The Obstructive Power of Ideas: The Role of Ideational Conflict in Preventing International Coordination

A thesis presented to
the faculty of
the College of Arts and Sciences of Ohio University

In partial fulfillment
of the requirements for the degree
Master of Arts

Kevin M. O'Hare
August 2012

© 2012 Kevin M. O'Hare. All Rights Reserved.
This thesis titled
The Obstructive Power of Ideas: The Role of Ideational Conflict in Preventing International Coordination

by
KEVIN M. O'HARE

has been approved for
the Department of Political Science
and the College of Arts and Sciences by

______________________________
James S. Mosher
Associate Professor of Political Science

______________________________
Howard Dewald
Interim Dean, College of Arts and Sciences
ABSTRACT

O'HARE, KEVIN M., M.A., August 2012, Political Science

The Obstructive Power of Ideas: The Role of Ideational Conflict in Preventing International Coordination

Director of Thesis: James S. Mosher

This thesis examines the effects that economic ideas have on international coordination and how ideational change affects international economic coordination. It traces the international responses to the Mexican Peso Crisis, the Asian Financial Crisis, and the Subprime Crisis while focusing on the nature of the response from international bodies such as the IMF, the G7/8 and G20. It is argued that in the absence of an economic hegemon, ideas are central to the policy responses, as the ideas policy makers hold about how the economy works at the microeconomic and macroeconomic levels can promote or hinder international economic coordination. As the ideas of some leaders have changed while others have not, ideational conflict has resulted. The primary conflict is between neoliberals, who believe that markets work almost all of the time and liberal interventionists, who believe that markets work a lot of the time, but can still fail in many cases. These two viewpoints about the economy lead to different conceptions of the correct policies needed to restore growth and stability to the international economy and as a result of these ideational conflicts, international economic coordination has suffered.

Approved: _____________________________________________________________

James S. Mosher

Assistant Professor of Political Science
For Mom and Dad
ACKNOWLEDGMENTS

I would like to thank many people for their support, encouragement, and constructive criticism during the writing of this thesis. The most important person in helping me develop this thesis has been Dr. James Mosher who kept me on track and challenged me to be a better scholar and writer. Without his guidance and advice throughout the writing process, this thesis would not have been possible. I would also like to thank Dr. Takaaki Suzuki and Dr. Andrew Ross for their input and assistance. I owe special thanks to my parents, family, friends, and classmates who believed in me and supported me while I was pursuing my Master’s degree.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abstract</td>
<td>3</td>
</tr>
<tr>
<td>Dedication</td>
<td>4</td>
</tr>
<tr>
<td>Acknowledgments</td>
<td>5</td>
</tr>
<tr>
<td>Chapter 1: Introduction</td>
<td>8</td>
</tr>
<tr>
<td>Chapter 2: Theories of International Cooperation and the Importance of Ideas</td>
<td>21</td>
</tr>
<tr>
<td>The Power of Ideas</td>
<td>24</td>
</tr>
<tr>
<td>Ideas and International Political Economy (IPE)</td>
<td>26</td>
</tr>
<tr>
<td>Chapter 3: Asymmetric Ideational Change and International Coordination</td>
<td>29</td>
</tr>
<tr>
<td>Chapter 4: The Mexican Peso Crisis and Response</td>
<td>37</td>
</tr>
<tr>
<td>Causes of the Crisis</td>
<td>37</td>
</tr>
<tr>
<td>Short-Term International Responses</td>
<td>41</td>
</tr>
<tr>
<td>Long-Term International Coordination Following the Mexican Crisis</td>
<td>47</td>
</tr>
<tr>
<td>The Halifax Summit</td>
<td>48</td>
</tr>
<tr>
<td>Post-Halifax</td>
<td>49</td>
</tr>
<tr>
<td>The G10 Report</td>
<td>52</td>
</tr>
<tr>
<td>The Lyon Summit</td>
<td>53</td>
</tr>
<tr>
<td>Post Lyon and Pre Denver</td>
<td>54</td>
</tr>
<tr>
<td>The Denver Summit</td>
<td>56</td>
</tr>
<tr>
<td>Conclusion</td>
<td>57</td>
</tr>
<tr>
<td>Chapter 5: The Asian Financial Crisis and Response</td>
<td>60</td>
</tr>
<tr>
<td>Causes of the Asian Crisis</td>
<td>61</td>
</tr>
<tr>
<td>Weaknesses in Asian Domestic Economies and International Capital Markets</td>
<td>61</td>
</tr>
<tr>
<td>Weaknesses in Asian Financial Institutions</td>
<td>62</td>
</tr>
<tr>
<td>Mismanagement of Exchange Rates</td>
<td>63</td>
</tr>
<tr>
<td>Self-Fulfilling Financial Panic</td>
<td>64</td>
</tr>
<tr>
<td>Political Factors</td>
<td>66</td>
</tr>
<tr>
<td>Short-Term Responses to the Asian Financial Crisis</td>
<td>67</td>
</tr>
<tr>
<td>Long-Term Responses: Between Asia and the Sub-Prime Crisis (1998 – 2008)</td>
<td>77</td>
</tr>
<tr>
<td>IMF and World Bank Spring Conference</td>
<td>78</td>
</tr>
</tbody>
</table>
CHAPTER 1: INTRODUCTION

“G8 splits over stimulus versus austerity,” reads the headline on the front page of the Financial Times of London from May 19, 2012 as leaders of the wealthier states dispute the policies being considered to help resume growth in the international economy. This headline and the debates continuing between policy makers highlight the power that ideas can have in promoting or blocking international coordination. As the recovery from the 2008 Subprime Crisis continues slowly and issues such as the Eurozone crisis remain and are intensifying, divisions within states domestically and between states internationally have developed and deepened. Meanwhile institutions such as the International Monetary Fund (IMF) and international bodies such as the Group of Eight (G8)\(^1\) and Group of Twenty (G20)\(^2\) have attempted to craft policies aimed at restoring growth to the world’s economy (See the footnotes for information on the origin and evolution of these international institutions.).

---

\(^1\) The G8 originated in 1975 as the G6 when the United States, the United Kingdom, France, Germany, Japan, and Italy met in Rambouillet, France, in November 1975. Canada was added in 1976 and Russia in 1998. The G7/8 has met yearly to discuss the important economic and political issues facing each state’s domestic society as well as international issues. The G8 offers an opportunity for leaders to develop relationships and communicate on a consistent basis concerning pressing issues of the day. In addition to the leaders of the G8, sherpas, who are the leaders’ personal representatives, also meet throughout the year to monitor progress and review the agenda. Ministers of various areas including finance, trade, energy, drugs, and development also meet periodically throughout the year to continue work that is discussed at each leaders summit (University of Toronto, G8 Information Centre, 2012).

\(^2\) The G20 began as a forum of finance ministers and central bank governors, which was formally created in September of 1999. The G20 consists of 19 countries and the European Union. These countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Korea, Turkey, the United Kingdom, the United States, and the European Union. The G20 was created "as a new mechanism for informal dialogue in the framework of the Bretton Woods institutional system, to broaden the dialogue on key economic and financial policy issues among systemically significant economies and to promote cooperation to achieve stable and sustainable world growth that benefits all" (University of Toronto, G20 Information Centre, 2010). In 2008, U.S. President George W. Bush invited the leaders of the G20 countries to the U.S. for the first leaders’ summit. In Pittsburgh during the 2009 summit, the G20 leaders decided that the G20 would be the premier forum for international economic cooperation (G20 Research Group 2009).
The current policy deadlock at the international level can be largely attributed to conflicting ideas about the economy held by policy makers, which offer differing solutions to the problems. The primary conflict is between neoliberals, who believe that markets work almost all of the time and liberal interventionists, who believe that markets work a lot of the time, but can still fail in many cases. These two viewpoints about the economy lead to different conceptions of the correct policies needed to restore growth and stability to the international economy and the ensuing ideational battles are proving to have a detrimental effect on international economic coordination.

International financial crises have recently become more commonplace with increased liberalization and deregulation of financial markets as well as the loosening of restrictions on capital flows. The international financial system has become more volatile and crisis prone in the past twenty years as Mexico, Thailand, South Korea, Indonesia, Malaysia, Argentina, Brazil, Russia, the U.S., and Europe among others have all been hit by financial crises. The changes to the international financial system and the wave of financial crises over the past twenty years have forced states and international financial institutions such as the IMF to adapt to the changing conditions of the international economy. These changes have also led to an increased role for groups such as the G8 and G20 to enhance economic coordination between states. As crises have become more international in nature, the importance of policy coordination at the international level has been amplified as the economies of the world are increasingly interconnected.

Despite the interconnectedness of the today’s world economy, domestic and international politics in G20 states have become more polarized and policy recommendations increasingly divergent. When times are good, ideational rivalries fade
or lose importance. However, during times of crises, international coordination becomes ever more important as policy missteps can serve to intensify a crisis. As uncertainty increases during a crisis, the economy and the political process proceeds much less smoothly than in good times and disagreement is more prevalent. Divisions between actors and flaws in existing policies are also revealed when crisis strikes. When policy makers are faced with situations where there are no clear criteria for judging a policy option, ideas act as a guide for shaping policy (Goldstein & Keohane 1993).

This thesis attempts to build upon and connect theories international coordination and theories of ideas, which have been thoroughly researched individually, but have not been studied together at such depth. Scholars such as Robert Keohane and others have researched international coordination, usually under the label of international cooperation, and scholars such as Mark Blyth and Peter Hall among others have studied the role of ideas with regards policy making. However, with the exception of Jacqueline Best, who explored how ambiguities in the international financial system are managed to allow for better international coordination and how the management of ambiguities has changed from the Bretton Woods era through the mid-2000s, the role of ideas in coordinating responses to financial crises has been largely absent from the literature. I attempt to bridge these two theoretical frameworks in order to add to the growing literature on the role of ideas in politics as well as our knowledge of international coordination. By acknowledging that ideas play an important role in international coordination, I break with orthodoxy, which has been much more concerned with the role of interests in international coordination. I do not attempt to downplay the role of interests, but interests are supplemented and shaped by the ideas individuals and
institutions hold about their material interests. Therefore, my analysis suggests that by understanding the importance of the ideas held by policy makers, researchers will be able to better explain the characteristics of international coordination following financial crises.

In combining these two theoretical points of view, I examine the effects that economic ideas have on international coordination and how ideational change affects international economic coordination. I focus on the international level because of the interconnectedness of the world’s economy. Crises are rarely isolated to one state or a few states but have the potential to affect every state, as the Subprime Crisis demonstrated. Responses to financial crises are increasingly international and to understand the nature of the responses to financial crises in the era of liberalized finance one must account for the international dimension. In this thesis I trace the international response to three financial crises: The Mexican Peso Crisis, The Asian Financial Crisis, and the Subprime Crisis (a.k.a. Subprime Mortgage Crisis, the Great Recession, and the 2008 Financial Crisis). In studying the responses to these three financial crises, I focus on the nature of the response from international bodies such as the IMF, the G7/8 and G20. These responses give insight into the economic ideas responsible for the policies that are agreed to and implemented.

I am chiefly concerned with the ideas of major power states such as the U.S., U.K., China, and Germany. While I am asserting that the ideas policy makers hold are central to the coordinated international response to financial crises, the ideas held by the leaders of a state such as the U.S. will carry much more weight than the ideas of leaders in Greece or Thailand. Also, by recognizing that the ideas of major power states will be
more influential than other states, I contend that international financial institutions such as the IMF will be highly influenced by the ideas of the major power states. Because the G7 states were vital to the construction of these institutions and contribute the largest quotas, G7 states have a disproportionate influence on the policies pursued by the IMF. I am not asserting that the IMF takes their orders from G7 states, but I am claiming that these institutions are likely to be influenced by the ideas of the dominant states of the time.

By tracing the policies agreed to by international bodies in response to these crises, I am able to witness changes in policy, which are linked to ideational change within the international system. Additionally, by noting when policies change or times when there is disagreement on policy, I can examine the effects of ideational change on international coordination. On a broad level, I assert that Ideas are an important component of international coordination. More specifically, I advance two central insights. The first insight is that when the ideas of international actors conflict, international coordination suffers. A capitalist international economy requires policy coordination, and policy coordination is difficult to achieve when international actors’ beliefs about how the economy functions are conflicting. When international actors have different conceptions of how the economy works, their policy prescriptions will be different and this leads to policy deadlock and a lack of international coordination.

Secondly, dominant economic ideas become entrenched in the international system and are difficult to change. As John Ruggie discussed, when a set of economic ideas achieves international dominance they become entrenched in the international economy as well as within domestic economies (Ruggie, 1982). Changing the dominant
economic ideas of an era entails retooling both domestic and international economies and requires a crisis or series of crises large enough to warrant that level of change. As I demonstrate in this thesis, when crises become deeper and more long lasting, ideas are more prone to be challenged, yet are difficult to displace.

For this analysis, I will define coordination as the adoption of policies between states that are mutually beneficial and/or mutually reinforcing even if not part of a formal agreement. There is diversity in how scholars use the terms coordination and cooperation, but I am choosing to use the term coordination as opposed to cooperation because cooperation has a tendency to become associated with leaders meeting and formally agreeing to enforceable policy action such as the WTO, nuclear arms treaties, or the Bretton Woods system. Scholars such as Robert Keohane (1984) have studied international cooperation thoroughly, and coordination, as will be used in this thesis, is very similar to Keohane’s influential definition of cooperation: “Cooperation occurs when actors adjust their behavior to the actual or anticipated preferences of others, through a process of policy coordination” (Keohane, 1984, p. 51). International coordination is usually used to describe something much less formal, and this greater informality is much more characteristic of the current international economic system in its governance of the financial system after the collapse of the Bretton Woods system, which was a much more formalized international financial regime. (In contrast, the world trading system tends to be quite formalized, e.g., the WTO, compared to the coordination that occurs in the current international financial regime.)

Since the 1970s and the fall of the Bretton Woods system, the world has become more economically integrated and actions of one state can unintentionally and directly
affect other states. The nature of our globalized capitalist economy requires policies to be synchronized in a manner that does not necessitate a formal agreement for changes to domestic or international policy, but requires states to coordinate policies based on informal agreements as well as reactions to other states’ actions. Therefore coordination in our current international economic system differs from the traditional conception of cooperation through the nature of policy formulation and application.

International coordination is central to maintaining the health of an international capitalist economy. Without international coordination in a world capitalist system, states may simultaneously pursue conflicting policies, which may adversely affect other states and produce an international economy where all states are worse off. The basic problem any state faces in a situation that requires international coordination is often one of prisoner’s dilemma. Prisoner’s dilemma can occur in many interstate interactions. In a prisoner’s dilemma situation there is an incentive for states to defect from the agreement in order to reap the benefits from defecting from the agreement. For example, if a number of states agree to stimulate their economies, there is incentive for a state in the agreement to impose austerity in order to relieve debt while at the same time benefiting from the other states economic stimulation. With regards to international economic coordination, defecting can be manifest as beggar thy neighbor policies, which include policies such as loose banking regulations and currency devaluations, which are designed to improve a state’s own economic position often at the expense of other states. Individually, beggar thy neighbor policies may seem logical, but when all states act in self-interest and attempt to improve their domestic economies by pursuing such policies, all states end up worse off due to the increased costs of doing business with other states and the possible ‘race to
the bottom’ in banking regulations that may result. Beggar thy neighbor policies can affect both trade and finance. History has shown the negative effects of beggar thy neighbor policies as they were implemented by most states during the Great Depression and led to even more economic turmoil and international discord.

Current economic coordination can take numerous forms. One example includes states directly coordinating policies that have been agreed to at meetings such as the G8 and G20, such as coordinated stimulus or coordinated banking regulations. States may agree to enact policies at such meetings and then develop domestic policy to fulfill these agreements. Policies are also coordinated in a more informal manner. Two examples of informal coordination include officials discussing policy off the record or states reacting to the policy actions of other states without direct communication. For example, the U.S. switched from using bank bailout money to buy toxic mortgage assets to using the money for bank recapitalization, which is an example of the U.S. following the lead of the U.K. by adopting similar policies in the absence of a formal agreement.

International economic coordination is not limited to states either coordinating or not coordinating policies. Coordination can be thought of in terms of a scale from 0 to 100, with 0 being no coordination and 100 being complete coordination. States can also coordinate some policies more than others or not coordinate policies at all. Moreover, states may be coordinating and not coordinating policy simultaneously. One might witness two states coordinating regulatory policy by enacting similar regulations on the banking industry, but one state may enact austerity to correct an economic downturn while the other attempts to stimulate their economy. Such an example demonstrates a type of fragmented response that may be witnessed.
Additionally, there may also instances where ideational harmony between policy makers does not lead to policy coordination and ideational conflict does not prevent policy coordination. In these situations, factors outside of the leaders’ ideas about how the economy functions, such as domestic stability, may also play a key role. For example, the Chinese stimulated their economy in 2009, but this was not only because they believed in liberal interventionist fiscal stimulus to offset an economic downturn, which they did. Chinese leaders were so worried about the economic downturn because political issues were tied to the economic issues. The fact that a severe economic downturn could lead to social unrest sped up the implementation of previously planned government spending. In many cases efforts at international coordination need to dovetail will domestic imperatives (Putnam, 1988). In these situations, factors specific to each individual case must be also be accounted for. Despite some situations like this, many of the areas of conflict in this thesis revolve around ideational conflicts.

What is revealed in this thesis is that the responses to the three financial crises are typically defined by one of two economic assumptions; (1) markets work and (2) markets are good but can fail. Those who believe markets work will be classified as neoliberals, and they also believe markets are self-correcting and fail only when the government interferes in the economy or when information is incomplete. Those who believe markets work most of the time, but can fail in many cases will be classified as liberal interventionists, which are similar yet different to Keynesians. They are similar in the fact that they believe that markets are not always self-correcting and can fail on their own. They are also similar because they believe that governments should intervene in the economy when it becomes imbalanced in order to correct the imbalances and help
markets function better. Liberal interventionists differ from Keynesians in the fact that they favor activist regulation where Keynesians are largely quiet on this issue outside of capital controls.

The neoliberals and liberal interventionists have different notions of how the economy works best at the macroeconomic and microeconomic levels, which has led to disagreement in four key policy areas as the ideas of some international actors have switched from the neoliberal point of view to more liberal interventionist views. This change has happened to varying degrees in all four areas of disagreement, but as the severity of each financial crisis has increased from the Mexican Crisis to the Subprime Crisis, the pushback against the dominance of neoliberal policies has become more pronounced. The ideational debate is not between a new ideational paradigm and an old dominant paradigm. Today’s debate is between two existing schools of thought that have been jostling for dominance over the past century. What is being witnessed is but a rebalancing of the two ideational paradigms away from the overwhelming dominance of neoliberal ideas.

The first area of disagreement is whether governments should implement stimulus or austerity in times of economic downturn. This area of disagreement includes fiscal stimulus vs. fiscal austerity and monetary stimulus vs. tight monetary policy. In times of economic downturn neoliberals favor fiscal austerity and liberal interventionists favor fiscal stimulus. In following the three crises, fiscal austerity was implemented by the IMF on Mexico and the Asian states with little or no pushback from policy makers. In the Subprime Crisis states initially responded with fiscal stimulus and then disagreement ensued as some leaders wanted to pursue fiscal austerity while others felt fiscal stimulus
was still needed. This has led to a lack of international coordination as some states have pursued fiscal stimulus while others have opted for fiscal austerity. With each crisis, the pushback against fiscal austerity was more pronounced, but the coordination of fiscal austerity or fiscal stimulus has been very fragmented, representing a shift from fiscal austerity being the dominant policy.

Monetary policy recommendations were uneven throughout the three case studies. The IMF forced Mexico and the Asian states to tighten monetary policy and raise interest rates when their crises ensued, which was the response welcomed by the neoliberals and opposed by the liberal interventionists. When the Subprime Crisis hit, the G7 states lowered interest rates and loosened monetary policy. This action was supported by both neoliberals and liberal interventionists. Despite the recommendations for tight monetary policy on others, when the largest economies were threatened, their central banks acted in a liberal interventionist manner to attempt to prevent an economic downturn from becoming worse. Moreover, monetary policy recommendations were coordinated at a high level in the response to the Subprime Crisis despite the inconsistency of recommendations across all three cases.

The next policy debate is transparency vs. regulation, which includes regulation that calls for more transparency and regulation that restricts activities. This occurred in the long-term responses to financial crises as crisis prevention becomes a priority. Neoliberals favor more transparency and regulation that calls for more transparency where liberal interventionists encourage activist regulation that restricts activities. During the responses to the Mexican and Asian crises nearly every long-term reform was based on calls for more transparency and regulations that force transparency showing the
dominance of neoliberal ideas. Not until the Subprime Crisis brought the world’s financial system to the brink of disaster were more demands for regulation that limits activities voiced. These calls led to stricter banking regulations on the largest international banks through the passage of Basel III and less self-regulation. There was a partial shift from total neoliberal dominance to some liberal interventionist policy, but calls for more transparency have not ceased or become displaced by regulation that restricts activities.

The third area of debate is free capital flows vs. capital controls. Internationally there has been consistency in promoting free capital flows, but some states have implemented capital controls in times of stress, signaling a shift in attitudes toward free capital flows by some states. Although free capital flows played an important role in both the Mexican and Asian crises, states were encouraged by the IMF and G7/8 to further liberalize their capital accounts and to prepare to accommodate capital flows. This was the overwhelming consensus internationally as many states continued liberalizing their capital accounts, but Malaysia enacted capital controls in response to the Asian Crisis. China has also been very slow and hesitant in liberalizing their capital account. Following the collapse of their currency in 2008, Iceland implemented capital controls. Thus far the only type of capital controls Europe and the U.S. have considered are taxing currency trades to slow the speed of currency transactions. Instead of limiting capital flows internationally, international financial institutions, the G8, and the G20 have switched from promoting unrestricted capital flows to promoting capital flows with proper monitoring and management to prevent imbalances and instability.
Bank and state bailouts are the final area of contention examined in this thesis. Throughout the case studies, bailouts of states and banks were present, although Mexico had no direct bank bailouts. Despite the unpopularity of both types of bailouts, when faced with crisis situations policy makers opted to bailout both banks and states. Both the IMF and the Eurozone have increased their funds for future state bailouts should states face liquidity or debt issues. While more regulations have been placed on Global systemically important financial institutions (G-SIFIs) in the wake of the Subprime Crisis, should a bank’s failure threaten the financial system, the precedent for bailing them out has been set and appears to be what policy makers are preparing for in the future.

The remainder of this thesis proceeds in the following manner. Chapter two reviews the literature on international coordination as well as the role of ideas in international relations. Chapter three presents the theoretical framework for explaining why ideas change and the effects ideational change have on international coordination. Chapters four through six are case studies of the Mexican, Asian, and Subprime crises, respectfully. These three chapters contain three elements. They describe (1) the causes of each crisis, (2) the initial international responses, and (3) the long-term international responses to each crisis. Chapter seven includes my analysis of the importance of economic ideas in response to financial crises and the role of ideational change on international coordination.
CHAPTER 2: THEORIES OF INTERNATIONAL COOPERATION AND THE IMPORTANCE OF IDEAS

Scholars in the realist and neoliberal camps have historically dominated the study of international cooperation and international coordination. Realist scholars view states as being preoccupied with power, which makes cooperation and/or coordination very rare and extremely difficult to achieve. Neoliberals on the other hand argue that cooperation is difficult but can be achieved by repeated interactions mediated through international institutions. More recently, constructivism, which focuses on the impact of norms, attitudes, beliefs and social constructs, has become more popular with international relations scholars and including those studying international political economy. Despite the growing literature on the role of ideas in various areas of the social sciences, the role of ideas and their effects on international coordination has not been explored in as much depth. Adding to the existing literature on international coordination, ideas, and the processes of social and institutional change, I examine the impact of economic ideas on international economic coordination in response to financial crises and how international coordination is affected when ideas change asymmetrically.

Realists view the world as a continual struggle for survival, advantage, and conflict, in an environment of global anarchy and because of these factors cooperation is likely to fail, even in the face of mutual interests (Greico, 1993, pp. 118-119). Under the conditions of anarchy that define the international realm, realist scholars argue that states are prone to competition and conflict as they attempt to maximize power. When discussing cooperation, realist scholars are principally concerned with states cheating and focus on relative state power rather than absolute power. Because states are untrusting,
any agreement between states will be entered rarely and cautiously as cheating could provide a state with larger gains relative the other states in the agreement. According to realists, states view the world in terms of their competition and how much power they have relative to other states. States are motivated by self-interest and power maximization over cooperation and coordination, making cooperation and coordination unlikely to occur (Greico, 1993, pp. 116-123).

In contrast to the skeptical view of international cooperation and coordination that realists take, neoliberal scholars have argued that cooperation and coordination are possible despite conditions of anarchy. Game theory has been a popular way of exploring issues of international cooperation. By using a game theoretic model, liberal scholars argue that with a sufficient shadow of the future, and repeated interactions between actors, cooperation can be achieved (Axelrod & Keohane, 1993, p. 86).

Liberal scholars state that the shadow of the future is a promoter of cooperation because as actors expect to have recurring interactions with one another, incentives to be trustworthy are created. In addition, the more value that is placed on future payoffs over current payoffs, the less of an incentive states have to defect now. The prospect of future gains is extremely important in economic affairs, because unlike security matters where a preemptive war can eliminate an opponents’ ability to retaliate, one single move in economic interaction is unlikely to eliminate another states’ ability to retaliate. Therefore actors expect to be interacting in the long term and behaving in an uncooperative way will have negative consequences due to the inability to eliminate other states’ ability to retaliate (Axelrod & Keohane, 1993, pp. 91-92).
According to neoliberals, in addition to the distribution of payoffs, institutions are central to facilitating relations between states. Institutions such as the United Nations and the World Trade Organization should be used to structure interactions between actors in a way that cooperation is encouraged and defectors are punished. By using institutions to create more incentives to cooperate, states will be more likely to cooperate with one another. Robert O. Keohane (1984) states that institutions attempt to minimize uncertainty by providing more quality information to governments. This enables agreements to be reached that could not be made under conditions of high uncertainty. Keohane continues, declaring that states act differently in environments with good, quality information as opposed to environments where information is poor or lacking (Keohane, 1984, pp. 245-247). Moreover, liberal scholars argue that with a sufficient shadow of the future and international institutions to mediate between states, international cooperation is possible.

More recently constructivism has ascended as powerful way to examine international relations. With constructivism’s emphasis on culture, norms, ideas, identities, and other social constructs, new explanations are being added to the social science literature on a variety of subjects. Constructivism’s main insight is that “collectively held ideas shape the social, economic, and political world in which we live” (Abdelal, Blyth, & Parsons, 2010, p. 2). This view of the world differs from and extends both the realist and neoliberal schools and challenges the notion that political actions can largely be explained by examining rational responses to “objective and largely knowable and transparent environments” (Abdelal, Blyth, & Parsons, 2010, p. 3).
Understanding international cooperation or coordination from a constructivist point of view requires an emphasis on the expectations that behaviors produce, the ideas actors have about the world, and their effects on identities and interests. By accommodating expectations, norms, identities, culture etc. constructivists offer insight into how the aforementioned variables affect interactions between states. Moreover, our ideas and beliefs about the world shape our interpretations of it.

