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FINANCIAL DIPLOMACY AND THE CREDIT CRUNCH: THE RISE OF CENTRAL BANKS

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Economic diplomacy can be defined as the method by which states conduct their external economic relations. It embraces how they make decisions domestically, how they negotiate internationally and how the two processes interact. Economic diplomacy has been transformed in the last two decades with the end of the Cold War and the advance of globalization. Its subject matter has become much wider and more varied and it has penetrated more deeply into domestic politics—no longer being limited to measures imposed at the border. Internationally, it engages a far larger range of countries, including new rising powers like China, India and Brazil. Yet the relative power and resources of governments have been shrinking, so that they often seem to be trying to do more with less.[1]

Governments have adopted four broad strategies to meet the new demands made on its economic diplomacy. They involve ministers—i.e. cabinet-rank politicians—far more alongside bureaucrats. They try to get non-state actors, like private firms or civil society bodies, to share its burdens. They encourage greater transparency to widen understanding and support. They use international institutions to advance domestic as well as external aims and to make the system more inclusive. In many areas of economic diplomacy, notably international trade and the global environment, these strategies yielded major advances in the 1990s. The World Trade Organization (WTO)—in operation since 1995—embraced all trade, including agriculture, services and intellectual property, engaged virtually all countries and went deeply into domestic policy, as well as introducing judicial settlement of trade disputes. In 1992, the United Nations Conference on Environment and Development launched a series of binding treaties on issues like climate change and biodiversity with global institutions in support. This would have been inconceivable during the Cold War.

Financial diplomacy—a subset of economic diplomacy—changed more slowly. The International Monetary Fund (IMF) and World Bank, while not achieving

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universal membership, remained the dominant institutions. A major upheaval came with the Asian financial crises that began in 1997 in Thailand, Indonesia and South Korea and proved highly contagious, spreading far beyond East Asia. Previous financial crises, up to the Mexican Financial Crisis of 1994, had been caused by the imprudence of governments. This time, the crisis was provoked by the private sector. The three Asian countries in question were pursuing sound fiscal policies and their main mistake was to fix their currencies to the U.S. dollar, which was falling. This encouraged irresponsible financial behaviour by local borrowers and Western lenders, which became a disaster when the dollar began to strengthen.[2]

Resolution of this last financial crisis of the 20th century followed the usual pattern. The finance ministers of the Group of Seven (G-7) countries, led by the United States, encouraged the IMF to mount rescue packages linked to policy reforms.[3] The G-7 then worked out proposals for "new international financial architecture" to be adopted by the IMF and the World Bank and to prevent the recurrence of similar problems. The process was interrupted in 1998 by Russia's default and capital flight from Brazil, but the new architecture was finally agreed upon by the IMF and the World Bank in 1999.[4] Many of the agreed policy measures fell short of their promise, but the institutional changes were valuable. The IMF's ministerial committee was formalized as the International Monetary and Financial Committee (IMFC). The Financial Stability Forum (FSF) was created to provide multilateral surveillance of financial regulators. A new grouping of finance ministers, the Group of Twenty (G-20), successfully associated the emerging powers like Brazil, China, India and South Africa with the original G-7.[5]

After the advances of the 1990s, however, the 2000s have been disappointing for trade and environmental diplomacy. Multilateral negotiations have struggled. The WTO's Doha Development Agenda, launched in 2001, has still not concluded—the last attempt to do so failed in July 2008. Emerging countries are more engaged than in the past, but this has not made it any easier to reach consensus. Bilateral and regional trade agreements are proliferating, so that the system risks fragmentation. In the environment, especially climate change, transatlantic differences have inhibited progress. In Europe, policy has been driven by consumers and lobby groups that favor limits on greenhouse gas emissions. In the United States, policy has been driven by producer interests, mainly in the energy sector, which oppose controls. The Bush Administration, therefore, rejected the Kyoto Protocol of 1997, which would have required the United States to reduce emissions. The Kyoto Protocol does not bind emerging countries like China and India—which are becoming the largest emitters—and they will not move unless the United States does. The position should improve with President Bush's successor but—meanwhile—a decade has been lost.

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The financial scene was calmer at first. In 2001, the collapse of Argentina and the shock of September 11 were easily contained. Thereafter, the world economy enjoyed buoyant growth with low inflation sustained over several years and embracing all regions—not only China and other dynamic Asian economies, but even sub-Saharan Africa, which had fallen far behind. In G-7 countries and the European Union (EU), this successful performance was attributed in part to the growing independence of central banks in determining monetary policy, beginning with the creation of the European Central Bank (ECB) in 1998.

