Special Issue

Strategies for Solving Global Crises – The Financial Crisis and Beyond

Articles

Global Governance of the World Financial Crisis?
Roman Goldbach, Thorsten Hasche, Jörn Müller & Stefan Schüder

The National Environmental Premium in Germany: A Rapid Reaction to the Financial Crisis at the Expense of Democracy?
Julia Becker, Marcus Höreth & Jared Sonnicksen

Pride and Prejudice: How the Financial Crisis Made Us Reconsider SWFs
Luca Schicho

The Independence of Domestic Financial Regulators: An Underestimated Structural Issue in International Financial Governance
Régis Bismuth

Yes We Can (Control Them)? – Regulatory Agencies: Trustees or Agents?
Stefan Handke

South-South Regional Monetary Cooperation: Mere Myth or New Opportunity for Financial Stability?
Laurissa Mühlich

Storming, Norming, Performing – Implications of the Financial Crisis in Southern Africa
Franziska Müller

Who Guards the Guardians: Legal Implications for the Operation of International Financial Institutions in Times of Financial Crisis
Jakob Wurm

Dying a Thousand Deaths: Recurring Crises and Exceptional Measures in International Law
Maria Agius

An Unusual Suspect? Monetary Sovereignty and Financial Instability
An Hertogen

Effective Law-Making in Times of Global Crisis - A Role for International Organizations
Stefan Kirchner

The Snake and the Tail: Evolutionary Theory of Derivatives' Regulation and the Asymmetry of Global Financial Crises
Mariusz Golecki

Regional Power Shifts and Climate Knowledge Systems in (Global) Climate Governance
Babette Never

Beyond the Financial Crisis: Addressing Risk Challenges in a Changing Financial Environment
Marianne Ojo

The Productive Semantics of the Crisis
Florian Süssenguth

Lending and Sovereign Insolvency: A Fair and Efficient Criterion to Distribute Losses among Creditors
Juan Pablo Bohoslavsky
The Goettingen Journal of International Law is published Open Access and semiannually by Göttingen Law School students.

Submissions: The GoJIL encourages submissions addressing general international law and employing methodologies from neighbouring disciplines such as international relations, history, or economics. The Journal also welcomes contributions emanating from specialized branches of international law such as international criminal law, international humanitarian law, and international economic law, in particular if they address issues which are of general relevance.

The length of contributions is not restricted. However, we recommend a maximum of 15,000 words. Contributors are requested to insert a short abstract to their submission. Contributions should be saved in MS Word (any version through 7.0) format. Authors should be prepared to supply any cited sources upon request. The full Author Style Sheet is available online at http://gojil.uni-goettingen.de/authorguidelines.pdf.

The views expressed in all contributions to the GoJIL are those of the individual authors and do not necessarily represent the views of the Board of Editors or the Göttingen Institute of International and European Law.

Except where otherwise noted, all contributions are licensed under the Creative Commons Licence Attribution - No Derivative Works 3.0 Germany and protected by German Intellectual Property Law (UrhG).
Advisory Board
Prof. Dr. Kai Ambos (Göttingen University), Prof. Dr. Thomas Buergenthal (International Court of Justice), Prof. Dr. Christian Calliess (FU Berlin), Prof. Dr. Georg Nolte (HU Berlin/International Law Commission), Prof. Dr. Andreas L. Paulus (Göttingen University), Dr. Dietrich Rauschnig (Göttingen University), Prof. Dr. Walter Reese-Schäfer (Göttingen University), Prof. Dr. Frank Schorkopf (Göttingen University), Prof. Dr. Bruno Simma (International Court of Justice), Prof. Dr. Peter-Tobias Stoll (Göttingen University).

Scientific Advisory Board
Katrin Arend (University of Göttingen), Helmut Aust (Humboldt-University of Berlin), Chen Ge (University of Göttingen), Matthias Goldmann (Max Planck Institute, Heidelberg), Carsten Hoppe (European University Institute, Florence), Oliver Kessler (University of Bielefeld), Stefan Korte (FU Berlin), Thomas Kleinlein (University of Frankfurt/Main), Bernhard Kuschnik (University of Tübingen), Clemens Mattheis (University of Göttingen), Nele Matz-Lück (Max Planck Institute, Heidelberg), Sven Mibling (University of Göttingen), Jörn Muller (University of Göttingen), Killian O’Brien (Walther Schücking Institute, University), Niels Petersen (Max Planck Institute, Bonn), Lydia Lörner (University of Göttingen), Tobias Thienel (University of Kiel), Ignaz Stegmiller (University of Göttingen), Markus Wagner (University of Miami).

