”¹²¹ The following paragraphs summarize three such crises, all striking first at the national level and then gaining such momentum as to present the risk of contagion. These crises,

115. *Id.*

116. Timothy Curry & Lynn Shibut, *The Cost of Savings & Loan Crisis: Truth & Consequences*, FDIC BANKING REV., Dec. 2000, at 27, available at http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf.

117. See J. Steven Beabout, *The Effect of the Tax Reform Act of 1986 on Real Estate Transactions*, 16 COLO. LAW. 207, 207 (1987).

118. Curry & Shibut, *supra* note 116, at 27.

119. See Chrono-Bibliography, *supra* note 109.

120. *Id.*; Michael P. Malloy, *Financial Services Regulation: a Mid-Decade Review: Colloquium: Double Toil and Trouble: Bank Regulatory Policy at Mid-Decade*, 63 FORDHAM L. REV. 2031, 2035 (1995).

121. DOUGLAS W. ARNER, FINANCIAL STABILITY, ECONOMIC GROWTH, AND THE ROLE OF LAW 64 (2007).

afflicting Mexico, a trio of Asian countries, and Russia, each prompted substantial IMF involvement.

1. The Mexican Peso Crisis

The peso crisis of 1994 cannot be adequately understood without reference to the 1982 debt crisis summarized above. The origins of Mexico's 1982 default can be traced back to the oil price boom of the latter half of the 1970s, as the Mexican government built its economic growth plan around oil-price forecasts that later proved to be overly optimistic.¹²² The large fiscal deficit, reaching 14.1% of the GDP in 1981, was financed through international borrowings.¹²³ But with oil revenues falling far short of expectations, and with no other substantial sources of revenue, Mexico began witnessing a tide of capital outflow.¹²⁴ The peso came under attack, and the government used short-term external borrowings to try to keep its fixed exchange rate; this proved unsustainable.¹²⁵ With debt service in 1982 consuming sixty-two percent of exports revenues, and foreign debt measuring over US\$92 billion,¹²⁶ Mexico was unable to meet its debt obligations.

In the aftermath of the 1982 crisis, Mexico's banking sector was nationalized¹²⁷ and the peso was devalued. Mexico started a recovery plan, supported by a financing arrangement under the IMF's Extended Fund Facility, with the aims of lowering inflation, cutting government spending, and restoring the country's trade balance.¹²⁸ In August 1983, about a year after the crisis first erupted, Mexico signed an agreement with its creditors to restructure its outstanding debt.¹²⁹

Mexico's banking system remained under government control between 1982 and 1987, and during this time Mexico's economy was stagnant and inflation was high.¹³⁰ However, another financial crisis hit the country in 1988 (a presidential election year); when Mexico's stock markets crashed, the peso was devalued, and foreign capital fled again.¹³¹ The answer this time was a market oriented plan along with a privatization scheme and re-privatization of banks.¹³²

122. NORA LUSTIG, *MEXICO, THE REMAKING OF AN ECONOMY* 20 (2d ed.1998).

123. *Id.* at 21.

124. *Id.* at 24.

125. *Id.*

126. *Id.* at 31.

127. Leonardo Torre, *Banking Crisis in Mexico*, in *GLOBAL FINANCIAL CRISES AND REFORMS CASES & CAVEATS* 213 (B.N. Ghosh. ed., 2001).

128. LUSTIG, *supra* note 122, at 29. The IMF later stopped the disbursements under the EEF as Mexico failed to achieve some of the targets.

129. Toro, *supra* note 107, at 69.

130. See Francisco Gil-Diaz, *The Origin of Mexico's 1994 Financial Crisis*, 17 *CATO J.* 303, 306 n.6 (1998), available at <http://www.cato.org/pubs/journal/cj17n3/cj17n3-7a.pdf>.

131. William A. Orme Jr., *Mexican President Tackles Stagflation With Tough Austerity Plan*, *WASH. POST*, Dec. 20, 1987, at K04., available at <http://www.washingtonpost.com/wp-srv/inat/longterm/mexico/>

This see-saw action of nationalization and then re-privatization of Mexico's financial institutions was to play a part in the peso crisis of 1994, as was another development in the years leading up to that year. The elections of 1987 brought to power President Carlos Salinas de Gortari, a free market supporter widely credited with bringing reform and recovery to Mexico. The North American Free Trade Agreement ("NAFTA") was signed in 1992 and came into effect in 1994. Mexico's macroeconomic indicators were positive: inflation dropped from 160% in 1987 to 8% in 1993.¹³³ Mexico allowed foreign banks to open branches in the country and new banks were established.¹³⁴ Mexico's reforms were successful in attracting foreign investment and movement of capital inflows replenished the Mexican economy.¹³⁵

However, the years of having a nationalized banking industry took their toll on the Mexican banking sector; the lack of trained bankers who were able to assess risks in a profit-oriented system led to poor risk assessment, which in turn developed into serious problems with non-performing loans.¹³⁶ Moreover, the process by which the banks were privatized was not without mistakes: some bank buy-outs were financed through loans from the very same bank; some banks were, and remained, undercapitalized; and the already weak financial supervisory authorities were overwhelmed by the influx of re-privatized and new banks.¹³⁷ The availability of credit from domestic and foreign sources encouraged consumer and government spending, thus increasing the current account deficit, which was financed through short-term borrowing.¹³⁸

The increase in credit availability did not reflect growth; GDP grew only by 2.9% between 1990 and 1994.¹³⁹ Apparently, the slow growth did not, until December 1994, affect the peso exchange rate. It remained within the highest end of the government-established exchange-rate band¹⁴⁰ and was not allowed to fall below 3.46 pesos to the dollar.¹⁴¹

stories/871220.htm.

132. Torre, *supra* note 129, at 213.

133. Gil-Diaz, *supra* note 130; Rudiger Dornbusch, Alejandro Werner, Guillermo Calvo, Stanley Fischer, *Mexico: Stabilization, Reform, and No Growth*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, 1994, at 253, 254-315.

134. Torre, *supra* note 127, at 214.

135. *Id.*

136. *Id.* at 219.

137. Gil-Diaz, *supra* note 130, at 305.

138. *Id.*

139. Toro, *supra* note at 107.

140. Following the 1982 crisis the peso had been allowed to move within a relatively narrow range, or band, of pre-determined highs and lows. Prior to December 1994, the peso was closest to the higher end of the band. See Gil-Diaz, *supra* note 130.

141. Anthony DePalma, *Crisis in Mexico: The Overview; With Peso Freed, Mexican Currency Drops 20% More*, N.Y. TIMES, Dec. 23, 1994, available at <http://www.nytimes.com/1994/12/23/world/crisis-in-mexico-the-overview-with-peso-freed-mexican-currency-drops-20-more.html?scp=1&sq=Mexico%201994%20peso%20crisis&st=cse>.

Thus the economic conditions were in place—viewed in retrospect, at least—for the Mexican peso crisis of 1994. It was only a matter of time before the peso would be recognized as an overvalued currency not supported by real growth. That recognition was hurried by a series of events in Mexico’s political arena. The year 1994 brought a rebellious uprising in the Chiapas region, the assassination of the dominant party’s presidential candidate, the resignation (later withdrawn) of the Minister of Interior, the kidnapping of a prominent Mexican businessman, the assassination of the highest-ranking official in the ruling party, and more.¹⁴²

Raising the specter of growing political instability and uncertainty, these developments naturally drew the attention of prospective foreign investors. Once those prospective foreign investors realized that the peso was overvalued, capital inflows started to slow down for fears of devaluation.¹⁴³ At the same time, existing investors started to exit,¹⁴⁴ selling their peso-denominated debts, thus putting demand on Mexico’s foreign currency reserves.

The Mexican government used its foreign reserves to defend the peso but those reserves were becoming dangerously low.¹⁴⁵ Accordingly, Mexico announced on December 20, 1994, that it was allowing the peso to move more freely against the U.S. dollar—though still within a band, now featuring a floor of four pesos to the dollar instead of the previous 3.46 to the dollar.¹⁴⁶ Three days after that, the government took action to free-float the peso,¹⁴⁷ and it dropped in value to 4.80 to the dollar. The effects of these events were catastrophic; private businesses and individuals who had foreign debts faced a sudden increase in the value of their debts and imports became dramatically more expensive.

2. *The Asian Financial Crisis*

In a companion article to this one, I have examined the Asian financial crisis in some detail.¹⁴⁸ In doing so, I have reviewed developments that I first wrote about roughly twelve years ago, at the very beginning of 1998, in the “heat of the moment” when the long-term implications of the crisis were of course completely unknown. Here is how I described the crisis at that time:

142. Torre, *supra* note 127, at 235; see also Tod Robberson, *Top Mexican Presidential Candidate Is Slain*, WASH. POST, Mar. 24, 1994, at A01; see also Joseph A. Whitt, *The Mexican Peso Crisis*, FED. RES. BANK OF ATLANTA ECON. REV., Jan.- Feb, 1996, at 2-3 (1996).