Paradoxically, these were unfavourable conditions for advances in financial diplomacy. Financial diplomacy makes the most progress in times of trouble; when things are going well, there is less appetite for reform. The United States, the usual source of initiative, was inactive. President Bush's first two Treasury secretaries took little interest in international financial diplomacy, and Henry "Hank" Paulson, Jr, who took office in 2006, concentrated on bilateral relations with China. The Europeans, despite their success in creating the Eurozone, were unable to unite at the international level. The IMF carried out a modest reorganization of its quotas to give more weight to rising powers like China, but demand for the IMF's lending programs shrank, and its new regime of multilateral surveillance of macroeconomic policies lacked teeth.

This calm was abruptly shattered by a financial crisis—the credit crunch—that began in August 2007. This article looks at how the instruments of financial diplomacy, both domestic and international, have responded to the credit crunch from August 2007 to August 2008 and what that signifies for economic diplomacy more widely. Its main findings are that, over the first year of the crisis, central banks emerged as the leading players. Domestically, they have gained authority at the expense of both governments and other regulators. Internationally, the action migrated away from the IMF, where finance ministers lead, to the Bank for International Settlements (BIS) and its committees, where central bankers are in charge. Central banks have many merits: precise objectives, technical expertise, instinctive prudence and the ability to make hard decisions. On the other hand, their predominance turns the usual strategies of economic diplomacy on their head. Financial diplomacy becomes less politically sensitive, transparent and inclusive, and more vulnerable to the errors of the private sector.

This ascendancy of the central banks is proving to be short-lived, however. Despite their efforts, the credit crunch got worse after August 2008. The international economy is being shaken by wider forces boosting inflation and threatening recession. Addressing these problems puts governments back in the lead and requires central banks and governments to work together again. They will need institutions that engage all international players, which should give a new lease on life to the

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IMF. The distinct financial diplomacy of the credit crunch could therefore prove a brief episode, not a new trend.

The First Financial Crisis of the 21st Century

In industrial countries, the strong growth in the beginning of the 21st century was encouraged by the rapid expansion of credit due to imaginative financial innovation. Traditionally, banks kept their loans on their own balance sheets and relied on increased deposits to back higher lending. However, the practice of "securitization" enabled banks to package up their debts and sell them as securities on the worldwide markets. Loans for house purchases, backed by mortgages, were especially popular because they generated asset-backed securities, which looked like a sound risk. Banks used mortgages to underpin a cascade of complex, non-transparent instruments, often creating vehicles outside their balance sheets to hold them. Rating agencies graded such instruments highly, compared to other forms of lending. Regulators regarded them as benign since they spread risk more widely.

This practice, however, concealed three dangerous flaws. First, it encouraged lending for house purchases at extravagant levels to clients who could not afford them. Since banks passed on the risk, they were less worried about a default. However, when defaults began, the second flaw emerged: asset-backed instruments that looked solid and more highly rated proved worthless. This was compounded by the third flaw: the risks were now so widely spread, especially between United States and European banks, that it was not clear who was holding them. Dispersion of risk, thought to be beneficial, turned out to be disastrous. The housing crisis, domestic in nature, generated financial upheavals on an international scale.

The difficulties in U.S. "sub-prime" housing finance, such as loans to less creditworthy clients, had begun in 2006, but the consequences for banks only dawned in August 2007. Abruptly, the market for securitized instruments dried up and had not reopened a year later. The market for interbank lending also seized up as banks did not trust each other's solvency and wanted to hold on to what cash they had. This market, too, had not yet returned to normal. The United States, the Eurozone, the United Kingdom and Switzerland were most gravely affected.[6] Japan, Canada, the rest of Europe and emerging markets suffered indirect effects.

This was, once again, a crisis provoked by the private sector. When they realized the scale of the disaster, banks and other financial institutions took their own actions to repair the damage. Standards of lending were progressively tightened, so that credit became scarcer and more expensive. Gradually, banks revealed their losses, wrote down doubtful assets and strengthened their balance sheets by raising new capital, much of it from sovereign wealth funds based in Asia or the Gulf. Losses and write-downs were estimated by August 2008 at nearly $500 billion.[7] Among

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U.S. banks, Citigroup and Merrill Lynch had by then written down over US$50 billion apiece. In continental Europe, Union des Banques Suisses (UBS) wrote down $43 billion. Many of the large British banks were badly affected and struggled to raise new capital. But banks in the Eurozone generally survived better—thanks in part to more cautious regulation. While U.S. and UK banks raised capital to cover 95 percent of their losses, Eurozone banks were content to cover less than 60 percent.[8]