Editorial Board
Editors-in-Chief: Anja Eikermann, Mohammad Al-Hasani, Matthias Lippold

Editors

Contents

Editorial
Editorial.................................................................................................................. 5
Acknowledgments........................................................................................................ 9

Articles

Global Governance of the World Financial Crisis?
Roman Goldbach, Thorsten Hasche, Jörn Müller & Stefan Schüder ........... 11

The National Environmental Premium in Germany: A Rapid Reaction to the Financial Crisis at the Expense of Democracy?
Julia Becker, Marcus Höreth & Jared Sonnicksen............................................... 43

Pride and Prejudice: How the Financial Crisis Made Us Reconsider SWFs
Luca Schicho............................................................................................................. 63

The Independence of Domestic Financial Regulators: An Underestimated Structural Issue in International Financial Governance
Régis Bismuth.......................................................................................................... 93
Yes, We Can (Control Them)! – Regulatory Agencies: Trustees or Agents?
*Stefan Handke* .................................................................................................................. 111

South-South Regional Monetary Cooperation: Mere Myth or New Opportunity for Financial Stability?
*Laurissa Mühlich* ............................................................................................................. 135

Storming, Norming, Performing – Implications of the Financial Crisis in Southern Africa
*Franziska Müller* ............................................................................................................. 167

Who Guards the Guardians: Legal Implications for the Operation of International Financial Institutions in Times of Financial Crisis
*Jakob Wurm* .................................................................................................................... 191

Dying a Thousand Deaths: Recurring Emergencies and Exceptional Measures in International Law
*Maria Agius* .................................................................................................................... 219

An Unusual Suspect? Monetary Sovereignty and Financial Instability
*An Hertogen* .................................................................................................................... 243

Effective Law-Making in Times of Global Crisis – A Role for International Organizations
*Stefan Kirchner* .............................................................................................................. 267
The Snake and the Tail – Theory of Derivatives’ Regulation and the Asymmetry of the Global Financial Crisis
Mariusz Golecki .......................................................... 293

Regional Power Shifts and Climate Knowledge Systems in (Global) Climate Governance
Babette Never................................................................. 311

Beyond the Financial Crisis: Addressing Risk Challenges in a Changing Financial Environment
Marianne Ojo................................................................. 335

The Productive Semantics of the Crisis
Florian Süssenguth ......................................................... 365

Lending and Sovereign Insolvency: A Fair and Efficient Criterion to Distribute Losses among Creditors
Juan Pablo Bohoslavsky .................................................. 387
Editorial

When founding GoJIL, the idea was to publish a journal which contributes to discussions on international law and discussions on current developments and emergencies. Well before the publication of “Russia in International Law – From the North Pole to the Caucasus”, our first special issue published in May 2009, the decision for the next special issue was already made: the financial crisis. As a result, this GoJIL Special Issue Vol. 2, No. 1 (2010) is dedicated to the topic “Strategies for Solving Global Crises – The Financial Crisis and Beyond”, and is based on an interdisciplinary, international workshop of the same title, held in Göttingen on 15-16 October 2009.

Why this topic? Global Crises have always been an issue in international law, as is well put by Maria Agius in the heading of her article, “Dying a Thousand Deaths”. Some, such as Michael Reisman, go further and argue that crises or incidents should be regarded as “the basic epistemic unit of international law”. Even if this view may be looked at critically, since the attribution of an exceptional character to international law may run the risk of limiting its role in day-to-day life, one has to recognize that, especially in crises and conflict situations, international law has to prove its effectiveness. Although international crises are not something new, they enjoy a whole new level of reception and consequence in a globalized world, where a subprime crisis in the US rapidly influenced the economies of other continents. Looking not only at the last few years, but also at the last decade, one may also take a look at the dot-com bubble (the so-called crisis in the new markets), the terror attacks on 11th September, the climate crisis or the 2009 “swine flu” pandemic, to realize how many crises were publicly perceived. How are these different crises linked with, and differ from, each other?

---

Furthermore, against this background of interdependence in a global world one may ask whether the concept of domaine réservé is an illusion in the 21st century or at least more weakened, in case a state cannot act in a way which to the utmost probability will not affect the other states' societies and systems. Given this global character of recent crises, the question to ask is: How does international law react to these new challenges? A question, which can be broken down into sub-questions, such as: How can international law react? And where is the balance that international law can be both: effective and legitimate? These questions are far away from being answered and therefore will still remain in discussion. This workshop was an opportunity for a young generation of the scientific community to find solutions, discuss strategies and to coin the future.

