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From Crisis to Crisis

The Global Financial System and Regulatory Failure

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Chapter 1

History of the Global Financial System

1.1 HISTORY

To understand our international financial system, it helps to know some history.

Sovereign debt crises are nothing new. Spain in the sixteenth century and France in the eighteenth are the most commonly cited examples. In the case of Spain, the King would sporadically receive shipments of bullion and treasure from his overseas empire. These he used to finance fighting in Italy, France and Holland. Alas, engaging in a war is like building a house: it usually costs more than you intended and can afford. The Spanish King made up the difference by borrowing from banking houses. Periodically, he could not afford the repayments and there was, in modern parlance, a combination of rescheduling and debt relief – maturities were extended and interest rates reduced. This happened more than once: in 1557, 1575, 1596, 1607, 1627 and 1647, to be precise. Yet the bankers had lent so much that their fortunes were linked umbilically to those of the Hapsburg Empire and thus they continued to lend. The sixteenth century debt crisis lasted a century.[1]

In the eighteenth century, France funded its repeated and costly wars with England by borrowing from Swiss and Dutch bankers. After almost a century of a similar pattern of defaults, rescheduling and debt relief, the limits of the lenders were reached and the loans stopped. The French monarchy collapsed a few years later.

The history of Latin American debt crises coincides with the rise of independent nations in the region in the 1820s. Most Latin American nations

1. H. James, 'Deep Red – The International Debt Crisis and Its Historical Precedents' (Summer 1987) *The American Scholar* 331, 334–336. Modern national names are used for convenience to describe geographical regions.

except Brazil engaged in large bond issuances in London in the 1820s. By 1828 all were in default.[2] A pattern soon emerged in lending to the region. Once the previous default had been resolved and capital was again abundant in Europe, it would find its way to Latin America, usually by way of Europeans purchasing Latin bonds. Within a decade, the debtors would be unable to service the bonds and would default. For instance, capital flowed south in the 1860s. The collapse came in 1873. It flowed to Argentina in the 1880s, and led to the crisis of 1890 (and the first near collapse of Barings Bank). It again went to the region in the 1920s, and, with the Great Depression, almost 70% of Latin American sovereign dollar-denominated bonds and almost 90% of municipal, provincial and corporate bonds were in default by the mid-1930s.[3] The two principal exceptions to this region-wide default following the Great Depression were Argentina and Venezuela. Argentina sold off much of its gold reserves to service its national government bonds although it had to default on many of its provincial and municipal bonds. Venezuela had prepaid most of its debt before the Great Depression and did not default. Argentina honoured its national obligations to the letter throughout the 1930s and 1940s. It never took advantage of the substantial concessions that were extended to Brazil and would have been forthcoming had Argentina threatened to default. Argentina repaid its national debts in full in gold and yet when capital did flow to the region, it did not receive access to it any earlier than its neighbours or at preferential interest rates.[4] Argentina did the right thing (at least from the perspective of its creditors) in the 1930s and 1940s for no reward.

In short, there is nothing new about financial crises – they have occurred frequently throughout history.[5] In the overwhelming majority of sovereign debt crises, from the sixteenth century to the mid-twentieth century, sovereign debtors defaulted on their debts.

More recently, this pattern has changed, which is a theme to which we will return much later.

But it is time to begin to understand where we are today, and to do that we must focus on the events of 1944.

With the end of World War II in sight, the Allied powers began to chart the post-war global economy. Foremost in their minds were two periods. From 1873 until World War I had been a period of general prosperity characterised by ever increasing trade and capital flows. The decade after World War I was, in sharp contrast, characterised by isolationism between countries and declining trade and capital flows, and this led to the Great Depression of 1929. The Depression in many

2. C. Marichal, *A Century of Debt Crises in Latin America* (1989), 43; and F.G. Dawson, *The First Latin American Debt Crisis* (1990).
3. Marichal, *A Century of Debt Crises in Latin America* (1989), 95, 96, 99, 120 and 149–150; D. Delamaide, *Debt Shock* (1984), 53–54; and M.E. Skiles, 'Latin American International Loan Defaults in the 1930s' (1989), 1, 15.
4. J.D. Sachs, *Developing Country Debt* (1989), 23; Marichal, *A Century of Debt Crises in Latin America* (1989), 218; and P.H. Lindert & P.J. Morton, 'How Sovereign Debt Has Worked'(1989), 231–232.
5. See C. Reinhart & K. Rogoff, *This Time is Different* (2009).

ways persisted until the advent of World War II. So it was at the forefront of the minds of those who designed the post-war system.

Because the architecture of the post-war financial system was designed principally by the United States and Britain, it reflected rich country perspectives on the world economy and was designed to safeguard their economic interests. However, it also represented a rare moment of altruism: both nations were genuinely concerned with building a more prosperous and secure world. In President Harry S Truman's words:

> A just and lasting peace cannot be attained by diplomatic agreement alone, or by military cooperation alone. Experience has shown how deeply the seeds of war are planted by economic rivalry and by social injustice. [. . .] [The UN Charter] has set up machinery of international cooperation which men and nations of good-will can use to help correct the economic and social causes for conflict.[6]

The highest priority of those who had lived through the Great Depression and the Second World War was to ensure that such a depression and war would never happen again. This spurred unprecedented cooperation that allowed the creation of new international institutions, including the United Nations, the World Bank and the International Monetary Fund (IMF). In addition to the scarring experience of the war, the Great Depression had a profound effect on those who lived through it. In the United States, for example, national income and production declined by 50% between 1929 and 1932, rendering more than 14 million people unemployed. Accordingly, the delegates at Bretton Woods sought to create a stable international financial system upon which could be built a new post-war prosperity and full employment.[7]

Of particular relevance to those with an interest in law is Bretton Woods' contribution to the general acceptance of a multilateral, rules-based approach to international economic relations. Notwithstanding humanity's long history of conflicts between nations over economic relations, 'the existence of a rules-based framework for the resolution of international economic conflicts can help promote cooperation'[8] and Bretton Woods was, in many ways, the first such framework to endure.

The architects of Bretton Woods were Britain's John Maynard Keynes and the United States' Harry Dexter White. Keynes was the most influential economist of his time, an Honorary Adviser to the British Treasury, and a regular advisor to US President, Franklin D. Roosevelt. White was a former academic economist and Assistant to the Secretary of the US Treasury, Henry Morgenthau.[9] From 1941, the two men independently started developing plans for the post-war economic order.

6. Text of address to the plenary conference that created the United Nations, in S. Schlesinger, *Act of Creation* (2004), 292–293.
7. A. Endres, *Great Architects of International Finance* (2005).
8. R. Lastra, 'The Bretton Woods Institutions in the XXIst Century' (2001), 69.
9. *Ibid.*, 71; A. Van Dormael, *Bretton Woods* (1978), 42.

In August 1941, Franklin Roosevelt and Winston Churchill met off the coast of Canada and laid down their vision of a peaceful world order after World War II in the Atlantic Charter.[10] This document was essentially based on three pillars: peace, financial stability and trade between equal nations. The second and third pillars focused on preventing international economic instability and high unemployment of the sort seen in the interwar period (1918–1939) and supporting economic development through reintegration of domestic economies.