143. Toro, *supra* note 107, at 77.

144. *Id.* at 78.

145. Sebastian Edwards & Miguel A. Savastano, *The Morning After: The Mexican Peso in the Aftermath of the 1994 Currency Crisis* 13 (NPER WORKING PAPER NO. 6516, 1888), available at <http://www.nber.org/papers/w6516>.

146. DePalma, *supra* note 141.

147. *Id.*

148. See generally Head-2010, *supra* note 3.

The second half of 1997 proved disastrous for Asia—particularly Thailand, Indonesia, and Korea. The 1997 financial crisis that hit those countries was massive in scale. Here are some representative figures showing the magnitude of the damage:

- The Thai baht, having traded at around 25 to the dollar for thirteen years, lost over half of its value between July 1997 and January 1998, when it was trading at about 55 to the dollar. Thailand's stock market value declined over 60% in that same period.
- The Indonesian rupiah lost about 75% of its value against the dollar between mid-1997 and early 1998. The Indonesian stock market dropped in value even more than Thailand's had—by over 75% in the second half of 1997.
- Korea was in some ways the hardest hit of all—and this is especially significant because of its economic importance in Asia. The won fell in value 70% between mid-October and mid-December 1997, and Korea's stock market lost two-thirds of its value from August to December. Korea's foreign exchange reserves fell by more than 50% in the space of two months. Bonds issued by one of Korea's biggest banks were trading at 60% of face value in December 1997, down from 100% of face value in October 1997.¹⁴⁹

A year later, in early 1999, I wrote another article on the Asian Financial Crisis and explained some of the damage it had done as of that point:

It has been a crisis for millions of people in Asia in terms of their household economies, businesses, savings, education, health, and futures. President Clinton, in his state of the union address in January [1999], called it “the most serious financial crisis in a half a century.” A leading economist has referred to it as “something that has no parallel in human history.” For millions of people, it has increased unemployment, prices, and poverty, while cutting opportunities for education, health, and other social programs.¹⁵⁰

In a nutshell, the economic trauma that hit Asia a dozen years ago caused widespread distress, particularly in Thailand, Indonesia, and Korea. It left both the populations and the governments of those countries severely wounded.

149. John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J.L. & PUB. POL'Y 70, 70 (1998) [hereinafter Head-1998] (citations omitted).

150. John W. Head, *Global Implications of the Asian Financial Crisis: Banking, Economic Integration, and Crisis Management in the New Century*, 25 WM. MITCHELL L. REV. 939, 940 (1999) [hereinafter Head-1999] (citations omitted).

3. *The Russian Debt-and-Currency Crisis*¹⁵¹

The Russian experience of the late 1990s provides confirmation that the risk of contagion is real: the Asian financial crisis, summarized above, provided a push that helped send the Russian economy over the edge in late 1997. However, the history of what became the Russian crisis begins much earlier than 1997. After the collapse of the Soviet Union in December 1991, Russia began a transition from a planned economy to a market-based economy. As early as August 1992, Russia was a recipient of an IMF stand-by arrangement amounting to SDR 719 million.¹⁵² In 1994 the IMF provided transitioning Russia with assistance under its brand-new Systemic Transformation Facility. Russian efforts remained unsuccessful, however, to drive inflation down and increase Russia's foreign currency reserves, so Russia returned to the IMF, which in April 1995 approve another standby arrangement to help put the Russian efforts back on track.¹⁵³ By the end of 1995 inflation was down to single-digit levels,¹⁵⁴ and Russia started an economic reform and stabilization program under a three-year IMF Extended Fund Facility arrangement.¹⁵⁵ The 1996 program aimed at achieving certain macroeconomic goals by the end of 1998: lowering ongoing inflation to a single-digit annual rate, increasing Russia's foreign currency reserves, restoring the budget deficit to moderate levels (0.4%), enhancing government tax collection, and achieving GDP growth.¹⁵⁶ The structural reform portion of the 1996 program included trade liberalization and privatization.¹⁵⁷

The actual crisis in the Russian economy constituted a blend of a short-term debt crisis and a currency crisis. The debt crisis had its roots in the fact that one of the main tools used by the Russian government for driving down inflation¹⁵⁸

151. In addition to other sources cited in the following paragraphs regarding the Russian crisis of the late 1990s, see generally Abigail J. Chiodo & Michael T. Owyang, *A Case Study of the Currency Crisis: The Russian Default of 1998*, 84 FED. RES. BANK OF ST. LOUIS REV. 7 (2002), available at <http://research.stlouisfed.org/publications/review/02/11/ChiodoOwyang.pdf>.

152. Int'l Monetary Fund [IMF], *Chronology: IMF Evolves in Response to Over Half a Century of Challenge and Change*, <http://imf.org/external/pubs/ft/survey/sup0998/14.htm> (Sept. 1998).

153. Press Release, IMF, *IMF Approves Stand-by Credit for Russia*, No. 95/21 (Apr. 11, 1995), available at <http://www.imf.org/external/np/sec/pr/1995/pr9521.htm>. This loan was in an amount of SDR 4.3 billion (about US\$6.8 billion).

154. Press Release, IMF, *IMF Approves Three-Year EFF Credit for the Russian Federation*, No. 96/13, (Mar. 26, 1996), available at <http://www.imf.org/external/np/sec/pr/1996/PR9613.htm>.

155. *Id.*

156. *Id.*

157. *Id.*

158. Most accounts point to a weak tax base, tax collection delinquencies, a barter system between the Government and businesses and hence falling government revenue. One commentator described the Russian government's policy to issue GKO's as a "measure covering up the failure of transition to market, the de-industrialization of the country. The GKO pyramid scheme set Russia on a course of disaster by relying more and more on foreign borrowing, which was not invested into infrastructure, not invested in production, but in covering up the growing deficits to make Russia look like it was moving to a market economy." Vladimir Brovkin, *Wishful Thinking about Russia?*, BEYOND TRANSITION NEWSLETTER, May/June 1999, at 22-25, available at <http://www.worldbank.org/html/prddr/trans/mayjun99/pgs22-25.htm>.

was the issuance of debt instruments for use in borrowing (instead of printing money, thus running the risk of spurring inflation). The use of GKO (the Russian abbreviation for Treasury bills or short term Government bonds¹⁵⁹) and, to a lesser extent, the OFZ (medium to long term bonds¹⁶⁰) were open to domestic investors initially, and in 1997 “non-resident” investors were allowed into the GKO/OFZ market as well.¹⁶¹ The sheer size of government borrowing through GKO and OFZ was not insignificant, reaching twenty percent of the Russian GDP in 1996, as well as in 1997.¹⁶² Moreover, the total estimated value of GKO/OFZ redeemable only in 1998 was 1.5 times higher than that year’s total revenues of the Russian Federal budget.¹⁶³

One cause of the Russian currency crisis is to be found in contagion from the Asian financial crisis. It may be that the crisis of confidence among investors (especially foreign investors) that precipitated the crisis in Thailand, Indonesia, and Korea moved to Russia.¹⁶⁴ Another precipitating factor could be the deterioration of oil prices¹⁶⁵ (due to lower demand for crude oil¹⁶⁶), which negatively affected Russian reserves of foreign exchange.

Since Russia had a fixed exchange rate (although the ruble was allowed to move within a band), speculative attacks—that is, speculative selling by currency traders—took place on the ruble, just as attacks had taken place against national currencies in the context of the Asian financial crisis. Russia exhausted billions of dollars to sustain the ruble at its pre-crisis levels.¹⁶⁷ Finally, on August 17, 1998, Russia devalued the ruble and announced its inability to pay its ruble-denominated debt.¹⁶⁸ It also restructured all of its obligations due until the end of 1999 and imposed a ninety-day moratorium on private foreign principal payments.¹⁶⁹

159. Kaj Hobér, *Investment Arbitration In Eastern Europe: Recent Cases on Expropriation*, 14 AM. REV. INT’L ARB. 377, 396 (2003).

160. *Id.*

161. Brian Pinto, Evsey Gurvich, & Sergei Ulatov, *Lessons from the Russian Crisis of 1998 and Recovery*, in *MANAGING VOLATILITY & CRISES: A PRACTITIONER’S GUIDE 4* (Joshua Aizenman & Brian Pinto eds., 2004), available at <http://www1.worldbank.org/economicpolicy/mv/mvcguide.html>.

162. Evsey Gurvich, *Looking Back at Russian Financial Crisis 4* (GET PROJECTS, FORD FOUNDATION, Working Paper No. 2001/030, 2001), available at <http://www.nes.ru/english/research/pdf/2001/Gurvich.pdf>.

163. *Id.*

164. Pinto, Gurvich, & Ulatov, *supra* note 161, at 4.

165. JOSEPH E. STIGLITZ, *GLOBALIZATION AND ITS DISCONTENTS 199* (2d ed. 2003).

166. See Wikipedia, *1998 Russian Financial Crisis*, http://en.wikipedia.org/wiki/1998_Russian_financial_crisis (last visited Nov. 1, 2009).