Why a workshop? Instead of “only” publishing a further special issue we invited scholars and international lawyers to Göttingen, to provide an opportunity not only to present their arguments but also to discuss them with each other and to develop their respective thesis with the inclusion of new thoughts and arguments. All participants appreciated the highly productive and fruitful atmosphere of discourse with various arguments and methodology. We are trying to incorporate such a culture of debate in future issues by developing further editorial concepts.

Why interdisciplinarity? “If we are to understand the significance of international law and how it works and evolves, it is essential to look outside the law itself.”

This applies even more when talking about crises with their complex political, economic and sociologist influences. The enforcement or implementation of international law depends on the legitimacy of the law-making process. Any doubts as to this legitimacy or political reservations may hinder an effective implementation, as we witnessed in Iceland with regard to the referendum a few weeks ago. On March 6, 2010 more than 93 % of the Icelanders voted “no” in Iceland’s first referendum and rejected a deal to repay the U.K. and the Netherlands €3.9 billion lost in the collapse of an Icelandic Internet bank. The payback-bill was based on long negotiations between Iceland, the United Kingdom and the Netherlands and was passed by the parliament of Iceland but not signed by the president. It is difficult to treat international law as detached from a social or political atmosphere and to ignore the background, facts and consequences which are affected by international law and its norms.

The openness to and of an interdisciplinary approach is, since the beginning, part of the identity of GoJIL that “takes up the challenge of present-day methodological pluralism.”

Due to the initiative and the outstanding help of the workshop organizers Anja Eikermann, Roman Goldbach, Thorsten Hasche, Sven Mißling, Jörn Müller

---


and Stefan Schüder we are able to publish the results of this debate. We are proud to publish a multitude of articles, which in their diversity contribute to a multifaceted character of this issue. Thorsten Hasche, Roman Goldbach, Jörn Müller and Stefan Schüder introduce to this special issue. They deliver background insights from the interdisciplinary workshop on strategies for solving and preventing global crises and put them within the broader frame of global governance. The authors Julia Becker together with Marcus Höreth, Jared Sonnicksen, as well as Luca Schicho, Régis Bismuth and Stefan Handke examine the dynamics of global phenomena by taking a look at actors and processes before and during global crises, such as Sovereign Wealth Funds, potential international standard-setting organizations, as well as national executives and national regulatory agencies. Questions of how to strengthen a democratic, transparent and effective financial governance or to ensure transparency on the national level, or the concern of whether the quick reactions of states to combat a crisis leads to “deparliamentarization” – these are just a few of many interesting questions posed by the authors in their contributions.

Further, Laurissa Mühlich, Franziska Müller and Jakob Wurm analyse possible prevention and solution strategies for global crises by considering regional – South East Asia, South Africa and South America - and institutional – IFIs – approaches. Can regional cooperation have a stabilizing impact, and if so, under which conditions? To what extent can International Financial Institutions- instead of directing measures against their members- become subject of measures directed against them, is a question which brings to mind the famous Tin-Council Case which remains in discussion even after 23 years.

The role of international law for solving global crises is taken into account by Maria Agius, An Hertogen and Stefan Kirchner. The authors shed light on the question of whether international law is an obstacle to or an instrument for solving global problems, considering the tension between the exceptionality of crisis-situations against the nature of norms to maintain or ensure normalcy. The issues discussed here are those which are dear to the hearts of general international lawyers. What is the meaning of state sovereignty in international law of the 21st century? Here a strong point is made that sovereignty may not only be defined by international agreements, for instance, but also especially by the reality of interdependence from which it follows that “sovereign” acts are no longer limited to acts on a state’s territory but rather acts which influence other states. In conjunction with the concept of sovereignty (not mentioning the famous “Lotus Case” here surely would be a missed opportunity) one has to see that by using the classical norm creating process of making a treaty, international law may be slow to react to crisis. With effectively and legitimacy of law-making in mind, one must therefore ask whether international organizations may be the answer to this problem.

Finally, Mariusz Golecki, Babette Never, Marianne Ojo, Florian Süssenguth and Juan Pablo Bohoslavsky explore matters beyond the financial crisis by employing theoretical models for global crises. How can we identify risk and minimize them? It is the ambitious attempt to develop concepts with theoretical and em-
pirical parts which may serve not only to understand and to prevent future crises, but also to inspire appropriate action in the event of crises.