From this basis, White and Keynes began to share their ideas from mid-1942 and, although the initial plans differed considerably in relation to exchange rate flexibility and capital mobility, agreement was eventually reached on a joint plan, which was published in April 1944. This proposal formed the basis for negotiations with other nations at Bretton Woods, New Hampshire.[11]

The International Monetary and Financial Conference of the United and Associated Nations was held in July 1944 to formulate the ground rules for the new international financial system, attended by delegates from forty-five nations. Developing and least developed nations had very little input at the conference, certainly relative to the input they seek to have today in the policy settings and operations of the IMF, World Bank and World Trade Organization (WTO). At the conference, there was a high degree of consensus among delegates about the problems of the interwar years. Conflict in international economic relations between the wars had often been characterised by the use of currency devaluations as a trade weapon and the imposition of trade restrictions.[12] Hence, exchange rate stability was a particular focus of the new system, as was the need to guard against volatile capital flows.

The most difficult issue in Keynes' view was to determine the level of discretion nations should be allowed. The model agreement sought to strike a balance between facilitating international financial stability and allowing the accommodation of domestic policy priorities. Such trade-offs are rarely easy: rules that are overly rigid may leave nations little choice but to leave the international system, which is not conducive to international order. Yet a lack of rules may lead to international financial chaos. The final Anglo-American proposal opted for a strong element of national discretion: it included some strict requirements but most of the proposed Articles of Agreement were closer to guidelines.

The final adopted proposal was closer to White's version than Keynes', reflecting the fact that the United States was the dominant partner in the wartime alliance and by far the stronger economic power, producing in 1945 nearly half the world's industrial production.

The design encompassed three fundamental features. First, its structure was formal and institutional, based on an interlinked set of international treaties and

10. See S.I. Rosenman (ed.), *The Public Papers and Addresses of Franklin D. Roosevelt, New York 1938–1950* (1941), 314.
11. H. James, *International Monetary Cooperation Since Bretton Woods* (1996), 35–46.
12. V. Argy, *The Postwar International Money Crisis* (1981), 2.

institutions. Second, it strongly encouraged closed national financial markets,[13] with limited capital flows, and open markets for trade in goods. Third, relationships among closed national systems were structured through an international institutional framework.[14] Institutionally, the Bretton Woods system was to include three new interlinked international organisations: the IMF, the World Bank and the International Trade Organization (ITO).

Under the design, the overall political coordination of economic affairs was meant to take place through the United Nations (established in 1945), primarily through the United Nations Economic and Social Council (UN EcoSoc).[15] Monetary arrangements were to be based on currencies being fixed to the US dollar which in turn would be fixed to gold, and were to be maintained through the IMF (established in 1945).[16] Responsibility for the financing and coordination of reconstruction and development was placed with the World Bank (established in 1945).[17] Liberalisation of trade and investment was to be the responsibility of the ITO. As global capital flows were to be limited, and finance was to be essentially national, the Bank for International Settlements (BIS) was to be abolished.[18]

The essential underlying theory of both Keynes and White and the final structure adopted was based on a system of stable exchange rates. All negotiators involved felt that, while it was impossible to return to the gold standard as it existed prior to the First World War, it was important to return to a parallel system, with money circulating on the basis of a fixed relationship to gold, rather than on the basis of pure paper currencies ('fiat money'). This design was intended to provide a stable base for finance, investment and trade – the other central pillars of the structure – and to avoid the sorts of monetary instabilities seen during the interwar period. Capital movements were to be largely controlled through domestic national restrictions, with the IMF supporting the system through monitoring of capital flows and facilitating orderly exchange readjustments when necessary.

However, the international economic architecture as designed never came to be. The ITO was still-born.[19] Instead, international trade relationships were structured through a series of rounds of negotiations, formalised through the General

13. Article VI, s. 3 of the Articles of Agreement of the IMF available at <www.imf.org/external/pubs/ft/aa/aa06.htm>.
14. See Proceedings and Documents of the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, 1–22 Jul. 1944, Washington DC, US Governmental Printing Office (1948).
15. See UN Charter (1945), Chs IX–X, esp. 57, 63; <www.un.org/ecosoc/>.
16. The IMF Articles of Agreement were adopted at the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire on 22 Jul. 1944 and entered into force on 27 Dec. 1945. They have subsequently been amended three times: (1) Board of Governors Resolution No. 23–5, adopted 31 May 1968 and effective 28 Jul. 1969; (2) Board of Governors Resolution No. 31–4, adopted 30 Apr. 1976 and amended effective 11 Nov. 1992; and (3) Board of Governors Resolution No. 45–3, adopted 28 Jun. 1990 and effective 11 Nov. 1992. See <www.imf.org>.
17. World Bank Agreement, <www.worldbank.org>.
18. See BIS, Post War and Bretton Woods, <www.bis.org/about/bretton_woods.htm>.
19. See J.H. Jackson, *The Jurisprudence of GATT and the WTO* (2000), 21–22.

Agreement on Tariffs and Trade (the GATT, established in 1948).[20] At the same time, cross-border investment was left to bilateral arrangements. Even with a narrower focus than planned, the GATT was, in fact, highly effective in gradually reducing trade barriers, especially among the developed countries, and in relation to trade in manufactures.[21]

At the same time, because the ITO was never formed, the planned coordinating structure between UN EcoSoc, the ITO, the IMF and the World Bank was never established.[22] Perhaps as a result, the IMF and the World Bank have often been criticised for failing to coordinate their activities – despite sitting on opposite sides of the same street in Washington, D.C. Some efforts were made in this direction following problems arising after the 1980s debt crisis, including the creation of what is now called the 'International Monetary and Financial Committee' (IMFC)[23] and the 'Development Committee'[24] to coordinate activities, but the lack of effective coordination remains a continuing concern.[25]

It was not until 1994 that the GATT members agreed to establish the WTO, reflecting a general consensus in support of greater trade liberalisation and the need of particularly the United States to extend the global trade regime to embrace intellectual property.[26] Therefore, by the fiftieth anniversary of the Bretton Woods conference in 1994, the successor to the ITO had finally emerged, to much fanfare and high expectations. However, while the WTO might appear similar to the ITO, it has a quite different operating ethos and a much more limited scope of coverage than the ITO was intended to have, and the system of fixed exchange rates with which the trade organisation was meant to operate had long since ceased to exist.