The Power of Ideas

Arising from the constructivist school is an even more focused literature that concerns the power of ideas and their impact on actions taken by policy makers. The prominent role that ideas have on affecting policy has been explored by a number of scholars across various subfields including international relations, comparative politics, American politics, and political economy (Abdelal, Blyth, & Parsons 2010; Béland & Cox 2011; Berman 2011; Best 2005; Blyth 2003; Blyth 2011; Campbell 2004; Goldstein & Keohane 1993; Hall 1989; Kirshner 2003; McNamara 1998). However, the emphasis on the role of ideas is not universal. As Sheri Berman points out, Marxists, most realists, and many rational choice scholars tend to view ideas as something that ebbs and flows depending on interests (Berman, 2011, p. 105). Jal Mehta (2011) argues that the question we should be asking is not whether ideas matter, but how they matter. He argues that an idea matters “when it (a) shapes people’s actions and (b) is not reducible to some other nonideational force” (Mehta, 2011).

The reasons why ideas matter are greatly varied depending on how one looks at ideas. Ideas shape how people view the world around them. Ideas are produced in our minds and are linked to the material world around us by our how we interpret our
environment (Béland & Cox, 2011). Ideas about how the world should work provide lenses through which individuals filter the world around them. Reactions to events are triggered by the beliefs held by individuals regarding those events, which garners different reactions to the same events from those who hold different ideas about the world. Ideas have also been described as worldviews, principled beliefs, and causal beliefs that offer roadmaps for policy or glue to hold together efforts at coordination (Goldstein & Keohane, 1993). Mehta (2011) has categorized ideas as policy solutions, problem definitions, and public philosophy or zeitgeist – sets of cultural, social, or economic assumptions that are disproportionately dominant at a given time (Mehta, 2011).

Mark Blyth (2011) argues that ideas are important because our world is one of uncertainty rather than risk. Blyth contends that a world of risk assumes the world is stable most of the time and the parameters of risk can be assessed and accurately judged based on available information from past events whereas a world of uncertainty is characterized by the inability to accurately and consistently predict the future. When faced with uncertainty, policy makers will have to rely more heavily on ideas because, whether they conform to the ideas that are currently dominant or have different ideas, the ideas held and shared by policy makers will affect the policies enacted (Blyth, Ideas, Uncertainty, and Evolution, 2011). As Goldstein and Keohane assert, when political actors are forced to choose between sets of outcomes for which there are little or no “objective” criteria to analyze their choices, ideas guide expectations and strategies (Goldstein & Keohane, 1993). Moreover, ideas are important for many reasons. Ideas guide policy in times of uncertainty as well as providing a lens for individuals to filter
events and make sense of the world. Finally, ideas provide a framework for developing solutions to problems and also act as a dominant paradigm for moments in time.

Ideen und Internationale Politische Ökonomie (IPE)

As the role of ideas has begun to spread throughout many of the social sciences, the explanatory power of ideas has become more important to scholars in political economy. Scholars have studied the impact of ideas in a number of areas concerning political economy. Peter Hall (1989) compared how Keynes’ ideas were received by major industrial states and details how Keynesian ideas became a more important component of policy in some states than others. Hall discusses three factors that are crucial in determining whether an idea is adopted as policy; (1) economic viability, (2) administrative viability, and (3) political viability. Economic viability of ideas referred to their ability to solve current economic problems; administrative viability takes into consideration the biases held by officials in positions responsible for implementing policy as well as the capability of a state to implement the desired changes; and political viability concerns an idea’s ability to be adopted by politicians to provide a political advantage over candidates. In order for Keynesian policies to be adopted, all three of the previously mentioned factors had to be seen as having some viability. Therefore, if Keynesianism could solve the economic problems and officials were willing and able to implement the policies, but politicians viewed Keynesianism skeptically the policy would not be adopted (Hall, 1989).

While Peter Hall focused on how and why Keynesian ideas were adopted by states, Kathleen McNamara (1998) traced how formation of a neoliberal consensus among European elites played an important role in the formation of the European Union.
Through a process of redefining interests with the changes occurring in the economic and political environments McNamara argued that the neoliberal consensus was dependent on policy makers’ shared experiences and beliefs. McNamara insists on the connection between ideas and interests as causal ideas and not treating them as competing causal variables. In explaining the triumph of neoliberalism over other policy choices, McNamara discusses how the shared experience of macroeconomic policy failure in the wake of the first oil crisis of the 1970s led to a search for alternatives to Keynesian policies. In the political space left by the failures of Keynesian policies, monetarist theory offered an alternative that made anti-inflationary policies a priority over unemployment or growth. Additionally, monetarism adjusted to include fixed exchange rates and provided solutions in a time of high uncertainty.

Finally, Germany provided a model for Europe to emulate as they adopted a practical version of monetarist policy, which promoted a strong and stable currency. Because neoliberal ideas defined the problem, supplied an alternative solution, and confirmed their effectiveness in policy, there was a convergence among European elites toward a neoliberal policy preference. As the international economy moved toward more mobile capital, the neoliberal paradigm became a more desirable policy choice. McNamara argued that the neoliberal consensus redefined the interests of European states regarding cooperation, strengthened stability in the European Monetary System, and persuaded political leaders to accept the necessary domestic policy adjustments required to stay within the system. (McNamara, 1998).

One scholar that has combined international cooperation/coordination and ideas is Jacqueline Best (2005). She examined ambiguity in the international financial system and
the roles that ideas, institutions, and the governing process work together to manage ambiguity. Best argued that ambiguity is a problem because it creates uncertainty, but it can also be constructive. As institutions internalize some of the properties of ambiguity, room is created for the necessary flexibility institutions need to adapt to a changing world. As the definition of ambiguity has changed, so have strategies for containing ambiguity. Because ambiguities can never be eliminated, they must be accommodated. The present neoliberal order has attempted to contain ambiguities by eliminating them through enhanced transparency and better information. Technical ambiguities such as information asymmetry were more prevalent in the early Bretton Woods era, whereas Best claims that intersubjective ambiguities such as perceptions of which states maintained “good” monetary policy led to the financial instability of the 1990s (Best, 2005). Moreover, ambiguities create problems because they can lead to uncertainty and disagreement in various areas, but they can also be constructive by permitting institutions to be adaptive in their responses to unforeseen events.

As this chapter demonstrates, much scholarship has been produced discussing international cooperation and/or coordination and ideas, but little has been written in a way that illustrates the power that ideas can have on international coordination. In the following chapter I will present a theoretical framework for evaluating the impact of ideas on international coordination.

---

3 Best refers to ambiguity as policies that lack specific details and allow for multiple interpretations.
CHAPTER 3: ASYMMETRIC IDEATIONAL CHANGE AND INTERNATIONAL COORDINATION

As the work of other scholars has demonstrated, policy is affected by ideas as policy reflects the ideas that policy makers hold. Ideas about how the international economy should function will be revealed through the institutions responsible for its functioning as well as the agreements made between states. Interests will influence policy, but perceived interests are developed through ideas about what an actor believes their interest to be. When ideas are similar, international policies will mirror these similarities. When ideas of policy makers are different, policy will be fragmented and disjointed. Dominant paradigms in economic policy at the global level have risen and fallen. When there is the dominance of one group of ideas, international coordination is easier and when there is disagreement, international coordination suffers.

To illustrate the effects of ideas on international coordination, a framework must be provided that enables one to trace the impact of ideas on economic coordination at the international level. My broad contention is that because ideas matter with regards to international coordination, when the ideas of international actors conflict, coordination suffers. In addition, ideas are difficult to change because ideas become entrenched in domestic and international systems and institutions, making it costly to change course (Ruggie, 1982). Furthermore policy makers usually become attached to “traditional behavior or decision-making patterns even when confronted with powerful incentives to change (Berman, 2011, p. 106).

Ideas are especially important in international economic coordination because of the nature of the current global capitalist economy. Today’s global economy is much less
formal than the global economy during the Bretton Woods era, as policies are
coordinated between states with varying levels of communication as opposed to formal
agreements. Economic coordination requires the actors to have similar conceptions of
how the economy functions if policy actions of multiple states are to complement each
other. If state A is adhering to Keynesian economic theory, and state B is implementing
policies inspired by monetarist theory, the ability of these two states to coordinate policy
is limited due to vastly different conceptions of how the economy functions at the
macroeconomic level. When the ideas international actors hold about the economy
conflict, coordination will suffer.

Coordination in economics also differs from other forms of coordination, because
of the interconnected nature of the global economy. If the U.S. Federal Reserve decides
to raise interest rates, which results in a slowdown of the U.S. economy, Chinese
manufacturers may be forced to lay off workers due to a decrease in sales to the U.S. The
interconnectedness of the international economy allows for the actions of one state to
directly affect other states, making economic policy inherently international.

International economic coordination following financial crises also faces higher
levels of uncertainty than other forms of coordination. A state with a capitalist economy,
where every citizen is an actor in the economy and their personal economic decisions will
have an impact on others. Such large numbers of actors increase the opportunity for
unexpected shocks to originate in many more places. In times of economic crisis,
uncertainty becomes even more prevalent as the opacity regarding the reactions of
individuals, businesses, and governments to the economic crisis deepens the insecurity
caused by the crisis.
Policies are inspired by ideas, but ideas are also influenced by experience. When policy is enacted, it has an ideational backing that gives credence to that policy. The process of economic ideas coming into prominence and falling out of favor will depend on experiences with implemented policies. Once a policy is implemented there are consequences which could be positive or negative. If the consequences are positive, it is sensible for policies with a similar ideational backing to continue. However, if the consequences of a policy are negative, there is a chance that the policies and the ideas responsible for the policies could come under scrutiny. If a crisis occurs, the negative effects will be felt by society at large even as some sectors of society are more affected than others.

When a crisis occurs, there will be numerous explanations regarding the causes as well as the solutions. The push for policy change will depend on two factors. First, the causes of the crisis must be directly linked with the dominant economic ideas of the time to achieve push for change from societal actors, policy makers, or both sets of actors. For example, if a state enacts neoliberal reforms that include deregulating their financial sector, and then experiences a financial crisis in the future, the explanations for the causes of the crisis will determine whether it is directly linked to the reforms or not. One explanation of the crisis could argue that deregulating the financial sector allowed banks to take excessive risks. If this explanation becomes the dominant explanation, the crisis may be viewed as directly linked to the deregulation that previously took place and may encourage a more aggressive push for change against financial deregulation. However, if another explanation, such as crony capitalism, that does not directly link the deregulation
of the financial sector to the financial crisis; the same push against financial deregulation is not to be expected.

The second factor in determining the push for change is the severity of the crisis. The more severe and prolonged a crisis is, the more likely a push for change will be made. In a crisis like the Mexican crisis of 1994/95 where the crisis was resolved relatively quickly and only affected a few states, the push for change can be expected to be minimal. Conversely, if a crisis continues for a longer period of time and affects many states as witnessed during the Great Depression, the push for change can be expected to be more aggressive.

Moreover, for there to be push for policy change, the causes of the crisis must be directly linked to the dominant economic paradigm and a crisis must be severe enough to materially damage large sectors of society. As history has shown, one crisis is generally not sufficient for an ideational change to occur. Multiple shocks will be required to discredit an existing ideational paradigm.

Should these two conditions not be met, international economic coordination can be expected to follow the principles of the dominant ideas. If the causes of a less severe crisis are directly linked with the current ideational paradigm, and leaders believe that the current system can be fixed or tweaked, there will be a continuance of the dominant ideas, but with reforms to “enhance” the current system in order to increase its functionality and prevent future crises. In other words, if the dominant ideas are not seriously in question, evolutionary reforms to correct flaws the current economic paradigm will be made in accordance with the principles of the dominant ideas.
For an ideational shift to materialize, a viable alternative must also be presented. Should a crisis be severe and directly linked the dominant economic ideas of the time and policy makers believe a different policy would work better; more of a push for change is to be expected. For significant push back to occur, the shock or sequence of shocks to the current system must be large enough to cast real doubts about the merits of the policies inspired by the current ideational paradigm. Once the current dominant ideas as well as the policies they have produced have been tarnished where enough doubt about its merits exists, new ideas will be posited as a better way forward. In order for a new set of ideas to replace the old ideas they must do two things: offer (1) “a satisfying explanation of the world and (2) a guide for mastering it” (Berman, 2011, pp. 106-107). If the alternative ideas are not perceived as legitimate, policy will once again be guided by the previously dominant ideas. However, if there is a legitimate alternative, these ideas will compete with the old ideas for “mind share” (Berman, 2011).

Should no group of ideas become dominant, it is expected that international policy coordination will become fragmented. State leaders will be more prone to coordinate policies with other leaders who share their ideas, while leaders with conflicting ideas will be less prone to coordinate policies. This kind of fragmented coordination could take many forms as states with leaders whose ideas are similar will be more likely coordinate policies while those with different ideational orientations may not. For example, Germany may coordinate implementing austerity measures with the U.K., but the U.K. might implement more stringent regulations on the trading of over-the-counter derivatives than Germany. Meanwhile the U.S. could stimulate their economy while also coordinating the regulations of over-the-counter derivatives with the U.K. Any
number of combinations of fragmented coordination are possible, but leaders whose ideas are similar will be more likely to coordinate policies while leaders whose ideas conflict will be less likely to coordinate policies.

The competition for ideas plays out over time, as dominant ideas are not easily replaced and history shows it is easier to maintain the current path rather than forge a new one. This is known as status quo bias, when policy makers hold on to “traditional behavioral or decision-making patterns even when confronted with powerful incentives to change” (Berman, 2011, p. 106). If one examines the adherence to the gold standard or classical economics in the face of failing policy during the 1930s it becomes apparent that ideas, like policy or interests can become entrenched. This can happen at the domestic or institutional level as well (Ruggie, 1982).

Ideational change poses problems to an international system that is dependent on coordination by its very nature. With ideas changing at different rates and some states or policy makers holding onto ideas while the ideas of others are changing, international economic coordination will be affected by these changes. When the ideas of some policy makers change but the ideas of others do not, what is witnessed is an asymmetrical ideational shift. The effect of an asymmetric ideational shift on international economic coordination is profound. First, if there has been an asymmetrical shift, the causes of a crisis will be viewed differently and therefore solutions should also be expected to be different. By itself, a disagreement on the causes of a crisis could be enough to hinder economic coordination.

Should there be agreement on the causes and the aspect or aspects of the international financial system that need reform, the proposed solutions will be formed by
the multitude of ideas proposed by policy makers. These ideas will be competing for legitimacy in the minds of policy makers and their populations. During the period of criticism where dominant ideas are being questioned and new ideas are presented to replace the dominant set of ideas, international coordination will be perceived to be lacking as ideational difference hinders coordination (Berman, 2011).

Moreover, the case I have made is that ideas play a particularly important role in the level of international coordination in responses to financial crises because of the nature of our current international financial system and the high level of uncertainty accompanied by financial crises. When ideas conflict, international coordination suffers. Conflicting ideas of how the economy functions will produce conflicting policies. The other main point expressed in this chapter is that ideas are difficult to change (Ruggie, 1982). Ideas become entrenched domestically and internationally as well as in the minds of leaders and require multiple, severe shocks to warrant change.

This is illustrated as I trace the responses by international bodies such as the G7, G20, and IMF to the Mexican peso crisis in 1994-95, the Asian Financial Crisis of 1997-98, and the Subprime Crisis of 2008. These crises were chosen because of their international nature. The least international case in terms of the number of states affected is the Mexican Peso Crisis, but the response was an international effort involving both the U.S. and Europe. The Asian and Subprime crises were both characterized as the greatest financial crisis since the Great Depression as they were unfolding, but the Subprime Crisis has proven to be much deeper and more serious as four years after its onset policy makers are still attempting to ensure a recovery and are dealing with additional shocks. I will be examining both official documents of the G7, G20, and IMF as well as the major
news media covering the events exploring initial policy responses, any calls for change, and if calls for change deviate from the existing dominant economic paradigm. What I believe is witnessed with each crisis is an increasing push back against the neoliberal policies that have guided the international economy for roughly the past thirty years. However, the questioning of neoliberal ideas is not universal, and has not led to a uniform policy shift. The asymmetrical shift that has occurred, has led to international disagreement about the best policies to ensure growth and stability for the international economy.
The Mexican peso crisis struck in late 1994, as an unexpected devaluation of the peso crowned a financial crisis fueled by investor panic and capital flight. Prior to the crisis, Mexico had been lauded for their successful market-oriented reforms and appeared to be moving towards becoming a more advanced state with increased stability and prosperity. Mexico had been experiencing modest growth in the early 1990s and had just entered into NAFTA\(^4\), which was expected to be a boon for the Mexican Economy. When the crisis hit, then Managing Director of the IMF, Michel Camdessus, allegedly described the Mexican Peso Crisis as “the first crisis of the twenty-first century” as the Mexican Peso Crisis was the first crisis in which securitized capital flows played a significant role. (Edwards & Naim, 1997, p. 2). The devaluation of the peso was the tipping point for investors during the very tumultuous year of 1994 that included political assassinations, rebel uprisings, and policy missteps. All of which resulted in investor panic, capital flight and subsequently a currency crisis that led to a liquidity crisis and ended with what, at the time, was the largest emergency stabilization package in the history of the IMF along with other funds provided by the BIS and U.S.

**Causes of the Crisis**

While the trigger for the crisis was the unexpected devaluation of the peso, the deeper causes of the crisis revolve around a loss of investor confidence and the reversal of capital inflows. The reversal of capital inflows have been linked to unanticipated political shocks and an unsustainable current account deficit, which increased Mexico’s

---

\(^4\) The North American Free Trade Agreement (NAFTA) went into effect January 1, 1994. NAFTA is a trilateral trade agreement between Canada, the United States, and Mexico that eliminated tariffs on most goods produced within all three states and enables free movement, shipment, and trade between all three states (United States Customs and Border Patrol, 2012).
vulnerability to panic. Once panic ensued and foreign reserves were additionally drained in attempts to defend the peso, the peso was allowed to freely float leading to the devaluation of the peso and further draining of currency reserves pushed Mexico into a liquidity crisis. Exacerbating the crisis was the mishandling of the devaluation by the Mexican government and the sluggish initial attempts at securing loans from states and international financial institutions to provide the Mexican government with a stabilization package.

Three unanticipated political shocks occurred in 1994 that made Mexico vulnerable to investor panic prior to the devaluation. The assassinations of Luis Donald Colosio⁵ and Jose Francisco Ruiz Massieu⁶ combined with the armed uprising in the Chiapas province all cast doubts about the political stability of Mexico. The assassination of Colosio sparked a brief financial panic in March, which forced the Mexican government to step in order to maintain the value of the peso and led to the loss of about $11 billion in international reserves in a four-week span (Whitt Jr, 1996, p. 1). When the Mexican government allowed the peso to float in December of 1994, resulting in a large devaluation, the government blamed it on the Zapatista uprising in Chiapas province (The Economist, 1994).

In addition to the political shocks, the Mexican current account deficit was worrisome to investors. The current account deficit was the result of too much Mexican investment and not enough domestic savings (Sachs, Tornell, Velasco, Giavazzi, & Székely, 1996). Following the passage of NAFTA Mexico’s risk premium had fallen.

---

⁵Luis Donald Colosio was a Mexican presidential candidate from the Institutional Revolutionary Party (Whitt Jr, 1996, p. 3)
⁶Jose Francisco Ruiz Massieu was one of the highest ranking officials in the Institutional Revolutionary Party (Whitt Jr, 1996, p. 3)
Mexico’s private sector had also been borrowing heavily from foreign creditors. In 1994, due to the unexpected political shocks, there was a slowdown of foreign lending. The slowdown in foreign lending coupled with the large current account deficit led to the further draining of foreign currency reserves (Sachs, Tornell, Velasco, Giavazzi, & Székely, 1996). By December, the slowdown in lending from foreign creditors combined with the depletion of international reserves left Mexico with roughly $6 billion in international reserves and led to the devaluation of the Mexican peso by nearly 50%.

Mexico’s government had been using their exchange rate as a way to fight inflation, which led to the peso’s overvaluation. Mexico was highly dependent on capital inflows and in order to continue attracting foreign capital, interest rates began to rise, which threatened to slow the Mexican economy. Concerns over an economic slowdown only increased capital flight from Mexico (Fidler & Bardacke, 1994). According to the Mexican government, the outflow of capital began for two reasons; the rebel uprising in Chiapas and concerns over Mexico’s current account deficit, which was approaching $28 billion (8% of GDP) for 1994 (Bardacke & Fidler, 1994a).

While political upheaval and an unsustainable current account deficit led to investor panic and capital flight, the mishandling of the devaluation by the Mexican government and a shaky initial international response helped to intensify the crisis. On December 22, 1994 the Mexican government stopped trying to defend the peso and let it float freely against the dollar (The New York Times, 1994). The move to devalue the peso was triggered by the drastic fall in international reserves, making it impossible for the central bank to defend the peso and keep it within the trading band (Bardacke & Fidler, 1994b). Devaluing the peso, which the Zedillo administration said it would not do,
surprised investors, which only furthered capital flight and led to many investors questioning the credibility of the young Mexican government, which had been in office for about 3 weeks when the crisis ensued (The Economist, 1995c).

During the first few weeks of the crisis, many investor concerns centered on the $28 billion worth of tesobonos, which were Mexican Treasury bonds that were indexed to the dollar and were scheduled to fall due in 1995. Eighty percent of the tesobonos were held by foreigners, and many of them decided to cash them in for dollars, effectively removing that money from Mexico instead of rolling them over to longer term debt (Depalma, 1995c). As stated by the Financial Times, “Investors would not have been so worried about the short-term debt had there been big international financial support at the time of the devaluation - or if the devaluation had occurred earlier with reserves higher...Foreign governments had not been informed; there was no plan for domestic economic adjustment” (Fidler & Bardacke, 1995b). The devaluation posed threats such as high inflation, higher interest rates, less domestic savings, and potential political unrest to domestic and foreign investors as well as the Mexican government, banks, and citizens.

The peso’s fall continued through the New Year as worries of a deepening financial crisis persisted, and on January 4, 1995 the pesos to dollar amount reached 5.57 to 1 (The Economist, 1995c). The crisis also prompted U.S. and Canadian central banks agree to exchange up to $6 billion worth of pesos for an equal sum in dollars and the Canadian Government authorized an exchange up to $1 billion (DePalma, 1994). On December 28, 1994 the Mexican government began talks with the IMF and other financing agencies to discuss an “emergency financial package” (Bardacke, Fidler, & Reuter, 1994).
Short-Term International Responses

The first attempt at an organized international response was to be revealed on January 2, 1995 during a speech by Mexican President Ernesto Zedillo, but the speech was postponed due to talks with Mexican labor leaders. Eventually, the details of the rescue package as well as a Mexican austerity plan were revealed in addition to the earlier help from the U.S. and others. The proposed rescue package included an additional $18 billion from foreign governments and banks, including $9 billion from the United States, $5 billion from other ‘friendly’ governments in an arrangement through the Bank for International Settlements, $1.5 billion from Canada, and $3 billion from various international banks (Fidler & Bardacke, 1995a). The austerity measures were to include both wage and price controls (DePalma, 1995b). The unexpected devaluation of the peso along with the delays in revealing the rescue package and austerity measures were interpreted by the rest of the world as the Mexican government lacking control, which made investors very wary (The Financial Times, 1995). When President Zedillo’s speech was finally delivered on January 4, 1995 the markets response was less than enthusiastic as both the stock market and the peso fell (Rich, 1995).

On January 6, 1995 Mexico formally asked the IMF for help, which included an immediate $2.5 billion loan with the talks to begin the following week. Despite the news of IMF assistance, confidence in the peso remained low. As markets continued their downward slide and investor confidence in the $18 billion dollar plan waned, the Mexican banking system was hit with a downgrade from Moody’s on some of their deposits, as worries about solvency were revealed. Moody’s cited poor asset quality and poor reserve coverage for the worries about bank solvency (Bardacke, 1995).
On Jan 11, 1995 Bill Clinton was set to increase the amount of aid to Mexico and also called on the IMF and World Bank to institute a large lending program for Mexico, but an IMF representative told the New York Times that a loan deal could take upwards of two months (Bradsher, 1995). Meanwhile, President Clinton and Republican leaders were negotiating a U.S. aid package for Mexico that consisted of loan guarantees, which acted as insurance on Mexican bonds in the case Mexico would default on their loans (Sanger, 1995a).

The belief from the U.S., and especially the White House was that Mexico’s crisis was a liquidity crisis and not an all-out debt crisis, therefore Mexico only needed funds to pay off short term debt (Fidler, 1995). The Clinton Administration's proposed plan would guarantee up to $40 billion of Mexican loans in order to convince investors that Mexico would be able to pay their bondholders. The U.S. attached conditions to the proposed loan guarantees. Mexico was to adopt strict monetary and fiscal controls such as taming inflation and its trade deficit, and promising to pay back lenders, if necessary, with future oil revenues (The New York Times, 1995).

President Clinton and others in his administration attempted to shore up the U.S. aid package to Mexico but increasing hostility from Congress slowed the process. Many members of both Democrats and Republicans saw the plan as a bailout for Mexico’s incompetent government and investors on Wall Street, but the Clinton administration feared that the Mexican crisis might spread to other states with which the US had a vested interest. As the crisis prolonged, there was an overarching fear that the crisis would spread to other Latin American states such as Argentina and Brazil and Latin American
leaders had to defend their economies from critics who claimed they were next (Sanger, 1995b).

While the U.S. Congress and President Clinton debated the proposed $40 billion rescue plan, Mexico asked the IMF for further assistance. On January 26, 1995 the IMF tentatively agreed to a $7.78 billion standby loan to Mexico. This was the largest standby loan ever given by the IMF. Mexico also agreed to implement an economic adjustment program at the behest of the IMF, which included a tight monetary policy, cuts in government spending, as well as other actions to fight inflation and limit public spending (Bardacke & Crawford, 1995). In agreeing to the loan, the IMF was forced to make exceptions to its own rules as states were only allowed to borrow a fixed amount, and all outstanding loans must be subtracted from the fixed amount. Mexico still had to pay ¾ of a loan they took out in 1989, but the rule was waived in this instance, because the IMF perceived the new recovery plan as credible (DePalma, 1995a).

The initial $40 billion aid package developed by the Clinton administration stalled in Congress because of Democratic opposition to the deal as it reignited many of the debates surrounding NAFTA. As it became apparent to the Clinton Administration that the original $40 billion package for rescuing Mexico had fallen through and the situation in Mexico was worsening, a quick solution was needed. Money continued to be removed from Mexico at an astonishing rates and without help, Mexico’s finance minister Guillermo Ortiz believed they would soon be unable to convert the peso (Bardacke, Fidler, Graham, & Norman, 1995, p. 4).

On January 31, 1995 President Clinton turned to ‘Plan B,’ where he used the US Exchange Stabilization Fund to throw Mexico a lifeline without the approval of
Congress. Leaders in Congress supported this move because they would not have to vote on the package, which shielded them from political criticism. Officials in both the U.S. and Mexico understood they needed more backing than what was currently being offered by the U.S. and the BIS. Hence, they turned to the IMF. The IMF pledged $17.8 billion, including the $7.8 billion that was agreed to the previous week, which would be available immediately. The additional $10 billion would come from non-industrialized central banks. The Bank of International Settlements in Basel was informed of the tentative switch to ‘Plan B’ and discussions started for a doubling of the BIS portion of the original $40 billion package to $10 billion from $5 billion. The stabilization package was finalized in a conference call between the IMF’s Michel Camdessus, his deputy Stanley Fischer, and U.S. Treasury Secretary Robert Rubin, and U.S. undersecretary for international affairs Larry Summers. Camdessus notified the IMF board before President Clinton addressed the National Governors Association to unveil the plan. (Bardacke, Fidler, Graham, & Norman, 1995, p. 4).