167. STIGLITZ, *supra* note 165, at 198.

168. Pinto, Gurvich & Ulatov, *supra* note 161, at 4.

169. *Id.*

The brief chronological survey offered in this section shows a pattern of crisis that I find deeply troubling. I have identified eight major instances of financial chaos and distress that had significant international implications: (1) the financial-crisis aspects of the Great Depression; (2) the inter-war experience with competitive devaluations; (3) the collapse of the par value system; (4) the 1982 debt crisis; (5) the U.S. S&L crisis; (6) Mexico's peso crisis; (7) the Asian financial crisis, and (8) the Russian debt-and-currency crisis. Others could also have been included in this short survey,¹⁷⁰ but this litany of financial chaos is surely adequate to illustrate the depressing regularity and frequency with which such crises have occurred.¹⁷¹ This in turn serves to underscore the importance of addressing these related questions: (i) What keeps going wrong; and (ii) What, if anything, can be done to break this pattern?

V. THE LONGER VIEW: FAILURES, "FIXES," AND FUNDAMENTALS

In the preceding pages I have tried to provide: (1) a thumbnail account of how the GFC 08/09 unfolded; (2) a survey of the international institutional response to the GFC 08/09 (with special emphasis on the IMF); and (3) a reminder of the broader historical landscape of global economic crises, of which I see the GFC 08/09 as merely the most recently added geographical feature. Now I wish to draw on those various points to offer some evaluative observations.

In particular, I wish to address these questions: (i) What specific defects or failures (if any) does the outbreak and spread of the GFC 08/09 reveal in the system of global finance; (ii) What lessons can we learn (if any) about the "fixes" that might be applied in order to reduce the likelihood of such crises occurring again, or to mitigate their severity if they do occur; and (iii) What more fundamental issues do we need to address—including, for example, fundamental ideological values and human realities that might stand in the way of any significant reform? I shall offer some answers to those questions based on my own opinion and informed speculation (influenced, of course, by others), but some of my answers will amount to little more than further questions. This reflects a theme that emerges from my study of the GFC 08/09: there is a great deal that we simply do not know, and possibly cannot know, about global economic affairs.

170. One crisis that culminated in the early 2000s occurred in Argentina. For useful accounts of that crisis, see Brad Sester & Anna Gelpern, *Argentina's Pathway Through Financial Crisis* (Global Economic Governance Programme, GEG Working Paper 2004/02, 2005), available at <http://www.globaleconomicgovernance.org/wp-content/uploads/Setser%20and%20Gelpern%20-%20Argentina.pdf>; J. F. HORNBECK, CONGRESSIONAL RESEARCH SERVICE, REPORT NO. RS21130, THE ARGENTINE FINANCIAL CRISIS: A CHRONOLOGY OF EVENTS (2002), available at <http://fpc.state.gov/documents/organization/8040.pdf>.

171. A recent IMF report is said to have counted the cost of "88 banking crises over the past four decades." See *The Long Climb*, *supra* note 2, at 4. For a chart identifying several crises that have occurred in the past century—including most of the ones summarized above—see ARNER, *supra* note 121, at 66.

A. *Failures*

1. *The Scope and Coordination of National Financial Regulation*

In my view, we need not look far in our search for defects or failures that the GFC 08/09 reveals in the system of global finance. Surely one failure lies in the performance of national regulatory authorities and processes: in the United States and elsewhere, regulatory regimes failed to protect the financial systems against imprudence that created excessive systemic risk.¹⁷² In one of a series of papers issued by the IMF in early 2009 assessing certain “lessons of the Global Crisis,” the IMF’s Monetary and Capital Markets Department identified as “priorities for action” these regulatory processes and approaches (among several others) that had not been given adequate attention:¹⁷³

- “The perimeter of financial sector surveillance needs to be expanded to a wider range of institutions and markets[,]”¹⁷⁴ so as to avoid having some entities (such as securities and insurance companies) and some activities (such as off-balance-sheet activities) avoid regulation or enjoy under-regulation;
- “Prudential regimes should encourage incentives that support systemic stability; discourage regulatory arbitrage; and adopt a broad concept of ‘systemic’ risk.”¹⁷⁵
- Capital adequacy requirements, provisioning requirements, and liquidity requirements “should be more demanding in good times to build buffers that in bad times can help to offset procyclical pressures.”¹⁷⁶
- More and better information regarding financial institutions, especially those that are lightly regulated or that have off-balance-sheet transactions, should be required;¹⁷⁷
- Financial supervision by national regulators should be supplemented by (i) better capacity of central banks to provide liquidity in times of

172. For a discussion of this failure, see Int’l Monetary Fund [IMF], *IMF Survey Magazine: IMF Research, New Methods Aim to Identify Systemic Financial Risks*, (Apr, 21, 2009), available at <http://www.imf.org/external/pubs/ft/survey/so/2009/RES042109A.htm> (reflecting the findings of an IMF report finding that the “global crisis has highlighted that further progress is needed to identify and address systemic risks—those that threaten the financial system rather than individual financial institutions or markets”).

173. See generally *IMF Regulation Lessons*, *supra* note 18.

174. *Id.* at 4. For details regarding the “perimeter of financial regulation”, see *id.* at 8-11.

175. *Id.* at 4.

176. *Id.* at 5. For details on the need for more effective capital adequacy requirements, see *id.* at 12.

177. *Id.* at 5.

crisis and (ii) the removal of impediments to effective regulation of cross-border institutions.¹⁷⁸

The third of these points, capital adequacy, has received intense attention recently from many quarters. These include, in addition to the IMF, the U.K. Chancellor of the Exchequer, the European Council, and the Basel Committee.¹⁷⁹

Another way to view the shortcoming I am discussing here—that is, a failure in the performance of national regulatory authorities and processes—is in terms of “sequencing.” As Professor Arner has explained, in considering “how countries should go about achieving the benefits of [financial] liberalization . . . while at the same time reducing risks of financial crisis, . . . the focus . . . is increasingly on the concept of sequencing[,] . . . which looks to the process of [financial] liberalization and the process of [financial] institutional strengthening” through appropriate regulation.¹⁸⁰ We might therefore characterize the failure of domestic financial regulation as being too-fast liberalization of national financial sectors combined with too-slow strengthening of national financial regulatory norms and institutions.

2. *Failure of the Theory of “Self-Regulation”*

A second failure, also located mainly at the national level, appears in the theory of so-called “self-regulation.” Just as the official *public-sector* regulatory regimes—manned and managed by national government officials—failed to prevent the chaos by ensuring that risky behavior would be held in check by effective regulation, the *private-sector* financial institutions and their managers also failed to prevent the chaos through what some thought was the magical steadying hand of self-regulation. As Professor David Westbrook explains in his insightful and provocative book, *Out of Crisis*, it simply is not true, at least in the context of a chaotic bubble market, that financial institutions need no official regulation because the competition found in the marketplace imposes its own prudence-inspiring discipline. Instead, as he expresses it, “competition cannot be presumed; and therefore market discipline cannot be presumed; and therefore self-regulation cannot be presumed; and therefore government regulation may be prudent.”¹⁸¹

Because the theory of financial “self-regulation” held such long-standing power over sophisticated economies, especially that of the United States, it is

178. *Id.*

179. See *The Devil's Punchbowl*, *ECONOMIST*, July 11, 2009, at 55. For other articles emphasizing the need to concentrate on, and toughen, capital adequacy requirements, see *Target Practice*, *ECONOMIST*, July 11, 2009, at 73; *Appetite Suppressant*, *ECONOMIST*, July 11, 2009, at 16.

180. ARNER, *supra* note 121, at 268.

181. WESTBROOK, *supra* note 10, at 10. For Westbrook's specific reference to “a rather chaotic bubble market” as being the setting in which the logic of “self-regulation” breaks down, see *id.* at 11.

worth a brief examination. Westbrook offers this explanation of the theory as practiced in the United States:

As a policy matter, for some decades it was argued that no more substantial regulation of financial market actors (or their instruments or activities) was required, because such entities regulated themselves. (Really.) So accounting firms, credit rating agencies, derivatives, hedge funds, private equity funds, . . . [and other institutions and markets] all escaped substantial regulation. . . . By the same logic, even as financial industries evolved and new products were developed, expressing new opportunities with new risks, (for examples, collateralized loan obligations [CLOs], collateralized debt obligations [CDOs], credit default swaps [DCSs], and an inexhaustible array of over-the-counter arrangements) additional regulation for traditional highly regulated entities, such as banks, brokerage houses, and exchanges, was deemed an unnecessary drag on innovation. In 2004, the [US Securities and Exchange Commission] relaxed the capital requirements on the biggest investment banks, largely responsible for the creation and marketing of these new products, and the banks promptly began doing business with leverage ratios of thirty to one. As late as the fall of 2008, after admitting that the risk management edifice had collapsed, Alan Greenspan told Congress that additional regulation was hardly required, because this time Wall Street had learned its lesson about prudent investment, and would go forth and sin no more.¹⁸²

The theory that markets involving corporate entities (such as banks) will engage in “self-regulation,” Westbrook explains, “is based on a tacit imagination of the corporation as a risk-averse and rational individual, reliably disciplined by its competitors.”¹⁸³ The silliness of the notion of “self-regulation,” Westbrook argues, derives from the fact that every element of that tacit imagination is, in fact, false (or at least doubtful) in the circumstances that developed in sophisticated financial markets over recent years: (1) there was very little risk aversion (because a key purpose of a limited-liability company is in fact to take on risk); (2) a huge corporate entity cannot reasonably be regarded as having any real understanding of its own position, so that it makes little sense to speak of a corporation as acting rationally; and (3) for some imaginative financial products and actors, effective competition did not exist.¹⁸⁴

182. *Id.* at 8.