Indeed the only part of the structure to function as designed was the area of monetary relations, with the IMF at the centre of a system of fixed exchange rates

20. General Agreement on Tariffs and Trade, 30 Oct. 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194.
21. K. Dominguez, 'The Role of International Organizations in the Bretton Wood System' (1993), 358.
22. See Havana Charter, Arts 10, 86, 87. See also Secretary General's Panel of Eminent Persons on United Nations Relations with Civil Society, 'UN System and Civil Society – An Inventory and Analysis of Practices: Background Paper' (May 2003), <www.un.org/reform/civilsociety/practices2.shtml>.
23. See IMF, 'A Guide to Committees, Groups and Clubs – A Factsheet' (April 2009), available at <www.imf.org/external/np/exr/facts/groups.htm>.
24. *Ibid.*
25. See J. Stiglitz, *Globalization and Its Discontents* (2002); A.H. Meltzer, 'The Report of the International Financial Institution Advisory Commission' (2004). Recognising this, the Second Amendment established a power for the IMF Board of Governors to establish a Council by an 85% majority. Art. VII, s. 1. See Sch. D for operational details.
26. See e.g. A. Kruger, 'Introduction' (1998). According to the Agreement Establishing the WTO, Art. II:

    The WTO shall provide the common institutional framework for the conduct of trade relations among its Members in matters related to the agreements and associated legal instruments.

tied to the US dollar and its link to gold. This worked, arguably quite well, until the early 1970s, with financial crises in this period being far more limited than before or since.

The IMF was founded to:

> promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.[27]

This is a reasonable summary of the aims embedded in the IMF founding treaty, the IMF Articles of Agreement. According to the IMF:

> Since the IMF was established its purposes have remained unchanged but its operations – which involve surveillance, financial assistance, and technical assistance – have developed to meet the changing needs of its member countries in an evolving world economy.[28]

This may be formally true but is substantively questionable. The Fund's purposes have changed. They changed in the 1970s when most developed countries moved from fixed to floating exchange rates and the core function of the Fund, the maintenance of exchange stability, was ceded by governments to the market. The Fund's operations today involve surveillance and financial and technical assistance, but these operations are primarily in the service of the prevention and management of developing country financial crises, not exchange stability.

While the area of monetary relations functioned well in the 1950s and 1960s, one clause of the IMF's Articles fell into disuse. The so-called 'scarce currency clause' of Article VII empowers the IMF to identify a country that is consistently running trade surpluses and declare its currency a scarce currency, in which case other nations are allowed to discriminate against imports from that country by limiting exchange operations in the scarce currency.[29] The idea, which was principally that of Keynes, was to put the primary burden of adjustment on countries that chronically ran trade surpluses. Instead the clause has been ignored and the IMF has consistently placed the adjustment burden on countries that run trade deficits (except for the United States which, as the source of the global reserve currency, has had a free ride). This to date neglected idea is obviously of considerable importance today.

The third institution, the World Bank, was established to coordinate and provide financial support for reconstruction and development. The International Bank for Reconstruction and Development (IBRD) was the first institution of the World Bank, established in 1944. Based on government shareholders, it raises funds in the global financial markets, and issued its first bond in 1947 to finance the

27. IMF Website, available at <www.imf.org/external/about.htm>.
28. *Ibid.*
29. F. Stewart, 'Back to Keynesianism: Reforming the IMF' (1987), 472; and F.L. Block, *The Origins of International Economic Disorder* (1977), 52; and R.F. Harrod, *The Dollar* (1954), 110.

reconstruction of Europe in the aftermath of World War II. The World Bank's explicit mission is to reduce global poverty,[30] with this focused on the UN Millennium Development Goals (MDGs).[31] While the World Bank provides financial support in times of economic crisis and seeks to enhance social development, its key objective has been to promote policy and institutional reforms within lower and middle-income economies. Thus, loans have been coupled with conditionality of financial reforms, particularly focused upon improving the climate for private international investment.[32]

1.2 THE BRETTON WOODS SYSTEM

The delegates at Bretton Woods believed predictable exchange rates facilitated trade and yet sought to avoid the rigidity of the gold standard under which currencies' values were tied to gold absolutely – a system that had broken down in the chaos that followed the onset of the Great Depression.

The approach adopted at Bretton Woods was not as rigid as the gold standard but far less flexible than leaving rates to the market. A central feature was a system of fixed exchange rates that could be adjusted only in exceptional circumstances. This was enshrined in Article IV of the IMF Articles of Agreement, which provided that each member of the Fund agreed to maintain a fixed par value for its currency, expressed in gold or US dollars. Nations were expected to intervene in foreign exchange markets to keep the value of their currency within 1% of the par value. Par values could be changed but only to address a 'fundamental disequilibrium' and any proposed change of more than 10% from initial parity would require IMF approval. In addition, under Article VIII, the system would require nations to refrain from restricting current account convertibility, although Article XIV allowed for a transition in the removal of controls over currency transactions.[33]

The arrangements for exchange rate stabilisation and multilateral currency convertibility were important pre-conditions for enhanced international trade in goods and services. However, both Keynes and White were deeply suspicious of international capital flows, especially where these resulted from speculative activity. Hence, it was always envisaged that exchange rate stability would require nations to maintain capital controls.[34]

30. More specifically, its mission is:

> To fight poverty with passion and professionalism for lasting results. To help people help themselves and their environment by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors.

31. See <www.un.org/millenniumdevelopmentgoals/>.
32. See e.g. M. Gavin & D. Rodrick, 'The World Bank in Historical Perspective' (1995).
33. IMF, 'What is the IMF?'; Endres, *Great Architects of International Finance* (2005), 14, 22–23; Argy, *The Postwar International Money Crisis* (1981), 24.
34. Endres, *Great Architects of International Finance* (2005), 19; James, *International Monetary Cooperation Since Bretton Woods* (1996), 38–39; Lastra, 'The Bretton Woods Institutions in the XXIst Century' (2001), 77.

Of the two Bretton Woods financial institutions, the IMF is by far the most important for the functioning of the international financial system. The World Bank is a development institution focused on alleviating global poverty and thus less directly involved. The aims of the IMF agreed at Bretton Woods were:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
(iii) To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.[35]

The IMF Articles of Agreement included rules for the adjustment mechanism to correct balance of payments imbalances and rules governing the provision of credit to member countries. An important feature was the creation of a quota system. Quotas were calculated primarily on the basis of each member country's national income, trade and international reserves. Under Article 3, members were required to pay their quota into the fund, with 25% payable in gold or US dollars and the remainder in the member's own currency. Most of the negotiations at Bretton Woods centred on the size of quotas, which were linked to voting power in relation to the Fund. Given the size of their economies, the United States and Britain had between them more than 40% of the total vote. Quotas were also significant

35. IMF, 'Articles of Agreement of the International Monetary Fund', <www.imf.org/external/pubs/ft/aa/index.htm>. These purposes were supplemented by Art. IV(1), added by the Second Amendment in 1976:

> Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates.

because they determined the pool of resources from which the Fund, under Article V, could provide assistance to members to address temporary financial difficulties.[36]

The IMF began to operate in 1946 and the IBRD provided its first loan in 1947. Yet their initial impact was somewhat muted. The IMF, for example, was initially hampered in its operations by the world's practical dependence on key currencies, especially the US dollar, and only really became significant with the achievement of full current account convertibility (necessary for cross-border trade) at the end of 1958. In addition, the main vehicle for post-war European reconstruction became the Marshall Plan rather than the IBRD, which played a strategic but limited role in providing loans to a few European countries.[37] This forced the World Bank to move on, far more quickly than had been envisaged, to the second part of its mandate, the development of poor countries – the role it continues to play today. Finally, the BIS was not abolished and continues to function today as a leading forum for central bank and financial regulatory cooperation and coordination.[38]