President Clinton’s announcement to the National Governors Association angered European officials, as the details of the $50 billion rescue plan were heard for the first time in the news. Expressing his frustration, one European official told the Financial Times, “President Clinton goes to the press and says the Fund will do this and that. It was just not acceptable. We are not banana republics” (Bardacke, Fidler, Graham, & Norman, 1995). Despite Clinton’s praises of international cooperation, western allies including Britain, Germany, Denmark, the Netherlands, Belgium and Switzerland abstained from approving the IMF loans and thought President Clinton acted too hastily, not consulting them nor giving enough time for them to review the plan. Leaders from many European
states were concerned with the funds of the IMF drying up and a change in procedure from past loans (Nash, 1995).

Mexico’s rescue package was at the time, the largest international rescue package ever assembled and the finance ministers of the G7 were meeting on February 3, 1995 with one of the topics of discussion being how to divide the bill. Mexico pledged oil revenues as collateral for the U.S. and has agreed to an economic reform program to receive the aid from the IMF (The Economist, 1995b). The Mexican rescue package was finalized later in February and arguments about its potential effectiveness continued. Some, including U.S. Secretary of State Warren Christopher, believed that the deal would put an end to the crisis, as Mexico could now retire or refinance about $16 billion of the $21.5 billion in outstanding tesobonos (The Economist, 1995a). Unfortunately, the rescue package itself did not calm fears of international investors as delays in Mexico implementing a credible austerity plan led to further turmoil (Graham, 1995). The peso continued to suffer, as did other Latin American currencies as they came under attack in the following weeks. The rescue package helped to bring Mexico from the brink of disaster, but the move that seemed to finally calm the markets was the implementation of austerity measures in March of 1995, which sent the country into recession but on the path to eventual recovery.

On February 4, 1995, days after the announcement of the rescue package for Mexico, a meeting of the G7 finance ministers and central bank governors was scheduled in Toronto, Canada. After detailing the need for the plan and smoothing over the rough edges there was consensus on the plan, but contention still existed about the way the U.S. cut Europe out of the decision making process. One German official told the Financial
Times that “It is in nobody’s interest to see the package collapse, but it had to be made clear that this must not happen again” (Bardacke, Fidler, Graham, & Norman, 1995). Despite the tensions between G7 leaders prior to the meeting all parties supported the Mexican rescue package. The official statement from the February 1995 meeting of the G7 finance ministers and central bank governors indicated that there was agreement and satisfaction that the Mexican plan by the IMF was “strong, coherent, and credible” (University of Toronto G8 Information Center, 1995).

The nature of the Mexican Crisis caught officials off guard with the speed at which it intensified and threatened to spread to other states. What the Mexican Crisis revealed was that the Bretton Woods institutions, especially the IMF, were ill equipped to prevent and respond effectively to crises in a liberalized international financial system. There was no early warning system to quell the crisis before it was a full blown panic and the amounts of money crossing international borders due to the liberalizing of domestic economies far exceeded the amounts that the IMF was prepared to account for when it was designed some fifty years earlier. This in turn, led the IMF to break its own rules about lending requirements in order to design a package that would be effective in calming the fears of investors and stabilizing financial markets. In essence, the realization that the world’s economy had evolved beyond the scope of the current institutions’ monitoring ability was beginning to dawn on those regulating the international financial system. There were new players and the needs of states were changing, both of which were making the governance of the global financial system more difficult and governments were behind trying to play catch up (University of Toronto G8 Information Center, 1995).
Long-Term International Coordination Following the Mexican Crisis

Following the approval of the international rescue package, policy makers began discussing long-term reforms to prevent similar crises in the future. At the World Economic Forum in Davos Switzerland, there was a session dedicated to discussing which state would be the next Mexico, highlighting the need for reforms in order to adjust to the changing international economic system in order to prevent another Mexico (Brittan, 1995). At the February 1995 meeting of G7 finance ministers and central bank governors in Toronto, it was agreed that inquiries into how international financial institutions could be reformed to better “monitor and, when warranted, to respond to financial and economic instability” should be undertaken in order to be discussed at the G7 summit of heads of state in Halifax, Canada in the upcoming spring (University of Toronto G8 Information Center, 1995). This agreement was essentially an extension of the request from the G7 Heads of State during the Naples summit in 1994 to review the international financial institutions.

U.S. Treasury Secretary Robert Rubin highlighted some of the biggest challenges discussed at the G-7 meeting of finance ministers and central bank governors in February of 1995, stating that the biggest problems institutions must address is that of private capital flows and the IMF and World Bank must realize they are not only dealing with “the problems of underdeveloped states but with overindustrialized former Communist states stumbling toward capitalism” (Carrington, 1995). Even with the admission that reforms were needed; there was discord on how to achieve these reforms in a responsible way. Hans Tietmeyer, Bundesbank President expressed concern regarding moral hazard should the IMF continue to rescue states from their economic mistakes, while Michel
Camdessus, the IMF’s managing director has said that more funds need allocated in order for the IMF to effectively respond to situations like Mexico (Carrington, 1995).

**The Halifax Summit**

In the run up to the 1995 G-7 heads of state summit in Halifax, Canada, the G-7 finance ministers and central bank governors met in conjunction with the IMF and World Bank for their annual meeting in April with reforming the IMF to more effectively prevent and address financial crises being a priority. The IMF Interim committee of the Board of Governors agreed that the IMF should increase surveillance abilities in the wake of the Mexican crisis that included enhanced dialogue between the Fund and its member nations. This was to be achieved through more constant policy discussion between member nations and the Fund. The idea was that timely reporting of economic data would lead to greater transparency of economic policy and help to avoid future crises. The IMF was also to work toward establishing economic reporting standards for all member countries to follow. Additionally, recognizing the risks inherent with easily reversible capital inflows, the IMF would scrutinize its members’ financing policies more strictly to help avoid crises such as was witnessed in Mexico. Finally, it was agreed that the IMF’s powers of surveillance should be more focused on member countries “where economic disturbances or policies could have broader implications for other states,” while at the same time maintaining meaningful dialogue between the Fund and all member countries (International Monetary Fund, 1995).

The Halifax summit in 1995 proved to be very important as this is where serious discussions of how to reform the international financial architecture began. At the 1995 G-7 summit in Halifax, the heads of state echoed what the joint session of G-7 finance
ministers and central bank governors along with the World Bank and IMF agreed to in April. The G-7 heads of state also suggested adding an “Emergency Financing Mechanism” in order to allow quicker access to IMF aid with “strong conditionality” during crisis situations. In order to fund the “Emergency Financing Mechanism,” the G-7 heads of state asked the G-10 and others to provide funding to double the amount available under the General Agreement to Borrow (GAB) for financial emergencies and to examine possible ways to further resolve sovereign debt crises by expanding upon the increased role of the IMF in such situations. The G7 heads of state also called for a cooperative approach to regulating and supervising financial institutions and markets while urging states to remove capital market restrictions. This recommendation was to be done with the guidance of international financial institutions. (Group of Seven Heads of State and Government, 1995).

Post-Halifax

In October 1995, following the Halifax summit, the IMF Interim Committee met and endorsed the IMF board’s creation of procedures for the “Emergency Financing Mechanism,” suggested by the G7 heads of state at the Halifax summit. This mechanism was designed to ensure that states facing a liquidity crisis would be able to have access to cash in a timely manner in order to prevent the further escalation of the crisis. In October 1995, the IMF also began work on the Special Data Dissemination Standard (SDDS), which implemented rules for states subscribing to the standard. These rules set out to

---

7 The Group of Ten (G-10) was originally the group of states participating in the IMF’s General Arrangements to Borrow (GAB), which began in 1962 and consisted of eight states (Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom, and the United States). Today the G-10 refers to a group of eleven states whose central bank governors and finance ministers meet throughout the year to discuss and coordinate economic, financial, and monetary matters and consists of the aforementioned eight states with the addition of Germany, Switzerland, and Sweden. Invalid source specified.
enhance the availability of timely and comprehensive statistics, which would contribute
to the pursuit of sound macroeconomic policies, and help, contribute to the improved
functioning of financial markets (International Monetary Fund, 2012b).

In addition to the changes made by the IMF, the Basel Capital Accord, which was
passed in 1988, was amended once in 1995 and once in 1996. The Basel Capital Accord
was created to stabilize and strengthen the international banking system by harmonizing
national capital requirements for the largest international banks in G10 states to limit
credit risk. Assets were given a risk classification where riskier assets such as private
sector debt and real estate were assigned a higher risk weight and less risky assets, such
as OECD government debt, were assigned lower risk classifications. The largest banks in
G10 states were required to hold capital equal to eight percent of their risk weighted
assets as an added protection of the financial system (Basel Committee on Banking
Supervision, 1988). The Basel Capital Accord also attempted to prevent regulatory
competition between G10 states. Prior to the Basel Capital Accord, states with a lower
capital requirement had an unfair advantage over those states with a higher requirement,
because their banks were able to make more loans with the same amount of capital (Basel
Committee on Banking Supervision, 2009c).

The Basel Capital Accord was amended in 1994 and the amendment was
implemented at end 1995. This amendment recognized the effects of bilateral netting of
banks’ credit exposures in derivative products and expanded the matrix of add-on factors.
Essentially, this amendment recognized that a bank’s credit risk exposure was not
accurately measured when derivative products were bilaterally netted. Bilateral netting is
when two counterparties consolidate multiple derivative products into one master
agreement. This results in one net agreement between counterparties as opposed to many agreements, which results in multiple payments back and forth. While the add-on factors of the original Basel Capital Accord were designed to include capture the risk of currency and exchange-rate instruments, they did not accurately capture commodity and equity derivatives, which were a rapidly growing sector of the economy. The expanded matrix of add-ons allowed banks to more accurately measure the risk associated with derivative agreements that are bilaterally netted (Basel Committee on Banking Supervision, 1995).

The second amendment, known as the Market Risk Amendment, was issued in January 1996 and added a capital requirement for the market risks arising from banks’ open positions in foreign exchange, traded debt securities, equities, commodities and options (Basel Committee on Banking Supervision, 2009c).

In November of 1995 the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions wrote a joint report on how the potential risk and profitability of an institution is affected by trading derivatives. The report was intended for the G10 states and its recommendations followed two themes. The first theme was that institutions should enhance disclosures based on information derived from an institution’s internal risk measurement and management systems which was to allow financial statement users to accurately analyze a firm’s ability to successfully manage exposure to credit risk, market risk, liquidity risk, and the impact of trading and derivatives activities on earnings (International Organization of Securities Commission, 1996).

The second theme is that institutions should provide financial statement users with a precise description of their trading activities and overall involvement in the
derivatives markets, as well as the impact of these earnings. To obtain direction on properly disclosing information about their derivatives activities, institutions were encouraged to refer to the common minimum framework presented in the Supervisory Information Framework paper. The goal of disclosure about trading and derivatives activities was to ‘reinforce the efforts of supervisors to foster financial market stability in an environment of rapid innovation and growing complexity.’ The idea was that if investors had the proper information they would be able to assess the risk and make appropriate choices on their investments (International Organization of Securities Commission, 1996). This report was later endorsed in Lyon, France by the G7 heads of state in June of 1996.

*The G10 Report*

The G10 Ministers and Governors, commissioned by the G7 heads of state, wrote a detailed assessment of ways to handle sovereign liquidity crises in a 69 page report titled “The Resolution of Sovereign Liquidity Crises.” This report was a collaborative effort between deputies of the G10, the IMF, the OECD, a European Commission official, and four officials from the secretariat of the BIS and was a blueprint for how sovereign liquidity crises would be handled in the future (Baker A., 2006, p. 193). The report acknowledged and endorsed efforts to prevent sovereign liquidity crises as the first and most fundamental element in crisis management, but the report was focused on the resolution of sovereign debt crises in which money is borrowed from private creditors. The report had a number of broad conclusions. First, in a crisis, the terms and conditions of all debt contracts were to be met while preserving market discipline and only in exceptional circumstances where the debtor needs more time to develop a credible
adjustment plan could debt payments be temporarily suspended. Additionally, the report stated that neither debtor countries nor their creditors were to expect to be bailed out by official financing in the event of a crisis as the market should be equipped to assess the risks involved in lending to sovereign borrowers. The report also focused on using a flexible, case-by-case approach to deal with the crisis. The primary responsibility of working out the crisis was between the debtors and creditors with the debtor being responsible for creating a cooperative atmosphere (Group of Ten Deputies, 1996).

The report also identified the three main actors in financial crises: the official community, consisting of governments of creditor states and multilateral institutions, private creditors, and the sovereign debtor. The essential role of all three actors is to communicate effectively and cooperate to avoid any panic that could make the situation worse. These three actors were to work together to solve financial crises by three-way communication with the primary responsibility falling on the debtor to be honest with the other two parties about potential problems, involving the IMF actively and early, and adopting strong domestic measures to deal with the crisis. Creditors were also encouraged to work collectively in order to reach an orderly resolution of the crisis. The ultimate role of the IMF in these negotiations is to act as an advisor to both debtor and creditor states and the IMF is the institution that is best situated to evaluate the debtor’s ability to pay. The IMF must also make sure the stabilization package is sufficient to avoid moral hazard, yet still resolve the crisis. (Group of Ten Deputies, 1996, pp. 19-21).

The Lyon Summit

In June of 1996, the G7 heads of state met for their annual summit in Lyon, France. Strengthening the international financial system was one of many items on the
agenda. The economic communiqué echoed the changes from the IMF, BIS, G10, G7 finance ministers, and the IOSCO. The G7 heads of state also wanted the G7 finance ministers in consultation with the relevant institutions to report back at the next meeting on adopting stronger prudential standards and supervisory authorities in emerging economies. The G7 finance ministers echoed this sentiment in their report to the heads of state on international monetary stability, stating that emerging markets experiencing high growth and/or substantial financial flows need effective prudential standards and supervision. The finance ministers encouraged the Basle Committee and the IOSCO to cooperate with the emerging economies in applying their standards. Much more attention was focused on the developing world, WTO negotiations, and bringing states previously under the control of the former Soviet Union into the world system.

Post Lyon and Pre Denver

After the G7 summit in Lyon much of the international cooperation continued business as usual and most institutions were optimistic about the world economy as well as the prospects for growth in the following year. Multiple institutions, including the IMF, G10, BIS, WORLD BANK, OECD, and the G7 Finance Ministers and Central Bank Governors, acknowledged the increasing importance of emerging economies. At the spring meeting of the IMF and World Bank the growth of Asian states was lauded and the previously established General Data Dissemination System’s 42 subscribers (International Monetary Fund, 1997a).

During the same time as the IMF/World Bank meeting and with the recognition that emerging markets were becoming a more important factor in the world economy, the G10 Deputies unveiled a report titled “Financial Stability in Emerging Economies,”
which was requested from the heads of state at the Lyon summit. The G10 Deputies report was developed in coordination with representatives from a number of developed and emerging economies as well as representatives from the Basle Committee on Banking Supervision, the International Accounting Standards Committee (IASC) and the IOSCO and staff members of the BIS, the European Commission, the IMF, the OECD and the International Bank for Reconstruction and Development (Group of Ten Working Party on Financial Stability, 1997).

The G10 Ministers and Governors endorsed the report, which made recommendations for an international strategy to cooperatively strengthen financial systems. There were several recommendations for implementing such a system in the report, all of which were guided by three principles: Sound macroeconomic and structural policies are essential for financial system stability; individual states are ultimately responsible for the policies they choose to strengthen their financial systems; and the adherence to international prudential standards, open competition, proper transparency, and the reporting of accurate information in order to promote financial sector stability (Group of Ten Working Party on Financial Stability, 1997).

The strategy also included four major components: The development of an international consensus on the key elements of a sound financial and regulatory system by both G10 states and emerging market economies; the formulation, adoption, and implementation of sound principles and practices in key areas such as bank supervision and securities market oversight using international groupings such as the BIS and IOSCO; “the use of market channels to provide incentives for the adoption of sound supervisory systems, good corporate governance and other key elements of a robust
financial system;” and the promotion by international financial institutions and regulators for emerging economies adopt sound principles and practices (Group of Ten Finance Ministers and Central Bank Governors, 1997). Moreover, all the strategies proposed in the G10 report suggested international cooperation to strengthen the international financial system.

The Denver Summit

The G7 transformed into the G8 when they met in Denver in June of 1997 as Russia was now part of the summit. While lauding the growth of the global economy, they did acknowledge that some G7 states had challenges ahead of them and that the stability of the international financial system needed to continue to be strengthened. The G7 Finance Ministers submitted a report on promoting financial stability, which was endorsed by the Heads of State and outlined the steps that had been taken to strengthen the international financial system since the Lyon summit the previous June and what steps should be taken to further this progress. The report praised the efforts of international bodies such as the Basle Committee, IOSCO, and IAIS, which had increased their regulatory cooperation and information sharing and also endorsed necessary changes in laws or regulations to improve cooperation and information sharing while preserving the confidentiality of the information. The Finance Ministers also endorsed the G10 working party report on financial stability in emerging economies and the Basle Committee on Banking Supervision report entitled “Core Principles for Effective Banking Supervision,” which was developed in cooperation with 15 developing countries (Group of Seven Finance Ministers, 1997).
The report on Core Principles for Effective Banking Supervision was released in April of 1997, and a final version was submitted in September of the same year. The Basle report created guidelines for states to follow in order to run a successful banking sector and was supplemented with a Compendium containing more in depth guidance concerning supervision. The report cited twenty-five general principles that needed to be in place for an effective supervisory system, and they were to be implemented by national governments. These principles included licensing and structure, prudential regulations and requirements, information requirements, methods of ongoing banking supervision, formal powers of supervisors, and cross-border banking (Basel Committee on Banking Supervision, 1997).

Overall, the mood concerning the global economy and the prospects for continued growth throughout 1997 and into 1998 appeared to be positive. Just weeks after the Denver summit, amid the optimistic atmosphere, the Thai baht came under attack from speculators, triggering a financial crisis in Asia that would threaten not only the emerging economies in Asia, but the entire world financial system.

Conclusion The responses to the Mexican Crisis closely followed neoliberal dictates in three of the four areas of debate between neoliberals and liberal interventionists, which included austerity, transparency, and the promotion of capital flows with bailouts being more liberal interventionist overall. Mexico received a stabilization package (bailout) largely from the U.S. and the IMF, which was the largest arrangement to date at the time. This subsequently revealed that the IMF needed more funding to credibly handle such crises in the future; therefore the IMF approved the Emergency Financing Mechanism and increased quotas to boost funding, illustrating an acknowledgement of and a
commitment to future bailouts. The G10 report prior to the Lyon summit did state that bailouts should not be expected, but as the Asian and Subprime crises illustrate in the following chapters, this was merely lip service to the idea of limiting bailouts. One of the primary conditions for Mexico receiving the international stabilization package was that they implement fiscal and monetary austerity. This is what neoliberals recommend in times of economic downturn as they believe it will prevent the government’s debt from increasing, provide confidence to businesses, and allow the markets to recover from the downturn.

All calls for regulation were either calls for more transparency or regulation that increased the transparency of emerging market states’ financial positions. The IMF was to enhance this process through better monitoring and encouraging states to adhere to the SDDS to provide better, timelier information to market actors. The IMF and G7 also encouraged the continued liberalization of emerging economies capital accounts and promoted international capital flows despite their centrality to the crisis. The solution to preventing capital flows from destabilizing economies was to better monitor their activity so market actors would not be caught off guard.

The reforms in the midst of and following the Mexican Crisis followed neoliberal ideas that markets almost always work and that a lack of transparency led to the crisis. Capital flows, while they were acknowledged, were not seen as inherently negative. Increased surveillance and data reporting as well as transparency were believed to be able to effectively manage capital flows while helping to prevent such a crisis in the future. The simple explanation for the kinds of reforms that were enacted is that capital flows are good; states just need to make reforms to more effectively handle influxes of capital.
CHAPTER 5: THE ASIAN FINANCIAL CRISIS AND RESPONSE

On July 2, 1997, shortly after the G8 summit in Denver, the Thai baht was devalued triggering a series of crises in East Asia, which came to be known as the Asian Financial Crisis. This crisis was largely unexpected because the economies of East Asia that were hit were among the fastest growing and best performing in the world prior to the crisis.\(^8\) (Radelet & Sachs, 1998). The Asian financial crisis developed in waves beginning with currency runs and devaluations, which led to bank failures, austerity programs, bailouts, and debt restructuring. Finally, the crisis brought recession, increased unemployment and political upheaval to the East Asian region. While Asian states were the most affected, the Asian crisis also contributed to the Russian and Brazilian financial crises that followed shortly after. This chapter will focus on the states in East Asia that were most affected in 1997-98 and not the Russian and Brazilian crises.

The causes of the crisis were a combination of domestic and international factors that led to a reversal of inflows of foreign capital resulting in huge capital outflows in 1997, which evolved into a crisis that threatened the global economic system. While there are many causes of the crisis, many economists recognize that easily reversible capital flows into East Asia were the primary cause of the crisis in 1997-98 (Carney, 2009). It is estimated that net private inflows fell from positive $93 billion in 1996 to negative $12.1 billion in 1997, a $105 billion swing, which amounts to 11% of the most affected states $935 billion GDP. Of the $105 billion that was withdrawn, $77 billion was from commercial bank lending, $24 billion was from the withdrawal of portfolio equity, and $5 billion was from non-bank lending (Radelet & Sachs, 1998).

---

\(^8\) The states most affected by the crisis were Indonesia, South Korea, Malaysia, Philippines, and Thailand.
Causes of the Asian Crisis

While easily reversible capital flows are recognized as the main cause of the crisis, other weaknesses in the East Asian economies and the international financial architecture made these states vulnerable to the rapid reversal of international capital flows. (Lee 2000; Carney 2009; Radalet & Sachs 1998). Some studying the crisis have focused on the liberalization of domestic economies within a flawed policy framework, including poor regulation and exchange rate mismanagement as a primary cause of the crisis (Noble & Ravenhill, 2000). The explanation that has gained the most recognition is that of self-fulfilling creditor panic and weaknesses inherent to international financial markets (Radalet 2000, Krugman 2009, Radalet and Sachs 1998, Baig and Goldfajn1999). Finally, others assert that the crisis cannot be fully explained without examining the political climate and the confidence that market participants have in a government’s ability to ‘manage the economy at that time’ (Haggard, 2000, p. 220).

Weaknesses in Asian Domestic Economies and International Capital Markets

The weaknesses in the structures of Asian financial institutions have their origins in the liberal financial reforms undertaken in East Asian states in the 1980s and continued into the 1990s. These weaknesses can be thought of as by-products of East Asia’s success during the 1990s, which aided in attracting foreign investment during the same time period (Radalet & Sachs 1998, Radalet 1999). There were many domestic factors that attracted capital flows to East Asian states. First, sustained high economic growth, gave investors confidence in the region as a whole. Second, financial deregulation allowed for the banks and corporations to obtain capital easily from foreign sources, which contributed to a massive expansion of banking in the region. Third, the financial
deregulation was not complemented by proper supervision, allowing banks to take on massive foreign currency and maturity risks. Fourth, the pegged or semi-pegged exchange rates made investing in East Asia seem safe and stable. Finally, governments incentivized foreign borrowing by domestic banks by offering special tax breaks and lower reserve requirements on foreign currency deposits (Radalet & Sachs, 1998, p. 9).

Like Asian domestic capital markets, capital markets were liberalized in industrialized countries, allowing international flows of capital to be invested more easily in emerging markets that had liberalized their economies. The ability to move capital quickly was attractive for investors in the U.S., Japan, and Europe and made more capital readily accessible for East Asian banks (Radalet & Sachs, The Onset of the Asian Financial Crisis, p. 9). The liberalization of both the domestic financial systems and capital accounts left many economies vulnerable to a quick reversal of the capital that had been pouring into East Asia during the early 1990s. Ironically, it was the same reforms that attracted the inflows of foreign capital that created structural deficiencies that made East Asian states susceptible to a crisis (Radalet & Sachs, 1998, p. 9).

**Weaknesses in Asian Financial Institutions**

As East Asian states liberalized their economies, the reforms also included loosening the requirements to enter the financial services industry, allowing private banks to be opened. Banks were subsequently given more freedom in their lending decisions, which led to the development and evolution of bond and stock markets. While these reforms opened new opportunities for banks and lending institutions, they also created new problems. New institutions such as the Bangkok International Banking Facility (BIBF) were designed to provide ‘new financial services and attract investment, and were
actively encouraged to borrow offshore to fund their activities’ (Radalet, 1999). The
deregulation and new freedoms given to lending institutions in Asia created an
environment that encouraged banks to borrow heavily from foreign lenders to finance
their lending activities, which were largely invested in non-tradable good such as
construction and real estate. This led to a domestic lending boom financed by short-term
external debt. (Radalet, 1999, pp. 4-6). With many Asian banks financing several long-
term illiquid projects with short-term foreign deposits that could be withdrawn quickly,
the Asian financial sectors were left vulnerable to the reversal of capital flows should
investor sentiment sour.

Adding to the weaknesses in Asian economies, the liberalization of the financial
sector was not accompanied by the proper regulatory framework and supervision and
therefore resulted in fragmented regulation that covered one area but left other areas
exposed, creating loopholes which were exploited by firms. South Korea and Indonesia
provide examples of the lack of supervision and governance. Prudential regulations, such
as lending to affiliated companies, were routinely broken by state owned banks with no
penalty. (Lee 2000, p. 5; Radalet, 1999, p.5).

*Mismanagement of Exchange Rates*

Another weakness in the East Asian economies, which attracted foreign investors,
was the fact that nominal exchange rates of East Asian states were semi-pegged to the
U.S. dollar. Pegged exchange rates normally assure investors that exchange rates will be
predictable, but semi-pegged exchange rates can also leave a currency vulnerable to
speculative attacks if the financial system were to become illiquid as in the case of East
Asia in 1997-98 and Mexico in 1995. When the dollar appreciated via the yen, the
exchange rates of East Asian states also increased. Additionally, competition from China
and Mexico in export markets and the increase in capital flows made East Asian exports
less competitive as the value of their currencies increased. (Lee, 2000, p. 11). When
states such as Thailand, Indonesia, and South Korea used their foreign currency reserves
in 1997 to maintain their pegged exchange rates, the susceptibility to financial panic
increased as foreign reserves were drained (Radalet, 1999). This was much like Mexico’s
attempt to defend the peso in 1994, which was discussed in chapter 4.

Self–Fulfilling Financial Panic

The explanation that the East Asian financial crisis was the result of a self-
fulfilling panic has become one of the most popular explanations of the crisis. While
those arguing that a self-fulfilling financial panic was the primary cause of the Asian
financial crisis generally acknowledge the weaknesses of the East Asian economies, they
argue that the weaknesses weren’t severe enough to cause a crisis of the severity that was

As Thailand ran out of dollars to protect the baht they were forced to raise interest
rates to prevent a further slide of the currency. When Thailand abandoned efforts to
protect the baht from speculators, the currency plunged about 50% causing investors to
lose confidence in Thailand’s currency and overall economy. When this happened,
investors who held baht and owed debts in dollars now had about twice as much debt,
and investors who owed debts in Thai baht found those debts increasingly harder to
service due to the rising interest rates. This combination of high interest rates and
troubled bank balance sheets meant that banks could not lend money and companies
needed to stop spending money, which sent the economy into a recession. The result was
a positive feedback loop that reinforced the investors’ lack of confidence. This feedback loop eroded investor confidence and eventually resulted in a contagion that spread to the other East Asian economies (Krugman, 2009, pp. 88-91). Once this began, it was rational for investors to pull their investments from a state ahead of everyone else because those waiting until the end are likely to not get repaid on time (Radalet, 1999, p. 11).