Yet, crises remain on the GoJIL agenda. We are delighted to announce an international conference on 7-9 October 2010 in Göttingen with the theme “Resources of Conflict – Conflicts over Resources”, which will deal with the multifaceted interdependence and interaction between resources and conflict. We are proud that one of the two keynote speeches will be held by Judge Bruno Simma (ICJ). As a young and dynamic journal and in line with our mission statement, we encourage in particular the participation of young academics, not only from international law, but also from the neighbouring disciplines. We are happy that we could persuade our former editor-in-chief, Anne Dienelt to take care of the submission process. Abstracts and questions regarding the conference can be addressed to her at anne.dienelt@gojil.eu. The prospective Panels are “Resources before, during and after Conflict”, “Actors of Armed Conflicts and International Law”, “Resources and Conflict Prevention: Access, Sharing and Regulation” and “Knowledge as a Resource: Access, Assessment and Legal Consequences”. The call for papers and more information about the conference, including panel descriptions with possible discussion topics, is available online at http://conference.gojil.eu.

To end, two remarks on our internal matters:

We are happy for Professor Andreas L. Paulus, member of our Advisory Board, for being appointed as Judge of the Bundesverfassungsgericht (German Constitutional Court). At this juncture, we would like to congratulate him and we wish him all the best for his future work in Karlsruhe. We are pleased that he will nonetheless continue advising us as a member of the AB.

Additionally, after Ludwig Bayern and Anne Dienelt, Anja Eikerman has also now resigned from her role as editor-in-chief. GoJIL is currently undergoing a generation shift, which happens in student law journals at shorter intervals than in other journals. Some of the first generation of the Editorial Board have now completed their education, and have withdrawn from day-to-day editing business (insofar as this is really possible), and are striking new paths. Their achievement has been singular! With a tremendous effort they invested much time over the course of two years to prepare the release of GoJIL and to run the journal in its first year of publication. We hope that they will all always remain close to GoJIL, and that we continue this journal in the spirit in which it was founded.

Now, we hope that the articles of this multifaceted issue will raise the interest of our esteemed readers.

The Editors
Acknowledgments

Without the incredible support and help of the following people, we would not have been able to accomplish this ambitious project. We would like to thank:

- All members of the GoJIL Advisory Board and Scientific Advisory Board
- The University and Law Faculty of Göttingen
- The Joachim Herz Stiftung
- The Göttinger Verein zu Förderung des Internationalen Rechts e.V.
- The Göttinger Universitätsverlag
- The Göttingen Institute for Public International Law and European Law
- KMU-Network of the GGG
- Foundation (under private law) of the Georg-August-University Göttingen
- The Institute of Political Science
- The Center for European Governance and Economic Development Research (cege)
- Anja Eikermann
- Roman Goldbach
- Thorsten Hasche
- Sven Mißling
- Jörn Müller
- Stefan Schüder
- Neela Badami
- Priya Bhatia
- Elizabeth Campbell
- Deepaloke Chatterjee
- Andrew Ewing
- Karen Kinkana
- Alex Murray
- Daniel Peat
Global Governance of the World Financial Crisis?*

Roman Goldbach**, Thorsten Hasche***, Jörn Müller**** & Stefan Schüder*****

Table of Contents

Abstract ............................................................................................................................................. 13
A. Introduction .................................................................................................................................. 13
B. An Interdisciplinary Perspective on Global Crises .............................................................. 15
C. Framing Perspectives on Global Crises ..................................................................................... 17
   I. Global Crises Phenomena ....................................................................................................... 18
   II. Conceptualizing Multi-Level-Governance ........................................................................ 19

* We would like to thank the whole team that organized and supported the Workshop “Strategies for Solving Global Crises” and this special volume. Without the tremendous work of Anja Eikermann, neither the workshop, nor our article would have been possible. Likewise, Sven Mißling was an outstanding colleague who played an important role in organizing and conducting the workshop. Furthermore, the whole GoJIL team did a tremendous job before and during the workshop, but especially by editing all the articles. We are grateful for the fruitful support by professors Andreas Paulus, Frank Schorkopf and Peter-Tobias Stoll from the Institute of European and International Law and professor Andreas Busch, Chair for Comparative Politics and Political Economy and by their staff. We would also like to thank our financial supporters, namely the SME-Network of the Göttingen Graduate School of Social Sciences (GGG) and the Foundation of the Georg-August University.