The banks also joined together on an international basis through the International Institute for Finance (IIF) to determine what went wrong and to make proposals for the future. The IIF admitted frankly that the banks were the cause of the crisis, yet it pleaded against correcting the problems by tightening regulations and argued instead for higher standards of good practice to be applied by the banks themselves.[9]

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Domestic Decision-making by the Authorities

These actions by the banks were spread over a year. Meanwhile, the authorities in the United States, the United Kingdom and the Eurozone took a number of crucial actions to lubricate the financial system and to prevent it from grinding to a complete halt. Up to August 2008, policy actions took three forms:

- Massive and repeated injections of liquidity into the market;
- Action on monetary and fiscal policy; and
- Rescues of institutions on the point of collapse.

At the same time, financial authorities began to prepare measures of regulatory reform that would limit the damage and prevent a recurrence. The next section of this article looks in more detail at the relevant decision-making in these areas—i.e. the domestic aspect of financial diplomacy.

The distribution of responsibility is different in each of the three centers.[10] The European Central Bank (ECB) has complete independence from government in exercizing its mandate to manage the euro, to keep down prices and to assure financial stability. This independence is jealously protected by the Eurozone central banks, which make up its council. While the ECB is strong in relation to European governments, it is weak because it has no direct responsibility for regulating banks or other financial institutions. This remains with each of the EU member states, whether in the Eurozone or not, and their national regulators, which meet periodically to share information.

In the United Kingdom, reforms dating from 1997 with a mandate to control

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inflation, strengthened the Bank of England's autonomy, especially in monetary policy. However, supervision of all banks and other financial institutions passed to the Financial Services Agency (FSA). The situation in the United States is highly complex. The Federal Reserve (the Fed), though independent, has to aim for both full employment and price stability. It is responsible for regulating many, but not all deposit-taking banks; regulation of other entities is widely fragmented. The U.S. Congress is far more directly involved than parliaments elsewhere. From the onset of the crisis, however, there has been remarkable unity between Congress, Treasury and the Fed, given that 2008 is an election year.

Injections of Liquidity

The ECB was the first to act. On 9 August 2007, it injected 128 billion euros into the European interbank market. It has continued similar operations in increasing amounts since then, while using other existing techniques. The Fed soon followed suit, improving the terms of its discount lending on 17 August. The Bank of England at first did nothing and criticized the ECB's actions as encouraging irresponsibility. However, British banks with a Eurozone presence were soon drawing on the ECB facilities. The Bank had to eat its words when Northern Rock, a housing finance bank, could only be saved from collapse by massive injections of money from the Bank of England. Thereafter, it too began providing liquidity as banks needed it.

Both the Fed and the Bank of England had to go beyond their existing procedures. They created new, more generous facilities with regard to the volume, terms and duration of the loans offered, as well as the types of assets accepted as collateral. After the near failure of Bear Stearns, an investment bank, the Fed extended its discount facility to other investment banks. In the process, the Fed has strengthened its links with other regulators like the Securities and Exchange Commission (SEC). Meanwhile, the share of its assets held as Treasury securities had fallen from 90 percent to barely 50 percent by August 2008.[11] Despite a year of these injections of liquidity, interbank interest rates were still above their normal level.

Monetary and Fiscal Policy

The Fed has aggressively loosened monetary policy by cutting interest rates often and by large amounts. It began with a 0.5 percent cut in September 2007—0.25 percent adjustments are more usual—and made cuts of 0.75 percent and 0.5 percent within a week in January 2008. By May, U.S. rates were down to 2 percent. The U.S. Treasury and Congress—with the Fed's approval—also launched a fiscal stimulus early in 2008; this was more a response to the housing crisis than the credit crunch. The Bank of England also cut rates more cautiously, but the government's deficit was too big to permit any fiscal action.

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In contrast, the ECB held interest rates steady so that the euro rose against the dollar and the pound. The ECB even raised rates by 0.25 percent in July 2008 to counter inflationary pressures. There was strong criticism of this cautious strategy from some Eurozone governments, especially from President Sarkozy of France, but the ECB ignored these attacks.