1.2.1 Pressures on the Bretton Woods system

The Bretton Woods system functioned effectively until the early 1970s. However, the par value system of managed exchange rates had defects: in particular, it was too rigid. Countries were reluctant to devalue in response to external imbalances, partly because devaluation was regarded as an admission of economic failure and partly because the Article IV requirement to notify the IMF might leave them vulnerable to currency speculation. The par value requirements discouraged countries from adjusting their exchange rates: they could not make significant changes in the absence of a 'fundamental disequilibrium' and hence were restrained in seeking to anticipate and head off problems. Small changes were unattractive because they might be insufficient to address underlying imbalances and yet would still signal an inclination towards further devaluations; hence, such measures could be inherently destabilising and provoke capital outflows. The

36. James, *International Monetary Cooperation Since Bretton Woods* (1996), 48; Argy, *The Post-war International Money Crisis* (1981), 23–25; Lastra, 'The Bretton Woods Institutions in the XXIst Century' (2001), 80–81.
37. Argy, *The Postwar International Money Crisis* (1981), 22–23; James, *International Monetary Cooperation Since Bretton Woods* (1996), 66, 73, 84; World Bank, 'World Bank History'.
38. Under the Statutes of the BIS, Art. 3, the objectives of the BIS are:

> [T]o promote the co-operation of central banks and to provide additional facilities for international financial operations; and to act as trustee or agent in regard to international financial settlements entrusted to it under agreements with the parties concerned.

See D. Arner, M. Panton & P. Lejot, 'Central Banks and Central Bank Cooperation in the Global Financial System' (2010) 23 *Pacific McGeorge Global Business & Development Law Journal* 1–41.

limitations of rigid exchange rates became more evident with the growth of capital mobility and the increasing porosity of capital controls.

Two political considerations also deserve mention. First, the emergence of the Cold War so soon after the end of the Second World War placed limitations on the degree of economic cooperation that could be achieved. Although the Soviet Union had been envisaged as an important member of the IMF, with one of the largest quotas, it never joined. Some Eastern bloc countries joined the IMF but later either left (e.g. Poland, Cuba) or were expelled (e.g. Czechoslovakia). As a result, a number of Communist countries were unable to benefit from the expansion of international trade in the post-war period.

Second, decolonisation in the 1950s and 1960s resulted in the creation of many new nations, especially in Asia and Africa. Many of these former colonies required access to significant amounts of capital for economic development and therefore had a particular interest in World Bank assistance. However, they could not access World Bank assistance without joining the IMF; thus, this period saw the greatest expansion of IMF membership. Today the IMF has 187 members as compared to the twenty-nine countries that signed the original Articles of Agreement in 1944.[39]

In the 1960s, a new problem emerged due to the importance of the dollar for the world economy and its convertibility to gold under the IMF Articles of Agreement. The Triffin dilemma, named after Yale economist Robert Triffin, was a function of the fact that the Bretton Woods system effectively encouraged non-US reserve banks to accumulate dollar reserves in order to meet any excess demands. Such accumulation only made sense if convertibility could be guaranteed. However, the greater the accumulation of dollars relative to US gold reserves, the greater the potential threat to that guarantee.

The response to this problem was the development of new forms of international liquidity, in the form of Special Drawing Rights (SDRs). However, SDRs were initially opposed by strong currency countries and, by the time they became effective in the late 1960s, further liquidity was unhelpful given growing inflationary pressures.

In summary, Bretton Woods has become synonymous with the post-war expansion, yet in the eyes of some the history of the post-war period highlights the tensions that arose from reconstruction and the limitations of the system adopted.

The institutions created at Bretton Woods were fundamentally unsuited to the combination of the international political climate of the early Cold War and the prevalence and persistence of the managed exchange and trade regimes inherited from the 1930s and the experience of war. The Marshall Plan and the initiatives associated with it, especially the European Payments Union, produced a much more effective immediate mechanism for promoting recovery and creating incentives for the earliest steps towards trade liberalisation.[40]

39. IMF, 'IMF at a Glance' (15 Sep. 2010), <www.imf.org/external/np/exr/facts/glance.htm>.
40. James, *International Monetary Cooperation Since Bretton Woods* (1996), 83.

Nevertheless, the system was able to continue throughout the first two decades after World War Two, largely due to the strength of the US economy and the recoveries in Europe and Japan. Given the importance of the US dollar to the Bretton Woods system, for the system to be stable the United States had to maintain responsible fiscal and monetary policies. In the second half of the 1960s, such responsibility could no longer be assumed.

1.2.2 Collapse of the Bretton Woods Exchange Rate System

Nations faced with a balance of payments imbalance have various responses available to them: they can devalue their currency, impose restrictions on current account transactions, impose capital controls, encourage trading partners to reduce trade barriers and/or adopt deflationary fiscal and monetary policies.

Only some of these options were practically available to nations of the Bretton Woods era. The scope to adjust currency values was restricted by the Bretton Woods exchange rate system. Nor did nations have much enthusiasm for increasing interest rates or curbing spending: in many Western countries, the post-war political consensus was based on increased social spending as a trade-off against wage demands. While a nation might be able to improve access to foreign markets, trade liberalisation was typically a slow process.

Prior to current account convertibility, restrictions on the current account were the normal national response. However, this option was foreclosed by the move to current account convertibility. Although capital controls were permitted under the Bretton Woods system, capital controls were proving increasingly difficult to apply in practice because of growing capital mobility, especially given the growth of multinational corporations. At any rate, capital controls were not an effective adjustment mechanism: they might provide temporary respite but did not necessarily change the underlying rationale for capital outflows.

Hence, in the 1960s, balance of payments problems became increasingly difficult to manage without recourse to unpopular deflationary measures or changes to exchange rates of the kind that Bretton Woods was designed to avoid. It is therefore remarkable that the Bretton Woods exchange rate system survived as long as it did, and it only did so because of the level of international cooperation between governments and central banks. Yet this cooperation came under increasing strain as the decade progressed. Leading economies and key US trading partners in Europe had an interest in maintaining stability and had been willing to resist pressures created by the increasing real value of gold against the dollar. However, because the dollar price of gold was fixed at United States Dollar (USD) 35 per ounce, the more the real value of gold exceeded this artificial peg, the stronger was the incentive for central banks to demand gold for dollars from the US Treasury. Furthermore, other countries became less enthusiastic about supporting the dollar (e.g. by selling their own gold reserves) when the United States did not appear to be willing to contain its military and social spending.