The financial downturn that started in Thailand quickly spread to other East Asian states despite differing fundamentals of their economies. Thailand and Malaysia had been in trouble concerning their current account deficits whereas South Korea and Indonesia had more sound fundamentals, yet were both struck hard by the crisis. Indonesia was a particularly special case, because they were in relatively good shape compared to the rest of the region despite concerns over corruption, crony capitalism, under-supervised banks, growing short-term debt, and monopoly power. Indonesia’s current account deficit was only about 3.5 percent of GDP, exports grew by 10.4 percent in 1996, the budget had a surplus of 1 percent, credit expansion was less than other states in the region, they had experienced no major corporate bankruptcies, and commercial banks’ foreign liabilities were 5.6 percent of GDP, which was much less than other East Asian states (Radalet & Sachs, 1998, pp. 21-22). Despite these measures, Indonesia was one of the states hardest hit and within a few months was in worse shape than all of the other states of East Asia (Krugman, 2009, pp. 91-93).

There are two general reasons why the crisis spread to states whose economic houses appeared as if they were in better order than the rest of East Asia. First, the East Asian states bought and sold products from each other. Malaysia sells products to Thailand and Thailand sells products to Malaysia, so a slowdown in one economy can
trigger a slowdown in the other (Lee, 2000, pp. 11-12). Second, there were direct financial linkages between the states in East Asia. When flows of money entered the region, they tended to be funneled through “emerging market funds” that grouped all of the states in the region together. This connection combined with the fact that all of the Asian economies were linked together in the minds of investors as evidenced by “the Asian Miracle” rhetoric, led investors to view problems in one state as indicators of the other states in the region (Krugman, 2009, pp. 91-94).

**Political Factors**

Others argue that economic explanations tell only part of the story and that political factors were of substantial importance in explaining the causes and intensification of the Asian Financial Crisis. Haggard (2000) argues that political factors played an important role in causing the crisis as well as the nature of the governmental responses. Before the crisis, many Asian states favored government intervention in the economy, especially in the business and financial sectors, which created significant moral hazard in Thailand, Indonesia, South Korea, and Malaysia (Haggard, 2000). The connections between government, business, and finance allowed for poorly regulated and “captured” liberalization of the economies. Cronyism, corruption, and nepotism resulted because of the poor regulation and moral hazard that occurred due to the close ties of government, banking, and business (Haggard, 2000, p. 45).

In Thailand, the connections of banks to the government could determine whether or not the bank was propped up in times of distress. In Indonesia, Malaysia, and South Korea politicians used the banking system not only as a tool to make policy but also as a tool for political gain. Politicians in South Korea and Thailand were often dependent on
the private sector for political support, which left them open to influence from business. The close relationship between business and government, which was initially reassuring for investors, proved to be hazardous as the economies evolved and became more advanced. When economies develop, the return on capital falls over time and the political situations stabilizes; the efficient allocation of resources becomes more important to sustaining growth. (Haggard, 2000, p. 46).

This political factors explanation concedes that political uncertainty was not the trigger for the crisis, but rather a situation that enabled Asian economies to become vulnerable shocks. Haggard also argues that market participants’ reactions to the initial shock were influenced not only by market fundamentals, but also by their beliefs about a government’s ability to respond to the crisis. The initial shock in this case was the devaluation on the Thai baht. When investor confidence eventually waned, many flaws underlying the system such as cronyism, corruption, and nepotism were exposed (Haggard, 2000).

As the following section describes, the responses of governments when the crisis hit either calmed markets or intensified the crisis. Some domestic policy responses contributed to the deepening of the crisis and further panic, leading to an intense response from the international and regional levels in order to quell the crisis.

**Short-Term Responses to the Asian Financial Crisis**

In the wake of the Asian financial crisis, the international response took multiple forms. The International Monetary Fund (IMF) responded with massive bailouts and tough austerity measures that were looked upon unfavorably by the leadership and the populations of many of the East Asian states. Individual states such as Japan and China
attempted to provide aid to their neighbors and regional institutions such as the Asia-Pacific Economic Cooperation (APEC) and the Association of South-East Asian Nations (ASEAN) attempted regional coordination to quell the crisis (Cohn, 2012). Thailand, Indonesia, and South Korea all obtained loan packages from the IMF in order to help service their debt and avoid economic collapse. The IMF packages in 1997 for these three states totaled $35 billion in loans while the IMF helped to gain commitments totaling $77 billion from the Asian Development Bank, the World Bank, and state to state aid. Additionally, the IMF lent Indonesia $6.3 billion in 1998 (Asian Development Bank, 1999).

Thailand received help first as they went to the IMF for “technical assistance” when they could no longer continue to defend the baht from currency speculators. Despite asking the IMF for help on July 2, Thailand didn’t get a proposal from the IMF finished until August 11 and a final deal wasn’t agreed to until August 20, 1997. To help Thailand until the IMF package was finalized, the BIS provided a $3.3 billion bridging loan from the world’s central banks (The Financial Times, 1997b). The BIS loan was led by Japan, with support from the U.S. and European central bankers. The IMF-led international loan totaled $16.7 billion, with contributions from a number of Asian states and the IMF. Among the Asian states making contributions, Japan led the way and China pledging to help as well. (The Financial Times, 1997a). The IMF pledged $4 billion, the World Bank and Asian Development Bank pledged $2.7 billion, Japan contributed $4 billion, and other states gave $6.5 billion (Nanto, 1998).

In return for the international loan, Thailand agreed that the loan money would be used to “shore up foreign reserves, cover a potential balance of payments shortfall, and
help restructure the financial system.” Thailand’s government also pledged to stop providing unlimited liquidity support for financial institutions that were trouble. As part of Thailand’s financial sector restructuring, they were to identify and close failing financial institutions, help weak banks and recapitalize the banking system, which included allowing foreign capital injection and the encouragement of mergers (International Monetary Fund, 1997d). Thailand also made cuts to education and infrastructure as well as raising the value-added tax in their attempts to balance the government budget (Bardacke, 1997).

As the negotiations for the IMF bailout of Thailand transpired, the Indonesian rupiah came under extreme pressure, forcing Indonesia to abandon their use of an exchange rate band. The Indonesian rupiah as well as the Philippine peso and the Malaysian ringgit all continued to fall through the month of September and on October 8, 1997 Indonesia officially went to the IMF for assistance as the rupiah had lost over 40% of its value since August (The Financial Times, 1997e). Indonesia’s position before the crisis had left them vulnerable to external developments. There were a number of structural weaknesses such as domestic trade regulations and various import monopolies that prevented efficiency and competitiveness. The lack of transparency in government decisions increased uncertainty and a weak banking system that relied heavily on foreign loans to finance domestic projects left Indonesia susceptible to the shift in market sentiment. On November 5 the IMF announced a stabilization package for Indonesia for around $40 billion, which included $11.2 billion from the IMF, $10 billion from the World Bank, and $21.1 billion in bilateral deals from the US, Japan, Singapore, China, Australia, Malaysia, and Hong Kong (fas.org, 1998).
In return for the package, Indonesia was to impose strict monetary policy in order to stabilize financial conditions and reduce the current account deficit in addition to maintaining the budget surplus. The IMF also required Indonesia to tighten its fiscal policy. This included postponing or rescheduling large state infrastructure projects and raising revenues through increased excise taxes, removing tax exemptions and increasing non-tax revenues. The financial sector of Indonesia was also required to restructure by closing unviable banks, repairing weak banks, strengthening regulations, and enacting stronger laws with better enforcement. Furthermore, Indonesia was to end government guarantees of private nonfinancial companies, both foreign and domestic. There was also to be the reduction of tariff barriers in certain sectors, enhanced domestic competition through deregulation and privatization and the phasing out of import and marketing monopolies as well as price restrictions (International Monetary Fund, 1997c).

Shortly after the Indonesians went to the IMF for help in the beginning of November 1997, the Hong Kong dollar came under a speculative attack, which led the Hong Kong government to act in its defense and sending their stock market falling as well as many other stock markets around the world, including the Dow Jones Industrial. The South Korean won also came under speculative pressure beginning in October and the won hit a record low at the time of 1,012.80 to the US dollar on November 19 (Burton, 1997d). The speculation on the won added to South Korea’s woes as a number of their chaebols had moved into bankruptcy in 1997. Linked with overinvestment in sectors such as steel and automobiles, the regional economic downturn produced serious negative consequences for the profitability of these sectors. The chaebol bankruptcies damaged the financial sector considerably, sending nonperforming loans soaring to 7.5%
of GDP. This combined with the sharp drop in stock prices led to a decrease of banks’
equity, which further reduced their net worth (International Monetary Fund, 1997b).

Additional problems with passing financial reform in attempts to correct
weaknesses in the banking system and weak prudential regulation only exacerbated the
uncertainty in Korea (Haggard, 2000, pp. 58-59). Eventually, South Korea was forced to
float their currency and approached the IMF for assistance on November 21. The initial
package sought was for $20 billion from the IMF, but no final deal had yet been reached
(Burton, 1997b).

Further pressure was placed on the entire region in November of 1997 as the
Japanese brokerage firm Sanyo Securities collapsed. Yamaichi Securities, the fourth
largest Japanese brokerage firm, and Hokkaido Takushoku, Japan’s tenth largest bank,
also collapsed in November of 1997. Japanese banks were the largest lenders to
Thailand, Indonesia, and Hong Kong; consequently their difficulties exacerbated
problems in Japan’s banking sector and sent the Nikkei falling, blaming uncertainty in
financial markets. In order to regain confidence in the Japanese banking sector, the
Japanese minister of finance and Ryutaro Hashimoto, the Japanese prime minister,
announced that the government would use public funds to support the financial sector
(The Financial Times, 1997c).

While South Korea and other Asian states were undergoing severe stresses on
their economies, the Finance and Central Bank Deputies from fourteen Asian and Pacific
states9 with representatives from the IMF, World Bank, and Asian Development Bank

---

9 The states with representatives present were Australia, Brunei Darussalam, Canada, People's Republic of
China, Hong Kong SAR of China, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines,
Singapore, Thailand and the United States (Ministry of Finance Japan, 1997)
met in Manila, Philippines on November 18-19. The meeting was called to discuss ways to improve regional cooperation in the wake of the financial turmoil engulfing Asia. This meeting ultimately set the groundwork for future cooperation as those in attendance agreed to four primary components of the Manila Framework. First, there was to be the development of a regional surveillance mechanism, which would act as a complement to the IMF’s global surveillance. Next, states agreed to improve economic and technical cooperation with a specific emphasis on strengthening domestic financial systems and regulatory capacities. Third, it was agreed that the IMF should increase its ability to respond to financial crises through increasing state quotas and creating a new mechanism to provide states with short term financing should a state be subject to large capital outflows. Finally, it was suggested that a cooperative financing arrangement specific to the Asian region be created to supplement the IMF’s funds (Ministry of Finance Japan, 1997).

Shortly after the meeting of Finance and Central Bank Deputies in Manila, leaders from the 18 nation Asia-Pacific Economic Cooperation (APEC) Forum met for their annual summit in Vancouver Canada from November 21-25. The 1997 agenda was largely focused on developing a plan to alleviate some of the recent stress placed on troubled East Asian economies. The leaders were hoping to build on the “Manila Framework,” which was drawn up by officials from Asian states, the US, Canada, and the IMF the week before the Vancouver APEC summit.

The idea most hotly debated by officials in the pre-Vancouver meetings was the creation of a fund, similar to the IMF, to help Asian states that were struggling with currency and balance of payments issues. The creation of an “Asian monetary fund” was
dismissed at the Vancouver APEC meeting. The Manila Framework, which was a plan designed to restore confidence in Asian markets, was endorsed in Vancouver at the APEC summit (Baker & de Jonquie'res, 1997). The Manila Framework included the assertion that the IMF was to remain the primary institution in the international monetary system and that its capacities for responding to and preventing crises should be expanded through increased surveillance and regulatory capacities. It was also agreed that there would be a financing arrangement for Asia that would supplement the IMF (Asian Finance and Central Bank Deputies, 1997).

Following the APEC meeting in Vancouver, on December 4, the IMF and South Korea agreed to a $57 billion support package. South Korea’s support package consisted of $21 billion provided by the IMF, the World Bank contributed $10 billion, the Asian Development Bank added $4 billion, Japan contributed $10 billion, the US gave $5 billion, and the rest of the package was covered by Italy, Canada, Australia, France, Germany, and the UK (fas.org, 1998). The conditions placed on South Korea for their support package included exercising a tight fiscal policy that included budget cuts, tax increases, a balanced budget as well as a tight monetary policy, reducing their current account deficit to 1 percent of GDP, and the maintenance of a flexible exchange rate. The financial sector was also to be restructured giving more independence to the central bank. There were also proposals to reform the government’s supervision of the financial sector, which would be passed by parliament by the end of the year.

Furthermore, South Korea promised to allow competition from foreign banks, allowing foreigners to create bank subsidiaries and brokerage firms by mid-1998 as well as opening the corporate bond market to foreign investment and eliminating trade
barriers. Finally, the cross-debt guarantee between chaebol subsidiaries was lowered and the government was banned from helping troubled groups through subsidies or tax breaks (Burton, 1997e).

Initially, markets responded positively to the South Korean IMF deal but with collapse of the Halla engineering conglomerate and Coryo Securities in early December, further concerns about the health of Korea’s financial sector were revealed. In the week following the South Korean agreement, which was the largest bailout ever, South Korea admitted their short term debt was over $100 billion, which the $57 billion loan would not be able to adequately cover, the won fell an additional 30 percent against the dollar and corporate bond yields increased almost 5 percentage points. Both the Seoul Bank and Korea First Bank were heavily exposed to Halla’s debt and on December 9, 1997 the South Korean government injected a total of $2 billion into the failing banks and also maintained control of Kia motors. These actions were contradictory the IMF’s recommendation to close both banks, which were part of the terms of the $57 billion rescue package, but the South Korean Government claimed their actions were to help the banks meet reserve requirements and was afraid that their failure would lead to further tightening of credit for corporations and could potentially lead to a run on deposits (Burton, 1997a).

Adding to the fears of investors was the impending presidential election in South Korea as the presidential candidates blamed outsiders for their economic woes (Burton, 1997c). Kim Dae-jung won the South Korean election in December and quickly said that he would implement the strong terms of the IMF’s austerity measures, which was a reversal of his rhetoric during his campaigns. However, many of Mr. Kim’s remarks
about the severity of the financial situation after winning the presidency did not help the
delicate situation. The markets continued to respond negatively to Mr. Kim’s rhetoric and
the uncertainty in South Korea throughout the month of December as the won continued
to fall and many investors were worried of a potential government default.

As the turmoil in Korea continued into late December of 1997 and fears of a total
economic meltdown emerged, the World Bank announced a new loan of $3 billion and
the Asian Development Bank approved a $2 billion loan on December 23. That same day
Standard & Poor’s cut South Korea’s foreign currency rating from BBB minus to B+
(Luce, 1997). On Christmas Eve the South Koreans were granted a second loan worth
$10bn from the IMF and Japan, the U.S., and 11 other states in return for a more concrete
schedule of reforms and the near complete abolishment of restrictions on foreign
investment in the financial and banking sectors (The Financial Times, 1997d).

The details of the conditions imposed by the IMF in the new bailout included the
central bank raising the rate at which commercial banks borrow dollars, the raising of
interest rates, removing all capital account restrictions, labor reforms, and the creation of
an independent central bank and regulatory body (The Financial Times, 1997f). The
newly implemented Supplemental Reserve Facility (SRF) of the IMF, which was
approved on December 17, was also used for the first time. The SRF was designed to
provide short-term liquidity to alleviate pressure on a state’s capital account and currency
reserves in the event of a sudden loss of market confidence (International Monetary Fund,
1997e). South Korea would negotiate a deal with international banks to roll over short
term debt in early January, 1998, which allowed them to begin negotiations with
international banks to finalize a deal to alleviate the nearly $25 billion in short term debt
(Waters, 1998). The deal was struck at the end of January when South Korea agreed to exchange short-term foreign currency loans made to Korean banks for new loans that were guaranteed by the state. Finally, South Korea closed ten of its merchant banks that were failing in their first attempt to restructure the financial industry.

Indonesia, who was given international loans worth $40 billion, had more trouble in January of 1998 as the budget released by the Indonesian government did not meet the IMF prescribed targets, which sent the rupiah falling to an all-time low against the dollar. The economic and political uncertainty caused by President Suharto’s lack of cooperation in adhering to IMF conditions forced Indonesia and the IMF to sign another agreement in mid-January that included swifter reforms. Indonesia’s troubles would continue through 1998 and into 1999 as the unwillingness of Indonesia to implement the reforms recommended by the IMF led to delays in the dispersal of funds and to subsequent renegotiations of the bailout packages.

In February, protests began as a response to the collapse of the economy as many were calling for the resignation of President Suharto or in some cases changes to the constitution and democratization. The increased protests in the spring of 1998 led to even more market turbulence and uncertainty as Suharto tried again to negotiate with the IMF. The protests continued into the spring and intensified after four students were killed outside Triskati University. The intensification of the protests and eventual riots in the wake of the killings ultimately led to Suharto’s resignation in mid-May and another delay in the disbursement of IMF funds to Indonesia (Haggard, 2000, pp. 115-117). Indonesia would renegotiate the terms of their deal once more on June 25, but political instability continued to plague Indonesia from making a solid recovery from the crisis.
As was demonstrated in this section, the international response during and after the Asian crisis involved three levels of assistance: state-to-state, regional, and international. The state-to-state and regional assistance tended to be the more immediate response as the most adversely affected states provided aid first in hopes of suppressing the crisis and preventing it from spreading, while the international response more time to materialize. Internationally, the IMF was the primary body responsible for organizing the aid to East Asian states, which was extended after states agreed to the conditions imposed by the IMF. After the initial response, reforms to the international financial architecture and regulatory framework were undertaken in the hopes of staving off future crises, which will be described in the next section.

Long-Term Responses: Between Asia and the Sub-Prime Crisis (1998 – 2008)

As the Asian Financial Crisis began to subside, those in regulatory and policy-making positions regarding the international economy began discussions regarding the causes and lessons from the Asian Financial Crisis. One of the larger issues that policy makers focused on was the strengthening of the global financial architecture, which began in the wake of the Mexican crisis and continued through the Asian crisis. While the attention given to reforming the international financial architecture abated during the Asian crisis, discussions intensified as the Asian crisis slowed. Because the main states involved in the Asian crisis were emerging economies, this is also the time period when talk of expanding the G7/8 becomes very important and ultimately culminated in the creation of the G20 in 1999.
IMF and World Bank Spring Conference

In the run up to the Birmingham G8 summit in May of 1998 the IMF and World Bank held their spring conference. Here, the policy recommendations for Asian states to move forward were discussed as well as the strengthening of the architecture of the international financial system. In the Communiqué of the IMF as well as the G7 Finance Ministers and Central Bank Governors, there were general recommendations to take several steps to take in order to prevent, manage, and resolve crises.

The first of these recommendations included “strengthening international and domestic financial systems by developing supervisory and regulatory frameworks consistent with internationally accepted practices and strengthened standards for bank and non-bank financial entities” (International Monetary Fund, 1998a). The Interim Committee noted the progress made in this area with the development of the Basle Committee’s Core Principles for strengthening banking regulation and supervision. The Basle Committee asked the IMF to assist in the distribution of these principles to its member countries and asked for them to develop incentives for their member countries to adopt the principles (International Monetary Fund, 1998a).

The Basle Committee’s Core Principles were comprised of twenty-five basic principles that should be implemented for a nation’s banking supervisory system to be effective. Essentially, the Core Principles are general guidelines for individual states to follow. The Core Principles fell into seven areas of regulation. These areas included: (1)

---

10 The BIS’s core principles for strengthening banking regulation and supervision were developed in cooperation with supervisory committees from fifteen emerging market countries as well as other supervisory committees around the world. The principles cover preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking (Bank for International Settlements, 1997).
Preconditions for effective banking supervision; (2) Licensing and Structure; (3) Prudential regulations and requirements; (4) Methods of ongoing banking supervision; (5) Information requirements; (6) Formal powers of supervision; and (7) Cross-border banking. The principles did not specify the precise manner in which they are to be implemented, but rather that each individual state is responsible for the details of their implementation (Bank for International Settlements, 1997, pp. 1-3).

Within each category of regulation were a number of more specific principles related to that category. For example, under “Information Requirements,” Principle 21 states that

Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Directly following the principle is a brief description of the reasoning for the principle. The reasoning for Principle 21 was “For banking supervisors to conduct effective off-site supervision of banks…they must receive financial information at regular intervals and this information must be verified periodically through on-site examinations or external audits” (Bank for International Settlements, 1997, pp. 35-37). The other components of Principle 21 include a number of brief descriptions and reasoning for requiring standards for information regarding accounting standards, the scope and frequency of the reporting, confirmation that the information which is submitted is
accurate, the confidentiality of supervisory information, and public disclosure of information regarding banking activities (Bank for International Settlements, 1997, pp. 36-37).

Core Principle 11 provides another example, stating “Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks” (Bank for International Settlements, 1997, p. 27). Unlike Principle 21, where a brief description and reasoning for the principle is given directly following the principle, the information given about Principle 11 is the principle alone. There were no sections following this, which give clarification on how to control for country and transfer risk. The Core Principles was a mix of these two types of descriptions, with the majority of principles being described in the same manner as Principle 21 and fewer including less of a description as seen with Principle 11.

The IMF also recommended increased IMF surveillance, which included greater scrutiny of financial sector issues and capital flows. This also involved giving more attention to policy interdependence and risks of contagion and asking the Executive Board to explore potential strategies to better monitor capital flows. The next recommendation was greater transparency of economic data and policies, in which it was agreed that the IMF should expand the Special Data Dissemination Standard (SDDS) to cover more financial data such as net reserves, debt, and other indicators of the stability of the financial sector. The IMF also asked for more members to fully implement the SDDS. The communiqué also states that given the important role it played in responding
to the Asian Crisis, the IMF should continue to play a central role in crisis management. However, it was acknowledged that its main role should be exercised through its conditionality in supporting necessary reforms, and not by financing every balance of payments deficit.

The final recommendation of the Interim Committee was to enact more effective measures for including the private sector in averting or resolving financial crises. This included holding creditors accountable for their decisions and involving them in the crisis resolution process at an early stage in order to make burden sharing between the private and official sectors more equal and to limit moral hazard. Incentives to limit excessive risk-taking by both creditors and investors were discussed but were not enacted by the Interim Committee (International Monetary Fund, 1998a).

The IMF also released their “Code of Good Practices on Fiscal Transparency” and encouraged member countries to adhere to the principles. It was believed that the “Code of Good Practices on Fiscal Transparency” would lead to better-informed public debate about the design and outcomes of fiscal policy, hold governments accountable for their fiscal policy, and enhance the credibility and public understanding of macroeconomic policies and decisions. The code was based on a number of principles and objectives. The objectives included that the roles and responsibilities in government should be clear; information on government activities should be provided to the public; budget preparation, execution, and reporting should be undertaken in an open manner; and fiscal information should be subjected to independent assurances of integrity (International Monetary Fund, 1998a).
The principles lacked specific details, much like the Core Principles for Banking Supervision mentioned earlier. The Principles on Fiscal Transparency included statements such as “A public commitment should be made to the timely publication of fiscal information” and “Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability” and “A public commitment should be made to the timely publication of fiscal information (International Monetary Fund, 1998a). A few weeks later, in London, the G7 Finance Ministers released a report after their meetings which echoed the sentiments from the IMF/World Bank meetings and were preparing proposals to present to the heads of state at the Birmingham G7 summit (Group of Seven Finance Ministers, 1998a).

**The Birmingham Summit 1998**

The leaders at the Birmingham summit discussed many issues pertaining to the global financial system. The G7 Finance Ministers presented the Heads of State with their reports on strengthening the global financial architecture and the principles for international financial information exchange. The report of the ten key principles for international financial information exchange was presented to the Heads of state in response to the Asian crisis and as stated in the press release the “recent events in Asia have highlighted the need for such cooperation and emphasized its urgency” (Group of Seven Heads of State, 1998). The report highlighted a belief in the importance of information sharing to prevent crises such as the one in Asia. The Ten Key Principles were (1) authorization to share supervisory information with foreign supervisors; (2) the sharing of information by supervisors from different sectors of financial services; (3) cooperation in identifying and monitoring the use of management and information
systems, and controls, by internationally active firms; (4) the sharing of objective information of supervisory interest about individuals such as owners, shareholders, directors, managers or employees of supervised firms; (5) information sharing between exchanges; (6) confidentiality of shared information; (7) the use of formal agreements and written requests for information exchange; (8) reciprocity requirements; (9) the use of information for law enforcement in cases which further supervisory purposes; and (10) the removal of laws preventing supervisory information exchange. The G8 Ministers believed that all states should aim to meet these principles and they should be promoted around the world (Group of Seven Finance Ministers, 1998c).

The G7 Finance Ministers submitted a report titled “Strengthening the Architecture of the Global Financial System” to the G8 Heads of State. The report was largely a disappointment given the fervor surrounding reform following the Asian Crisis. The Finance Ministers report acknowledged the areas of the global financial architecture that need reformed or improved in order to prevent another Asian type crisis but offered little in the way of specific solutions. Outside of a short list of specific recommendations or statements praising the creation of new standards, codes, or principles much of the language was very vague and generally amounted to statements urging new reforms or standards that did not currently exist to be developed.

The G7 report built on work performed in the previous four years and was claimed to represent the “emerging consensus” of proposed changes to be implemented in global financial architecture. The report stated a number of objectives clarifying the purpose of the report, such as aiding in the creation of large, robust financial systems that could withstand periodic failures and contain risks that posed a systemic threat. The
report also emphasized that all borrowers and lenders should be held accountable for their actions, whether they were governments, individuals, or companies. It was stressed that the suggested changes should not undermine individual countries’ implementation of “sound economic policies that promote sustainable broad based non-inflationary growth.” These policies were referred to as “the most important single contribution to avoiding a crisis,” but the exact nature of these policies was not elaborated on (Group of Seven Finance Ministers, 1998b).

The Asian crisis made the calls for reform more urgent; especially in the areas of crisis prevention and the management of crises should they occur. The report echoed the sentiments expressed at the April IMF/World Bank meetings, concluding that there were five key areas that needed immediate action. These areas included (1) enhanced transparency, (2) helping states prepare for integration into the global economy and for free capital flows, (3) strengthening national financial systems, (4) placing responsibility on the private sector for their lending decisions, and (5) further enhancing the role of International Financial Institutions as well as the cooperation between them. (Group of Seven Finance Ministers, 1998b).

The areas of the report with more specific policy recommendations were transparency, strengthening national financial systems and corporate governance, and enhancing further the role of the International Financial Institutions as well as cooperation between them. Regarding enhanced transparency, the report emphasized the belief that accurate and timely data would enhance economic management, investors’ risk assessment, market stability, and effective surveillance. The BIS was given the directive of taking the lead in collecting and publishing data quickly regarding the level of external
bank exposure while also improving the quality of that data by working with national authorities (Group of Seven Finance Ministers, 1998b).