Rescues of Failing Banks

Three German banks, both in the state-backed system, needed to be rescued by the authorities early on. SachsenLB was soon absorbed by Landesbank; WestLB was restructured. IKB Deutsche Industriebank, which lost US$16 billion, needed three injections of capital from its public shareholders and the federal government before being sold. For the most part, banks in the Eurozone have held up well, even in countries like Spain with a severe housing crisis.[12] The Swiss bank UBS, despite its heavy losses, was able to raise new capital. But continental Europe remains vulnerable to future shocks, especially a cross-border bank failure.

In the UK, the collapse in September 2007 of Northern Rock was a bad shock for the Bank of England. However, the episode revealed that the FSA, through its weak supervision, was more to blame for the disaster. It also showed that the UK did not have an effective deposit protection scheme. After a vain search for private sector solutions, the government nationalised Northern Rock in February 2008. By then, it had absorbed US$108 billion of public loans and guarantees.[13] No other British banks failed, but the housing crisis in the UK has made it hard for mortgage lenders to raise new capital.

U.S. banks withstood the early months of the crisis well, but troubles grew in 2008. Bear Stearns, the fifth largest investment bank, almost folded in March. Fearing the damage this would do to the system, the Fed—with the Treasury's encouragement—provided funds to enable JPMorgan Chase to buy Bear Sterns for a nominal sum. In July, the housing finance giants Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) came to the brink of failure. This time the U.S. Treasury had to intervene, securing legislation in Congress that greatly increased the state's commitment to the two government-sponsored enterprises (GSEs), which also gained access to the Fed's discount window. A smaller bank, IndyMac, was allowed to fail.

Regulatory reforms

Early in the crisis, EU finance ministers encouraged the European Commission and national regulators to agree on stricter rules to prevent a recurrence. The Commission proposed some ideas for greater transparency by requiring rating agencies to register, but progress toward an agreement was slow. Moves to create an

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EU-wide regulator and to tighten capital requirements on EU banks met resistance.[14] Separately, the ECB has been trying to extract more information from national regulators.

The British Treasury has proposed new measures to protect depositors and deal with failing banks for later legislative enactment. After some tussles with the Treasury, the Bank of England has strengthened its authority, gaining explicit responsibility for the stability of the overall financial system, while the chastened FSA looks after individual institutions. The Bank will also be in charge of winding up any failing banks that the FSA may identify.

The U.S. Treasury Secretary has likewise launched a "blueprint" for a radical overhaul of the regulatory system. The centerpiece of this would be new status for the Fed as a regulator of market stability for all financial institutions. The details of the program may well change after 2008, when Hank Paulson leaves office and a new administration takes over. However, the reforms as outlined would seem likely to give greatly increased powers and responsibilities to the Fed.[15]

Two general points emerged from this analysis of domestic financial decision-making in the first year of turmoil. First, the key players have been the central banks, which have borne the brunt of the crisis. They have the resources available to provide the liquidity needed to preserve the system. The central banks have used this to assert their responsibility for financial stability, while other regulators have been sidelined or even blamed, like the FSA, for failing to prevent the crisis. Governments have taken second place. They have been involved in the rescue of failing institutions and in drafting reforms that require legislative authority. However, these reforms seem likely to increase the powers of central banks. After initial stumbles, Federal Reserve Chairman Ben Bernanke, President of the European Central Bank Jean-Claude Trichet and Governor of Bank of England Mervyn King—have enhanced their reputation and earned the respect of both authorities and markets.

Second, measures to deal with the crisis have been taken at a national or Eurozone level without much regard for international repercussions. Fortunately, no cross-border institution needed rescuing up to August 2008. British banks with a presence in the Eurozone got a windfall because they could draw on the facilities provided by both the ECB and the Bank of England. Cooperative action has been limited to the simultaneous provision of liquidity by the American, British, Swiss and Canadian central banks and the ECB. This was first put into practice in December 2007, after agreement on the margins of the G-20 meeting in South Africa, and has been repeated at intervals thereafter.[16] Its purpose was partly to provide banks in other centers with access to different currencies, especially the U.S. dollar. But central banks have not tried to coordinate internationally the different

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methods of providing liquidity.[17] Thus, there has not been much international crisis management. The development of measures for future crisis prevention, however, has stimulated more active international negotiation. This is analyzed in the following section.

International Negotiation and the Credit Crunch

The International Monetary Fund (IMF)

The IMF provides the obvious focus for financial diplomacy. It has worldwide membership, though rich countries have more power than emerging markets or poor countries.[18] Unlike trade diplomacy, there is no competitive network of regional arrangements—the Eurozone is unique. At the IMF, finance ministers and central bankers sit down together, though central banks take second place. The IMF has handled all previous international financial crises. In the Asian financial crisis of the late 1990s, for example, the United States lost no time in stimulating IMF action backed by the G-7, and mobilizing the wider group of countries that later became the G-20.