183. *Id.*

184. *Id.* at 8-9.

3. *Collapse of the “Transparency” and the “Risk-management” Theories*

A third failure, still located mainly at the national level, lies in the ultimate bankruptcy of two theories, both of which were created and expected to avoid financial crisis, but which ultimately failed to do so. The two theories are (i) the “transparency” theory and (ii) the “risk-management” theory. As Professor Westbrook also explains, the forty year period from about 1933 to 1974 was characterized by a reliance on transparency to guard against financial chaos on the theory that supplying players in the marketplace with adequate information would guard against chaos and crisis.¹⁸⁵ That reliance was replaced around 1974¹⁸⁶ by a reliance on the “risk-management” approach, which accepts marketplace danger and copes with it by diversified and hedged portfolios.¹⁸⁷ Westbrook offers this historical synopsis, culminating in the collapse of both theories:

It makes some sense . . . to understand these modes sequentially, as the different approaches taken by, and defining, two different eras of finance. It could be said that the era of transparency in the United States ran from the Securities Act of 1933, which required companies offering securities to the public to disclose vast quantities of information, to the passage of ERISA in 1974, which had the unintended consequence of transforming retirement so that most middle-class Americans were turned into part-time portfolio managers. In the same spirit, we might say that the era of risk management runs from 1974 until the passage of the \$700 billion congressional bailout in the fall of 2008. We are, then, living after the death of the second era of finance.¹⁸⁸

My own observation based on Westbrook’s statement is this: to put it bluntly, we are not smart enough—any of us, whether we are ordinary investors or financial sophisticates—for transparency alone to help us guard ourselves, individually or collectively, against financial disaster given the complexity of the financial instruments and transactions that clever thinkers and integrated markets have produced in recent years. Hence, to use Westbrook’s metaphor, putting all our eggs into one basket and then watching the basket very closely (with the aid of voluminous information)¹⁸⁹ will not suffice. Nor will the “risk-management”

185. *Id.* at 49.

186. Although Westbrook implies that the “transparency” theory was abandoned in the 1970s, in fact it continued to operate in some ways. Westbrook acknowledges this in noting that “[t]he latest grand effort to achieve transparency is the Sarbanes-Oxley Act, passed in 2002 in response to Enron and other accounting scandals.” *Id.* at 46.

187. WESTBROOK, *supra* note 10, at 49. Because of its reliance on portfolio diversification, the “risk management” approach is also referred to, Westbrook explains, as the “portfolio management” approach. *Id.* at 36 (noting that “portfolio theory and risk management are one and the same – one term is used in banking regulation, and when things go badly, and the other is used in the academy”).

188. *Id.* at 49.

189. *Id.*

emphasis on diversified portfolios provide any protection against a tsunami-like panic in which *all* assets are suddenly regarded as unreliable or overvalued or both. To use Westbrook's metaphor again, putting eggs in different baskets to divide our risks of disaster¹⁹⁰ also will not work in a system that is thoroughly integrated. In short, both theories, "transparency" and "risk management," belong in our column of "failures" as we survey the lessons of the GFC 08/09.

Worrisomely, this now places us in a position of deep uncertainty and danger. Ironically, as the world emerges from the GFC 08/09, the danger is all the greater since some people might be led to believe that the system is *not* broken. Westbrook summarizes the danger this way:

In early 2009, as a few institutions started to recover and things stopped declining quite so badly, some financial elites had the temerity to suggest that [Americans] should not be too upset by the financial crisis. [According to these elites, the] industrial revolution hurt people. So the financial revolution may be expected to hurt people, too. All we need [according to this argument] is to try, try again, and the ingenuity of Wall Street would bring more prosperity, and more safety, than the debacle might suggest.

[However, the] argument that the present crisis is merely a detour in the triumph of modern finance, the equivalent of a truly horrible nineteenth-century industrial accident, fails to understand the nature of the crisis, and specifically, the reasons why the best information and modeling systems in the world, functioning under the best conditions the world has ever seen, failed so miserably.¹⁹¹

In reviewing the nature of the GFC 08/09, and particularly the role that information, rationality, and markets play in it, we should guard against over-reaction based on an exaggerated assumption of the efficiency of markets and rationality of players in it. Cornell University's Professor Robert Hockett, whose writings on international financial law have generated great interest, recently offered this explanation:

[T]he questions that have emerged in the current discussion are not only about what went wrong, but also more fundamental in character. They implicate not only regulatory policy, but also financial theory, monetary theory, macro theory more generally, and micro theory as well. "Maybe markets are not efficient after all," we hear some now saying. "Maybe market actors are not rational either," some also say. "Maybe it's all just psychology," or "irrational exuberance," . . . we hear more and more

190. *Id.*

191. *Id.* at 52.

often these days. Well, maybe indeed. But I've come to think that at least some of the discussion we're hearing these days rests on a misconception or two, and that it would be helpful to highlight them, even for those who are skeptical of market efficiency or trader rationality. Doing so should enable us better to recognize which proposed improvements to our financial system are apt to be most effective, and which of them less so.

So what are the misconceptions I think I detect? These: My impression is that there is a tendency among some participants in the current discussion—as well as among some policy-makers over the past decade or so—to equivocate, first, between two senses of “efficiency,” and second, between two senses of “rationality.” I suspect, moreover, that these equivocations might well be partly responsible for the pass in which we now find ourselves. Here's what I mean.

First, on “efficiency,” the so-called “efficient capital markets hypothesis” (also “ECMH,” sometimes “EMH”) familiar to finance is a pretty well corroborated conjecture concerning the speed with which the capital markets aggregate “information.” But the information in question, it bears emphasizing, is not restricted to facts actually bearing upon firms' “fundamentals” or future prospects. (If it were, then informational efficiency would conduce straightaway to allocative efficiency, more on which presently.) No, the “information” in question also can include misinformation, disinformation, incomplete information apt to be revised or more fully filled in later, and so forth. The idea animating the EMH, in other words, is simply that trading has become sufficiently rapid and easy, and the financial markets so liquid, that securities prices very quickly impound and reflect the beliefs of all market participants—even beliefs that in the end prove ill-founded, incorrect, only partly correct, or what have you.

Moreover, and possibly more crucially, the EMH has nothing whatever to say about facts bearing upon firms' future prospects of which no trader as yet has any knowledge or inkling at all—facts that would fall under the Keynesian (and Knightian) headings of “uncertainty” as distinguished from “risk.” Where we not only don't know which face of the die will land up, but also don't know what values are etched on the faces of the die to begin with, we cannot speak of probability distributions at all, hence cannot compute even “expected” values, let alone actual ones. Hence we speak less of “risk” than “uncertainty” in these settings. . . .

Now the equivocation on “efficiency” to which I alluded above is just this: There seems to be a tendency for some participants in the current discussion to conflate informational efficiency (on the EMH's permissive understanding of “information” just elaborated) either with allocative

efficiency, whereby capital flows toward its most valued uses; or just plain “efficiency,” understood as a rough sort of synonym for “the state of being really cool,” or “as good as it gets.” The unexamined thought seems, in other words, to be that, because the capital markets quickly take in and impound all value-pertinent information that there happens to be, they also immediately and unambiguously direct capital toward where it adds most value. But the moment one reminds oneself that “information” is actually employed in a much looser sense than the “fundamental-value-pertinent” sense for purposes of the EMH, one spots a gap between informational efficiency and allocative efficiency.¹⁹²

Taking these comments from Hockett together with the comments quoted above from Westbrook, I draw these conclusions: (i) both the “transparency” and the “risk-management” theories have failed to guard against systemic risk in financial markets; and also (ii) when viewed accurately, the notion of *informational efficiency* that has given many people confidence in financial markets in the first place should not be expected to provide *allocative efficiency*, which is much to expect.