** Georg-August University Göttingen, Department of Political Science.
*** Georg-August University Göttingen, Department of Political Science.
**** Georg-August University Göttingen, Department of Law. A member of the Scientific Advisory Board.
***** Georg-August University Göttingen, Department of Economics.

doi: 10.3249/1868-1581-2-1-goldbach
III. The Developing Role of the G20 ...................................................... 25

IV. Aspects of Regionalism ................................................................. 29

D. The Global Financial Crisis 2007-9 as a paradigm ..................... 32

E. Policy Implications ........................................................................ 39
Abstract

Our contribution evaluates the recent financial crisis in light of the ongoing global governance debate. We contextualize the insights from the interdisciplinary workshop on strategies for solving and preventing global crises and put them within the broader frame of global governance. We analyze solution and prevention mechanisms for global crises phenomena by investigating the reactions to the financial crisis of 2007-9. We provide particular insights into the modes of multi-level-, G20-related, and regional governance mechanisms. Our findings indicate that the dominance of transnational networks and the inherent particularistic interests prevail as regards the reactions to the financial crisis. We discuss whether this outcome can be generalized with regard to the potential implications for other global crises.

A. Introduction

The recent and ongoing crisis in the world financial system along with other global menaces such as climate change, the swine flu pandemic or the spread of weapons of mass destruction have highlighted the susceptibility of a globalized world to equally globalized crises. Yet, at the same time, efforts to establish global regulatory mechanisms are increasing. Setting up a system of “global governance” is portrayed as the answer to global crises. For example, the new President of the EU Council, Herman van Rompuy stated after his election:

“...We are living through exceptionally difficult times: the financial crisis and its dramatic impact on employment and budgets, the climate crisis which threatens our very survival. A period of anxiety, uncertainty and lack of confidence. Yet these problems can be overcome by common efforts in and between our countries. 2009 is also the first year of global governance, with the establishment of the G20 in the middle of the financial crisis. The climate conference in Copenhagen is another step towards the global management of our planet. Our mission is one of hope, supported by acts and action.”

Indeed, the G20 has gained prominence during the world financial crisis and may supersede the G8 as a cardinal means for global economic and financial governance. At the same time, the post-Kyoto Protocol negotiations on greenhouse gas emissions show that classic multilateralism is also a means of global governance in reaction to crises that affect humanity as a whole.

Whether these efforts to establish some form of global governance are a comparatively new development or rather a well-known, evolutionary process may be debatable. However, the change in the fabrics of global governance is a highly dynamic process. New actors, such as China and India are making their influence felt. New issues, such as climate change capture the attention of politicians. Therefore, some authors suggest that the order of global governance is changing rapidly – and that little is known about the current system of global governance, let alone the process of change. At the same time, an abundance of literature analyzing and categorizing the current global order has emerged in a multitude of disciplines, not only in international law, but also in international relations, economics and sociology.

Against this background, in October 2009, young academics from a wide range of disciplines came together at the Georg-August-University to discuss the phenomenon “global crisis”, to analyze it with the methodology of their respective disciplines and to debate about viable solution and prevention strategies for such crises. This issue of the Goettingen Journal of International Law collects their work.

The workshop discussions demonstrated the need to contemplate and investigate global crises phenomena from an interdisciplinary perspective. If global crises are understood as challenges for humanity as a whole, common sense dictates that the whole tool set of all disciplines should be used at the same time to develop concepts for crisis solution, management and prevention. Each discipline will have a different role to play, yet their results have to be brought together for comparison, discussion and evaluation. Interdisciplinarity is thus the means to open up the specific methods, suppositions and theories of economists, legal scholars, political

---


3 For a short overview of some important schools of international law and international relations striving to explain the global order, see Kennedy, Id., 43-54.
scientists and sociologists for each other to sketch a more holistic picture of
global crises phenomena.

The articles collected in this issue provide some important findings,
yet at the same time highlight that many decisive questions remain
unanswered. With our article, we intend to collect some of the workshop’s
insights in order to integrate them in the wider discussion about global
governance.

In the next section, we will outline how the different disciplines may
benefit from a cooperative approach towards the research on global crises
and give a short overview of the challenges interdisciplinarity has to face.
The third part will conceptualize the phenomenon “global crisis” by laying
out an analytical framework based on the concept of “global governance”.
We will then deal with concrete global crisis management and prevention
mechanisms and actors. In particular, we will deal with the G20 as a
possible new actor in global crises management and prevention. Moreover,
we will also look at regional approaches towards global crises. The fourth
section will then provide an empirical investigation of the world financial
crisis. We conclude by drawing policy implications for facing future global
crises.