This time, however, the IMF has been on the sidelines. Before the ministerial meetings of October 2007 and April 2008, the managing director called for multilateral action on the credit crisis to no effect. The October meeting proved inconclusive and simply passed the problem on to the Financial Stability Forum (FSF).[19] The FSF duly reported in April 2008, but the G-7 finance ministers and the IMF International Monetary and Finance Committee (IMFC), preoccupied with other problems, accepted their recommendations without further action.[20] The IMF's role, up to August 2008, was limited to issuing its assessment of the credit crisis and its impact. Its estimate of total losses was much higher than suggested by others, but is proving more accurate.[21]

There are several reasons for the IMF's inactivity. First, the IMF's actions in the Asian crisis were controversial. Many observers argued that fiscal and monetary tightening was the wrong way to curb a crisis provoked by the private sector. The IMF defended its policy and launched a complex Financial Services Action Plan, but has not developed a new strategy for use in the present case.[22] The U.S. administration, the usual source of initiative in the IMF, is now in its last year with a presidential election imminent. The EU cannot deploy its collective weight. Seats on the IMFC and the Fund's Executive Board are allocated to states; though the ECB is present as an observer, the European Commission is absent. The EU member states are scattered between ten constituencies, in seven of which an EU member is spokesman and attends the IMFC.[23] Yet there is no mechanism by which the EU, or even the Eurozone, can act as one.[24]

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With the IMF immobilized, the action has passed to other, less familiar institutions: the Financial Stability Forum (FSF), the Basel Committee for Banking Supervision (BCBS) and the Bank for International Settlements (BIS), which provides the secretariat for the other two. Central banks and other financial regulators—if present at all—passively control these institutions with finance ministries. These bodies became the drivers of international financial negotiation, matching the rise of the central banks in domestic decision-making.

The Financial Stability Forum (FSF)

The FSF is part of the new international financial architecture introduced in 1999 on the basis of proposals from the G-7. It consists of tripartite delegations—finance ministries, central banks and financial regulators—from the G-7 members plus monetary authorities from Australia, Hong Kong, Netherlands, Singapore and the ECB, with supporting international institutions and other BIS committees.[25]

Each country is likely to apply only those reforms that it has decided to introduce for its own reasons.

In response to its mandate from the IMF, the FSF has drawn up an extensive list of recommendations for changes to regulatory practices to prevent future credit crises. These embrace stronger prudential oversight, greater transparency, new rules for rating agencies, better responses to risk and improved arrangements for dealing with stress. The recommendations were prepared by a group composed wholly of central bankers and regulators.[26]

The FSF has done very well to draw up these recommendations quickly and to get them adopted by ministers at the IMF meeting in their entirety in April 2008. The parallel approach advocated by the IIF, which relied on the banks' own standards of good practice, found little sympathy from the ministers. The FSF was charged to continue its work and will report again later in 2008, but it has no executive or coercive power. It is up to national authorities to put their recommendations into practice. As often happens in economic diplomacy, each country is likely to apply those reforms that it has decided to introduce for its own reasons, while leaving the rest aside.

The Basel Committee on Banking Supervision (BCBS)

First founded in the 1970s, the Basel Committee on Banking Supervision (BCBS) issued Basel I in 1988, prescribing how much capital banks should hold in relation to their lending. These rules were intended to prevent a recurrence of the debt crisis of the early 1980s, when defaults by several Latin American countries

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threatened to bring down U.S. and European banks. The BCBS membership consists of central banks or regulators from the G-7 countries, together with Belgium, Luxembourg, Netherlands, Spain, Sweden and Switzerland—governments are not present.[27] An international liaison group brings in fifteen other countries, mostly members of the G-20 and the European Commission, but not the ECB.[28]

Over time, Basel I came to be criticised for its allocation of risk between different categories of lending. Basel II, a much more complex set of rules, was agreed upon after long negotiations and extensive input from the banking sector, represented by the IIF. Basel II was finally accepted by U.S. banking regulators as late as July 2007.[29] The new rules, however, did nothing to prevent the credit crunch and arguably made banks more vulnerable to it. The BCBS, like the FSF, has been hard at work over the last year to amend its rules in the light of the crisis. One proposal, issued for public comment in July, is to make banks maintain more capital against the securities they hold, comparable with banks holding capital held against loans.[30] Further BCBS reports will be issued later in the year.