Three factors came together to force the end of the Bretton Woods system: the inherent rigidity of the system itself, US spending on the Vietnam War and social programmes, and the divergence of national responses. Had US trading partners like Germany and Japan been willing to accept higher rates of inflation, the system could have continued. In James' words:

> The crisis of the Bretton Woods system can be seen as a particular and very dramatic instance of the clash of national economic regulation with the logic of internationalism. In the circumstances of 1971, the disruption of the system followed very obviously and directly from the policies of the United States. [...] Once one country (the United States) decided to use the system for the sake of power politics, other members would legitimately object, the markets would realise the unsustainability of the divergent national positions, and begin to prepare for a collapse of the parity structure.[41]

Matters came to a head in 1971 because of massive flows away from the dollar and towards the deutsche mark. Inflationary fears in Germany stopped it from intervening to keep the exchange rate of the mark down. Other European currencies also appreciated in value. The United States responded by suspending the convertibility of gold. The main western industrial nations tried to keep the system going by negotiating a new agreement on reform of the international monetary system at the Smithsonian Conference in late 1971. However, this agreement did not address underlying problems, such as the Triffin dilemma. The revaluation of the European currencies improved the competitiveness of US exports but this provided only temporary relief. A sell-off of sterling in 1972 forced Britain to float its currency outside the newly agreed band. This was followed by two further rounds of dollar flight because of an expectation of further US devaluations. The United States negotiated devaluations against the major European currencies and the yen. However, as the sell-off of the dollar continued, Germany and other European nations jointly floated their currencies, effectively signalling the demise of the Bretton Woods accord.

Since then, the international financial system has been based on floating exchange rates. In due course, IMF members amended Article IV to specify that countries are free to choose any form of exchange arrangement they wish, provided they do not peg their currency to gold, including floating their currency or pegging its value to another currency or currencies.[42]

Having lost much of its role in the 1970s with the end of the Bretton Woods accord, the IMF sought to replicate the tie of the US dollar to an external standard through the creation of a new synthetic currency, the SDR. However, this never really worked as intended.[43] Nonetheless, the IMF continued to maintain a certain

41. *Ibid.*, 207.
42. Lastra, 'The Bretton Woods Institutions in the XXIst Century' (2001), 75; IMF, 'What is the IMF?'.
43. The First Amendment established a facility based on the SDR, which took effect on 28 Jul. 1969, after acceptance of three-fifths of the membership.

role in the process of exchange rate adjustment. Additionally, the Second Amendment to the IMF Articles of Agreement reflected its new role in the international monetary system establishing that 'the Fund shall oversee the international monetary system in order to ensure its effective operation',[44] and allowing the IMF to focus increasingly on lending to support economies dealing with periodic exchange crises, including imposing a range of conditions for such support, which became known as 'conditionality'.[45] This move out of monetary affairs and into 'structural adjustment' was the major fork in the road in the development of the Fund – and its move into areas of development which were meant to be the realm of the World Bank. The lesson (which applies equally to the BIS, among others) is that when an international organisation loses much of its original mission, it is natural for it to seek to reinvent itself in new roles, and this should be anticipated by the international community.

In the early 1990s, the IMF argued for a further amendment to its Articles to formalise its role in encouraging and supporting capital liberalisation, especially in developing, emerging and transition economies.[46] In addition, with the collapse of the Soviet Bloc, the IMF began to focus on monetary aspects of the economic transition process – furthering its move into development work and out of its original remit of monetary affairs. By 1994, the fiftieth anniversary of the Bretton Woods conference, the IMF largely understood its role – and the mechanisms through which to achieve its goals – as being centred on the policy-focused ideas of the Washington Consensus.[47] The IMF was no longer a stabilisation fund but had instead become a broader international financial institution focused on debtor nation crisis management, surveillance, conditional financial support and technical assistance.

If Keynes and White had looked out and seen the truly global financial system in place today, it is reasonable to suppose they would have insisted upon the institutions for this system which each national financial system has (or should have) in place:

(1) a bankruptcy regime;
(2) a financial regulator with enforcement powers; and
(3) a lender of last resort.

Yet none of these institutions exist at the global level. Their absence in the Keynes and White architecture was reasonable, for the world Keynes and White looked out upon was one of capital controls, and very limited transnational capital

44. The second Amendment in 1976 established the rights of members to adopt exchange rate arrangements of their choice. IMF Articles of Agreement, Art. IV 'Obligations Regarding Exchange Arrangements'.
45. IMF, 'IMF Conditionality – A Factsheet' (April 2009), available at <www.imf.org/external/np/exr/facts/conditio.htm>.
46. The third Amendment, Board of Governors Resolution No. 45-3, adopted 28 Jun. 1990 and effective 11 Nov. 1992.
47. See P. Krugman, 'Dutch Tulips and Emerging Markets' (1995); J. Williamson (ed.), *Latin American Adjustment?* (1990); World Bank, *World Development Report 1991* (1991); S. Fischer, 'ABCDE: Past Ten Years, Next Ten Years' (2004).

mobility. Their absence in today's highly globalised financial system is far more problematic, a theme to which we will return to later in this book.

1.2.3 Financial Cooperation

In the area of cross-border finance, no international institutional framework was established, although meetings of central banks continued to take place through the BIS.[48] These were joined from the late 1960s by a range of informal groups of developed countries, including the Group of Ten (G10), Group of Five (G5), Group of Six (G6), Group of Seven (G7) and Group of Eight (G8), with the G7/G8 emerging by 1998 as the most significant forum for economic and financial cooperation. The various Gs met at the level of finance ministers and central bank governors, as well as deputies and heads of government as cross-border financial issues began to return to significance. Initially, international finance was allowed to develop outside individual domestic markets, particularly through the Euromarkets in the 1950s and 1960s.

In 1974, following the collapse of the dollar standard, the collapse of a small German bank, Herstatt Bank, caused the first major post-war cross-border financial crisis through its role in the international payments systems. Realising that cross-border finance posed risks, G10 central bankers in charge of banking supervision began meeting at the BIS as the Committee on Banking Regulations and Supervisory Practices, today called the Basel Committee for Banking Supervision (BCBS).[49] The BCBS was the first of a series of international financial organisations of varying levels of formality (though none as traditional international treaty-based organisations) formed to encourage financial cooperation and coordination, including most significantly the International Accounting Standards Board (IASB, formed as the International Accounting Standards Committee in 1973), the International Organization of Securities Commission (IOSCO, formed in 1983) and the International Association of Insurance Supervisors (IAIS, formed in 1994). In their respective areas, these organisations promote discussion and development of common solutions to cross-border financial issues, with domestic implementation of 'soft law' international agreements.

The combination of the G7/G8, IMF, BIS and international financial organisations thus comprised the international financial architecture as it existed until 1998.

1.2.4 The IMF at the Onset of the Global Financial Crisis

The IMF plays a pivotal role today in shaping the interaction between developing countries and global capital. The IMF advises countries upon when and how to

48. See D. Arner, M. Panton & P. Lejot, 'Central Banks and Central Bank Cooperation in the Global Financial System' (2010), 1–41.
49. See J. Norton, *Devising International Bank Supervisory Standards* (1995).

liberalise their financial systems and open up to global capital. In addition, for countries with an IMF programme in place, the Fund has direct input into the fiscal and monetary policy settings of the country.