4. *Inadequacies of Multilateral Institutions and Networks*

A fourth failure lies squarely at the international level: the multilateral institutions and networks that are seemingly responsible for handling global economic matters, and particularly for helping guard against global financial crises, evidently fell short. I have gone to some lengths in subsection III(B) of this article to describe the reforms the IMF has undertaken in the dozen years since the Asian financial crisis erupted; yet that set of reforms did not prevent the GFC 08/09. Nor were various international networks of regulatory entities and non-government organizations able to avert the crisis through “soft law.” Why not?

In my view, two assessments are required to address this question. One applies to the IMF. The other applies to the international “networks.” I shall deal briefly with the latter of these first.

Another of the participants in this symposium, Professor Douglas Arner of the University of Hong Kong, has explained the role and operations of the Financial Stability Forum (“FSF”) since the time of its creation in the late 1990s.¹⁹³ Professor Arner points out that the FSF, together with such other entities

192. See Bob Hockett, *What Maynard Keynes, James Dean, and Now Richard Posner All Have in Common*, DORF ON LAW, Sept. 28, 2009, <http://www.dorfonlaw.org/2009/09/what-maynard-keynes-james-dean-and-now.html>.

193. See generally Douglas W. Arner & Michael W. Taylor, *The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?* (Asian Inst. of Int'l Fin. L., Working Paper No. 6, 2009), available at <http://law.hku.hk/aiif/research/documents/AIIFLWorkingPaper6June2009.pdf>. Arner also explains the background and operations of the FSF in his earlier book. See

as the Basel Committee on Banking Supervision (“BCBS”), the International Organization of Securities Commissions (“IOSCO”), the International Accounting Standards Board (“IASB”), and the International Association of Insurance Supervisors (“IAIS”), can be seen as the principal form of “cooperation and coordination that nationally-based regulatory agencies have used to adapt to the realities of the global financial system in the past thirty years, with international standard-setting bodies being at the core of [the] response.”¹⁹⁴ Unfortunately, as Professor Arner makes clear, this policy network system, even following its enhancement after the Asian financial crisis into “a hardened soft law approach of coordinated networks,” proved to be “insufficient to address either prevention or resolution of a truly global financial crisis.”¹⁹⁵

As I understand Professor Arner’s views, the reason for this failure is that despite the increasing globalization of private-sector financial institutions and operations, the public-sector (official government) regulation of those institutions and operations remains predominantly at the national level, reflecting a decision at the time of the Bretton Woods discussions that “finance would be domestic and subject therefore only to domestic regulation.”¹⁹⁶ In my view, this approach must be reversed in today’s integrated international financial markets. I shall return to this issue below in subsection B(1). First, however, let us see why the IMF did not prevent the GFC 08/09, despite the reforms discussed above.

Although we might adduce several reasons—relating, for example, to the declining influence (and falling lending activity¹⁹⁷) of the IMF at the very time those reforms were being made, or to some substantive errors in the IMF’s judgment and prescriptions¹⁹⁸—I believe the largest reason for the failure of the IMF to prevent the GFC 08/09 lies with the handful of countries controlling the IMF. This leads me to identify a fifth and a sixth specific failure, relating respectively to legitimacy and “cultural intelligence,” described below. In other words, although I see a *failure* in the fact that the IMF did not avert the crisis, I believe the *responsibility* for that failure lies not so much with the institution

ARNER, *supra* note 121, at 74-79.

194. Arner & Taylor, *supra* note 193, at 2.

195. *Id.* at 28. Professor Westbrook underscores how one element in this “soft law” network – the so-called “Basle II” regime, which purported to fine-tune capital adequacy guidelines – proved especially inadequate: “Basel II provides an object lesson in irresponsibility. It is one thing for regulators to admit that they do not know how much capital to require banks to hold in reserve. Indeed, it is not clear that we can ever know precisely what capital requirements are adequate to confront an uncertain future. It is quite another thing to defer the decision to big banks, as does Basel II. . . . [This] was quite literally irresponsible. . . .” WESTBROOK, *supra* note 10, at 61.

196. Arner & Taylor, *supra* note 193, at 26.

197. See *supra* text accompanying note 72.

198. As in other aspects of IMF operations, I would point out that just because the GFC 08/09 occurred does not necessarily mean that the IMF activities in the years leading up to the GFC 08/09 were wrong-headed or negligent, since we can never know whether the crisis would have been even worse in the *absence* of those IMF activities. I have emphasized this point—the fact that there is no “counter-factual” reality with which to make a comparison—in discounting the criticism that IMF-prescribed economic and financial policies have caused countries to suffer economic distress. See, e.g., HEAD-2008, *supra* note 46, at 178-79.

itself as it does with the United States and a few other states whose governments largely control the institution.

5. *Failure of IMF Institutional Legitimacy*

A failure of legitimacy—the fifth specific failure in my list—relates directly to the “democracy deficit” described above in subsection III(B). As explained there, a handful of countries control the IMF through a combination of mechanisms. These include the weighted voting system (under which practically all voting power reflects proportional relative quota allocations), the claim of right by the European powers to select the Managing Director, the lack of external accountability through an effective system of judicial review, and more. I believe the IMF has been severely restricted in its influence because of the failure to replace or at least significantly reduce these mechanisms with a system of governance that is broadly accepted as legitimate. Without these severe restrictions in its influence, it seems altogether possible that the IMF would, in fact, have been a natural repository for regulatory authority and coordination of a sort that could have avoided the GFC 08/09 or substantially reduced the devastation that the crisis caused so many people and countries.

6. *Failure to Exercise Cultural Intelligence*

The sixth failure on my list—also concentrated among those few countries that control the IMF, especially the United States and European states—is a lack of “cultural intelligence.” By this I mean a lack of understanding of (or interest in) the capacities and needs of most of the world, particularly national financial systems. This lack of understanding has led, I believe, to an assumption among private-sector financiers and public-sector regulators that sophistication in financial operations and institutions that they are able to create and permit, respectively, is appropriate for use by persons outside the narrow community of financial whiz-kids.

I expect this to be a complicated and controversial point, so I shall try to “unpack” these assertions. I believe certain financial products, such as CLOs and CDOs and DCSs¹⁹⁹—found attractive in the last few years because of the liquidity they provide through securitization—are too sophisticated. Too sophisticated for whom? Too sophisticated for (i) most investors world-wide, including those inside highly-developed financial systems such as that of the United States, and (ii) most regulators in countries that do not have highly-developed financial systems. These new and highly sophisticated financial products constitute a form of “attractive nuisance”—something that is harmless if left alone by unknowing

199. These instruments – collateralized loan obligations, collateralized debt obligations, and credit default swaps, respectively – were identified in Westbrook’s description of increasingly sophisticated financial products. See *supra* text accompanying note 182.

passers-by (for example, young children) but which is extremely dangerous if *not* left alone. For better or for worse, many investors, including seemingly astute institutional investors, were attracted to the sophisticated financial products emerging from the imagination of their creators. These sophisticated financial products contributed, in my view, to what the IMF's chief economist has called an "economic environment [that] is so complex as to appear nearly incomprehensible."²⁰⁰

Indeed, the complexity of some financial instruments and operations can be so great as to flummox even those persons who invented them. Gillian Tett, an award-winning assistant editor at the *Financial Times*, gives this account of how a group of former JPMorgan officials who played a central role in developing and marketing the so-called "super senior" aspect of CDOs—that is, the part of a CDO that was supposed to be immune to any default—reacted when that assumption proved to be false:

[Bill] Demchak didn't know whether to laugh, cry or just shake his head in wonder In fact, he was horrified: the way [officials of Citigroup] told the story, super-senior had turned into a scourge that had created most of its unexpected losses.

"How could this happen?" Demchak wondered." . . .

To most Citi executives, the bottom-line hit was as stunning as if the ground had opened up under the bank. On the day of the announcement, Jamie Dimon, chief executive of JP Morgan, bumped into a former senior colleague at Citi. "What happened?" Dimon asked. "We are not entirely sure ourselves," the man replied. Dimon had no reason to doubt him. By 2007, Citi operated as a vast empire so fragmented—and feuding—that the many businesses within it rarely interacted. As a result, few of the bankers outside the CDOs team knew how the operation worked. "Perhaps there were a dozen people in the bank who really understood all this before—I doubt it was more," one senior Citi manager recalled bitterly.

As the losses mounted, the former members of the JP Morgan team that had originated the idea of building collateralized debt obligations out of credit derivatives reeled in shock. . . .

200. Olivier Blanchard, *(Nearly) Nothing to Fear But Fear Itself*, *ECONOMIST*, Jan. 29, 2009, available at http://www.economist.com/finance/displaystory.cfm?story_id=13021961. For a similar view, see IMF, IMF Survey Magazine: IMF Research, *IMF: Prevent Institutions Becoming Too Connected to Fail* (Apr. 21, 2009), available at <http://www.imf.org/external/pubs/ft/survey/so/2009/RES042109B.htm> (explaining that an April 2009 IMF report asserts that "the growing complexity and globalization of financial services can . . . lead to situations where an institution's miscalculations of its risks could lead to its demise, spawning a large number of failures of financial institutions, liquidity squeezes, and even severe capital losses in the financial system" and that "the ongoing crisis has shown how financial innovations have enabled risk transfers that were not fully recognized by financial regulators or by institutions themselves").