The Bank for International Settlements (BIS)

The Bank for International Settlements (BIS)—based in Basel, Switzerland—is the oldest international financial body, going back to 1930. It was pushed into the background for a time by the creation of the IMF and was regarded with some suspicion by the United States—the Federal Reserve only became a full member in 1994. Its members are monetary authorities only and come from fifty-four countries, including all EU and G-20 countries, plus the ECB. The twenty-strong BIS board of directors, however, is strongly weighted towards Europe; China is the only member from outside the OECD. Its staff provides support for the FSF and the BCBS, as well as other committees.[31]

Governors of BIS member central banks meet at Basel every second month throughout the year. This greatly encourages a collegial spirit among the members. These meetings, however, are non-transparent. The most accessible part of BIS work is its Annual Report, prepared by the staff and issued around late June.[32] Over the past several years, this report has been warning of the dangers of excessive credit growth and calling for an international precautionary framework.[33] While this analysis has been highly praised, the member central banks were more concerned with monetary policy and the risks of international economic imbalances, and therefore did not act on the warnings until the credit crunch was upon them.

Conclusions I: Financial Diplomacy to August 2008

The analysis so far shows that, while central banks may have been part of the problem in allowing the credit crunch to break out, they initially provided the solu-

tion. They were able to supply liquidity to banks in need and prevent the markets from seizing up altogether by virtue of the resources at their disposal. This allowed them to increase their standing and their authority at the expense of other regulators and of government. Other regulators were often powerless to act and sometimes had to take the blame. Governments stood back, only reluctantly rescuing financial institutions in trouble. Some of these institutions in the United States and Germany even enjoyed public guarantees. Governments also began to formulate reform proposals needing legislative blessing. Even here, the new regimes envisaged stronger roles for the central bank. The international scene confirms the ascent of the central banks. The IMF, where finance ministers lead, has done little except shift the responsibility. The action has moved to less familiar institutions where central banks are in the lead and where finance ministries may not even be at the table.

At first sight, the emergence of central banks as the key players in financial diplomacy has many merits. Central banks have precise, explicit aims, such as checking inflation and assuring financial stability, while not becoming distracted by a wider range of objectives. They have the technical expertise needed to understand the workings of complex markets. They are cautious and prudent, avoiding eye-catching initiatives. Their independence enables them to resist political pressures so they can introduce painful, but necessary, measures and maintain them over time. The American, British and Eurozone central banks—led by Ben Bernanke, Mervyn King and Jean-Claude Trichet, respectively—displayed these qualities when seeking to unblock the credit crunch.

There are drawbacks, too, especially in the context of economic diplomacy in general. The four strategies of economic diplomacy adopted in response to advancing globalization consist of politicians working alongside bureaucrats, burden-sharing with non-state actors, enforcement of greater transparency and the utilization of international bodies for greater inclusiveness. The new financial diplomacy is retrogressive in all four areas. Central bank independence keeps politicians out deliberately to avoid the errors of government. This makes it harder to win public support when necessary. Central banks and other regulators engaged non-state actors such as private banks. However, they indulged them too much and were thus complicit with the private sector errors that caused the crisis. Central banks can be transparent, especially about their domestic operations, but transparency does not come naturally to them—especially in their international meetings. The BIS for example, is opaque. While the IMF is slowly becoming more inclusive, the central bankers' groupings are heavily weighted towards the G-7. They do not sufficiently reflect the rising power of emerging markets and owners of sovereign wealth funds.

Conclusions II: the Future of Financial Diplomacy

The conclusions so far are based on two unrealistic assumptions. The first is that the credit crunch was under control by August 2008. The second is that the financial diplomacy of the credit crunch can be assessed in isolation from other economic issues. As these assumptions crumble, governments are moving back into the lead.

The credit crunch got much worse in September, going far beyond what central banks and regulators could handle. The U.S. Treasury was obliged to take the initiative. It assumed full control of Fannie Mae and Freddie Mac. It took over nearly 80 percent of the insurance giant American International Group (AIG), funding a loan to AIG from the Federal Reserve of $85 billion. The Treasury declined to rescue investment bank Lehman Brothers, thus leading to its bankruptcy. On top of these emergency measures, Secretary Paulson announced a plan for a government-financed program to buy up all banks' doubtful assets at a cost of up to $700 billion. This was government intervention on the largest scale imaginable. No other G-7 country copied the U.S. example. In the United Kingdom, the government overrode competition rules to allow Lloyds TSB to take over the vulnerable Halifax Bank of Scotland (HBOS).