B. An Interdisciplinary Perspective on Global Crises

In the past two decades, interdisciplinarity has not only become a
buzzword for a wide range of loosely coupled scientific journals, research
centers, study programs and disciplinary cooperation. Moreover, discourses
promoted by federal agencies, private foundations and universities tend to
view interdisciplinary research as more transparent and more profitable for
political, social and economic development than the traditional, disciplinary
bound scientific research based on well-defined and sharply differentiated
disciplines.4

“Interdisciplinarity” as a term emerged in the arts during the 1920s.
Basically, it implies “an integration or synthesis – an interconnection

---

Review of Sociology (2009), 45-48 and A. Barry et al., ‘Logics of Interdisciplinarity’,
37 Economy and Society (2008) 1, 20-23. This article is based on field research at
private institutions in 3 different sectors (environment and climate change research,
ethnography in the IT industry, art-science).
between different academic disciplines”⁵ During their emergence, modern scientific disciplines have not only led to the formation of distinct notions, methods and theories, but also to a more or less transparent corpus of social and cultural practices that regulate the inclusion and exclusion of members of the academe into the different disciplines, as the following remark emphasizes:

“Disciplines discipline disciples. A commitment to a discipline is a way of ensuring that certain disciplinary methods and concepts are used rigorously and that undisciplined and undisciplinary objects, methods and concepts are ruled out. By contrast, ideas of interdisciplinarity and transdisciplinarity imply a variety of boundary transgressions, in which the disciplinary and disciplining rules, trainings and subjectivities given by knowledge corpuses are put aside or superseded.”⁶

At a general level, the literature differentiates between “multidisciplinarity”, which is characterized by a low degree of cooperation between the disciplines, and “transdisciplinarity”, which goes beyond disciplinary confines and develops new modes of scientific enquiry often driven by practical demands. Thus, „interdisciplinarity” can be best understood as middle ground between the two and is characterized by “[...] cross-disciplinary cooperation feeding back into disciplinary knowledge [...]”⁷

Furthermore, contemporary research based on case studies in the privately and publicly funded sector strives to identify existing types or modes of interdisciplinarity.⁸ This research shows that the actual mode of interdisciplinary cooperation is defined by the degree of organizational connection between the related disciplines, the degree of cognitive coupling between the participating scientists⁹ and that it further entails different

---

⁶ Barry et al., supra note 4, 20-21.
⁸ Id. This survey is based on field research at extra-university research institutions in Germany (3 Max Planck institutes, 3 Leibniz institutes and 1 Helmholtz center). Barry et al., supra note 4 is another analysis in point.
⁹ Lengwiler, supra note 7, 425-426.
forms of logics. It could e.g. lead to the synthesis of a new kind of scientific knowledge beyond disciplinary confines (integrative-synthesis), to the dominance of one of the participating disciplines (subordinate-service mode) or “[…] be driven by an agonistic or antagonistic relation to existing forms of disciplinary knowledge and practice”.  

In this regard we are well aware of the limitations inherent in what can only be a short encounter during a workshop. Moreover, interdisciplinarity is no shortcut to scientific progress and valid scientific results. Therefore, our interdisciplinary approach during the workshop aimed at initiating contact and communication between the participating scholars with the goal to elaborate how each discipline can profit from one another and how the connection between them can create a more holistic picture of global crises phenomena. Each participating discipline at our workshop is encouraged to learn from the results of the others where they suspect their own disciplinary weaknesses and where a more holistic view leads to a better and practical useful insight toward the prevention of global crises. Furthermore, in this contribution we synthesize the workshop’s links between the participating disciplines to a more comprehensive framing of global crises phenomena. To this end, we apply the concept of global governance, which is able to connect the respective research in a viable way.

C. Framing Perspectives on Global Crises

What determines a crisis – the “peak of a dangerous development” – and in particular, what determines a global crisis? A recent economic contribution discusses ten major challenges of global magnitude and, analyses (not explicitly) two kinds of crises. Several dangerous developments are national or local crises which have no direct global (or international) development at its core, but receive their so-called global character from the fact that the crises exist in several countries and are publicly discussed as a big issue of mankind. An example would be

---

10 Barry et al., supra note 4, 28-29 (cited text is from 29).
11 Ongoing interdisciplinary research reacts to such difficulties and reflects these in developing epistemological and methodological frameworks. See R. Frodeman et al. (eds), Oxford Handbook of Interdisciplinarity (forthcoming 2010), Chapters 3 and 7.
13 B. Lomborg (ed.), Global Crises, Global Solutions, 2nd ed. (2009).
malnutrition in many developing countries that does not incur direct repercussions on other countries. The second kind of crises is the one of actual global character, as its causes are stemming from several national sources or even an international source, and culminate in effects that affect several locations at the same time and are not controllable by local/national authorities. The latter depicts what we refer to by the phrase *global crises phenomena*, and from our viewpoint it is this kind of ‘peak of a dangerous development’ that has undergone significant change within the last decades.