[B]y late 2007, the e-mails bouncing between their BlackBerries were expressions of disbelief. “What kind of monster has been created here” one of the former JP Morgan group wrote in a heartfelt e-mail. Another observed: “It’s like you’ve known a cute kid who then grew up and committed a horrible crime.”²⁰¹

Given how unsuspecting those inventors of CDOs were of the havoc their complicated invention could (and would) cause, it should come as no surprise that investors were likewise unsuspecting. By way of illustration, one of the participants in our symposium explained how German state-owned banks invested heavily in such sophisticated financial products and suffered huge losses from doing so.²⁰²

Naturally, a judgment as to whether a product of any sort, whether a CDO or a chainsaw, should be prohibited from use or sale would need to be based on a weighing of the danger it poses versus the benefit it promises. Given the danger that creative and complicated new securitization products have now (via the GFC 08/09) been proven to pose, my own assessment is that this danger outweighs the purported benefit that such securitization offers. Let me use an analogy that I find apt: just as the “precautionary principle” has been generally accepted in international environmental law,²⁰³ it should also apply to the introduction of complex new financial products. In my view, such products should be prohibited—or at least designated as “off limits” to any investor not satisfying strict “suitability” standards²⁰⁴—unless, and until, the potential benefit of those

201. Gillian Tett, *How Greed Turned to Panic*, FIN. TIMES, May 8, 2009, at 17.

202. See Harald Hau & Marcel Thum, *Subprime Crisis and Board (In-)Competence: Private vs. Public Banks in Germany* (CESifo, Working Paper No. 2640, 2009), available at http://www.ifo.de/pls/guestci/download/CESifo%20Working%20Papers%202009/CESifo%20Working%20Papers%20May%202009/cesifo1_wp2640.pdf (quoting Wolfgang Münchau, *Another Landesbank bites the dust*, Eurointelligence, Aug. 8, 2007, <http://www.eurointelligence.com/Article3.1018+M50fcec22186.0.html>, bemoaning the fact that the supervisory board members of state-owned banks in Germany “do not fully understand the ins and out [*sic*] of investments in new financial instruments, such as CDOs or DCS”).

203. See, e.g., U.N. Conference on Environment and Development, Rio de Janeiro, Braz., June 3–14, 1992, Rio Declaration on Environment and Development, U.N. Doc. A/CONF.151/26 (Vol. I) (August 12, 1992) (stating that “[i]n order to protect the environment, the precautionary approach shall be widely applied by States according to their capabilities. Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation”). See also PHILLIPE SANDS, *PRINCIPLES OF INTERNATIONAL ENVIRONMENTAL LAW* 210 (1995).

204. Such “suitability” standards – also referred to as “sophisticated investor” standards – are found, for example, in Section 4(2) of the US Securities Act of 1933 (as amended in 15 U.S.C. § 77(a)), which permits private placements (that is, sales) of securities without the filing of an extensive registration statement, if certain procedures are strictly followed. Among these is the requirement that all of the purchasers in that private placement “must be sophisticated – that is, they must have sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment”. See Legal & Compliance, LLC, *Private Placement Offerings*, <http://www.legalandcompliance.com/Private-Placement-Offerings.html> (last visited Mar. 13, 2010). See also MARC I. STEINBERG, *UNDERSTANDING SECURITIES LAW* 94 (3d ed. 2001) (offering a similar definition of the level of sophistication a person must have in order to be a suitable purchaser in a private placement for purposes of Section 4(2)).

products is definitively proven to outweigh the danger they have already been shown to pose to the international financial system.

It is worth noting that the danger such financial investments pose has been especially intense in less economically developed countries. Regulators in those less sophisticated economies generally did not, in the run-up to the GFC 08/09, impose restrictions prohibiting financial institutions under their supervision from dealing with such products. And how could they? In a global and essentially borderless system of finance, it would be almost impossible to impose and police such restrictions. To apply my metaphor, no fence could adequately keep passers-by away from the attractive nuisance.

A similar point applies to the danger posed by certain types of financial institutions. That is, in looking beyond financial *instruments* to financial *institutions*, we see that a wide range of so-called “shadow banks”—including not only hedge funds but also other forms of structured investment vehicles—have emerged in recent years and have largely avoided the disciplining scrutiny of regulation.²⁰⁵ In my view, such institutions should be prohibited or strictly regulated. A country that fails to do so exposes itself to systemic risk that is difficult to assess and difficult to guard against effectively.

I am not alone in my criticism of sophisticated financial instruments and operations. For example, the chief economist at the World Bank recently emphasized that “[t]he size and sophistication of financial institutions and markets in the developed world are not appropriate in low-income markets.”²⁰⁶ Even more broadly, the prominent economist Paul Krugman has offered this broadside attack on “shadow banks” and the failure to regulate them properly:

As the shadow banking system expanded to rival or even surpass conventional banking in importance, politicians and government officials should have realized that they were re-creating the kind of financial vulnerability that made the Great Depression possible—and they should have responded by extending regulations and the financial safety net to cover these new institutions. Influential figures should have proclaimed a simple rule: anything that does what a bank does, anything that has to be rescued in crises the way banks are, should be regulated like a bank.²⁰⁷

205. For an explanation of “shadow banking” and the risks it poses, see Mike Konczal, *Shadow Banking: What It Is, How It Broke, and How To Fix It*, ATLANTIC ONLINE, July 13, 2009, http://business.theatlantic.com/2009/07/exclusive_interview_what_is_shadow_banking_and_how_did_it_fail.php. See also Hugh Dixon & Richard Beals, *Europeans Favor Regulating ‘Shadow Banks,’* N.Y. TIMES, Feb. 23, 2009, available at <http://www.nytimes.com/2009/02/24/business/24views.html> (noting perceived dangers of unregulated hedge funds and other “shadow banks”).

206. Justin Lin, *Walk, Don’t Run*, ECONOMIST, July 11, 2009, at 76.

207. PAUL KRUGMAN, *THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008* 163 (2009). Krugman also asserts that the lack of regulatory control of the shadow banking system amounted to “malign neglect.” *Id.*

Two other extremely high-profile economists have called for even more radical regulatory change: a re-imposition of the operational separation between commercial banking and investment banking—in short, a return to the days of the Glass-Steagall Act.²⁰⁸ According to both Paul Volker (former chairman of the U.S. Federal Reserve Board) and Joseph Stiglitz (Nobel prize-winner and former economic advisor at the World Bank), the repeal of that legislation in 1999 helped cause the GFC 08/09 and should therefore be reversed.²⁰⁹ My own view is that this legislative change, radical though it would be, is indeed worth careful consideration. The Glass-Steagall repeal both permitted and invited bankers to downplay the significance of risks they were exposing themselves to, at the ultimate expense of their depositors, their shareholders, their institutions, and the financial system more generally.

B. “Fixes”

I have identified above six specific failures that help account, in my view, for the GFC 08/09. To summarize, they are:

- A failure of national regulatory authorities and processes to protect against systemic risk;
- A failure (also at the national level) of “self-regulation” as a means of guarding against crisis;
- A failure (still at the national level) of both key theories that have characterized the thinking about how to avoid financial disaster—that is, both the theory of “transparency” and the theory of “risk management”;
- A failure of international institutions, both the IMF and the “policy networks” applying “soft law”, to prevent global financial crisis;
- A failure of the handful of countries controlling the IMF, particularly the United States, to accept (at least until very recently) the need to give that institution adequate legitimacy; and
- A failure of the same handful of countries (again, particularly the United States) to act with “cultural intelligence” regarding extremely sophisticated financial instruments and operations.

208. For discussions of the Glass-Steagall Act and its pertinence to the GFC 08/09, see Anand Chokkavelu, *The Biggest Cause of the Financial Crisis*, MOTLEY FOOL, Apr. 13, 2009, <http://www.fool.com/investing/general/2009/04/13/the-biggest-cause-of-the-financial-crisis.aspx>; William Kaufman, *Shattering the Glass-Steagall Act*, COUNTERPUNCH, Sept. 19, 2008, <http://www.counterpunch.org/kaufman09192008.html>.

209. See Louis Uchitelle, *Volcker Fails to Sell a Bank Strategy*, N.Y. TIMES, Oct. 20, 2009, available at <http://www.nytimes.com/2009/10/21/business/21volcker.html?dbk> (reporting Volker’s proposal for reintroducing the Glass-Steagall restrictions, and Stiglitz’s endorsement of that view).

What “fixes,” if any, might counteract these failures? I place the word “fixes” in quotation marks to signify that it can carry two different shades of meanings. On the one hand, a “fix” might be a genuine repair that would permit whatever is broken to operate properly again, as if to begin life anew. On the other hand, a “fix” might be a temporary injection of a drug that an addict seeks. In the following paragraphs, I offer some observations about “fixes” of both sorts.