Meanwhile, the credit crunch and the reactions to it are already having their economic impact. Just as generous credit stimulated growth, tighter lending standards are restraining it. Loosening monetary policy in the United States and United Kingdom has made these economies more vulnerable to inflation. These direct effects of the credit crunch have combined with other forces acting on the whole world economy, especially the rapid rise in oil and other commodity prices in the first half of 2008. The fears of both surging inflation and falling growth are reinforced by mid-year figures from all G-7 countries and the Eurozone, while many other countries are facing financial and economic turbulence. These problems have already preoccupied meetings of the G-7 and the IMF, and the Group of Eight (G-8) summit held so far in 2008, and will demand their attention in the future. Any serious debate on these issues must involve all international players, especially major emerging countries, not just those affected by the credit crunch. It must also engage finance ministers and governments in general, not just central banks and regulators. While the IMF has remained detached from the credit crunch, these wider troubles provide an opportunity for it to find a new sense of purpose as the channel for international consultation and even policy coordination.[34]

In August 2008, central banks dominated both decision-making and negotiation and were extending their authority. This is proving a short-lived episode of financial diplomacy, rather than a new trend. The persistence of the credit crunch and the advance of more traditional macroeconomic problems of growth and inflation will oblige governments and central banks to join forces again. This will favor the IMF,

where both governments and central banks are present, rather than the BIS and its committees. The new financial diplomacy prevailing in the first year of the credit crunch is being superseded by a return to the established strategies of involving politicians alongside bureaucrats, improving transparency and working through international institutions for greater inclusiveness. ♔

NOTES

[1] Nicholas Bayne and Stephen Woolcock, *The New Economic Diplomacy: Decision-Making and Negotiation in International Economic Relations* (Aldershot, UK: Ashgate, 2003, revised edition 2007).

[2] Paul Blustein, *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* (Cambridge, MA: Perseus Books Group, 2001).

[3] The G-7 consists of the United States, Japan, Germany, France, Italy, United Kingdom and Canada. The European Union (Commission, Presidency and European Central Bank) sometimes attends G-7 finance ministers meetings. The G-7 members no longer meet at summit level, but only as the G-8 with Russia.

[4] Peter Kenen, *The International Financial Architecture: What's New? What's Missing?* (Washington, DC: Institute for International Economics, 2001).

[5] The G-20 consists of the G-7 members and the EU, plus Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. See Peter Hajnal, *The G8 System and the G20* (Aldershot, UK: Ashgate, 2005), 151-58.

[6] The fifteen Eurozone members are Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, Netherlands, Portugal, Slovenia and Spain. EU members outside the zone are Bulgaria, Czech Republic, Denmark, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Sweden and the United Kingdom.

[7] John Gapper, "The Cost of a Wrong Turn," *Financial Times,* 5 August 2008.

[8] A summary of U.S. Treasury ideas is in Secretary of the Treasury Henry Paulson's speech in London on 2 July 2008 (http://www.ustreas.gov/press/releases/hp1064.htm).

[9] Chris Giles, Ralph Atkins and James Wilson, "Bankers Act to Head off Regulation", *Financial Times*, 10 April 2008; Josef Ackermann, "How the Banks Can Win Back Confidence," *Financial Times*, 30 July 2008.

[10] Howard Davies and David Green*, Global Financial Regulation: the Essential* Guide (London: Polity Press, 2008); Tommaso Padoa-Schioppa, *The Euro and its Central Bank: Getting United after the Union* (Cambridge, MA: MIT Press, 2004).

[11] "Mission Creep at the Fed," *Economist,* 9 August 2008, 65-70.

[12] In France, Société Générale suffered serious losses from the activities of a rogue trader, but was able to raise new capital from its shareholders.

[13] "A Bank by Any Other Name" and "In the State's Tender Hands," *Economist,* 23 February 2008.

[14] Swiss regulators, however, are contemplating higher capital ratios for their banks. "Briefing: Swiss Banks," *Economist,* 5 July 2008, 89-90.

[15] Paulson (2008).

[16] "Central Banks Make Joint Assault," *Financial Times,* 13 December 2007.

[16] Jean-Pierre Roth, governor of the Swiss National Bank, though favouring this, admits that it is not happening. See Ralph Atkins and Haig Simonian, "Banks Urged to Coordinate More in Emergencies," *Financial Times,* 19 August 2008.