The report also encouraged the IMF to urge its member countries to provide transparent data and to subscribe to the SDDS, which was enacted in 1996. Additionally, the report commended the work the IMF was performing in trying to update the SDDS to encompass internationally comparable measures of reserves, the external exposure of financial sectors, and indicators of financial sector stability. The IMF was also given the responsibility to find the best method for improving the quality of data on the external debt of the corporate sector and to ensure the member countries adhered to the standards and fully implemented them while publicizing failures to meet the standards (Group of Seven Finance Ministers, 1998b).

The G7 report specifically welcomed the IMF’s Code of Good Practices on Fiscal Transparency, which was described earlier, and encouraged the IMF to work on such a code for monetary policy. Greater transparency of International Financial Institutions was also recommended by the report, specifically through the timely release of Press Information Releases (PINS) and was seen as increasing trust in such institutions (Group of Seven Finance Ministers, 1998b).

Many of the statements included by the Finance Ministers concerning help to states preparing for free capital flows were unclear at best. The report acknowledged that the Asian crisis revealed that states with weak fundamentals, including weak financial systems, can quickly be exposed by global capital markets, but did not specify what was meant by weak fundamentals or weak financial systems. The advice from the Finance Ministers was for states to seek advice from the IMF on how to liberalize their capital
account in an orderly fashion as correctly managing the liberalization process was viewed as essential to maintaining stability during the process. Also vital to the liberalization process was ensuring the proper regulatory framework as well as sound macroeconomic policies were in place. In addition to seeking advice from the IMF, the IMF was recommended to be the organization able to best monitor states’ vulnerability to capital flows. The IMF was also encouraged to cooperate with the World Bank, BIS and Organization for Economic Cooperation and Development (OECD) in order to regularly collect more data on the levels of external debt (Group of Seven Finance Ministers, 1998b).

The section on strengthening national finance systems and corporate governance recommended implementing the Basle Committee’s core principles for banking supervision. The report also urged proper information disclosure and emphasized that specific reforms be put in place at the national level in accordance with international institutions such as the IMF and BIS. This included statements such as “Supervisors, cooperating at Basle and elsewhere, should work to encourage private sector financial institutions to adopt better systems in private sector financial institutions for country risk assessment” (Group of Seven Finance Ministers, 1998b).

The part of the report concerning burden sharing by the private sector and moral hazard focused on the need for the private sector to be held responsible for risks they take when making loans, that they are involved in crisis resolution, and that the private sector bears the costs and rewards of their lending decisions. The Finance Ministers report emphasized the need use caution in the event of a crisis and avoid implicitly insuring the debts of the private sector. The Finance Ministers report also stated that national policy
should bear responsibility for creating the proper incentives for the private sector. This included introducing effective bankruptcy laws; by making explicit and creating financially viable deposit insurance systems; and by ensuring that lender of last resort assistance in domestic currency is used only when illiquid institutions pose a systemic risk. The report argued that the implementation of these recommendations in conjunction with enhanced prudential supervision would send accurate signals to the private sector (Group of Seven Finance Ministers, 1998b).

Finally, the issues of resources and financing were discussed. Due to the scale of the Asian crisis and the level of financial commitments from the IMF, it was argued that there was a need for the New Arrangements to Borrow (NAB) to be brought into effect as soon as possible in order to ensure the IMF has sufficient funds to respond in the future (Group of Seven Finance Ministers, 1998b).

Between Birmingham and Cologne

Developments in reforming the international financial architecture following the Birmingham summit proceeded along the path of the Birmingham summit, promoting more transparency and better and timelier information reporting in order for markets to function properly. Following the Birmingham summit, the G7 Finance Ministers as well as other international bodies continued work on reforming the global financial architecture. At the annual IMF/World Bank meeting in October of 1998, the views of the report on strengthening the global financial architecture were echoed, but less than a month later at the G7 Finance Ministers’ meeting there was agreement on the implementation of a small number of the recommendations from the past year. The reforms continued to be focused on the five key areas addressed in the report at the
Birmingham summit\textsuperscript{11} and the Finance Ministers agreed to comply with the IMF’s Code of Good Practices and Fiscal Transparency and the internationally agreed Code of Conduct on Monetary and Fiscal Policy despite the latter having not yet been completed. One specific recommendation was for the private sector to assist in the use of “collective action clauses,” which allow a supermajority of bondholders to negotiate a debt restructuring that all bondholders must legally abide by (Group of Seven Finance Ministers and Central Bank Governors, 1998). Much of the document contained the same vague language that was witnessed in the G7 Finance Ministers’ report on the global financial architecture during the Birmingham summit.

The IMF made a number of changes between Birmingham and Cologne. In November of 1998 the New Arrangements to Borrow (NAB) became effective, which enabled the IMF to receive more funding from the 25 member countries at the time. The NAB combines with the General Arrangements to Borrow (GAB) to double the amount of resources available to the IMF to address balance of payments difficulties and potential systemic threats (International Monetary Fund, 1998b). In March of 1999 the IMF Executive Board approved the expansion of the SDDS to include more comprehensive and expedient reporting of data concerning states’ international reserve positions (Group of Seven Finance Ministers, 1999). At the recommendation of Hans Tietmeyer, the Deutsche Bundesbank President, the IMF created Financial Stability Forum (FSF), which met for the first time in April of 1999. The FSF’s purpose was to promote stability in the international financial system by improving international

\textsuperscript{11} These areas were (1) enhanced transparency, (2) helping countries prepare for integration into the global economy and for free capital flows, (3) strengthening national financial systems, (4) placing responsibility on the private sector for their lending decisions, and (5) further enhancing the role of International Financial Institutions as well as the cooperation between them.
cooperation and coordination by bringing national and international supervisory bodies together as well as international financial institutions (Financial Stability Board, 2012a).

The Cologne Summit

Discussions for strengthening the international financial architecture at the Cologne Summit built upon the statements made by the G8 on the world economy the previous October. The statement concerning the economy from the Heads of State and the statement from the Finance Ministers welcomed the changes from the IMF mentioned above and offered action in a number of familiar areas. Both reports emphasized enhancing the IMF’s surveillance and transparency and expected the IMF to continue to play an important role in financial crisis resolution. Enhancing transparency and promoting best practices was also focused on. The Finance Ministers and Heads of State asked that codes of transparency and standards of best practice be completed by the international financial institutions responsible for their development and that they be implemented as soon as possible. This included such codes and standards as the Core Principles for Banking Supervision as well as the IMF’s Code of Good Practices on Fiscal Transparency, which were discussed earlier.

The next area of concern was how to strengthen the financial regulations of industrialized states. The Finance Ministers and Heads of State encouraged action to ensure that investors and creditors were acting prudent in assessing their risks properly and to limit excessive leveraging. This included enacting the proposed modifications to the Basle Accord, which added the risk involved in lending to emerging markets as well as short-term lending to their risk assessments in order to make the accords more sensitive to risk (Group of Seven Finance Ministers, 1999).
With the Asian Crisis involving a number of emerging economies, the G8 urged emerging economies to strengthen their macroeconomic policies and overall financial systems. This was to be accomplished by focusing on ending their reliance on excessive short-term borrowing and that “capital account liberalization should be carried out in a careful and well sequenced manner, accompanied by a sound and well-regulated financial sector and by a consistent policy framework” (Group of Seven Finance Ministers, 1999).

It was agreed that the governments of emerging economies should be primarily responsible for strengthening their economies and in order to accomplish this should seek advice and technical assistance from IFI’s on the best potential policies and standards to implement (Group of Seven Finance Ministers, 1999).

After the 1999 summit in Cologne the focus of economic cooperation shifted to the G20 as more emerging markets became involved in international negotiations. The G8 continued to meet, but with more of a focus on issues such as the environment, terrorism, and energy. After the attacks of September 11, 2001 there was also greater emphasis on stopping the financing of terrorists through international banks and less of a focus on devising new reforms for the international financial architecture, which had begun in the 1990s. Other concerns revolved around development of poorer nations and the rising oil prices in the mid-2000s. The overarching themes found in the G8 and G20 reports and communiqués revolved around economic development and alleviating poverty which largely remained unchanged throughout the 2000s and in the lead up to the Subprime Crisis in 2007-08.
A key development concerning finance between the Asian and Subprime crises was Basel II. The Basel Committee began its review of the original Basel Capital Accords in 1998 after it became apparent that the original accords had fallen behind the times as new financial instruments and more complex products presented new risks that were not accurately captured by Basel I. The Basel Accords were voluntary and only applied to internationally active financial institutions. Many of these banks were finding ways to appear as if they were lowering exposure to risk without actually doing so, which created incentives to engage in regulatory arbitrage. Work on Basel II continued throughout the 2000s and after five years of impact studies, input from the banking industry, and negotiations a new capital adequacy framework was developed (Lall, 2009, p. 6). The Basel II framework was completed in 2004 but wasn’t implemented in many G10 states until 2007 or 2008, and in the U.S. in 2009 (Council of Mortgage Lenders, 2010).

In the 2004 revised framework, the main objective of Basel II is described as revising “the 1988 Accord…to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks” (Basel Committee on Banking Supervision, 2004). Other objectives included “providing incentives to adopt more advanced risk-sensitive approaches of the revised framework and paying due regard to particular features of the present supervisory and accounting systems in individual member countries” (Lall, 2009, p. 8).
The Basel II Accord was founded on three pillars, with most of the attention given to pillar one. The pillars of the new accord were (1) new minimum capital requirements, (2) a new supervisory review process, and (3) market discipline (Basel Committee on Banking Supervision, 1999). Basel II was intended to increase risk sensitivity in order to give banks a better way to measure more types of risk, which would give banks access to better information and the ability to make better decisions. Three types of risk are captured in the first pillar of Basel II.

The first is credit risk, which banks were encouraged to use the “advanced internal ratings-based” (A-IRB) approach to estimate. This allowed banks to create and use their own models to estimate parts of their risk (Lall, 2009, p. 6). Other modes of assessing risk such as the Standardized Approach, which allows use of ratings of credit rating agencies, were available, but the A-IRB approach was recommended. Pillar one also addressed operational risk, which is the risk posed by the internal workings of a bank. Operational risk also has multiple models a bank may choose from to measure. The final type of risk covered in the first pillar is market risk, which is the risk associated with losses due to price changes, interest rate and equity prices (Ahmed & Khalidi, 2007, p. 14).

Pillar two was expected to detect risk factors not encompassed by the first pillar and to provide the information necessary for banks to adjust their capital requirement accordingly. This forced banks to analyze a host of risk factors that might not be included in their models for the first pillar such as interest rate risk, credit risk, operational risk, and securitization. In implementing ways to measure the risk posed by these other factors banks were encouraged to use mathematical models to estimate their “value-at-risk,”
which is the “probability that the value of a given portfolio will decline by more than a
certain amount within a specific time horizon” (Lall, 2009, p. 7) Another issue with the
“value-at-risk” models was that banks were encouraged to develop their own models to
assess their own risk (Crotty, 2009, p. 571). The idea was that banks knew their risks
better than anyone outside their institution; therefore allowing self-regulation would
produce more accurate and efficient risk models.

Pillar III is designed to complement pillars I and II by improving disclosure and
transparency through the strengthening of banks’ financial reporting systems. By
allowing important stakeholders to analyze key pieces of information with regards to “the
scope of application, capital risk exposures, risk assessment processes, and capital
adequacy of the institution” market discipline was encouraged. By adding market
pressures to the equation, Pillar III supplemented and reinforced the first two pillars by
promoting “better risk management and adequate levels of capital in the banks and keep
key stakeholders fully informed about the risk profile of banks and enables them to take
prudent decisions while transacting business with them” (Ahmed & Khalidi, 2007, p. 15).

While Basel II attempted to fix the holes that had developed in the original
framework by increasing risk sensitivity, the Basel II framework would need to be
revised again after the Subprime Crisis displayed some glaring weaknesses in the existing
Basel II framework. Throughout much of the 2000s the world’s economy appeared to
function rather well, but the housing bubble inside the U.S. and the financial instruments
tied to U.S. mortgages proved to be a shock that would bring the world’s economy to its
knees.
Conclusion

Just as the long term reforms were being discussed following the Mexican Crisis, the Asian Crisis began, which delayed some of the reforms due to the immediate action that was required to quell the Asian Crisis. Like the Mexican Crisis, the Asian Crisis followed neoliberal ideas very closely in three of the four areas, with bailouts being the exception once again. The immediate response to the Asian Crisis was to authorize stabilization packages to a number of states that were in trouble in return for fiscal and monetary austerity. Unlike the Mexican Crisis, the austerity forced upon Asian states drew criticisms from some policy makers and noted economists and led to riots that toppled the Suharto regime. In some instances such as Indonesia, states were not as cooperative with implementing the austerity measures leading to a delay in the disbursement of funds. However, the pushback against fiscal and monetary austerity did not result in a policy change at the international level. In the long-term there was a deeper commitment made to providing funds to states that found themselves in need of a stabilization package with the approval of the New Arrangement to Borrow by the IMF.

Reform once again revolved around increasing transparency and creating regulations that force transparency. This was in an effort to provide better and timelier information to market actors. The IMF expanded their SDDS, making more states responsible to its reporting standards and increasing the data to be reported. The IMF’s Code of Good Practices and Fiscal Transparency aimed at ensuring the proper information is released by states so market actors so they can make wise investment choices. The report on strengthening the international financial architecture is also very telling in this respect as the first key area of reform deals with increasing the transparency
of states. The Basel II accords also fell largely in line with the neoliberal mantra of markets almost always work and that transparency will prevent most market failures. Risk assessments were largely done internally with the belief that banks could most accurately judge their own risk and as long as banks post their risk assessments for investors to view, investors will make wiser decisions.

Finally, the response to capital flows is much like the response to the Mexican Crisis as capital flows continued to be encouraged and states were supposed to better prepare for capital flows. The sudden reversal of capital was blamed by most international actors on bad macroeconomic policy, crony capitalism, and a lack of government transparency, therefore according to the IMF and G7/8 states, it was the governments of Asia that brought about the crisis and not the inherently destabilizing nature of easily reversible capital flows. However, a significant minority, including several well-respected economists (Stiglitz etc.) at least partly blamed the crisis on the free flow of international capital, especially “Hot Money.” The response to the Asian Crisis displayed a continuation of and entrenchment of neoliberal ideas internationally, although more pushback was witnessed outside of policy making circles, especially surrounding the fiscal and monetary stimulus forced upon Asian states.
CHAPTER 6: THE 2008 SUBPRIME CRISIS AND RESPONSE

The “Subprime Crisis” of 2007-08 (A.K.A. “The Great Recession or the Financial Crisis of 2008) began as a housing bubble in the United States and quickly spread into a worldwide financial crisis that threatened the entire global economic system, threatened to bankrupt states such as Iceland and Ireland, and required multiple government bailouts into the trillions of dollars. The Subprime Crisis introduced people all over the world to terms such as sub-prime mortgages, credit default swaps, collateralized debt obligations, securities, derivatives, and adjustable rate mortgages. The trigger of the Subprime Crisis was the bursting of the U.S. housing bubble that led to a sequence of crises across the financial system and into the real economy. Similar bubbles in either the banking and/or property sectors had formed in Spain, Ireland, Iceland, and the U.K., which were subsequently triggered by the collapse of the U.S. housing bubble, escalating the U.S. crisis into a worldwide crisis. The causes are the result of many years of policy missteps inside the United States and internationally as well as a series of bad decisions involving banks, individuals, and ratings agencies.

Causes of the 2008 Subprime Crisis

The domestic explanations regarding the causes of the “Subprime Crisis” are many. Mortgages were given to people with little or no ability to repay them, and other mortgages were given with the expectation that the owner would either default or refinance within a few years, depending on whether housing prices rose or fell (Acharya & Richardson, 2009). Also, investment banks, with easy access to cash, poured money into new financial instruments (securities, collateralized debt obligations, and derivatives) that were connected to house mortgages with the belief that housing prices would
continue to rise. The banks holding these financial instruments used various techniques of placing assets in to off-balance-sheet entities to evade capital adequacy standards. This reduced the amount of capital banks were required in relation to these financial instruments. Also, due to capital regulations, banks were able to reduce the amount of capital held against AAA rated assets whether they were on or off their balance sheets enabling more loans to be made at the expense of using more leverage (Acharya & Richardson, 2009).

Other domestic factors contributed to the crisis, including the rise of the shadow banking industry, which had very little if any oversight, historically low interest rates within the U.S., and failures of domestic and international regulatory agencies (Krugman 2009; The Financial Crisis Inquiry Commission 2011; Bianco 2008; Barnett-Hart 2009). Internationally, the “global savings glut” (GSG) hypothesis supported by Ben Bernanke (2005, 2007) states that increased capital inflows to the United States from Asian emerging markets and commodity exporters, who were looking to save, helped to keep U.S. longer-term interest rates lower than expected during the housing boom, which artificially extending the housing boom (Bernanke, Bertaut, Pounder DeMarco, & Kamin, 2011; Reinhart and Rogoff, 2009). Transforming the problem of a U.S. housing bubble into an international crisis involved two factors. First, there was a credit boom fueled by massive international capital flows coming into the U.S. from investors in emerging economies. Second, Europeans purchased large amounts of U.S. asset backed securities including private label mortgage backed securities (Bertaut, Pounder DeMarco, & Kamin, 2011).
When housing prices began to fall in 2006, defaults and foreclosures began to rise as many who were given sub-prime loans with adjustable rate mortgages could no longer make their monthly payments. As this continued, investors and banks holding mortgages or mortgage backed securities lost billions of dollars as their money streams dried up. Additionally, the risky financial products made by American banks that depended on the U.S. housing market continuing to grow were sold to investors around the world who believed them to be safe because of the AAA ratings given to them by ratings agencies (Barnett-Hart, 2009).

These factors enabled a U.S. housing bubble to transform into a global crisis from which the world is still recovering. IMF assistance was sought from both Iceland and Ireland as their domestic banking systems crumbled, many states in the EU are struggling with sovereign debt issues while Europe is in the middle of attempting to save Greece from outright default, and the United States is dealing with a very fragile recovery and high unemployment. Paul Krugman’s description of this crisis is quite accurate, calling it the “Sum of All Fears” (Krugman, 2009, p. 166).

The Rise of Shadow Banking

The institutions at the center of the 2008 crisis were mainly large banks. Some of these banks had both investment and commercial divisions while others were strictly investment banks. The crisis also encompassed other financial institutions operating in capital markets outside of the scope of the regulatory framework. Investment banks and commercial banks had been separated in the U.S. by the Glass-Steagall Act since the Great Depression and were subject to different sets of rules. Commercial banks were discouraged from taking excessive risk through tighter regulation and their deposits were
covered under FDIC deposit insurance. The other bank entities were largely unregulated, did not have to meet capital adequacy standards, and FDIC deposit insurance did not cover consumer deposits in these institutions. This allowed investment banks to leverage their investments at a higher rate, which would bring them better returns on their investments in good times, but left them more vulnerable to insolvency in the event of a crisis, which is eventually what happened in 2008 (The Financial Crisis Inquiry Commission, 2011).

Beginning in the 1960’s and continuing up until the 2008 Crisis, the shadow banking industry continued to grow rapidly and convinced many people to bank with them because of the higher rates of returns they could offer on their investments. Firms such as Merrill Lynch and Fidelity created money market mutual funds, which took depositors’ money and invested it in short term, safe securities such as instance, Treasury bonds and top rated corporate debt. Despite the safe nature of these investments, the rates of return were higher than the commercial banks could offer giving investment banks a competitive advantage. Investments in money market mutual funds grew from $3 billion in 1977 to $1.8 trillion in 2000 (The Financial Crisis Inquiry Commission, 2011, pp. 27-30).

As time progressed, investment banks started to offer services that looked more and more like bank accounts commercial banks would offer (money market mutual funds, cash management accounts), but could offer higher interest rates to attract customers. To keep this advantage, the investment banks began investing in “commercial paper” and “repo markets.” Both of these instruments were short-term debt or “hot money” that was usually rolled over often, allowing the financing to continue. Both
markets also had crises\(^\text{12}\) in which the Federal Reserve acted as lender of last resort and effectively bailing out both markets. Due to actions by the Federal Reserve propping up these two markets, confidence in both markets was restored and the shadow banking system continued to grow (The Financial Crisis Inquiry Commission, 2011).

As the shadow banking industry grew throughout the 1980s and 1990s, it eroded the commercial banks’ competitiveness. Following the Savings and Loan Crisis in the mid-1980s, the commercial banks put more pressure on regulatory agencies to loosen restrictions enacted through the Glass-Steagall Act, to allow for commercial banks to engage in ‘bank-ineligible’ activities such as holding certain types of securities. These ‘bank-ineligible’ securities were initially highly restricted by the Federal Reserve but by 1997 they could represent up to 25 percent of any subsidiary’s revenue (The Financial Crisis Inquiry Commission, 2011). In 1999 Congress fully repealed the Glass-Steagall Act, which allowed commercial banks to enter investment banking and therefore take on more risk (Krugman, 2009, p. 163).

*The Role of Leverage and Hot Money*

The propping up of the commercial paper and repo markets along with the repeal of Glass-Steagall were both important events leading up to the Subprime Crisis for a couple of reasons. More commercial banks began entering investment banking and investment banks increasingly relied on “hot money” such as commercial paper and repo markets to fund their investments throughout the 2000s. Rules regarding leverage

---

\(^{12}\) The commercial paper market’s crisis occurred when Penn Central Transportation Company filed for bankruptcy and had $200 million in commercial paper outstanding. Holders of other commercial paper refused to roll over their loans to corporations and the Federal Reserve stepped in with just under $600 million in emergency loans to commercial banks. The repo market crisis happened in 1982 when securities firms Drysdale and Lombard-Wall defaulted on their repo obligations.
concerning investment banks were amended in April of 2004, as the SEC granted the
wishes of five Wall Street firms\textsuperscript{13} to loosen restrictions in order for them to take on more
debt, which would allow them to release billions of dollars that were being held by
capital requirements (Labaton, 2008).

Before the April 2004 amendment, investment banks were limited to leverage of
twelve to one under SEC regulations, but after the amendment acceptable levels of
leverage increased to forty-to-one. Calculation of the amount of leverage was done within
each bank and compliance with the regulations was voluntary. Hot money became an
issue because many investment banks were creating asset to equity ratios of thirty five to
one higher prior to the crisis with as much as half of the funding for their investments
coming from overnight repos, which could be withdrawn at the first sign of trouble
(Crotty, 2009, p. 574). The reliance on “hot money” to finance many risky investments
left numerous banks vulnerable to shifts in market confidence, which could cut off their
credit lines. Unlike investment banks, many commercial banks appeared to be
sufficiently capitalized, but this was only because commercial banks overestimated the
value of on-balance-sheet assets while most of their riskiest assets were in off-balance-
sheet vehicles. Bank of America and Citibank were both leveraged at levels greater than
50 to 1 by the time the crisis hit. Such high leverage by both commercial and investment
banks meant that if banks began to lose money on their investments they would not have
adequate capital to cover those losses.

\textsuperscript{13} According to the New York Times, the five banks requesting the loosening of restrictions were Merrill
Lynch, Bank of America, Goldman Sachs, Lehman Brothers, and Morgan Stanley (Labaton, 2008)
Beginning in 1998, housing prices had begun to rise rapidly in the United States and in other markets around the world such as Australia, France, China, Ireland, India, Spain, Russia, the United Kingdom, and Korea. The United States experienced tremendous growth in the prices of homes in some markets in 1998\textsuperscript{14} despite very little change in real building costs and labor costs in the housing market. Over time real home prices in the U.S. rose more rapidly, increasing 86% between the fourth quarter of 1996 and the first quarter of 2006 (Schiller, 2008, p. 90). Robert Schiller argued the U.S. housing bubble operated “as a classic speculative bubble, driven largely by extravagant expectations for future price increases” (Schiller, 2008, p. 117). The housing bubble was fueled by multiple factors in addition to the expectations that prices would continue to rise including a continuous real rise in housing prices as well as massive inflows of cheap foreign capital resulting from record trade balance and current account deficits which aided in keeping U.S. long term interest rates low, and a lax regulatory policy that “helped propel the dynamic between these factors” (Reinhart & Rogoff, 2009, p. 207).

Following the bursting of the dot com bubble in 2000 and the ensuing recession in 2001 the Federal Reserve cut interest rates by nearly 5.5 percent to a historical low of one percent. With mortgage rates usually being set in relation to 10-year Treasury bond yields, which are influenced by federal fund rates, the Federal Reserve admitted the link between low interest rates, high home values, and increased liquidity in the economy that results from higher home prices (Bianco, 2008). Due to the rate cuts by the Federal

\textsuperscript{14} According to Robert Schiller in his article “Understanding Recent Trends in House Prices and Homeownership,” west coast markets such as San Diego, San Francisco, and Seattle had jumps in housing prices of up to 10% in 1998.
Reserve, mortgage rates fell and home refinancing skyrocketed from $460 billion in 2000 to $2.8 trillion in 2003. This refinancing binge allowed homeowners to withdraw equity they had previously accumulated to consume more although wages had become stagnant. Between 2000 and 2007 Americans withdrew $2 trillion through refinancing their homes (The Financial Crisis Inquiry Commission, 2011, p. 5).

As the housing boom continued and houses could not be built fast enough to keep up with demand, the prices of houses continued to rise and speculators, eager to buy and flip homes for a profit, became more prevalent in the housing market. By mid-2005, more than one out of ten home sales was to an investor, speculator, or someone buying a second home (The Financial Crisis Inquiry Commission, 2011, p. 5).

During the housing boom U.S. banks made many loans to people who were perfectly capable of meeting their payments and owning a home, but many loans were also made to individuals who had little or no proof that they would be able to pay back the loan. Traditional mortgages of 30 years with 20 percent down fell by the wayside replaced by non-traditional or adjustable rate mortgages. Many of the housing loans that were issued were done so by specialized mortgage lenders who were not regulated in the same manner as traditional banks. This allowed them to make riskier loans to people who had no proof that they would be able to pay the loan back (Bianco, 2008, p. 7). These loans were often referred to as Alt-A, subprime, I-O (interest-only), ninja loans (no income, no job, no assets) or liar loans. The adjustable rate generally rose after the first year leading many borrowers unable to pay the increased mortgage payment (The Financial Crisis Inquiry Commission, 2011, p. 6). Subprime mortgages increased from 9
percent of total originations in 1996 to 20 percent in 2006. In 2006 subprime mortgages totaled $600 billion, about one-fifth of the U.S. home loan market (Bianco, 2008, p. 6).

**New Financial Instruments - The Securitization of Sub-Prime Mortgages**

The booming housing market in the United States spurred opportunities for many people and businesses to profit from the various services and investments related to and dependent on a healthy housing market. One of the motivations for mortgage brokers to sell mortgages to risky buyers was because they were quickly selling the loans to other banks that would securitize and sell those products to investors across the globe. Because mortgage brokers were not retaining the mortgages and were collecting fees for selling mortgages, the incentive to make good loans was overshadowed by the incentive to make as many loans as possible. Investment banks bought the mortgages from other banks and mortgage lenders and sliced them into collateralized debt obligations (CDOs), which were then sold to investors as what are known as mortgage backed securities (MBS).