1. Strengthening Financial Regulation

For one thing, I believe there should be, and there almost surely will be, a burst of enthusiasm for additional regulation at the national level. Many entities within national systems will pay close attention to the specific nature and emphasis of such regulation.²¹⁰ Supplementing these national-level initiatives will be advice coming from the multilateral level. The IMF, for its part, has already identified a first round of “lessons learned” in terms of national financial regulation.²¹¹ As noted above, these include expanding the “perimeter” of financial sector surveillance, strengthening capital adequacy standards, improving the dissemination of information, and so forth.²¹² Andrew Crockett, who has served as General Manager of the BIS, as a staff member and Alternate Governor of the IMF, and as president of JPMorgan Chase International, has summarized the categories of national financial regulatory reforms that are needed by dividing them “into those that affect the institutional *coverage* of regulation, those that change the substantive *content* of supervisory rules, and those that modify the *structure* of regulatory oversight bodies.”²¹³

Reflecting the integration of the global economy, this new enthusiasm for regulation also will extend beyond the borders of nation-states by prescribing methods for international coordination among national regulators²¹⁴ and harmonization of the standards they apply to institutions operating within and across their borders, what I referred to in subsection I(C) as “regulation of the regulators.” As expressed by the IMF, “[p]rogress is needed in tackling political

210. As Professor Hockett has noted, discussions and hearings were launched in September-October 2009 by the Angelides Commission and by US House and Senate committees, to consider possible improvements to—and perhaps even a complete “overhaul” of—the US system of financial regulation. See Hockett, *supra* note 192.

211. See generally *IMF Regulation Lessons*, *supra* note 18.

212. See *supra* text accompanying note 178.

213. Andrew Crockett, *Rebuilding the Financial Architecture*, FIN. & DEV., Sept. 2009, at 18.

214. Even before it was transformed into the Financial Stability Board, the Financial Stability Forum was already, as of February 2009, coordinating efforts by the IMF, national authorities, and others to address deficiencies in the system. See *IMF Regulation Lessons*, *supra* note 18, at 4. Professor Arner notes in this regard that “[t]he FSF agreed upon twelve key standard areas, including a total of fifteen standards, as the basis of internationally agreed minimum standards of financial regulation.” Arner & Taylor, *supra* note 193, at 7, citing the FSF website, http://www.financialstabilityboard.org/cos/key_standards.html. Various G-20 working groups have also been set up to address some of these issues. See *IMF Regulation Lessons*, *supra* note 18, at 7.

and legal impediments to the regulation and resolution of cross-border institutions.”²¹⁵ Although I see some possibility that the enthusiasm for increasing regulation will fade quickly with a recovery from the GFC 08/09, at least some more and better regulations should be put in place to help guard against the specific ills that contributed to, triggered, or exacerbated the crisis. These will include, I hope, the prohibitions or restrictions I recommended above regarding highly sophisticated liquidity-producing securitization investments, as well as a wide array of standards and requirements that, as Professor Arner has reported, the FSB has been instructed by the G-20 to put in place.²¹⁶

The new mandate of the FSB is important enough to warrant our closer attention. Professor Arner offers this explanation:

The enhanced mandate awarded to the Financial Stability Forum (Board) at the G20 London Summit reflected these demands for greater international coordination. It reflects both the objective of improving the on-going supervision of cross-border banking groups and the desire to improve crisis management arrangements. Specifically, the FSB’s new mandate [involves the following]:²¹⁷

- (a) monitor and advise on market developments and their implications for regulatory policy;
- (b) advise on and monitor best practice in meeting regulatory standards;
- (c) undertake joint strategic reviews of the policy development work of the international SSBs (Standards Setting Bodies) to ensure their work is timely, coordinated, focused on priorities and addressing gaps;
- (d) set guidelines for and support the establishment of supervisory colleges;
- (e) manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- (f) collaborate with the IMF to conduct Early Warning Exercises.

[The FSB will assume these responsibilities in addition to those originally assigned to the FSF, namely] to assess vulnerability affecting the financial system, identify and oversee action needed to address them, and promote coordination and information exchange among authorities

215. *IMF Regulation Lessons*, *supra* note 18, at 5. Special emphasis is placed on developing harmonized insolvency regimes and on coordinating crisis responses across borders. *Id.*

216. *See* Arner & Taylor, *supra* note 193, at 11.

217. *Id.* at 11-12.

responsible for financial stability.²¹⁸ In support of its new objectives, the FSB will establish a Standing Committee for [i] Vulnerabilities Assessment; [ii] Supervisory and Regulatory Cooperation (including the supervisory colleges and cross-border crisis management); and [iii] Implementation of Standards [and Codes].

The intention underlying these reforms is clearly to enhance the existing framework of soft law and to create something akin to an enforcement mechanism beyond the current largely voluntary system.²¹⁹ As [part of their] obligations of membership, member countries and territories [of the FSB will] commit to pursue the maintenance of financial stability, maintain the openness and transparency of the financial sector, implement international financial standards (including the twelve key international standards and codes), and agree to undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Programme reports.²²⁰ The latter represents a departure from existing practice as participation in the IMF/World Bank FSAP process has remained a purely voluntary exercise and the United States, for one, has not so far undergone such an assessment.²²¹

Another form of regulatory “fix” with both national and international features would be the adoption of an insurance scheme, funded by financial institutions themselves, to cover the risks that the financial sector creates. The IMF’s Managing Director referred to this in early October 2009:

Considering that the financial sector is creating a lot of systemic risk for the global economy, and that it is just fair that such a sector would pay some part of its resources to help mitigate the risks that they are creating themselves, having some money coming from the financial sector to create a kind of fund for insurance or funding for low-income countries is something that we are going to consider.²²²

2. IMF Reform Toward Crisis Prevention

In addition to these FSB-based efforts to provide a “fix” in the area of financial regulation, it also seems a sure thing that numerous IMF reforms of the sort noted above in subsection III(B)(2) will be implemented. These include

218. Press Release, Financial Stability Forum, Financial Stability Forum re-established as the Financial Stability Board 2 (Apr. 2, 2009), available at http://www.financialstabilityboard.org/press/pr_090402b.pdf [hereinafter FSF Press Release].

219. Arner & Taylor, *supra* note 193, at 11.

220. FSF Press Release, *supra* note 218, at 1.

221. Arner & Taylor, *supra* note 195, at 12.

222. IMF, IMF Survey Magazine: In the News, *IMF Chief Puts Focus on Building Stable Post-Crisis World*, (Oct. 2, 2009), available at <http://www.imf.org/external/pubs/ft/survey/so/2009/NEW100209A.htm>.

modifications of quota allocations, revisions in the Managing Director selection procedures, and a probable realignment of governing bodies' responsibilities.²²³ These reforms, all of which can be seen as responses to the “democracy deficit” criticism, complement numerous other very recent IMF initiatives designed to provide greater flexibility in providing financial assistance to its member countries in times of crisis.²²⁴

In short, I have little doubt that we will see each type of “fix” identified above—that is, (1) an increased enthusiasm and scope for financial regulation, including enhanced efforts at multilateral coordination, and (2) the adoption of a series of changes in the IMF and its operations, reflecting the G-20's call for what I have referred to as the “reactivation” of that institution to respond to the GFC 08/09. However, I see a significant risk that each “fix” will be only short-term in nature, followed by backsliding. For example, I fear that the current enthusiasm for strict, broad-based, internationally-coordinated financial regulation will fade once the crisis seems to have receded.²²⁵

This would expose the deficiency that Professor Arner has identified in the FSB-based system:

Although the FSB will play a role in facilitating discussion among its members, what is lacking from the system is the ability to put its members under binding obligations that will lead to a greater willingness to burden-share the costs of cross border bank failures [Hence,] without a more formal and binding arrangement for burden sharing and dispute resolution arrangement, probably through a formal treaty and/or international organisations, the problems raised by the failure of global financial institutions will not be adequately addressed by the current approach to international financial regulation.²²⁶

In my view, overcoming this deficiency in the FSB-based system is precisely the sort of function that the IMF could serve, if the political will could be mustered to give that organization the mandate and the legitimacy to do so. However, I fear that the reforms made in the IMF's governance, significant though they are, might end up being only a “flash in the pan,” with the effective control of that institution remaining in the hands of a small cluster of countries, thus squandering the opportunity to increase the perceived legitimacy of the

223. See *supra* text accompanying notes *IMF Quotas*, *supra* note 70, *Quota Recommendation*, *supra* note 84, *IMF Consents to Agreement*, *supra* note 87, *IEO Governance Report*, *supra* note 90, *Experts Governance Report*, *supra* note 92, at 3-4.

224. See *supra* text accompanying note 77.

225. As one observer has expressed it, “[a] few months ago financial newspapers were debating the future of capitalism. Now they are merely discussing the future of capital requirements. Shock has given way to relief.” Cox, *supra* note 2, at 4.