I. Global Crises Phenomena

Giving a historical review on global crises is outside the scope of this contribution. Instead we argue for a particular vantage point of what made crises truly global within the last fifty years. The argument here is that our societies were able to reduce transaction costs of global exchange tremendously, thereby generating a pronounced boost in international exchange relationships. Yet this development also cleared the way for increased externalities, which could not be borne by legitimized authorities – the externalities outgrew the authorities.

Consequently, a crisis’ global character is derived from its creation of international externalities, which cannot be controlled by traditional (especially nation-based) authoritative institutions. One blurry feature remains, namely whether a strategic choice of national autarky is a valid option in order to circumvent the external effects on a nation: There are crises where these exclusionary strategies are at least a theoretical option, even if highly improbable; there are, however, also phenomena of such kind that make it simply impossible to exclude a territory from its external spill-overs, which is particularly true for natural disasters. In this light, we see the challenge of controlling, or internalizing, external effects from intensified international exchange as central concept at the core of global crises phenomena, and accordingly as decisive for prevention and solution mechanisms.

On the question how to internalize international externalities, one can take several vantage points. In the vein of the workshop contributions and discussion we focus particularly on institutional and efficiency-related

14 This is mainly due to external effects, climate change being the popular example.
16 One might think of national exclusion from international capital markets by prohibiting foreign investments.
Global Governance of the World Financial Crisis?

questions of valid strategies, structuring potential mechanisms along three dimensions: The first dimension is the level of governance, ranging from global/transnational over regional, national, to local. The second dimension is the possible form of codification between the extremes of hard law and soft law\textsuperscript{17} and also implies the categorization of formal – informal rules. Finally, the third dimension is the question about the mode of governance: along the public – private, as well as the inclusive – exclusive\textsuperscript{18} spectrum.

Manifold governance issues arose along these vantage points throughout the workshop sessions, but cascaded into three pivotal topics, namely the viability and legitimacy of multi-level-governance solutions, secondly G20-related structural fissures in the global governance regime, and finally regionalism as a possibly underestimated alternative or supplement. In the following parts, we will frame these concepts and offer critical insights in relation to the connected factual challenges.

II. Conceptualizing Multi-Level-Governance

As demonstrated previously, countering the global crises is a social enterprise that concerns humanity as a whole. Although not all solutions may necessarily be international in nature, it is a truism that the actors of the international system will have to deal with global crises and their solution. This system is characterized by the interaction of a multitude of actors at a multitude of layers dealing with a multitude of issue areas. However, measures taken on several levels by multiple actors within the context of diverse policy fields may contradict each other. It is by no means uncontested who should take the lead and what methods to employ when dealing with a particular crisis. We currently see several strategies at work: For example, in relation to climate change, the attempt to reach a global

\textsuperscript{17} We are also including loose cooperation agreements into account, even though these do not constitute codifications in the strict judicial sense.

\textsuperscript{18} The inclusion – exclusion dimension draws upon political economy literature analyzing, whether political economy mechanisms and decisions are rather of a nature including affected groups into the decision making process as well as in the resulting economic system (see e.g. P. Mooslechner et al., “Financial Market Regulation and the Dynamics of Inclusion and Exclusion”, in P. Mooslechner et al. (eds), The Political Economy of Financial Market Regulation. The Dynamics of Inclusion and Exclusion, (2006); this distinction mirrors the democratic legitimacy deficit stemming from non-democratic club model approaches to governance as opposed to legitimate democratic processes, see e.g. D. Drezner, All Politics is Global: Explaining International Regulatory Regimes (2008).
consensus in form of a treaty through multilateral negations (yet accompanied by action on a regional\textsuperscript{19} and domestic level\textsuperscript{20}) is dominant. In relation to the current financial crisis, the G20 attempt to take the lead (thus leaving many states on the sidelines), while at the same time the focus seems to be less on creating multilateral treaty law but rather on better coordination and possibly the building of institutions.

The impression of the current global system is that of a system undergoing rapid change.\textsuperscript{21} Global crisis contribute to these changes and may serve as catalyst for them in various ways: First, they may lead to the establishment of new institutions and orders. For example, one early outcome of the current financial crisis is the replacement of the Financial Stability Forum with the new Financial Stability Board. We may also see the G20 emerge as a powerful actor in the wake of the financial crisis. Secondly, global crises may also challenge existing regulatory mechanisms, possibly causing them to collapse. Lastly, the collapse of a subsystem of international law in itself may constitute or trigger a crisis – for example, a complete breakdown of the Nuclear Non-Proliferation Treaty may be seen as a crisis in its own right.\textsuperscript{22} In sum, global crises are closely connected to the state of the current system of global governance. Studying this system is thus crucial for understanding the dynamics behind global crises.