According to Anna Katherine Barnett-Hart (2009):

> The basic principle behind a CDO involves the re-packaging of fixed income securities and the division of their cash flows according to a strict waterfall structure. A CDO is constructed by creating a “brain-dead” company, a special purpose entity (SPE) or structured investment vehicle (SIV), which buys assets and issues bonds backed by the assets’ cash flows. The bonds are divided into a number of tranches with different claims on the principal and interest generated by the CDO’s assets. These CDO’s were a very profitable investment that began accelerating in 2004. Many CDOs were bought by individual investors as well as institutional investors looking for a
safe investment for retirement or pension funds. Investment banks used CDO’s to allocate risk and to free up capital reserves. Using CDO’s, banks were able to pool numerous assets together to decrease risk. CDOs also allowed a number of tranches to be created that contained multiple risk profiles to satisfy the differing needs of investors. The highest rated senior tranches would offer fewer returns but were also less risky, while the lowest rated junior tranches would offer higher returns but have more risk. In the middle there were “mezzanine tranches.” By pooling the bundled loans together and placing the loans in off-balance sheet vehicles or selling them to investors, banks were able to decrease the capital required by the Basel Accords as well as their own internal risk requirements, which freed up cash to make new loans (Barnett-Hart, 2009, pp. 6-7).

This structure worked well as long as the assets used as collateral continued to perform. As CDOs became more popular and demand outpaced supply the quality of their collateral began declining. More and more of the subprime mortgages and home equity loans were used as collateral. The next evolution in the CDO market was the invention of what came to be known as the CDO squared. Banks repackaged the mezzanine tranches into new CDOs that created a new set of tranches. The new AAA rated tranche was derived from the mezzanine tranches of another CDO making it much more risky than was previously thought. In essence, investment banks were using their own CDOs as collateral for the CDO squared. The final step of evolution in the CDO market was the use of pools of credit-default swaps (CDS), which were basically insurance protecting against the default of an asset-backed security. Because the demand for asset-backed security bonds for CDOs was so high, there weren’t always enough

---

15 Collateral composition of asset backed CDOs changed from 0% of home loans less than prime in 1999 to 36% in 2007. (Barnett-Hart, 2009, p. 9)
asset-backed securities to construct a CDO. By using CDS, underwriters and managers “could take ‘bets’ on any bond they found desirable, regardless of its limited supply” (Barnett-Hart, 2009, pp. 8-14).

As long as the market continued to perform, CDS were one more route financial institutions could take to leverage their exposure to the mortgage market. The CDS market grew steadily in the 2000s reaching $60 trillion in 2007. Of the $60 trillion, AIG, which received over $100 billion in a bailout loan, was individually responsible for almost $500 billion in CDS. Much of the growth in the CDS market was due to hedge funds as they contributed almost 60 percent of the volume of CDS trades in 2006. Because the growth in the CDS market was driven mainly by unregulated, highly leveraged institutions such as investment banks and hedge funds that were leveraging their exposure to CDOs and fronted very little capital, when the bubble burst large insurance companies involved in the CDS market were unable to pay the amounts promised (Neil Baily, Litan, & Johnson, 2008, pp. 32-33).

**Rating Agencies**

Ratings agencies such as Moody’s, S & P, and Fitch were involved with rating institutions such as Lehman Brothers and Goldman Sachs as well as MBS. The ratings agencies gave many of these MBS ratings of AAA during the boom years, which led many investors at many different levels to purchase bonds the ratings agencies had given top ratings to. The incorrect ratings of many of the mortgage related securities and the overreliance of investors on ratings agencies only helped to further fuel speculation. When housing prices began to fall, “Moody’s downgraded 83 percent of the $869 billion in mortgage securities it had rated at the AAA level in 2006” (Alessi & Wolverson,
The ratings agencies also played an indirect role in the banks being too highly leveraged as their ratings were taken into account when banks calculated their “Value-at Risk” according to Basel II requirements. Because many of the MBS were highly rated, many large international banks to falsely believe they had enough capital on hand relative to their risk.

**International Factors**

While most factors responsible for the 2008 crisis were domestic factors within the U.S., international factors, such as the influx of money from global savings glut (GSG) countries were partly responsible for keeping the long term interest rates low and therefore exacerbating the housing bubble. The international factors that caused the effects of the U.S. housing bubble collapse to be transmitted internationally focus particularly the purchases of MBS from banks, investors, and governments in Europe. (Bernanke, Bertaut, Pounder DeMarco, & Kamin, 2011).

The GSG countries, which included emerging economies in Asia and oil exporting countries had an overabundance of savings built up from the 1990s and were looking for safe, high quality financial assets that were unavailable in their own countries but were available in advanced countries. Most of the GSG savings went to the United States to purchase new issues of U.S. Treasuries, Agency debt, and Agency sponsored MBS. This offered the type of investment that was desired but also contributed to keeping yields on U.S. Treasuries and Agencies very low (Bernanke, Bertaut, Pounder DeMarco, & Kamin, 2011, pp. 4-6). GSG countries were also purchasing assets from Europe such as government bonds and bank deposits. This displays how the GSG countries provided financing to the U.S. through their direct purchasing of U.S. and
European assets, which was a contributing factor in the European purchasing of U.S.
assets by providing Europeans with more capital. (Bertaut, Pounder DeMarco, & Kamin,
2011, p. 10).

Advanced economies, such as those in Europe, were also looking for safe, high
quality financial assets much as the GSG countries, but were willing to make riskier bets
and therefore purchased large quantities of highly rated MBS issued by American banks.
Most of the purchasing of U.S. MBS were done by the off balance sheet vehicles of the
large international banks, which were situated in Europe. Adding to the desire of
Europeans to look to the U.S. for investments was the reduction of longer-term interest
rates in Europe which made the purchase of U.S. MBS more appealing (Bernanke,
Bertaut, Pounder DeMarco, & Kamin, 2011).

Additionally, the European banks were looking for low-risk assets because Basel
II required a lower capital adequacy requirement for low-risk assets (Cox, Faucette, &
Lickstein, 2010). 55 percent of the highly rated securities that were issued by U.S.
residents from 2003 to 2007 were issued to foreigners. In addition to the AAA rated
securities, European banks also bought large quantities of non-AAA rated securities, such
as corporate bonds, much of which was still investment grade despite the lack of the
AAA rating. The purchase of U.S. assets by European banks was done primarily through
short-term dollar denominated liabilities such as commercial paper or bank deposits.
When the crisis hit, European banks and investors had considerable exposure to U.S.
MBS, making the Subprime crisis an international crisis almost instantly (Bernanke,
Bertaut, Pounder DeMarco, & Kamin, 2011). In the following chapter, I will discuss the
sequence of events as the international financial system was brought to the brink of collapse as well as the policy responses.

The Subprime Crisis Meltdown and Response

The U.S. housing bubble began its descent in the fall of 2005, but the fallout from the collapse in housing prices took time to materialize. Sales began to fall first even as the prices of homes continued to rise into 2006. In the second quarter of 2007, according to the Case-Shiller home price index, housing prices had fallen 3 percent from their previous highs in 2006, but accelerated to a 15 percent decline over the next year. Estimates were that housing was overvalued by more than 50 percent at the height of the housing bubble, meaning that prices would need to decline by one third in most areas and would need to nearly be cut in half to approach an equilibrium price in some of the biggest bubble areas. The subprime lending boom was predicated on the assumption that housing prices would continue to rise, therefore when housing prices began to fall the entire system, which had been created during the boom became destabilized. Refinancing or selling one’s house in the event that mortgage payments could not be made was no longer an option and rates of default began to rise. As more people began to default on their mortgages it became apparent that the investments all over the world made on the assumption that housing prices would continue to rise, even the most highly rated MBS, turned out to be unsafe investments and the house of cards came tumbling down (Krugman, 2009, pp. 166-169).

Because the largest purchaser of MBS were banks, when the MBS began losing their value in 2007 and banks were holding large amounts of MBS on their balance sheets, it became apparent that both lenders of mortgages and investors who bought MBS
would lose a lot of money. As the scale of losses banks were to incur due to exposure to mortgage backed assets came to light in 2008, confidence in the entire shadow banking system was undermined, which led to a cycle of deleveraging as the reality of the “Subprime Crisis” set in (Krugman, 2009, pp. 169-172).

Despite the many economic tremors that prefaced the impending economic turmoil such as JP Morgan’s purchase of the investment bank Bear Stearns in March of 2008 after an attempted Federal Reserve bailout and Bank of America’s purchase of Countrywide Insurance in June of 2008, the severity of the Subprime Crisis became apparent to the world on September 15, 2008. In one day Lehman Brothers, a 158 year old Wall Street institution who underwrote many mortgage backed securities, filed for bankruptcy, Bank of America purchased Merrill Lynch, and AIG’s debt was downgraded by all three major ratings agencies\(^\text{16}\). This chain of events sent stocks tumbling all over the world and governments scrambling to save their economies, but was only one of the series of shocks that hit the world economy between 2007 and 2009.

**Responses to the Subprime Crisis**

Similar to previous crises, the responses to the Subprime Crisis were two fold. There were immediate responses, which aimed at preventing the crisis from deteriorating further, and there were longer-term responses, which focused on reforms aimed at fixing flaws in the current financial system and preventing future crises. The immediate responses were performed mainly by individual governments and the international responses were coordinated by bodies such as the G20 and IMF, which began organizing discussions for longer term international responses as soon as November 2008.

\(^{16}\) AIG invested heavily in credit default swaps and would eventually be rescued by the U.S. government in multiple bailouts
The Immediate Response

The immediate responses of individual governments in response to the series of failures of financial institutions and multiple threats to the global financial system took many forms all over the globe. Individual governments responded quickly in the attempt to stabilize their financial systems by using a number of strategies, which follow in no particular order.

One strategy was to impose a temporary banning of the short-selling financial stocks. This went into effect by September 19, 2008 in the U.S., France, Canada, Ireland, and the U.K. By October 14 Japan and Italy had also temporarily banned the short selling of financial stocks. In the U.S. the ban was put in place to protect shares of publicly traded companies against exploitation and in the hope of restoring order to financial markets. Short-sellers were blamed by some for driving down the share prices of Lehman Brothers and AIG and causing other financial institutions’ stock prices to fall (Chung, 2008). Other states banned the short-selling of financial stocks for reasons similar to the U.S.’s; however the length of the bans varied depending on the state with the U.S. ending its ban on October 9, the U.K. ending their ban in January of 2009.

The next strategy was a coordinated international effort by many central banks around the world as they cut interest rates across the board in an attempt to stop falling share prices and unfreeze credit markets. The Federal Reserve, the European Central Bank, the Bank of England, as well as the central banks of both Sweden and Canada lowered their primary lending rates half a percentage point. China also lowered its key interest rate along with lowering the reserve requirements of their banks in an attempt to increase the availability of cash (Andrews & Dougherty, 2008). The Federal Reserve cut
their federal funds rate from 2 to 1.5 percent and would cut it to 1 percent in late October and eventually cut it again to near zero (New York Federal Reserve Bank, 2011).

Beginning directly after the stock market crash in mid-September, 2008 the United States along with Canada and a number of European states either raised their guarantees on bank deposits and/or guaranteed to safeguard some or all of their nation’s banks to ensure them from failing. On September 20, 2008 the Irish government raised their deposit insurance to €100,000 and on September 30 Ireland gave six banks guarantees on all deposits, covered their bonds, senior debt, and dated subordinated debt (Ireland Department of Finance, 2008). In January of 2009 Ireland nationalized the Anglo Irish Bank due to its poor funding position and “unacceptable practices (Ireland Department of Finance, 2009). Iceland issued an unlimited guarantee for all savings accounts following the government’s purchase of Glitnir, Iceland’s third largest bank (BBC, 2009). In the United States, FDIC guarantees were raised from $100,000 to $250,000 and the U.K. raised their deposit insurance to £50,000. The U.K. also announced a plan to guarantee the short term debt of their banks while both France and Italy stated that they would not let institutions fail. Italy passed their bank financing guarantee without specifying the amount of money that will be available and France provided €320 billion in loans to banks and other financial firms (New York Federal Reserve, 2012).

Liquidity and rescue interventions included loan guarantees, recapitalization of banks, and capital injections into the financial sectors of many states. The U.S. passed the Troubled Asset Relief Program (TARP) that authorized the U.S. Treasury to use $700

---

17 The six banks were Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide building Society, and the Education Building Society.
billion to buy troubled mortgage backed securities. France pledged €360 billion to help their troubled banks, which the majority of the money (€320 billion) was used for loan guarantees and €40 billion was to be used to purchase stakes in French banks struggling to raise capital (de Beaupuy & Fouquet, 2008). Germany also pledged €500 billion in loan guarantees and capital to help their banking system. €80 billion of which would be used for bank recapitalization. Finally, the U.K. government and Bank of England provided emergency loans and lending guarantees for its banking sector in the amount of £500 billion and a £37 billion bailout of the Royal Bank of Scotland Group Plc, HBOS Plc and Lloyds TSB Group Plc (Cremer, 2008).

Long Term Response

The immediate response was quick, drastic, and unprecedented as it involved enormous amounts of money. The world’s economy stood on the brink of collapse and scarcely avoided disaster. Because of the speed at which the crisis unfolded and the international dimension of the crisis, the G20, G7, IMF, and other International Financial Institutions reacted with great haste to start discussions on how best to prevent such an occurrence from happening in the future. The work that had been done in the 1990s to reform the international financial architecture needed to be reexamined and retooled to ensure that a calamity such as the Subprime Crisis would not happen again. Understanding the causes of the crisis took some time but was the first issue that had to be resolved in order to make realistic proposals for regulatory reform. The G20 summits directly following the outbreak of the Subprime Crisis dealt with preventing the current crisis from becoming any worse as opposed to making long-term changes. Suggestions for long-term reform were posited, but the details took time to negotiate and develop.
Beginning in 1999 with the founding of the G20 and continuing throughout the 2000s, the G20 Finance Ministers and Central Bank Governors met on a regular basis, but the first ever G20 Leaders summit was not held until November of 2008, in Washington D.C. This particular meeting had a large media buzz due to the ongoing financial crisis as well as the magnitude of the summit. The G20 leaders came together to discuss three main issues: The causes of the crisis, the short term actions to address the immediate crisis, and the principles for reforming financial markets, which were accompanied by an action plan to implement those principles. Short term changes included many of the responses mentioned in the previous section such as providing economic stimulus, protecting deposits, and calming financial markets (Group of Twenty Leaders, 2008).

The principles for reform can be organized into the following categories:

- Strengthening transparency and accountability;
- Enhancing sound regulation;
- Promoting integrity in financial markets;
- Reinforcing international cooperation; and
- Reforming international financial institutions (IFIs).

These principles could be seen as the groundwork for future reform as the declaration of these principles began the work needed to make more specific reforms once more detailed data became available. The action plan that accompanied the principles contained close to fifty measures to be taken in both the immediate and medium-term. Both sets of measures were general in nature and offered little as far as specific policies.
but offered suggestions such as strengthening accounting and disclosure standards for off-balance sheet vehicles, ensuring that credit rating agencies are of the highest standards, avoiding conflicts of interest, and requiring more stringent standards for the disclosure of complex financial instruments. Other statements contained such statements as “Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts” and “The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality accounting standard” (Group of Twenty Leaders, 2008).

The Finance Ministers were given the tasks of making recommendations for mitigating pro-cyclicality in regulatory policy, reviewing and aligning global accounting standards, strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risk, reviewing compensation practices as they relate to incentives for risk taking and innovation, reviewing the mandates, governance, and resource requirements of the IFIs, and defining the scope of systemically important institutions and determining their appropriate regulation and oversight. The findings of the Finance Ministers were to be completed by the April 2009 G20 Leaders meeting in London (Group of Twenty Leaders, 2008).

The principles for market reform, the accompanying action plan, and the tasks of the Finance Ministers were big proposals that would not be completed quickly. Dana Perino, a White House spokesman was accurate in her predictions of the accomplishments of this G20 summit, stating “We have always said that this is going to be a series of summits; nothing is going to be solved overnight; But we’re going to get a long way toward moving the ball down the field tonight and tomorrow afternoon” (The
Financial Times, 2008). In essence, the November 2008 G20 summit was used as a chance to exchange information and ideas to try and stop the crisis from worsening and to set the groundwork to enable future reform.

Between the November summit in Washington D.C. and the April summit in London there were two key developments. First, the Financial Stability Forum (FSF) of the IMF enlarged their membership to include all G20 states. Second, the G20 Finance Ministers met in March of 2009 to continue work on immediate economic stimulus as well as long-term financial reform and to achieve the goals presented to them by the Leaders the previous November. The major outcome of the Finance Ministers meeting was to increase the IMF’s available resources from $250 billion to $500 billion to aid the immediate recovery. This agreement would be presented to the Leaders at the April summit for final approval (Giles, 2009).

G20 Summit – April 2009 – London

When the Leaders of the G20 met in London the global economy was still in recession and they were confronted with the potential of a global contagion, therefore much of the summit was still focused on the immediate recovery. The G20 considered and endorsed the suggestions from the Finance Ministers meeting in March. The FSF was expanded to all G20 states and was renamed the Financial Stability Board (FSB). The FSB had a broader mandate than that of the FSF as was intended to promote financial stability, not just to facilitate cooperation between IFIs, regulatory and supervisory bodies, central bank experts, and governments (Financial Stability Board, 2012a).

Promoting financial stability was to include working with the IMF to assess

---

18 The FSF was established in 1999 in response to the Asian Crisis and was designed to more accurately assess weaknesses of the international financial system (Financial Stability Board, 2012a).
macroeconomic and financial risks as well as responses to address the risks. G20 Leaders also agreed to expand the resources available to the IMF from $250 billion to $750 billion, an increase of $500 billion in commitments. Half of the new $500 billion was available immediately, which was in the form of bilateral borrowing arrangements with states such as Japan ($100bn), China ($40bn), the U.S. ($100bn), and Europe ($100bn). However, there was $145 billion that the G20 committed that needed to be covered by other states (Lex Column, 2009).

In addition to aforementioned agreements, a number of other changes regarding long-term regulation were approved in principle, but the details were yet to be worked out. The G20 agreed to redesign their regulatory systems to include macro-prudential risks19 and agreed to enact new rules regarding hedge funds and securitization. The G20 also called for changes to bank capital requirements through the implementation of Basel II. The G20 endorsed the FSF’s new principles on bankers’ pay and compensation schemes to limit excessive risk taking, extended regulation to ratings agencies, called on accounting standards setters to revise and improve accounting standards, and endorsed the publishing of the OECD’s blacklist of non-cooperative jurisdictions which included tax havens (Group of Twenty Leaders, 2009b).

At the conclusion of the London summit the reformed international financial architecture consisted of three main bodies: the G20, the IMF, and the Financial Stability Board. Each was assigned different tasks, consisted of different membership, and had different legal status. The G20 would be the forum that would oversee the international financial system. The IMF would provide the resources, and the Financial Stability Board would oversee the macro-prudential risk assessment.

---

19 Macro-prudential risk assessment takes into account the health of the essential financial institutions in a financial system and assesses the financial system’s vulnerability to economic shocks (International Monetary Fund, 2012).
economy as well as the regulations and international financial standards. The IMF, with its newly approved financial resources, had universal membership, and in addition to its traditional tasks was focused on surveillance of the international economy and implementation of international financial standards. The FSB was responsible for coordinating the standard setting process, and was to be the organization that the standard setting bodies such as the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) would report to (Giovanoli, 2009, pp. 98-99).

*The Pittsburgh G20 Summit – September 2009*

The G20 Leaders met in Pittsburgh amid a large crowd of protesters and a recovering, yet fragile global economy. During the Pittsburgh summit, the G20 was officially designated as ‘the premier forum’ for international economic cooperation. This summit continued to revolve around the two major themes of the previous G20 summits, which were continuing recovery and establishing long-term reforms. The short-term goals of the summit included continuing stimulus to ensure a durable recovery as well as pledging to ensure that when growth resumes, it is accompanied by jobs. There was also agreement that the exit strategies for states withdrawing “extraordinary policy support” would be done in a timely, cooperative, and coordinated way (G20 Research Group, 2009). Moreover, states were not going to stop their stimulus programs in a way that would destabilize the world’s economy.

The long-term reforms can be placed into two categories. First, there was agreement that there needs to be a framework for strong, sustainable, and balanced growth that avoids the asset bubbles and unsustainable capital flows, which contributed
to the crisis. Second, there needed to be a strengthening of the international regulatory system in the areas of banking, compensation practices, accounting standards, and tax havens. There was also agreement on the need to reform the IFIs to reflect the current global economy, which ultimately resulted in promises to financially support the IMF and other Development Banks (G20 Research Group, 2009).

According to the Leaders Statement, the framework for sustainable growth needed to collectively analyze fiscal, monetary, trade, and structural policies to ensure each state’s policies are “collectively consistent with sustainable and balanced trajectories of growth. This amounted to a three-step process. The G20 was to agree to “shared policy objectives,” which then each government would implement these policies in their state. Once each government developed the policies, they would be presented to the IMF and Finance Ministers for “mutual assessment.” The details of how this process would play out were not yet formulated, but were to be discussed at the upcoming Finance Ministers meeting in November of 2009. The results of the first mutual assessment would be presented at the G20 summit in 2010 (Group of Twenty Leaders, 2009a).

The G20 included a number of recommendations for different sectors of the economy to further strengthen the international regulatory system. With regards to banking, the G20 asked that work continue on revising Basel II and that an agreed to develop “internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage.” It was also agreed that Basel II would be implemented in all G20 financial centers by 2011 (Group of Twenty Leaders, 2009a).

The G20’s recommendations for reforming compensation practices in an attempt to support financial stability focused on implementing the Financial Stability Board’s
(FSB) Principles for Sound Compensation Practices, which focus on generating long-term value creation and discourage excessive risk taking. These principles include avoiding multi-year guaranteed bonuses, making firms’ compensation policies and structures transparent, requiring much of the variable compensation to be deferred, based on performance, subject to appropriate clawbacks, and placed in a stock or stock-like instrument. Additionally, the principles call for certifying that senior executives and employees that are capable of putting a firm at risk are compensated according to performance and risk exposure, limiting variable compensation when it is inconsistent with maintaining a sound capital base, and ensuring that compensation committees are able to make adjustments to compensation accordingly in order to offset additional risks (Group of Twenty Leaders, 2009a).

There were also commitments made to improve the over-the-counter (OTC) derivatives markets and to address cross-border resolution systems for systemically important financial institutions (SIFI). It was agreed that OTC derivatives markets should be improved by creating consistency in reporting standards and transparency to reduce the incentives for regulatory arbitrage. The FSB was to oversee the regulatory process and judge whether it would be sufficient to improve transparency, mitigate systemic risk, and protect against market abuse. Addressing resolution systems for systemically important financial institutions (SIFI) was to be done in a way that safeguards financial stability and limits moral hazard. SIFIs that became in danger of failing needed a mechanism to resolve their crisis in an orderly way that would be respected by all states internationally and the FSB was also to propose possible strategies to achieve more effective oversight of SIFIs by October 2010 (Group of Twenty Leaders, 2009a).


Basel II Reform

As previously stated, the Pittsburgh summit called for all G20 financial centers to have adopted the Basel II Capital Framework by 2011. During 2009 the Basel Committee on Banking Supervision (BCBS) was busy trying to reform the framework to improve the accord. There were three goals of strengthening the regulatory framework. The goals were to encourage banks to enlarge capital buffers that could be drawn down in periods of stress, to strengthen the quality of bank capital, and to introduce a leverage ratio as a backstop to Basel II. All three pillars of Basel II were enhanced in an attempt to fix their prior shortcomings. The first pillar, which dealt with minimum capital requirements strengthened its sensitivity for certain securitizations such as Asset Backed Securities and Collateralized Debt Obligations, by increasing the risk weights to more accurately portray the risk associated with these products. Banks were also required to employ more stringent credit analyses of externally rated securitization exposures (Basel Committee on Banking Supervision, 2009a).

The Basel Committee issued supplemental guidance for the second pillar, which was responsible for detailing the supervisory review process. The second pillar was revised to address weaknesses in the risk management practices being used prior to the crisis. The areas addressed were firm-wide governance and risk management, capturing the risk of off-balance sheet exposures and securitization activities, managing risk concentrations, and providing incentives for banks to better manage risks and returns over the long-term (Basel Committee on Banking Supervision, 2009a).

Pillar three, which concerned promoting market discipline and transparency within banking institutions by forcing banks to disclose their risk profiles, was revised to
force banks to include a number of new areas of disclosure. These enhancements aimed to prevent the “recurrence of uncertainties about the strength of banks’ balance sheets related to their securitization activities” (Basel Committee on Banking Supervision, 2009b, p. 28). Essentially, the enhancements to pillar three were to help banks more accurately publish information about their securities exposure and actual risk, including areas such as sponsorship of off-balance sheet vehicles and resecuritization (Basel Committee on Banking Supervision, 2009a, p. 29).

The revisions to Basel II were scheduled to be implemented by 2011, but by the April meeting of the G20 Finance Ministers, the deadline had been pushed back to the end of 2012 for implementation as details continued to be negotiated between leaders.

**G20 Finance Ministers Meeting – April 2010**

The April G20 Finance Ministers meeting preceded the Toronto G20 Summit in June and produced a slightly more specific Framework for Strong, Sustainable, and Balanced Growth but reminded leaders that states should tailor policy frameworks to their individual situations. The Finance Ministers agreed on what some of the characteristics of each area of growth should consist of, stating that the objectives of strong, sustainable, and balanced growth are “closely related and need to be pursued in a way that is mutually reinforcing.” The descriptions lacked details, favoring vague statements such as “strong growth should close current output and employment gaps in G20 states as soon as possible,” and “sustainable growth should be based on sustainable public finances and price and financial stability” and “balanced growth should be broadly based across all G20 states and regions of the world” (Group of Twenty Finance Ministers and Central Bank Governors, 2010b).
In addition to statements about what each type of growth should resemble, the Finance Ministers presented the IMF, who would be supervising states’ policies for growth, with a set of principles for formulating alternative policy scenarios in the event that a state’s policies do not reflect the stated goals of the Framework. The principles presented to the IMF consist of general guidelines for the IMF to follow. Examples of the principles intended to guide the IMF were: present a limited number of proposals, the scenarios must include policies geared toward a collective outcome that helps the G20 come closer to its shared policy goals, and “the policy scenarios should consider the choices between the pace of implementing policy actions and their feasibility, credibility and effectiveness. Also, consideration should be given to the choices of raising global growth and of achieving more sustainable and balanced growth” (Group of Twenty Finance Ministers and Central Bank Governors, 2010b).

*The Toronto G20 Summit – June 2010*

The Leaders of the G20 met in Toronto as the global economy was showing signs of recovery but other problems were beginning to present themselves. The Greek sovereign debt crisis was unfolding quickly in June of 2010 as Moody’s downgraded Greek debt to junk and 10-year Greek bond yields had risen to above ten percent (Bernard, Cadman, & Minto, 2011).

The worries about government debt created by the Greek debt crisis were reflected by some of the commitments made by the G20 leaders as an agreement for all advanced economies to halve their deficits by 2013 and for all advanced economies to stabilize or reduce their debt-to-GDP ratios by 2016 was agreed to (Group of Twenty

---

20 Moody’s was the last of the major rating agencies (Moody’s, Standard & Poor’s, and Fitch) to downgrade Greek bonds to junk (Bernard, Cadman, & Minto, 2011).
Leaders, 2010a). There was disagreement among leaders as to when the stimulus that had been implemented since 2008 should be withdrawn. Europeans were more in favor of withdrawing stimulus sooner, but Barack Obama warned European states of the lesson learned from previous recessions when stimulus was removed prematurely (Atkins, 2010).