226. Arner & Taylor, *supra* note 193, at 30.

institution.²²⁷ Without such increased legitimacy, the IMF could not, and should not, be granted enhanced authority over national and cross-border financial regulation. I explore below in subsection C the reasons for my pessimism on these two points—that is, my fear that we will not see *enough* of either (i) enhanced networks for international coordination of financial regulation, or (ii) enhanced IMF legitimacy and effectiveness in crisis prevention.

3. Renewed Ideological Commitment to Multilateralism

A third type of “fix” that I believe should be put place, but that I also fear will ultimately fall short of what is needed, relates to international trade, international investment, and multilateralism more generally. Although the G-20 communiqués from Washington, London, and Pittsburgh all urged further work toward successful completion of the Doha Round of trade negotiations and urged against protectionism tendencies generally,²²⁸ the temptations in the other direction are strong, and some observers already warn of a resurgence of protectionism.²²⁹ This would be a mistake. As I have urged elsewhere, trade liberalization should be accompanied by effective safeguards against certain distributional and social injustices that often accompany headlong rushes toward such trade liberalization,²³⁰ but the overall benefits that a liberal trade (and investment) regime brings far outweigh the costs.

The same is true of multilateralism more generally. As I have also urged elsewhere, I believe there is an urgent need now to restore confidence in a multilateral regime dedicated to searching for global solutions to global problems.²³¹ I need not expand on that theme here, except to express the hope that a new U.S. administration might provide the leadership needed to start such a restoration of confidence as a broad-based populist ideology. However, I fear that the same temptations that could draw states and their people toward protectionism in their trade and investment policies might also undermine their commitment to multilateralism more generally.

If they could be implemented, these three “fixes” might provide strong armor against another global financial crisis falling close on the heels of the GFC 08/09.

227. On this point, I am influenced by the historical survey that James Boughton, the IMF Historian, has offered on the numerous calls for a “new Bretton Woods”. See James M. Boughton, *A New Bretton Woods?*, FIN. & DEV., Mar. 2009, available at <http://www.imf.org/external/pubs/ft/fandd/2009/03/boughton.htm> (noting that although efforts to create a “new Bretton Woods” have been made several times, “[m]any of those efforts failed”).

228. See *supra* text accompanying notes 31-33.

229. See, e.g., Karl P. Sauvant, *FDI Protectionism Is on the Rise*, 6-15 (World Bank Policy Research Working Paper 5052, Sept. 2009), available at http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2009/09/14/000158349_20090914084924/Rendered/PDF/WPS5052.pdf.

230. HEAD-2008, *supra* note 46, at 173.

231. See, e.g., HEAD-2008, *supra* note 46, at 321-22.

A more robust, more comprehensive, and more internationally coordinated system of financial regulation might substantially reduce the risk of systemic failures of the sort that precipitated the GFC 08/09. A reactivated and visibly legitimized IMF might attract the support it would need to make it a listener, a leader, and a lender—that is, a forum for a rich diversity of viewpoints to be voiced and debated, a welcome source of substantive guidance, and a supplier of short-term financial support on terms broadly regarded as reasonable. A deep popular commitment to multilateralism, especially intent on expanding the benefits of trade and investment liberalization with distributional and social protections, could set the stage for a more cooperative international community.

C. *Fundamentals*

“When pigs fly,” one might be tempted to say. That is, these three “fixes,” and the benefits that could flow from them, might seem completely unrealistic when viewed in the harsh light of reality, especially once the immediacy of the GFC 08/09 fades.

I am undecided on this point: I am not confident enough to offer a firm prediction of whether or not these three “fixes”—a much better system of financial regulation, a legitimized IMF, and a victory of multilateralism over protectionism—can in fact be implemented and sustained. However, as suggested above in subsection B, there are strong reasons for doubting they will be. In the following paragraphs, at the risk of uttering discouraging words despite the state song of Kansas (*Home on the Range*), I shall summarize some reasons for pessimism on the question of whether long-term effective changes will be made to guard against another global financial crisis erupting relatively soon.

First, old ideologies die hard, especially if they are embraced by a class of people long entrenched in power. As asserted by Simon Johnson, the former chief economist of the IMF, the financial elites are quite firmly entrenched in power – so much so, he says, that “[a] whole generation of policy makers has been mesmerized by Wall Street,”²³² and “the financial sector [has] a veto over public policy”²³³ I regard it as highly unlikely that Johnson’s call to “nationalize [the] troubled banks and break them up as necessary”²³⁴ on grounds that “[a]nything that is too big to fail is too big to exist”²³⁵ will, in fact, be heeded. Further, I am not prepared to pass judgment on whether the big banks *should* be broken up or not. However, I do believe that without some drastic structural change putting financial institutions in new hands with new mindsets, we are unlikely to see the first of the “fixes” mentioned above—the

232. Simon Johnson, *The Quiet Coup*, ATLANTIC MONTHLY, May 2009, available at <http://www.theatlantic.com/doc/print/200905/imf-advice>.

233. *Id.*

234. *Id.*

235. *Id.*

implementation of a significantly better system of financial regulation. The ideology of deregulation²³⁶ is too strong for that to occur.

Second, the possibility of a new way of thinking about international economic relations, including global financial regulation, exists best—perhaps only—in a time of crisis. While some observers have emphasized just how severe a crisis the GFC 08/09 has been by asserting that there will now be a “new normal,”²³⁷ I question whether even this crisis has been severe enough to prompt profound changes. The GFC 08/09 has not been as severe (so far, at least) as the Great Depression. Moreover, our circumstances today are unlike the circumstances in 1944, when the specter of yet another world war prompted leaders of those countries who had just emerged from the second one in roughly a quarter-century to design multilateral regimes to address global economic problems.

Third, we have very little evidence that humans learn large-scale economic lessons from large-scale economic mistakes. In Part IV above, I summarized several twentieth-century episodes in which economic mistakes brought devastating distress over and over and over again. Even the passage of a mere dozen years—from the Asian financial crisis to the GFC 08/09—seems more than enough to erase memories, so that the pattern of enthusiasm, greed, deregulation, boom, and bust gets replayed again.

Fourth, as long as U.S. influence continues to dominate international economic relations, the culturally ingrained disdain in this country for government—curiously, even self-government—will augur against multilateralism by which global problems are attacked with global solutions organized and implemented by governments. Paul Krugman traces the apparent intransigence of the U.S. anti-government attitude to the 1980s, when U.S. President Ronald Reagan was able to instill in millions of Americans “an ideology that says government intervention is always bad, and leaving the private sector to its own devices is always good.”²³⁸ Krugman faults U.S.

236. Johnson lists these elements of “a river of deregulatory policies” that has flowed into the US financial system in recent years:

- insistence on free movement of capital across borders;
- the repeal of Depression-era regulations separating commercial and investment banking;
- a congressional ban on the regulation of credit-default swaps;
- major increases in the amount of leverage allowed to investment banks;
- a light hand at the SEC in its regulatory enforcement;
- an international agreement [Basel] to allow banks to measure their own riskiness;
- an intentional failure to update regulations so as to keep pace with financial innovation.

Id. at 5.

237. See Cox, *supra* note 2, at 5 (claiming that “a ‘new normal’ for the world economic is in sight, [and] it will be different from the old normal in a number of ways.” including sluggish demand, the necessity to maintain government stimulus plans for a long time, a rise in public debt, continued high unemployment, and suppression of innovation). See also Westbrook, *supra* note 10, at 55 (asserting that “this is a new day” in finance).

238. Paul Krugman, *All the President's Zombies*, N.Y. TIMES, Aug. 23, 2009, at A17. The famous line encapsulating this ideology, appearing in Reagan’s first inaugural address, asserts that “[i]n this present crisis, government is not the solution to our problem; government is the problem.” See Ronald Reagan, U.S. President, Inaugural Address (Jan. 20, 1981), available at <http://www.presidency.ucsb.edu/ws/index.php?pid>

President Obama for not using “the bully pulpit to confront government-is-bad fundamentalism.”²³⁹ He also offers this perspective on the GFC 08/09:

There’s a lot to be said about the financial disaster of the last two years, but the short version is simple: politicians in the thrall of Reaganite ideology [of “government-is-bad” fundamentalism] dismantled the New Deal regulations that had prevented banking crises for half a century, believing that financial markets could take care of themselves. The effect was to make the financial system vulnerable to a 1930s-style crisis—and the crisis came.²⁴⁰

=43130. According to a February 2009 Rasmussen telephone survey, a very large majority of Americans endorse that view. See *59% Still Believe Government Is the Problem*, RASMUSSEN REPS., Feb. 26, 2009, available at http://www.rasmussenreports.com/public_content/politics/general_politics/february_2009/59_still_believe_government_is_the_problem.

239. Krugman, *supra* note 238, at A17.

240. *Id.*