More than ninety IMF Member States have sought loans or technical assistance from the IMF.[50] In the Debt Crisis that commenced in 1982, most African and Latin American countries sought IMF assistance. In the decade and a half prior to the global financial crisis (GFC) in 2008, the IMF arranged bailout packages in the wake of the Mexican crisis in 1994, the Asian crisis of 1997 and offered assistance following crises in Russia, Brazil, Turkey and Argentina. Countries that approach the IMF for assistance are often already in considerable financial difficulty and suffering from macroeconomic mismanagement.[51] The IMF provides loans to states to seek to correct balance of payments problems and promote economic growth by implementing adjustment policies and reforms. The IMF also offers technical assistance, aiding states in formulating and managing economic policy, and advising upon domestic banking systems, fiscal policy and management of public finances. Technical assistance is usually implemented by placing IMF staff in the relevant government departments of the recipient country and by training nationals of the recipient country (the IMF has established regional training centres in Africa, the Caribbean and the Pacific). Countries that adhere to IMF policy recommendations are eligible for assistance from the Fund's Poverty Reduction and Growth Facility.[52]

The IMF's financial support is contingent upon entering an 'arrangement' with the Fund. The arrangement requires that policies designed to restore financial balance be implemented. The country seeking assistance must provide the IMF with a 'Letter of Intent' that outlines the policies it intends to implement. The IMF website states that the policies are formulated by the country seeking financial assistance 'in consultation with the IMF'.[53] However, the policies and procedures are often effectively imposed upon Member States, leaving domestic governments with little scope for input. A government must demonstrate its commitment to the implementation of these economic policies.[54] The recommended policies are intended to reduce public debt and bring about economic stability. The prescriptions are well-intended; however, they take decision-making out of the domestic realm. Domestic policy-making is replaced by policies imposed by IMF economists.[55]

50. IMF, 'How the IMF Helps to Resolve Economic Crises', <www.imf.org/external/np/exr/facts.crises.htm>.
51. K. Rogoff, 'The IMF Strikes Back', <www.imf.org/external/np/vc/2003/021003.htm>; and J.P. Joyce, 'Through a Glass Darkly' (2002), 2–3.
52. IMF, 'Policy Statement on IMF Technical Assistance', <www.imf.org/external/pubs/ft/psta/index.htm>; and Joyce, 'Through a Glass Darkly' (2002), 4.
53. IMF, 'IMF Lending', <www.imf.org/external/np/exr/facts/howlend.htm>.
54. IMF, 'IMF Conditionality: A Factsheet', <www.imf.org/external/np/exr/facts/conditio.htm>, 4 Dec. 2007.
55. C. Santiso, 'Good Governance and Aid Effectiveness' (2002), 1.

Stiglitz suggests the IMF has overstepped its mandate by viewing all matters of domestic policy as factors that potentially contribute to economic instability, and thereby claiming input into a very wide range of domestic structural issues. These policies invariably impose the 'harsh fiscal austerity'[56] of the 'Washington Consensus'. The 'Washington Consensus' describes the policies advocated by the IMF, the World Bank and the United States Treasury, which include reduction of public expenditure, privatisation of public enterprises, deregulation of financial systems and removal of barriers to trade. These policies reflect a quite extreme free market ideology. Stiglitz suggests these policies do not address the root causes of financial strife, which vary among countries. IMF policies regularly fail to address human rights issues such as healthcare and food shortages. Nonetheless, less-developed countries accept IMF prescriptions due to their weak bargaining power and acute financial need. IMF policies attract vigorous and increasing criticism regarding their formulation, implementation, lack of transparency and lack of accountability.[57]

Furthermore, if a country rejects IMF policies it will forfeit its right to assistance from the World Bank. The World Bank only offers credit to countries that comply with IMF policy prescriptions.[58]

Nonetheless, over the years several developing countries have chosen not to follow IMF prescriptions. China has enjoyed strong economic growth for three decades by charting its own, unique, economic course. China has a high degree of autonomy in setting its own policies due to the capital controls that isolate its financial system from the vagaries of global capital, the domestic ownership of its financial system, and the strong desire of foreign corporations to do business in China irrespective of the policy environment. Malaysia, Chile and Colombia have also effectively implemented locally determined policies. These countries all implemented policies the IMF opposed at the time, such as capital controls, restrictions on speculative trading, and the retention and development of state-owned assets.

1.2.5 The World Bank at the Onset of the GFC

The 1980s debt crisis caused a fundamental reassessment of the World Bank's programme of state lending, as it became obvious that resources lent for general purposes and even for specific projects had often been squandered and in some cases caused more harm than good.[59] As a result, in addition to state lending and grants, the World Bank began to focus to a greater extent on providing private sector assistance through the International Finance Corporation (IFC) and

56. Rogoff, 'The IMF Strikes Back' (2003).
57. S. George, 'A Short History of Neo-Liberalism' (1999); Joyce, 'Through a Glass Darkly' (2002) 2; and K. Raffer, 'International Financial Institutions and Financial Accountability' (2004).
58. World Bank, 'About Us', <www.worldbank.org/about>.
59. P.A. Wellons, *Passing the Buck* (1987).

Multilateral Investment Guarantee Agency (MIGA), established in 1956[60] and 1988,[61] respectively. By the end of the 1980s, the World Bank Group included the IBRD, IFC, IDA (International Development Agency), MIGA and ICSID,[62] dealing with (respectively) state lending and technical assistance, private sector projects, grants to poorer developing countries, investment guarantees and the resolution of cross-border investment disputes.[63]

With the collapse of the Soviet Bloc, the World Bank, like the IMF, added the transition economies to its development assistance portfolio. Nonetheless, unlike the IMF, the World Bank directly faced many questions about its role and future at the time of the fiftieth anniversary of the Bretton Woods conference in 1994, a reappraisal that was supported by the appointment of a new President of the Bank in 1995, James D. Wolfesohn. This reappraisal led it to focus on the overarching objective of poverty reduction. At the same time, with the growth of other multilateral development institutions, bilateral programmes and non-governmental organisations, and especially with the increase in financial flows to developing countries from the private sector, the World Bank now takes a much less central role in global capital flows than was envisioned in the post-war design.