The Framework for Strong, Sustainable, and Balanced Growth had produced the findings from their first stage of the Mutual Assessment Process. The conclusion was that the G20 states could do much better. The IMF and World Bank estimated that if “more ambitious paths of reforms” were chosen, over the medium term this could result in increased global output by nearly $4 trillion, create tens of millions of jobs, reduce poverty, and significantly reduce global imbalances. In addition to cutting deficits and reducing debt-to-GDP ratios, the G20 agreed to a number of general commitments to promote strong sustainable and balanced growth that included such things as strengthening social safety nets, enhancing corporate governance, and enhancing infrastructure spending (Group of Twenty Leaders, 2010a).

The G20 also continued to discuss financial sector reform. It was declared that financial sector reform rested on four pillars: Strong regulatory framework, effective supervision, resolution and addressing systemic institutions, and transparent international assessment and peer review. With regards to a stronger regulatory framework, the Basle Committee on Banking Supervision was continuing its work towards a new global regime of bank capital and liquidity standards, which would make banks better able to withstand shocks of the magnitude witnessed in 2008. It was agreed that an agreement would be reached at the next G20 summit in Seoul, South Korea and that the G20 states would aim
to implement the new standards by 2012, but that the adoption must be done in a way that is consistent with sustained recovery and limits market disruption (Group of Twenty Leaders, 2010a).

The second pillar, effective supervision, was tasked to the FSB in consultation with the IMF. They were directed to report to the G20 Finance Ministers and Central Bank Governors in October of 2010 on their recommendations for strengthening oversight and supervision. The FSB and IMF were specifically asked to offer recommendations “related to the mandate, capacity, and resourcing of supervisors and specific powers which should be adopted to proactively identify and address risks, including early intervention” (G20 Research Group, 2010).

The third pillar was also tasked to the FSB, where they were asked to develop policy recommendations to develop a system that could effectively restructure or resolve all types of financial institutions in crisis, while preventing moral hazard and without taxpayers ultimately footing the bill. The policy recommendations were to be proposed by the Seoul Summit in October of 2010. The fourth pillar, transparent international assessment and peer review, consisted of the G20 stating they strengthened their commitment to the IMF/World Bank Financial Sector Assessment Program and pledge to support robust and transparent peer review through the FSB (Group of Twenty Leaders, 2010a).

As the G20 Finance Ministers and Central Bank Governors met in October of 2010 to discuss the issues on the agenda for the Seoul Leaders summit in November they agreed to a number of proposals regarding the IMF’s quota and governance. These proposals included a shift in quota shares to allow emerging market and developing
countries (EMDCs) more say in the operations of the IMF as more than six percent of the IMF’s voting power will be transferred to under-represented countries. It was also agreed that there would be a move to an all elected Executive Board (Group of Twenty Finance Ministers and Central Bank Governors, 2010a).

*The Seoul G20 Summit – November 2010*

Leading up to Seoul, there was much talk about the need for global cooperation but anxieties over the fragility of the recovery as well as concerns that not all states are implementing the reforms that were agreed to were evident. Short-term concerns with the uneven and slow recovery as well as “currency wars” dominated the news headlines about the summit but talks about long term reforms pushed forward.

The Basel Committee on Banking Supervision (BCBS) finalized their agreement on new bank and capital liquidity framework, known as Basel III, and presented it to the G20. The new standards were praised by the G20, who offered their support and called for all states to begin implementing the standards by January 1, 2013 with the new standards to be fully implemented by January 1, 2019 (Group of Twenty Leaders, 2010b). In the September between the Toronto summit and the Seoul summit, the BCBS released Basel III: International framework for liquidity risk measurement, standards, and monitoring. This document represented the liquidity section of the reforms to the banking sector. Basel III changed the existing framework of the reformed Basel II in a number of ways.

Capital requirements were increased as the minimum requirement for common equity was raised from 2 percent to 4.5 percent, and banks were required to hold a capital conservation buffer of 2.5 percent as a cushion against future episodes of stress. The
common equity was therefore increased to 7 percent and would be phased in by January 1, 2015. Additionally, the new requirements reinforced a stronger definition of capital, which was agreed to in July of 2010 by the Governors and Heads of Supervision as well as higher capital requirements for trading derivative and securitization activities, which would be presented by the end of 2011. There would also be an additional countercyclical buffer between 0 percent and 2.5 percent to act as a mechanism of macroprudential protection against periods of excess credit expansion, which could pose system wide risk. The capital requirements were complemented by an additional non-risk based leverage ratio to serve as another layer of protection (Basel Committee on Banking Supervision, 2010).

The G20 also endorsed the Financial Stability Board (FSB) report on reducing moral hazard posed by global systemically important financial institutions or financial institutions that are “too big to fail.” The recommendations from the FSB included:

- Ensuring that Global Systemically Important Financial Institutions (G-SIFIs) are subject to higher loss absorbency capacity;
- G-SIFIs are subject to more intense oversight;
- Reducing the risk of contagion by ensuring that G-SIFIs have robust financial market infrastructures

These recommendations were to be complemented by additional measures to be taken by the home jurisdictions of the G-SIFIs. These recommendations included using international supervisory colleges to conduct coordinated assessments of the G-SIFIs, making international recovery and resolution planning mandatory, and subjecting G-SIFI policies to review by the Peer Review Council. Implementation of these
recommendations would be subject to either the FSB thematic or country peer review assessments as well as being part of the IMF/World Bank Financial Sector Assessment Program. The specifics of the standards to be met for the individual recommendations were not yet determined but were to be developed by either international bodies and/or national authorities and reviewed by 2011 or 2012 (Financial Stability Board, 2010).

The Finance Ministers and Central Bank Governors also presented achievements made in strengthening the global financial safety net and helping states cope with financial volatility. This included enhancing the Flexible Credit Line by extending its duration and eliminating the access cap for states with strong fundamentals and policies and the creation of the Precautionary Credit Line, which allows states with sound fundamentals and policies to access additional liquidity to reduce any vulnerabilities they might have (Group of Twenty Leaders, 2010b).

Outside of the agreement to implement Basel III by 2019 the progress made towards reforming the international financial architecture was minimal. Due to the ongoing Eurozone crisis and high unemployment in Europe and the U.S. as well as the tension between the U.S. and China over exchange rates, dealing with long-term reform was demoted in importance to deal with more short-term issues.

Following the Seoul summit, the BCBS continued to refine Basel III and agreed to the details of global regulatory standards on capital adequacy and liquidity. The BCBS published the Basel III rules along with a quantitative impact study of the new rules in December of 2010. This framework addressed both microprudential and macroprudential issues with the goals of having better-quality capital, better risk coverage, and the introduction of a leverage ratio as a final line of defense to the risk-based requirement,
actions to encourage the accumulation of capital that can be drawn down in periods of stress, and the introduction of two global liquidity standards. The newly published standards were very similar to the changes agreed to in September of 2010. As agreed to by the G20 in Seoul, the standards would be implemented in a gradual manner as to not disrupt markets and damage the global recovery.

Following the G20 summit in Seoul, international coordination faced many difficulties as the Eurozone crisis deepened and reform to the international financial system slipped down the agenda. When the G20 met November 3-4 in Cannes, France the global recovery had slowed and unemployment was still high. Overall, the summit was very disappointing as little was accomplished with regards to reforming the international financial system and divisions concerning the handling of the Eurozone crisis prevented policy coordination. Many of the statements concerning the international financial system included in the communiqué reaffirmed their commitment to previous agreements.

Conclusion

The responses to the Subprime crisis differ in many ways from the responses in the Mexican and Asian crises as neoliberal ideas are still present but not as dominating. The Subprime Crisis originated in the U.S. and severely affected many G7 states as opposed to the Mexican and Asian crises that primarily concerned emerging economies. The initial responses to the Subprime Crisis were carried out primarily at the domestic level, which is a change from the previous crises, which were handled mainly by the IMF. Initial responses included both fiscal and monetary stimulus from many states, which is a break from the neoliberal orthodoxy of austerity that was witnessed in the Mexican and Asian crises. Stimulus began in many places in 2008 and continued into
2010, when some leaders opted for fiscal austerity while others wanted to continue fiscal stimulus. The shift in leaders’ ideas has hampered international coordination with regards to fiscal stimulus and austerity and continues to be a contentious debate.

The other major initial response was to bailout large financial institutions that were considered ‘too big to fail’ and to provide stabilization funds to states such as Iceland, Greece, and Ireland, which found themselves in trouble following the crisis. Fundamentally, this follows a more liberal interventionist approach, but as history has shown, neoliberals have not been opposed to bailing out banks or states. Because large international banks were at the forefront of the Subprime Crisis, the long-term response included the passage of Basel III, which placed more strict capital requirements on such banks. The increased regulation that restricts activities illustrates a partial shift from the dominance of reforms centered on transparency as seen in the Mexican and Asian crises to policy makers being more willing to implement regulations that restrict activities. Moreover, the solution to ensuring systemically important banks from failing was to increase their capital cushion. Once again, the IMF and member states acted as if more stabilization packages and bailouts would be needed in the future by increasing the IMF’s available resources to $750 billion.

The calls for more regulation that restricts activities are present in a number of other areas in addition to Basel III but these are also mixed with demands for more transparency and regulation that enforces transparency. Individual states have taken Basel III and passed their own legislation to adhere to the agreements made at G20 summits. This is also a shift from previous responses where calls for transparency dominated. Additionally, the Financial Stability Forum (FSF) was created to promote financial
stability and set standards for states to use when reporting information which has included elements of restrictive regulation and transparency further illustrating a shift away from the overwhelming dominance witnessed in the previous two crises.

The discussions surrounding capital flows were much less intense than in the Mexican and Asian crises as the states most severely affected by the Subprime Crisis had liberalized their capital accounts. The one exception is Iceland, who implemented domestic capital controls following the collapse of their financial sector in 2008. However, there were discussions on how to handle such large flows and reforms centered on increased monitoring of capital flows, which is a continuation of adherence to neoliberal principles. Moreover, the responses to the Subprime Crisis show a change from the Mexican and Asian crises with regards to the types of policies implemented to deal with the crisis. Instead of the dominance of reforms based on neoliberal ideas, reforms include many more liberal interventionist ideas such as stimulus and activist regulation. What began as a charged call to action for reforming international financial institutions, regulations, and the international financial architecture has ended up stalling as new problems, such as the Eurozone crisis, have emerged. Ever divergent views about the economy have led to leaders being unable to agree on some policies and international coordination has suffered. In the next chapter I analyze the Mexican, Asian, and Subprime crises using the theoretical framework from chapter three.
CHAPTER 7: IDEAS AND INTERNATIONAL COORDINATION IN RESPONSE TO FINANCIAL CRISES

When responding to financial crises, ideas have played an important role in shaping policies at both the domestic and international levels. Policy makers’ ideas about how the economy works and the proper policies that should be enacted in times of crisis give us insight in why responses to financial crises take the various forms they do. In the previous three chapters I have outlined the causes as well as the short-term and long-term responses to each crisis. In this chapter I examine how ideas have affected the responses to the three crises in four areas: (1) austerity vs. stimulus (2) transparency vs. regulation (3) unrestricted capital flows vs. capital controls and (4) bailouts. I then explore how the ideas policy makers held about what policies were best suited to respond to the crisis affected international coordination. These issues play out at both the domestic and international levels and are directly interrelated.

The responses actors take in response to financial crises are generally defined by one of two economic assumptions; (1) markets work and (2) markets are good but can fail. A third assumption argues that markets are essentially bad, and is promoted by scholars such as dependency theorists and neo Marxists, but this assumption is not widespread among current policy makers. The first two ways of thinking about the economy highlight the primary themes of much of the disagreement found in the case studies regarding crisis responses. Essentially we have two different conceptions of how the economy works best at the macroeconomic and microeconomic levels. The first approach argues that ‘markets work,’ and will function properly as long as governments allow markets to function properly. Under these assumptions markets are self-correcting
when imbalances occur. Neoliberals, who prefer a smaller government, less government involvement in the economy, deregulation, privatization, and a more free market approach, have been one of the most influential groups to adopt the ‘markets work’ stance. According to neoliberals, markets fail (1) when the government interferes in the economy, which provides perverse incentives that distort markets or (2) when information is incomplete.

The ‘markets can fail’ position, posits that markets are not always inherently stable or always self-correcting, especially in times of economic downturn. Therefore, liberal interventionists argue that markets require careful management by the state, as the state is often the only actor large enough to correct the market. According to liberal interventionists, imbalances at the microeconomic and macroeconomic level are bound to occur and the government should step in to fix these imbalances or take preventative measures to ensure the proper functioning of markets. Liberal interventionists believe that markets can fail on their own and consider government intervention in the economy necessary to stabilize markets and help them function properly.

With two opposite notions of how the economy works, the role of government in the economy, and what types of policies should be implemented, it is understandable that disagreements originating from these two schools of thought would lead to a lower level of international coordination. Austerity vs. stimulus, transparency vs. regulation, the debate over capital controls, and bailouts vs. moral hazard all are affected by the markets work/markets can fail debate. These specific issues are where much of the ideational conflict when responding to economic crises occurs, and can be related back to one assumption or the other.
Austerity vs. Stimulus

One of the central issues when debating responses to an international financial crisis is whether governments should use austerity or stimulus during an economic downturn. The key to recovering from an economic downturn is to foster economic growth, but this debate centers on the best way to accomplish growth and involves both fiscal and monetary policy. States can enact fiscal austerity or fiscal stimulus and states can implement monetary stimulus or abide by a strict monetary policy.

Because neoliberals view markets as self-correcting, they recommend fiscal austerity and the elimination of debt in order to bring the larger economy and government finances back into balance. Furthermore, governments need to avoid excessive debt in order to restore confidence in markets and to maintain the government’s credibility with investors and the business community. It is argued that once the economy is in balance businesses and consumers will regain confidence and begin spending money, which will allow the economy to grow again. Neoliberals are divided regarding monetary policy. Those adhering to strictest of monetarist ideas would argue that monetary policy should only be used to address inflation and adjusting monetary policy will not help correct other types of economic imbalances. The rational expectations school in economics and those economists who emphasize the existence of a natural rate of unemployment are particularly critical of the idea that looser monetary policy can reduce unemployment and ease an economic slowdown. However, not all neoliberals adhere to this thinking. Milton Friedman famously has argued that monetary policy mistakes were responsible for the depth of the Great Depression, implying that monetary policy has a role to play beyond restraining inflation in limiting economic slowdowns. Less strict monetarists also
recognize a role for central banks in liquidity crises and as lenders of last resort. As this chapter illustrates, forcing the implementation of strict monetary policy on Mexico and Asia was easy for the IMF and G7 to do, but when the G7 economies were affected by the Subprime Crisis, central banks coordinated an interest rate cut and loosened monetary policy.

Liberal interventionists, who do not see markets as self-correcting advocate that the government counter a downturn by providing stimulus through government spending, hiring, and investment. It is claimed that the debt incurred by stimulating the economy will be supported in the future as the tax base grows once the economy recovers. Therefore balancing the budget in tough times is viewed as counterproductive to recovery because it makes the decline worse. Liberal interventionists also advocate monetary stimulus in times of economic hardship by lowering interest rates and expanding the money supply to encourage lending and economic activity.

The extent of fiscal austerity and/or stimulus policies in response to the first two crises was uneven. The initial response by international actors, the IMF, and G7/8 states to the Mexican and Asian crises was strict fiscal and monetary austerity. This is the same prescription of austerity that was given for Latin America during the 1980s debt crisis which resulted in a ‘lost decade’ for many Latin American countries. The failure of austerity in Latin America apparently failed to dissuade policy makers for recommending the same policies for Mexico and Asia in the 1990s. Mexico, as well as the Asian states \(^{21}\) that received stabilization packages from the IMF, were required to balance their budgets, cut capital account deficits, tighten monetary policy, and tighten fiscal policy. Despite the

\(^{21}\) These included South Korea, Indonesia, and Thailand
domestic unpopularity of austerity in Mexico, their economy rebounded after the difficult years of 1995 and 1996 and this formula was implemented again in Asia.

Both the Mexican and Asian crises began as capital account deficits fueled by foreign investment which led to capital flight and subsequently resulted in currency crises. Because the Mexican and Asian economies were so heavily dependent on foreign investment, when foreign investors pulled their money out of these states because of a loss of confidence, the IMF instituted fiscal austerity in order to increase investor confidence and quell the crisis. By limiting a government’s ability to take on more debt, the IMF believed that markets would calm and stability and confidence would be restored. Internationally, the austerity imposed on Mexico was never truly questioned by policy makers.

As fiscal and monetary austerity measures were implemented in Asia, criticisms arose from domestic populations as well as respected economists. Students in Indonesia rioted in protest of the austerity measures which eventually led to the toppling of the Suharto regime; Joseph Stiglitz, then President of the World Bank, criticized the IMF of inducing capital flight and panic in states with which it was attempting to reduce panic. Stiglitz also accused the IMF of sticking too stringently to neoliberal ideas and using “Hooverite contractionary policies” (Stiglitz, 2003, p. 105). Jeffrey Sachs and Paul Krugman were also critical of the fiscal and monetary austerity measures imposed on the Asian states, with Krugman criticizing the fiscal austerity and spending cuts forced on governments as well as the raising of interest rates to defend Asian currencies, arguing that both actions helped deepen the recession (Krugman, 2009). Despite the protests, the
response was very clear; austerity was the formula. The only question that remained was how much austerity is the appropriate amount.

While there was some pushback against the austerity measures in the Asian cases from domestic populations, economists, and some policy makers, the pushback didn’t result in major policy changes at the international level, as policy adhered largely to neoliberal principles. However, forcing tough austerity measures on states was criticized outside policy-making circles during the Asian crisis for being too harsh and was accused of driving the Asian countries further into recession. The IMF initially recommended austerity, but the IMF adjusted their measures slightly once they realized that some of the austerity measures were too harsh. For example, the IMF loosened the conditions on Thailand’s budget surplus target and eased interest rates in January of 1998 at the request of the Thai Finance Minister Tarrin Nimmanahaeminda (The Financial Times, 1998). Even with the IMF loosening conditions on Thailand, the pushback against austerity in policy making circles subsided as the Asian economies began recovering and resumed growth entering the twenty-first century.

When examining why fiscal and monetary austerity would be implemented on Mexico and Asian states one must ask who benefits from the idea that austerity is the only prescription that will work. A large amount of the bailout money to these states was to go toward helping them pay off their debts, which happen to be owed primarily to large American and European banks that invested in Mexico and Asia and then pulled their investments once panic ensued. By enforcing austerity and not allowing states take on any more debt the banks in the U.S. and Europe were ensuring they were going to be paid back for money lost when the crisis hit. Moreover, the self-interest of the developed
states and the protecting of their banks was quite evident in both the Mexican and Asian crises as those crafting the international response were from the same states whose banks would have incurred the largest losses if Mexico or the Asian states would have defaulted.

The responses to the Subprime crisis were much different than both the Mexican and Asian crises, yet have also been fragmented. What began with fiscal stimulus in most places then faded to calls for fiscal austerity in some places. However, as growth has been painfully slow and unemployment remains largely unchanged, protests and even riots have led to renewed calls for stimulus. As some leaders have remained firm on their recommendations for austerity, others have switched their position, leading to disagreement at the international level on which policies to pursue.

The nature of the subprime crisis was different in that the financial sectors of the largest economies, specifically the U.S, were primarily responsible for the crisis. Instead of recommending monetary austerity and raising interest rates, Central banks agreed to lower interest rates and inject liquidity. Domestically, the U.S. attempted to avoid recession with the Federal Reserve lowering the federal funds rate from 5.25 percent in August of 2007 to between 0-0.25 percent in December of 2008, where it has remained since. The European Central Bank (ECB) cut the marginal lending rate from 4 percent in August of 2007 to 1 percent in the spring of 2009, where it has remained since. The Bank of England (BoE) also cut interest rates from 5.75 percent in August of 2007 to the current rate of 0.5 percent by March of 2009.

Central banks also began injected liquidity starting in late 2007, while providing lines of credit to troubled banking institutions. In this process, a high level of
coordination between the major U.S. and European central banks was displayed. As these three examples illustrate, monetary policy in G7 countries in response to the crisis initially favored stimulus over austerity, which differs greatly from what was recommended to Mexico and the East Asian countries in the 1990s. The Federal Reserve has usually acted Keynesian/liberal interventionist in times of crisis as has the BoE, but the ECB is a newer institution that has reluctantly followed the lead of the U.S. and U.K, due in most part by the dominance of Germany in ECB affairs and their hawkish stance on inflation fighting.

While monetary stimulus was widespread, fiscal stimulus in response to the subprime crisis has been much more uneven and fragmented than the monetary policy response and has become much more divisive as recoveries have slowed and unemployment has risen. Internationally, states agreed to stimulate their economies at the 2008 Washington D.C. G20 summit and reaffirmed this stance at the G20 summit London the following spring, but as the global economy began to show signs of recovery there was less agreement and some states began calls for austerity.

Domestically, the U.S. acted first as they tried to stimulate the economy directly through the Economic Stimulus Act of 2008 and then later passed a $787 billion spending package that included money for bank bailouts in October of 2008. Meanwhile, the Europeans had pledged $257 billion worth of stimulus by March of 2009, but European governments were stimulating their economies more than the $257 billion, due to more of a passive stimulus that was built into their welfare states via automatic stabilizers instead of the direct stimulus the U.S. was pushing for (Champion, 2009).

---

22 The 2008 U.S. stimulus package totaled $150 billion and was in the form of direct payments (Grant & Politi, 2008)
Perhaps the best example of a state provided direct stimulus was China’s stimulus package of 2009. The Chinese government instituted a $585 billion stimulus plan which focused on infrastructure and was applauded by the IMF (Dyer, 2008). China was in a better position than other states to institute such a large stimulus due to its low national debt and budget surplus. Additionally the Chinese government has had a persistent fear of social unrest and potential revolution; therefore maintaining a healthy economy has been a stability concern for the Chinese (Anderlini & Lau, 2009).

After the initial rounds of fiscal stimulus from G7 states and China, there has been a turn towards fiscal austerity to bring budget deficits into order. Due to the initial fiscal stimulus and bank bailouts provided by the governments around the world in 2008, sovereign debt became more of an issue starting in 2010. When fears of excessive debt came to dominate discussions within the U.S. and Europe, those advocating fiscal austerity became much more vocal and outspoken. Critics of fiscal stimulus use the fact that governments have spent billions of dollars in bank bailouts and stimulus to argue that government stimulus has done little for the economy except inflate government debts and make the recession worse.

The U.S. was deadlocked in Congress with regards to raising the debt ceiling in August of 2011, only reaching a deal at the last minute, which cost them their AAA credit rating. States such as the U.S. and Germany have opted to allow their fiscal stimulus to expire as opposed to directly cutting programs. However, other states have opted for more direct and immediate fiscal austerity. The best example of direct fiscal austerity has been the U.K. In 2010, the U.K.’s new coalition government unveiled an austerity package aimed at eliminating the annual budget deficit by 2015. The plan included goals
to eliminate 490,000 public sector jobs, cut government expenses by nineteen percent over the next four years, and to increase taxes. The British citizens have responded with protests that began in 2011 and were continuing into May of 2012 (Holden, 2012).

Since the initial fiscal stimulus from the U.S, the E.U, and China, the debate concerning fiscal austerity and fiscal stimulus has been amped up. Both sides of the issue say they want growth but how to achieve growth is the question. Europe has had sovereign debt issues with Greece, Ireland, Spain, Portugal, and Italy and the U.S. national debt has ballooned to nearly $16 trillion. Germany is pushing fiscal austerity on many of the E.U. states, which has exacerbated the social tension, and the U.S. is at deadlock with Republicans pushing fiscal austerity and Democrats advocating fiscal stimulus. The debate has divided the G8, the E.U, and the U.S as well as the countries inside the E.U. and states in the U.S. Austerity measures in Greece and the U.K. have led to violent protests in the street and Nicolas Sarkozy was defeated by Socialist Francois Hollande, who promised a push for growth and not austerity.

Since the London G20 summit in April of 2009, agreements on fiscal stimulus or fiscal austerity have been largely absent from any of the communiqués or official documents. Internationally, the push for austerity has come largely from Germany, who has insisted that Greece and Spain need to adopt fiscal austerity to bring their budgets under control. The U.S, France, Italy, the Organization for Economic Cooperation and Development, and the IMF have urged policies aimed at growth. The push for fiscal austerity and denouncing of fiscal stimulus from Germany may be tied to their past as their primary experience of fiscal and monetary stimulus resulted in hyperinflation and the rise of Hitler, creating a national mindset diametrically opposed to excessively high
debts. Angela Merkel has stated that she is in favor of growth, but refuses to adopt fiscal stimulus policies to achieve that growth (Birnbaum, 2012).

At the most recent G8 meeting in May of 2012, leaders agreed that more growth was needed but states might pursue different policy because of the split between stimulus and austerity. What started initially as rather high levels of coordination in both fiscal and monetary stimulus has deteriorated as the ideas on how to best achieve growth have changed in the minds of some and not others. This has in turn led to countries pursuing their own policies, and in the case of Europe; Germany is trying to push their austerity policies on the rest of the Eurozone. The result has been an asymmetric ideational shift regarding fiscal austerity and much lower levels of international coordination, which threatens a sustainable recovery from the ongoing economic crisis (McGregor & Kiran, 2012).

The ideational shift from fiscal austerity to fiscal stimulus has occurred asymmetrically as some leaders are challenging adherence to the neoliberal idea of fiscal austerity. This includes states such as France and the U.S, but has also occurred to a degree at the IMF, who recently told Europe their economies needed stimulated to prevent an even larger downturn. As states such as the U.K. have imposed more direct forms of fiscal austerity and their economies have failed to improve, calls for growth and fiscal stimulus have increased. The fiscal austerity being attempted in the U.K. has led to protests and their economy is still in recession and unemployment is still around 8.2%. Greece has struggled since 2010 with fiscal austerity imposed by the EU and the IMF and is in danger of leaving or being forced out of the Eurozone.
Many of the calls for fiscal austerity are coming from the neoliberals within governments in the U.S. and Europe as well as the business and financial sectors of society. The business and financial sectors are impacted by interest rates more than the average person as borrowing money is required frequently for various activities. Therefore their interest in seeing government debts minimized is directly related to their interest in keeping interest rates low in order to maximize profits. However, the calls for fiscal austerity are being offset by those hurt the most from austerity; the less fortunate and unemployed. Since a large portion of government spending is on the welfare state, and business and finance interests are less affected by cuts to these areas than the poor and vulnerable, cuts to the welfare state make sense to business and financial interests as a way to trim the deficit. As business and finance call for fiscal austerity and the trimming of budgets, unemployment remains high in Europe and the U.S, and the calls for more jobs and fiscal stimulus from the unemployed and poor have increased. Meanwhile the divide between those calling for fiscal austerity and fiscal stimulus continues to increase as states maintain divergent paths.