[18] The size of a country's contribution or quota determines its representation on the Executive Board and IMFC, where states are grouped in constituencies. Well-endowed countries get a seat of their own or act as spokesman for a multi-member constituency on a permanent or rotating basis. Poor ones have to rely on the constituency spokesmen or the IMF staff to get their views heard. Quotas are adjusted infrequently and do not yet fully reflect the advance of emerging market countries.

[19] See Jeremy Grant, "Global Turmoil Strengthens Case for Multilateral Action," *Financial Times,* 19 October 2007; Chris Giles, "Credit Squeeze and Criticisms Deepen Crisis of Legitimacy," *Financial Times,* 22 October 2007. David Dodge, governor of the Bank of Canada, is quoted as saying, "We didn't make any progress." Eoin Callan, "IMF failure 'could cause global economic crisis'," *Financial Times*, 21 October 2007.

[20] See Krishna Guha, "IMF Head Calls for Global Help on Turmoil," *Financial Times,* 7 April 2008; Chris Giles and Krishna Guha, "Subprime 'Just One of Many Problems,'" *Financial Times,* 14 April 2008.

[21] The Fund's *Financial Stability Report* (see www.imf.org/external/pubs/ft/gfsr/2008/01/index.htm), issued in April 2008 and updated in July, estimated total losses at $945 billion. The counter-estimate of the Organisation for Economic Cooperation and Development (OECD, www.oecd.org) was $420 billion. The OECD's figure has already been passed.

[22] Joseph Stiglitz, as chief economist of the World Bank, became a trenchant critic. See his *Globalization and Its Discontents* (London: Allen Lane, 2002). The Financial Services Action plan is assessed in Davies and Green, 118-126.

[23] France, Germany and the UK have seats of their own. Belgium, Italy, Netherlands and Sweden are the current spokesmen for constituencies mainly, though not entirely, of other EU members. Ireland, Poland and Spain are the only EU countries in their constituencies.

[24] The European Commission produced a review of the prospects for the Eurozone in May 2008 that recognized this weakness. See *EMU@10: Successes and Challenges After 10 Years of Economic and Monetary Union,* http://www.ec.europa.eu/economy_finance.

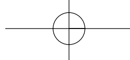
[25] Details are on its website, www.fsforum.org/about/overview.htm. See also Peter Kenen, Jeffrey Shafer, Nigel Wicks and Charles Wyplosz, *International Economic and Financial Cooperation: New Issues, New Actors, New Responses* (Geneva: International Centre for Monetary and Banking Studies, 2004), 71-75.

[26] The April 2008 report is accessible at http://www.fsforum.org/publications/r_0804.pdf and the update prepared in June for G-8 finance ministers is at http://www.fsforum.org/publications/r_0806.pdf.

[27] The original founders of the Basel Committee were the G-10—the countries that agreed to provide extra finance to the IMF. This accounts for its euro-centric membership. For details, see the website of the Bank for International Settlements, http://www.bis.org/bcbs/index.htm.

[28] The extra countries are Argentina, Australia, Brazil, Chile, China, Czech Republic, Hong Kong (China), India, Korea, Mexico, Poland, Russia, Saudi Arabia, Singapore and South Africa.

[29] Duncan Wood, *Governing Global Banking: the Basel Committee and the Politics of Financial Globalisation,* (Aldershot, UK: Ashgate, 2005). A critical assessment of Basel II is in Geoffrey Underhill and Xiaoke Zhang, "Setting the Rules in Global Monetary and Financial Governance," *International Affairs* 84, no. 3 (May 2008), 543-547.



[30] Paul Davies and Gillian Tett, "Basel Committee Looks to Close Bank Risk Loophole," *Financial Times,* 23 July 2008, and www.bis.org/press/p080722.htm.

[31] See the website, www.bis.org, and James Baker, *The Bank for International Settlements: Evolution and Evaluation,* (Westport, Conn.: Quorum Books, 2002).

[32] In the 2000s, the Annual Report has been the work of two veterans of the Bank of Canada: Malcolm Knight, as General Manager, and William White, as Chief Economist. Both left the BIS after the 2008 Report issued.

[33] The 2008 Annual Report is accessible at http://www.bis.org/pub/arpdf/ar2008e.htm. Earlier reports can be found by changing the date in this website reference.

[34] Once again, the IMF Managing Director called in September for a "global dialogue" on the credit crunch. Dominique Strauss-Kahn, "A systemic crisis demands systemic solutions", *Financial Times*, 23 September 2008.