1.2.6 The WTO at the Onset of the GFC

Since 1995, the WTO has stepped into the role originally intended for the ITO but in a world in which the volume of world trade is far beyond anything the delegates at Bretton Woods might have imagined. In its words, the WTO 'is the only international organisation dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible'.[64]

The WTO was born out of the Uruguay Round of Multilateral Trade Negotiations that concluded in 1994. The Uruguay Round expanded the global trade regime from goods into services and intellectual property by virtue of GATS (the General Agreement on Trade in Services) and TRIPS (the Agreement on Trade Related Aspects of Intellectual Property Rights). Previously, intellectual property issues had been dealt with in UNCTAD (the United Nations Commission on Trade and Development) and WIPO (the World Intellectual Property Organization). The protection of intellectual property only enhances the economic development of a nation when the advantages of being able to produce goods, pharmaceuticals, movies and music by copying those produced in the developed world are no longer greater than the disadvantages of not protecting locally

60. IFC, founded in 1956. See <www.ifc.org>.
61. MIGA, founded in 1988. See <www.miga.org>.
62. ICSID, founded in 1966. See <www.worldbank.org/icsid>.
63. See C. Jayarajah & W. Branson, *Structural and Sectoral Adjustment* (1995).
64. World Trade Organization, 'The WTO . . . in Brief', <www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm>.

produced intellectual property and of foreign investment not being accompanied by the latest technology. This is quite a sophisticated level of development, so, understandably, in UNCTAD and WIPO the vast majority of developing countries voted against the United States' consistent attempts to improve intellectual property protection globally.[65]

Shifting the forum for intellectual property protection from UNCTAD and WIPO to the WTO was a clever move by the United States but one that still required the assent of the developing countries by way of their agreement to TRIPS. This agreement was obtained as a quid pro quo for the promise by the United States and European Union (EU) of greatly liberalised access to their markets for the agricultural produce of developing countries. Yet once TRIPS was in place and enforceable, the promised access did not materialise for a host of reasons. Today the United States and EU still subsidise their agricultural producers extensively, to the great detriment of developing country exporters. The WTO and TRIPS were founded on, as lawyers would put it, a consideration that failed – the full price for the promise was never received.

1.3 THE GLOBALISED FINANCIAL SYSTEM TODAY

The global economy has changed profoundly. In 1970, the capital that moved around the globe to support trade in goods and services far exceeded that which moved to support direct and portfolio investment. Today capital flows outweigh trade flows by a factor of over 100 to one.[66]

The global financial system in the past forty years has been transformed by globalisation. Globalisation can be defined in numerous ways. It has been said to be 'the development and deepening of world markets in capital, in goods and in services by the increasing occurrence of commercial exchanges across international boundaries' and 'the increasing tendency toward an interconnected worldwide investment and business environment'.[67]

Our favourite definition of globalisation comes from John Farrar, who said, simply, that globalisation is all about convergence: convergence in markets in capital, goods, services and manufacturing methods, and convergence in cultures. Convergence, we find, is the most helpful way to think about this phenomenon. Globalisation is very highly developed in finance, well developed in the trade of commodities and goods, and less so in services.

Globalisation is about convergence, but it is not uniform or consistent. Capital markets, commodities markets, goods markets and cultures are all converging.

65. For an excellent account of this process, see J. Braithwaite & P. Drahos, *Global Business Regulation* (2000), 61–65.
66. P. Sutherland, 'Managing the International Economy in an Age of Globalisation' (The 1998 Per Jacobsson Lecture, annual meeting of the IMF and the World Bank).
67. M. Warby, 'Review', *The Australian Financial Review*, 22 Sep. 2000, 6 and Investorwords investing glossary <www.investorwords.com>, respectively.

However, wealth is not converging under globalisation. The richest 20% of humanity owned sixty times as much as the poorest 20% in 1990, seventy-four times as much in 2000, and in 2010 the richest 20% of the world's population accounted for three-quarters of the world's income.

Technology is not converging under globalisation. In 2005, 86% of patents granted at US, European and Japanese patent offices were granted to entities from only six countries: the United States, Japan, Germany, South Korea, France and the United Kingdom.[68] From 1977 to 2006, the least developed countries taken together were granted forty-eight patents by the US Patents and Trademark Office, which represented 0.0014% of total patents granted.[69] As of 2010, less than 29% of the world's people have access to the internet, with access rates ranging from 77.4% in North America to 10.9% in Africa.[70]

Labour markets are not converging under globalisation. As the wealth differential between rich and poor countries widens, so do the barriers keeping people out of the rich countries. In the previous period of strong financial and economic globalisation, from 1873 to 1913, an individual's mobility between nations was basically unimpeded. Globalisation today favours free movement of capital, but not of labour. It allows capital to go where labour is cheap but does not allow labour to move to where the capital and expertise are located and where wages and work conditions are better.

So globalisation is a very partial phenomena. It is partial in that it affects some aspects of economies and societies profoundly and other aspects hardly at all. It is also partial in that it favours some nations over others and some people within a nation over others in that same nation.

Globalisation finds perhaps its fullest expression in global capital flows and capital markets. The level of financial integration within, and across, the international economy is high and increasing because capital is perfectly suited to a global market – it moves around the world at the touch of a keyboard, and in response to information that comes in, principally, on a computer screen. It is difficult to think of any other product for which the global market is more integrated, and for which events in one part of the world will almost instantly cause repercussions in other parts of the world.

Globalisation is a product of two technological revolutions and an ideological one. The technological revolutions are in information and telecommunications. The ideological revolution is the victory of free market capitalism in the contest of ideologies, more specifically, the idea that free markets lead to an optimal allocation of resources and the highest levels of economic efficiency and growth – an idea that ruled the financial world for two to three decades until challenged by the GFC. While these revolutions are recent, globalisation is not a new phenomena.

68. OECD, Compendium of Patent Statistics, 2007, available at <www.oecd.org/document/10/0,3343,en_2649_34451_1901066_1_1_1_1,00.html>.
69. Brooks World Poverty Institute, University of Manchester, *Ending World Poverty*, available at <www.bwpi.manchester.ac.uk/>.
70. Internet World Stats, *Internet Usage Statistics*, available at <www.internetworldstats.com/stats.htm>.

The Roman Empire was the most important force for globalisation the world had seen[71] and globalisation introduced numerous Chinese initiatives to Europe from the eleventh century.[72] In the words of Nobel laureate, Amartya Sen:

> high technology in the world of 1000 AD included paper and printing, the crossbow and gunpowder, the clock, the iron chain suspension bridge, the kite, the magnetic compass, the wheelbarrow and the rotary fan. Each one of these examples of high technology . . . a millennium ago was well-established and extensively used in China and . . . practically unknown elsewhere. Globalisation spread them across the world, including Europe.[73]

Nonetheless, we live in an unusual and utterly unprecedented world today: a world of globalised finance in which poor nations lend to far richer ones,[74] a world in which over 1.4 billion people struggle to survive on less than USD 1.25 per day, with one-third of the world's population in multi-dimensional poverty,[75] yet massive amounts of capital flow around the globe looking for the most lucrative uses, a world in which foreign capital pours into poor countries in good times and promotes growth in those countries, and then later withdraws leaving crippling debt levels that typically severely damage the poor in these countries.[76]

The globalisation of capital flows and markets includes the following phenomena and trends:[77]

(1) Massive transnational capital flows are a fact of life and foreign investors are opportunists. Foreign investors move money into an economy quickly and in large quantities in good times and seek to remove it even more quickly when trouble looms. The exception to this being a limited number of currencies and markets which benefit from flights to safety in crisis periods, most especially the US dollar, euro and gold.
(2) The nature and management of investors changed radically in the 1990s. The proportion of capital controlled by large institutional investors (such as mutual funds, pension funds and insurance companies) increased substantially. For instance, assets managed by US mutual funds increased by a factor of more than four in just seven years in the 1990s.[78] Hedge funds