Transparency vs. Regulation

The transparency vs. regulation debate occurs when the long-term responses to financial crises are being discussed. The prevention of future crises becomes a priority only after the causes of a financial crisis have been able to be accurately identified. This discussion centers on crisis prevention, and disagreements occur over what is the best way to prevent future crises without damaging the economy. There are different levels of transparency and regulation that are considered. In a broad sense, there are discussions about whether transparency or regulation is preferred. In another sense, debates have
revolved around the manner of regulation that is desired. Regulation that restricts
activities operates differently than regulation that forces banks, corporations, or states to
be more open in order to make markets more transparent. Finally, if regulation is decided
on, debates about the proper level of regulation in a given area may transpire. These
disagreements are found throughout the three case studies and beliefs about the nature of
markets are again central to the debate.

For neoliberals, preventing a financial crisis requires providing higher quality,
more complete information through more transparency while restricting government
regulations that restricts activities, which can distort markets. Given that neoliberals
believe markets fail because either governments meddle in the economy, which distorts
markets or because market actors have incomplete information, increasing transparency
to provide better information to market actors is a better solution than regulation, which
will only hamper the proper functioning of markets. However, liberal interventionists are
more willing to implement regulations to directly prevent risky behavior. Liberal
interventionists agree with Keynes, who rejected the notion that a market-based system is
sufficient for growth and stability and argued that regulations were needed for stability
and growth (Best, 2005, p. 40). The belief that markets can fail on their own lends
credence to the view that regulating specific aspects of markets and preventing risky
behaviors that make market failures more likely is necessary for the overall health of the
economy.

The dominance of neoliberal ideas was displayed in the response to the Mexican
and Asian crises as transparency dominated the calls for reform. Because Mexico and the
Asian states were ‘emerging economies’ that were in the process of integrating into the
new international system of liberalized finance much of the initial blame for the crises was able to be placed on crony capitalism, poor information from governments, banks, and businesses which provided international financial interests a scapegoat for bad investment decisions and irrational behavior. Due to international financial institutions as well as many G7 states adhering to the neoliberal ideas, markets were not believed to be the cause of either of these crises, which leaves incomplete information or government interference in markets as the causes. By blaming governments, crony capitalism, and a lack of credible information, financial institutions can mask any flaws within liberalized financial markets from which they so handsomely benefit. The rational response to a crisis if government interference and incomplete information are to blame, is to increase information to ensure that market actors are aware of governments distorting markets and to prevent information imperfections that lead to bad loans.

Strengthening the international financial architecture to accommodate these changes began in response to the Mexican crisis and continued after the Asian crisis. This process was started at the Halifax G7 Heads of State summit and continued after the Asian Crisis. The discussions and reports from the IMF, G7, and G10 were all based on the neoliberal position of transparency. The market failures in the Mexican and Asian crises were initially blamed on a lack of information; therefore reforms were aimed at increasing information through more transparency. Transparency was to be increased at all levels. The IMF was to increase its surveillance of member countries following both the Mexican and Asian crises and developed the Special Data Dissemination Standard to enhance the reporting of economic data from member countries. Financial institutions were urged to release more timely and accurate data.
The 1998 G7 finance ministers report on global financial architecture also displays the overarching belief that better information will lead to better markets and better decisions by market actors. Nearly every recommendation to improve the architecture revolves around the notion that more information might have prevented the Asian crisis and might help markets function well in the future. As evidenced from the report, there is a strong belief that if they only had more information economic actors would have responded appropriately and the crisis could have been prevented. It’s hard to know whether proper reporting of all information would have made a difference in the development of the Asian Crisis, as it is impossible to know if actors would have responded correctly to market signals and if the information was reported accurately.

Transparency and deregulation were partly tarnished in the eyes of many with the developments of the Subprime Crisis and the lack of oversight in financial firms. Due to the nature of the crisis, calls for transparency have been heard alongside calls for increased regulation that restricts activities as well as regulation that forces transparency. While international financial firms would like to continue as they have always operated, possibly with more transparency, the fact that the entire world economy was brought to the brink of destruction due to the reckless actions of banks, lack of regulation, and inadequate oversight, has led to a more vigorous debate about regulation at the international level. This is not to say that calls for more transparency have stopped. Internationally, the Financial Stability Board (FSB), which was created in 2009, was given the task of monitoring the international economy and helping states implement international standards. The FSB also performed tasks such as aiding information exchange among authorities responsible for regulation, reviewing member countries
adherence to regulatory standards, and collaborating with the IMF to conduct Early Warning Exercises (Financial Stability Board, 2012b).

However, the calls for more active regulation have led to new standards for banks, which were at the center of the crisis. Regarding banking regulation, there is agreement that more regulation is needed after the hands off approach during the 1990s and 2000s nearly brought the world’s economy to a crash. International banks, which tend to be neoliberal, have been more in favor of less regulation whereas those on the opposite side, such as consumer advocacy groups have been in favor of more regulation. The Basel II and Basel III Accords accurately illustrate this dispute. The debate was not whether there should be regulation, but what the nature of the regulation should be. Those involved in constructing the accords were concerned with the proper manner in which to weight risk and what the capital adequacy standards for large international banks should be. In response to the excessive leverage taken on by banks in the lead up to the Subprime Crisis, the amount of common equity was raised to provide more of a cushion in tough times and risk was weighted differently to include over the counter derivatives and credit default swaps.

In addition to Basel III, the U.S, U.K. and Europe have differed in the financial reforms adopted, as each has passed different financial reform laws to adhere to their agreements made at G20 summits. The U.S. passed the Dodd Frank bill which has a number of provisions that are intended to “improve transparency, stop banks from taking excessive risks, prevent abusive financial practices and end “too big to fail” by authorising regulators to seize any big, tottering financial firm and wind it down” (The Economist, 2012). In Europe, the U.K, which bragged of their ‘light touch’ approach to
regulation of their financial sector during the 2000s, has followed the U.S.’s lead and switched gears in their handling of financial regulation. The U.K. now has higher capital adequacy standards and has one of the most stringent regulatory regimes in the world and is much stricter on enforcement. Meanwhile the EU is attempting to pass multiple new financial laws to limit short selling, high frequency trading, and shadow banking (Masters, 2012).

As one examines the regulatory responses to the Subprime Crisis, a shift to more regulation that limits activities of banks is witnessed, especially investment banks. The problem with international coordination on regulation is that states have an incentive to be the least regulatory in order to attract businesses from more harshly regulated states. The U.K, U.S, and EU are all increasing financial regulations to adhere to Basel III, but depending on how the specifics of each regulatory regime are constructed, one state or group of states may have a competitive advantage, which could result in financial firms moving location in search of less regulation and higher profits. As finance has gone global, hard law and enforceable regulation is still done within states despite agreements to adhere to international standards. Because finance and banking operates in the global sphere and no global authority exists to enforce identical standards on all states, financial institutions have an advantage over regulators when choosing where to do business.

Another complication is when banks have branches in more than one state. In this situation it is not entirely clear whose rules the bank should follow and can lead to confusion about proper regulations and standards. While there has been coordination in the area of regulation and transparency, the details of new regulations are still being worked out at both the domestic and international levels and how the details are
structured will ultimately determine if coordination is as high as it appears at the current moment. What is certain is that strict regulation has been called for in lieu of the hands-off regulatory approach preferred in the lead up to the Subprime Crisis.

Unrestricted Capital Flows vs. Capital Controls

Short-term capital flows have posed problems in all three crises examined in this thesis. The ability to move money around the globe quickly presents opportunities for large amounts of money to be made if investments are made wisely, but can wreak havoc on economies because capital can be withdrawn at the first hint of uncertainty, drying up sources of financing. This can very quickly create a capital account deficit, which could drain foreign reserves and lead to a currency crisis. Liberal interventionists have favored regulating unrestricted short-term capital flows since the Great Depression because of the volatility they can create. Keynes felt that free capital flows should be highly regulated because no country could either allow funds to leave or enter freely without having destabilizing effects (Best, 2005, p. 45).

Conversely, neoliberals promoted free short-term capital flows and actually encouraged further liberalization of capital accounts following the Mexican and Asian crises, despite their central role in both crises. Neoliberals and those who believe ‘markets work,’ including large investment banks, advocate unrestricted capital flows because they feel it is the most efficient way to allocate capital to where it is most needed. It is also argued that unrestricted capital flows provide incentives for governments to keep their economic house in order to make investing in their countries more appealing. Investment banks and financial interests favor free capital flows because it allows them to invest anywhere in the world with low costs while allowing them to pull
their money if they feel the investment will go bad or they feel governments will act in a way that is detrimental to their investments (Blyth, 2003, p. 256). This gives international financiers tremendous sway over governments and enables them to influence government decisions concerning markets while still making large profits.

When the Mexican and Asian economies received a large influx of short-term capital flows, increases in financing for longer term investments occurred in both the private and public sectors. Because these economies were dependent on investors rolling over their short-term loans to continue financing, once the sources of funding were stopped, states were left with a balance of payments crisis. In the cases of Mexico and the Asian states, money was withdrawn by foreign investors and reserves from capital accounts were depleted, which left governments and banks unable to pay back loans denominated in other currencies. Because of these states’ adherence to a fixed exchange rate to the dollar and the draining of foreign reserves to defend their own currencies, currency crises ensued. In the Subprime Crisis the “Global Savings Glut” states invested largely in the U.S, which was one of the factors leading to an excess of cheap credit. Once the housing market slowed down and investors began losing on their investments, lending stopped and credit markets froze, creating a financial panic.

To solve the issues that unrestricted short-term capital flows pose, neoliberals defined the problems in Mexico and Asia as states acting irresponsibly with their financial liberalization, practicing crony capitalism, and local banks making bad loans. These conditions left them vulnerable to the reversal of short-term flows. To fix the problem, more transparency was needed as well as improving financial systems to better accommodate capital flows. The G7 and IMF specifically discouraged states from
enacting capital flows despite the instability they caused in the Mexican and Asian crises. The Asian and Mexican crises can be seen as putting a supercharged engine (unrestricted capital flows) in a car that wasn’t quite finished being built (Asian and Mexican financial systems). Asian and Mexican financial systems were not able to effectively handle such and influx of capital flows. Therefore, once you slam on the gas the car might drive well for a while but eventually it is going to fall apart because the body cannot handle the power of the engine. However, the recent inability of the U.S. economy to efficiently handle influxes of capital flows leads one to question whether any economy can handle unrestricted short-term capital flows.

Liberal interventionists have advocated capital controls since Keynes and the Bretton Woods system, but the issue of capital controls has more recently revolved around ‘emerging economies.’ States such as Malaysia, who was affected in the Asian Crisis, China, and Iceland, have implemented capital controls to prevent capital flight. In the Mexican and Asian crises, states had liberalized their capital accounts quickly and irresponsibly with the urging of G7 countries. These countries did not have the economic and banking infrastructure to handle such flows despite the G7 states encouraging the liberalization of their capital account.

Despite the role “hot money” played in the Subprime Crisis, G7 countries have not seriously considered capital controls or capital constraints in the ways they were implemented during the Bretton Woods era, which were generally more direct controls restricting cross border currency transactions.23 The one exception for G7 countries is the Tobin Tax, which is aimed at curbing currency speculation. The Tobin Tax is being

---

23 Many of the issues with “hot money” in the Subprime crisis centered on “hot money” within the U.S. and not international capital flows.
debated in the media as well as in policy circles and would act as an indirect capital control on currency exchanges, as currency exchanges would be taxed in order to dissuade short-term exchanges that can be destabilizing. Despite the talk of a Tobin Tax and a few states implementing capital controls there has been a relatively firm consensus that free capital flows should continue. Because short-term capital flows were not at the heart of the Subprime Crisis there have been fewer calls to limit or restrict them in both the international and domestic realms.

Bailouts vs. Moral Hazard

The final component of the battle of ideas between neoliberals and liberal interventionists is whether or not states and financial institutions with debt or liquidity issues should be bailed out. This has been one of the most contentious debates, and has been intensified as banks and states have incurred ever-growing debts. There are two primary types of bailout that have been debated: bailouts of banks and bailouts of states. There are some instances such as Mexico and Thailand, where bailouts of states included some money to rescue or recapitalize the banking sector, but the main issue was centered on providing the state with enough liquidity to pay external debts.

Fundamentally, the neoliberal argument for each type of bailout contends that the bailouts create moral hazard. Moral hazard is when actors believe the government will intervene to rescue banks or states from their bad decisions. Moreover, when banks or states are bailed out, it creates a belief that they will be bailed out in the future which incentivizes actors to continue with risky behavior, which may lead to the next crisis. Regardless of whether one is discussing a bank bailout or a bailout to a state, the argument against the bailouts is the same. Bailouts create moral hazard and incentivize
risk taking. The G10 recognized the problem of moral hazard in their 1996 report on resolving sovereign liquidity crises, when they stated that no state or bank should expect to be bailed out by official financing. However, despite this statement, governments have continued to bail out banks that are seen as systemically important and the IMF has bailed out states to prevent further financial panic.

Liberal interventionists believe that the government should intervene to correct imbalances; therefore, bailing out states with debt or liquidity problems can be seen as necessary and stabilizing. Similar arguments have been made in regards to bailing out ‘too big to fail’ banking institutions (systemically important financial institutions or SIFIs). Because bank bailouts are reserved for banks that are seen as systemically important, it is argued that these banks must be bailed out if allowing them to fail would create a systemic threat to either the national or international financial system and possibly spread market panic to other banking institutions.

The bailing out of banks is not a new phenomenon as the history of bank bailouts can be traced to England in the 1820’s. However, the idea of bailing out banks was far less viable during the Great Depression and throughout the Bretton Woods years because the gold standard limited the amount of money available in circulation. Over the last thirty years, financial market deregulation and economic liberalization have enabled bank bailouts have become more common. The U.S. Federal Reserve bailed out U.S. investment banks in the Savings and Loan Crisis as well as the Penn Central crisis in the 1980’s. Direct bank bailouts were absent from the Mexican crisis, but reemerged in the Asian crisis on a small scale. The bank bailouts witnessed in the Subprime Crisis were of a magnitude that dwarfed any previous bailout. The U.S, Germany, France and the U.K.
among others spent hundreds of billions of dollars each towards rescuing their shattered banking sectors. Not all banks were saved, but the largest banks that were considered the most systemically important were generally rescued. Bailing out banks on this scale and magnitude is a new phenomenon as they became increasingly large and highly leveraged. Through deregulation, the conditions were created that enabled banks to become very large, important, and dangerous to the world economy.

Banks have always been simultaneously important and dangerous, but as banks increased their dependence on short-term wholesale funding in conjunction with states liberalizing their capital accounts and deregulating their financial sectors, banks became even larger and more highly leveraged. This combination made banks more systemically important and more dangerous to the economy. Because of the size of some financial institutions, they were considered systemically important to the global financial system, which left policy makers with little choice but to enact bailouts to save the financial system.

Bank bailouts have generally occurred at the national level and were subject to various domestic interests, yet bank bailouts have been coordinated internationally. In the Subprime Crisis, the U.S. originally passed a $700 billion bank bailout to purchase troubled mortgage related assets, but as it proved too difficult to determine the worth of the assets and economic conditions continued deteriorating, the U.S. switched to bank recapitalization. The switch in the use of the $700 billion was following the example of Gordon Brown, the U.K.’s Prime Minister, who preferred direct bank injections to purchasing toxic assets directly. This action illustrates an indirect form of coordination that is much less formal than a G8 or G20 summit. The hope was that if the U.S. and
U.K. proceeded down the same path, this might influence a more coordinated international approach of direct capital injections to banks, which was largely the result in Europe and other G8 states. This indirect form of coordination displayed that coordination doesn’t have to occur in a formal setting, but rather could be done by reacting to the actions of others.

Financial institutions have a particular interest in being bailed out and in some cases having states bailed out. Despite the usual adherence to the ‘markets work’ mentality, the large international banks that underwrote billions of dollars of bad securities, which contributed to the Subprime Crisis, took a ‘liberal interventionist’ stance and favored the bailouts. The banks in favor of the bailouts were primarily the large, international banking institutions that were the most highly leveraged and at the highest risk of going bankrupt had they not been bailed out. The ideational inconsistency displays the triumph of interests over ideology. When the ideational position of ‘markets work’ did not serve financial interests, their point of view changed to protect their interests. If large banks can be bailed out by governments, it allows them to benefit from the profits of the good times and socialize losses in times of crisis by asking taxpayers to foot the bill, leading to much criticism. The G20 has attempted to reduce the likelihood of bank bailouts by making systemically important financial institutions subject to more regulations including higher capital standards, but as the precedent for bailing out systemically important institutions has been set the future could see more bailouts if an institution’s failure threatens the financial system.

Although bailing out banks has some qualitative differences from bailing out states, there is a link between banking bailouts and state bailouts. The state bailouts of the
1990s were partly the result of emerging economies’ irresponsible capital account liberalization and consequent susceptibility to capital flight. International banks favored the Mexican and Asian bailouts because it was mainly American and European banks that lent money to either banks or the governments in these states. These bailouts were financed primarily through the IMF, which was largely funded by North American and European states with the exception of Japan. By supporting the bailouts, the banks were protecting their interests by bettering their chances of collecting on loans that had gone bad and states were protecting their banks and financial systems. Critics of the bailouts viewed the bailouts to Mexico and Asian countries as bailouts to the banks that lent the money in the first place, which was true, but the large industrial states also had an interest in preventing contagion in both crises.

More recent bailouts to states such as Greece, Iceland, and Ireland were due to issues with sovereign debt as well as bank failures. Although their governments have taken on large amounts of debt for different reasons, the responses have been bailouts over moral hazard. Despite the reasons for assistance throughout the case studies in this thesis, the general response has been to bailout Systemically Important Financial Institutions and states with liquidity or debt issues. Internationally, the G20 states have acknowledged the need to prevent bailouts of both states and banks, but states have simultaneously increased funds to the IMF for emergency financing and the Eurozone has created their own stability fund for the same reasons. The actions of G20 states seem to indicate that they have accepted the fact that bailouts of states are inevitable in the era of liberalized finance, as they have increased funds to the IMF for emergency financing to states in need.
Financial crises have occurred with increasing frequency and severity over the past twenty years. When financial crises are international, they demand a swift and substantial international policy response to prevent contagion to other states and further financial panic. Economic ideas have influenced international coordination in the responses to past financial crises over the last 100 years. Ideas are particularly important when coordinating responses to international financial crises because the two commonly relied upon coordinating mechanisms of hierarchy and markets are unavailable. In the absence of a world government to force states to behave a certain way hierarchy is not possible and because times of economic crisis indicate that markets have failed in some way, markets become unreliable. Therefore, in a world where hierarchy is not available and properly functioning markets are absent, coordination becomes central to the response to international financial crises, and ideas shape the coordinated response. This is one of the central findings of this thesis: ideas matter for international coordination.

The ideas shared by policy makers about how the economy functions at the macroeconomic level can either help or hinder international coordination. When ideas are in harmony as in the response to the Mexican Crisis, high levels of coordination can be achieved. But if ideas conflict as is witnessed in the more recent responses to the Subprime Crisis and policy makers have divergent views of the correct policies to pursue, coordination may be lacking or fragmented, leaving those involved in a crisis worse off.

During the past 100 years two points of view have dominated economic thought; (1) neoliberals, who think markets work and (2) liberal interventionists, who think markets can fail. Because of the opposing views of how the economy functions, these two
ideational viewpoints offer differing prescriptions for policy. As demonstrated by history, crises create opportunities for new ideas and policies to be considered and implemented (Gourevitch, 1986). Classical economic theory was replaced by Keynesianism as the dominant economic paradigm following the Great Depression and then Keynesianism was subsequently replaced by monetarism and neoliberalism following the stagflation, oil shocks, and large state debts of the 1970s. The past thirty years have witnessed the ascendancy of a neoliberal economic order at the international level. A loose consensus of neoliberal ideas centered on market-oriented policies such as deregulation, less government involvement in the economy, transparency instead of active regulation, and liberalized finance have diffused around the globe at various rates. However, more recently, repeated financial crises and economic volatility in the 1990s and 2000s has resulted in a questioning of the dominance of neoliberal ideas by some policy makers.

The changing of some policy makers’ ideas following the Subprime Crisis leads into the second key finding of this thesis: when the ideas of international actors conflict, international economic coordination suffers. Neoliberal free market ideas dominated the responses to the Mexican and Asian crises. This adherence to neoliberal ideas allowed the Subprime Crisis to happen in 2007-08 and the world economy continues to struggle with recover. However, neoliberal ideas have been tarnished in the minds of various leaders who have begun to change their views of how to best achieve recovery and growth by reexamining liberal interventionist ideas. On the other hand, other leaders have continued to support neoliberal ideas. The result was an asymmetric ideational shift. This asymmetric shift in ideas has led to conflicts between neoliberals and liberal interventionists in the four areas of contention mentioned earlier in this chapter.
States have recently become most publicly divided on whether to institute fiscal austerity or fiscal stimulus to their economies. Germany’s Prime Minister Angela Merkel and the U.K’s Prime Minister David Cameron have supported fiscal austerity measures while U.S. President Barack Obama and President Francois Hollande of France among others have been pushing for states to stimulate their economies via fiscal policy. This division has led to fragmented coordination internationally but domestic factors have also played a part in whether or not leaders are able to coordinate policies. President Obama would like to stimulate the U.S. economy but Republicans oppose anything that involves the U.S. increasing their debt. The situation inside the U.S. illustrates that the austerity vs. stimulus battle is not limited to international politics but in encountered in domestic politics as well and that domestic politics can have a real effect on international politics.

The battle between neoliberals promoting more transparency and liberal interventionists advocating more restrictive regulation has seen a shift from the Mexican and Asian crises to the Subprime Crisis. While calls for increased transparency and better information dominated the responses to the Mexican and Asian crises, calls for regulation that restricts the activities of banks have been more pronounced following the Subprime Crisis. What eventually resulted was the passage of Basel III, which is a victory for the liberal interventionists as it imposes stricter international regulation on systemically important financial institutions by the assigning of higher risk to over the counter derivatives and increasing large international banks’ capital requirement. However, Basel III is not required to be implemented in full until 2019 and many liberal interventionists argue that the increased regulations have not gone far enough to prevent risky behaviors by banks while neoliberals claim the regulations go too far by limiting the ability of
banks to make profit and take advantage of financial instruments considered safe before 2007-08.

A shift in the regulation of free capital flows has also been witnessed, but more at the domestic level. Despite the role free capital flows played in both the Mexican and Asian crises, states were encouraged by the IMF and G7/8 to continue liberalizing their capital accounts. While most states continued with liberalization, Malaysia implemented capital controls as a response to the Asian Crisis and China has been very slowly and reluctantly liberalizing their capital account. Iceland implemented capital controls after their currency collapsed in 2008 and Europe and the U.S. have considered applying a tax on currency trades to slow the pace of such trades. While these changes have occurred primarily at the national level, internationally there has been much less of a shift in regulating free capital flows as the focus has recently turned from unrestricted capital flows to the management of capital flows to avoid imbalances and prevent capital flows from becoming a source of instability. While this is a shift from promoting unrestricted international capital flows, the markets work ideas are prevalent, because the ways suggested by the G20 for managing capital flows revolve around more transparency and better information to avoid imbalances and instability. Moreover, capital controls have been more seriously considered domestically than internationally, which can provide tension when states discuss the issue at the international level.

Bank and state bailouts are an interesting case. Both are unpopular and have been denounced by states and international financial institutions, but when faced with crisis situations bailouts have been the policy solution. The Eurozone has expanded their funds to be able to provide assistance to states facing liquidity or debt issues and the IMF has
increased its ability to provide stabilization packages. Global SIFIs have been subject to more strict capital requirements than other banks through Basel iii but as history has shown, when the failure of banks threatens the stability of the financial system, they tend to be bailed out. Much to the chagrin of those favoring a free market approach, there have been policies enacted to prevent bank bailouts through increased capital requirements, but these policies are likely to mean very little should a G-SIFI threaten the world’s economy.

The final insight of this thesis is that ideas are difficult to change and only change when hard times warrant a shift. Economic ideas do not change until crisis threatens the entire system. When a set of economic ideas achieves international dominance they become entrenched within states and international institutions (Ruggie, 1982). Changing the dominant paradigm requires multiple shocks that (1) are directly linked to policies influenced by the current set of dominant ideas and (2) are severe enough to question the dominant ideas. What is currently being witnessed with each financial crisis is a shock to the neoliberal paradigm, which is gradually chipping away at its international dominance without neoliberalism being immediately replaced by another dominant paradigm. With each case study contained within this thesis the pushback against neoliberal ideas became more pronounced, but no alternative has yet been seriously embraced.

The Subprime Crisis was the largest event to date, but even that crisis wasn’t large enough to create a system wide ideational shift. Examining previous shifts in dominant economic ideas, large, multiple shocks were required to discredit the dominant ideas of the time. The dominance of classical economic theory was replaced only after the stock market crash of 1929 followed by the Great Depression and World War II. The
dominance of Keynesian policies that were adopted in the wake of World War II was supplanted only after the collapse of the Bretton Woods system and a decade of ‘stagflation’ during the 1970s.

What may be the case is that economic ideational discord is much more common than economic ideational harmony. Any dominant ideational paradigm will have critics, but these differences have a tendency to fade from the public discourse and become less relevant when times are good. The times of greatest harmony tend to come following periods of great turmoil. Only following the Great Depression and World War II and the economic turbulence of the 1970s, in which many people suffered, were policy makers willing to compromise and agree more fully on economic policy. The Bretton Woods agreement was much more formal and took much more compromise than the neoliberal and monetarist paradigm that emerged after its collapse because of the more active role required of governments in its execution. Moreover, agreement was more pronounced when policy makers had more incentives to agree, which happened to be after economic hardships.

The group of ideas that triumph in the wake of the Subprime Crisis will ultimately depend on how long the recovery and its fallout takes to achieve. The quicker the recovery the more likely the neoliberal free market ideas will continue to prevail. The longer states struggle with slow growth and unemployment, the more likely the liberal interventionist ideas will succeed. Should the world’s economy face more challenges such as the Eurozone crisis, the calls for a more ‘liberal interventionist’ approach may increase. What is certain is that these two competing views of how the economy functions at the macroeconomic level will continue to battle for ideational dominance at
the domestic and international levels. In the past one ideational paradigm has eventually come to dominate, but this is no guarantee that the same situation will ensue. These ideational views may compete for years, leading to a long period of ideational discord and a lack of economic coordination. There may also be another unexpected shock or series of shocks that provide leaders with incentives to compromise or change their ideational stances. One would always like to witness greater harmony and coordination between states, as it is likely to lead to greater prosperity for all. But if history is an indicator it seems as if more economic and social pain will be needed if that is to be achieved, as neoliberal free market ideas may have been tarnished but have not been replaced.


Anderlini, J., & Lau, J. (2009, June 13). *China's stimulus is working but social unrest fears persist.* Retrieved from The Financial Times: http://www.ft.com/intl/cms/s/0/e1ddf11a-57b1-11de-8c47-00144feabd0.html#axzz1whtiUqKG


Fidler, S. (1995, January 14). *A clearer view now of Mexico's debt troubles: Stephen Fidler analyses a commitment by the US, the big neighbour, to solve a severe problem next door*. *The Financial Times*, p. 03.


The Economist. (1994, December 24). The president, the peso, the markets and those Indians. The Economist, pp. 43-44.


University of Toronto G8 Information Center. (1995, February 3-4). Excerpts from the G-7 Ministers and Central Bank Governors Statement. Retrieved from University of Toronto G8 Information Centre: http://www.g8.utoronto.ca/finance/g7torfin.htm