71. J. Braithwaite & P. Drahos, *Global Business Regulation* (2000), 40–45.
72. See I. Morris, *Why the West Rules – For Now* (2010).
73. A. Sen, 'Global Doubts as Global Solutions' (Alfred Deakin Lecture, Melbourne, 15 May 2001), <www.abc.net.au/rn/deakin/stories/s296978.htm>.
74. Or, at least, rich individuals and companies in poor countries invest in and lend to entities in rich countries.
75. United Nations, 'Millennium Development Goal Report' (2010) 6; United Nations, 'Human Development Report' (2010), 86.
76. S. Edwards, 'How Effective Are Capital Controls?'(1999).
77. The following factors owe much to H. Kaufman, 'Protecting Against the Next Financial Crisis' (1999).
78. US mutual fund assets under management increased from USD 1,067 billion to USD 4,490 billion between 1990 and 1997: US Department of Commerce, *Statistical Abstract of the United States 1998* (118th ed.), 533.

brought aggressive new investment techniques to bear. Virtually all major commercial and investment banks and securities firms established departments that function virtually as hedge funds, making extensive use of leverage and derivatives and the capacity to move into and out of markets swiftly. Indeed, the entire money management industry has become far more performance-driven, less risk averse and more inclined to use leverage heavily. These trends, which began in the early 1990s, culminated in 2007.

(3) Access to instantaneous information facilitates investment decisions at great distances and speed, with foreign investors receiving relatively homogenised information. Before the communications revolution, long-term investment was often the only sensible approach to foreign investment. Today an investment portfolio abroad can be managed as aggressively and intensively as if it is one's own country. Yet the sources of information for such investment decisions will be far less diverse than if it was in one's own country, with volatility-enhancing consequences for investor behaviour.

(4) Modern financial derivatives provide tremendous opportunities for hedging risks, but are more often used to facilitate speculation and as integral elements of volatility inducing activities.

(5) Liquidity is often illusory but temptingly easy in which to believe. Capital markets that are deep and efficient in good times can rapidly become thin, volatile and illiquid in bad times, as we all saw in 2008.

(6) Due to the above factors, capital markets in the debt and equity of developed and developing nations are integrated and interdependent today to an unprecedented degree.

Each of these aspects of globalisation increases the volume of capital flows to and from nations and the volatility of such flows.

The globalisation of capital markets gives countries access to new sources of capital. There is much evidence that capital markets discharge critical functions in the efficient allocation of capital,[79] that capital markets promote economic growth,[80] and that effective financial systems and access to foreign capital promote development. Indeed, an innovative and effective financial system was central to the growth and modernisation of history's most successful 'emerging market', the United States of America, in the first half of the nineteenth century.[81]

79. J. Wurgler, 'Financial Markets and the Allocation of Capital' (2000) (unpublished manuscript). Wurgler found the efficiency of capital allocation to be positively correlated with the amount of firm-specific information in local stock markets and with the legal protection of minority shareholders.
80. R.G. King & R. Levine, 'Finance and Growth' (1993); R.G. King & R. Levine, 'Finance, Entrepreneurship and Growth' (1993); and R. Levine & S. Zervos, 'Stock Markets, Banks, and Economic Growth' (1998).
81. P.L. Rousseau & R. Sylla, 'Emerging Financial Markets' (1999).

However, as all the economic crises since 1982 have demonstrated, generous access to foreign capital is often far from a good thing for countries, especially developing countries. A slick intellectual trick is often perpetrated here. Free trade in goods and services is generally accepted among economists as welfare enhancing. It tends at times to cause severe change and economic dislocation in countries, but overall the result of free trade is a wealthier world. The trick is to assert that what holds for goods holds for money. Is not money just another good? Legally it is often treated as such.[82] Experience tells us otherwise.

Capital is only welfare enhancing if put to productive uses that generate returns in excess of the cost of the capital. The failure by Latin America to do this with the massive loans of the 1970s led to the debt crisis of the 1980s. The inability of the East Asian financial systems to channel the increased capital flows of the early and mid-1990s into productive uses contributed significantly to the Asian crisis of 1997. The Asian economies were performing strongly before foreign capital flows to the region increased due to local capital market liberalisation, surplus liquidity in the United States and the dissuasive effect the Mexican peso crisis in late 1994 had on further capital flows to Latin America.[83] It is therefore not surprising that the increased capital flows of the 1990s ended up fuelling speculative bubbles in stock and real estate markets in East Asia. Likewise, Argentina's excessive borrowing in the 1990s for general revenue purposes (with which the IMF agreed) was a major contributor to that country's economic collapse at the end of the decade.

Likewise, the increased capital flows to the United States in the 2000s facilitated the profound misallocation of capital in the sub-prime crisis. It is likely that when at some point China faces a financial crisis, it will also emerge from misallocation of capital.

The clearest lesson of the series of financial crises since the end of the Bretton Woods system is that unfettered capital mobility is not necessarily welfare enhancing and not an unmitigated good.[84] The huge loans to Latin America of the 1970s brought 'massive returns to the rich'.[85] However, when these loans had to be repaid in the 1980s they were repaid by increasing taxes, reducing price supports on essential items and cutting spending on public health care, public education and public infrastructure. The rich benefited from the loans; the common people and the poor repaid them.

Likewise, in East Asia the boom in portfolio capital flows and lending to the region in the early to mid-1990s principally benefited the rich. The dislocation and impoverishment brought on by the crisis in 1997, however, fell far more heavily on the shoulders of the common people: the poor and emerging middle class. The profound difference between those who benefit when international capital flows in, and those who suffer when it flows out, has been maintained.

82. F.A. Mann, 'The Legal Aspect of Money' (1992).
83. R.P. Buckley, 'An Oft-Ignored Perspective on the Asian Economic Crisis' (2000).
84. R.P. Buckley, 'International Capital Flows' (2001); N. Lustig, 'Crises and the Poor' (1999).
85. 'A Survey of Latin America', *The Economist* (UK), 13 Nov. 1993.

As Nora Lustig has written, 'Macroeconomic crises, with the exception of wars, are the single most important cause of large increases in . . . poverty.'[86] In Charles Calomiris' words, 'When the crisis has passed, the big winners are the wealthy, politically influential risk takers, and the biggest losers are the taxpayers in countries like Mexico or Indonesia.'[87]

Interestingly, if one substitutes the United States for Mexico or Indonesia, Calomiris' words apply equally to the United States in the wake of the GFC. In 2010 while spending on essential services was being cut across the country, which principally affects poorer Americans, the twenty-five most richly rewarded traders on Wall Street took home USD 25 billion in personal remuneration for their previous year's work.[88]

This transfer of responsibility onto the common people has long been one of the hallmarks of the impact of the global financial system upon developing countries. The GFC in 2008 saw the same fate visited upon the common people in rich countries.

86. Lustig, 'Crises and the Poor' (1999).
87. C.W. Calomiris, 'The IMF's Imprudent Role as Lender of Last Resort' (1998), 276–277.
88. A. Barr, 'Top Managers Earned Record $25 billion in 2009, Survey Finds', *Market Watch*, 1 Apr. 2010, available at <www.marketwatch.com/story/top-managers-earned-record-25-bln-in-2009-survey-2010-04-01>.