The term “global governance” was coined in the discipline of international relations. As an analytical concept, it came to prominence with the publication by James N. Rosenau and Ernst-Otto Czempiel “Governance without Government”\textsuperscript{23} in 1992. They reacted to ongoing debates about the dynamics and structure of international politics in a time of rapid transformation through globalization processes. In their thinking, the concept of global governance denoted all types of control in transnational politics at all levels of social interaction if related to transnational

\textsuperscript{19} E.g. the EU Emissions Trading System based on Directive 2003/87/EC.
\textsuperscript{20} E.g. national subsidies for the green energy sector.
\textsuperscript{21} D. Kennedy, \textit{supra} note 2, 37, 38-42 and 68.
Global Governance of the World Financial Crisis?

repercussions. Other authors have highlighted that there has not only been a diversification of actors, but also a “disaggregation” of the state, which is thus no longer necessarily a unitary actor in international relations.

As an analytical concept, global governance refers to different levels of societal interaction (global, regional, national, local) and therefore stands for the understanding of world politics as a complex multilayered system. Recently, studies in regional governance, especially on the European Union, have become an important topic of governance studies. At the same time, the concept differentiates between various types of social regulation. Beyond the typical steering mode of political authority and market coordination, it includes further modes such as scientific expertise, legal regulation as well as the regulatory role of solidarity.

However, the term has also been used as a normative or political concept. When used in this context, global governance stands for the political will to regain control of globalized politico-legal and economic structures of the world market. As a matter of fact, international organizations like the UN or the G20 too are political reactions to globalization. In this vein, some proponents of the concept express hope that international organizations may fill the regulatory gap that was left after the end of the Cold War.

It is not always possible to distinguish between the various competing understandings of global governance, since academics have used the concept to combine both analytical and political or normative elements. Politicians have also taken up the concept eagerly. For example, in 1995 the Commission on Global Governance published a report, detailing its concept of a reformed order of global governance. The commission comprised active and former high-ranking politicians. One of its key suggestions was a profound reform of the United Nations. Yet in its

25 For an overview see B. Kohler-Koch & R. Eissing (eds), The Transformation of Governance in the European Union (2005) and Schuppert, supra note 12.
27 Dingwerth & Pattberg, supra note 24, 193-196 point at criticism of this concept, since it is seen as disguising negative aspects of globalization in favor of the highly industrialized states.
29 Dingwerth & Pattberg, supra note 24, 195.
definition of governance, formal institutions play an important, but no exclusive role:

“Governance is the sum of the many ways individuals and institutions, public and private, manage their common affairs. It is a continuing process through which conflicting or diverse interests may be accommodated and co-operative action may be taken. It includes formal institutions and regimes empowered to enforce compliance, as well as informal arrangements that people and institutions either have agreed to or perceive to be in their interest.”

The concept is thus open for complex and diverse forms of governance beyond the classic forms of intergovernmental cooperation through diplomacy and international organizations. In particular, the diversification of actors is taken into account. However, while global governance as a purely analytical tool may tell us a lot about how the global system actually works, it tells us little about how things should work – despite the efforts made at understanding global governance as a normative concept. The question how and from where any form of governance may obtain its legitimacy remains largely unanswered.

International lawyers have taken up the question. The whole debate about the fragmentation or constitutionalization of international law may be seen as part of an ongoing effort to understand global governance and the role norms play within that system. Nevertheless, the legal structure of the emerging new system of global governance is by no means clear. Some authors speak of a fragmentation of international law. According to this

---

31 Commission on Global Governance, *Id.*, 2.
Global Governance of the World Financial Crisis?

view, international law will fray out into various legal systems that are governed by their own principles and rules. These systems are not necessarily connected to each other and the principles governing them may have little to nothing in common. If this is true, it would at least be highly questionable if international law may be the central tool for countering global crises, since global crises frequently have an impact that is felt beyond a single issue area.

However, numerous authors have striven to identify common overarching principles in international law – usually discussed as the idea of constitutionalism in international law. Some authors have focused on the UN Charter and tried to describe it as the constitution of the international community. Whether this approach may be warranted or not, at least in the context of global crises focusing exclusively on the UN Charter would be far too narrow, given the broad range of issue areas and the law governing them that are touched upon by global crises.

Other authors try to harness constitutionalist ideas in a broader way. Martti Koskenniemi calls for “constitutionalism as mindset”. Andreas Paulus asks for a “constitutional reading of the international legal foundations on which today’s fragmentation of international legal rules rests.” In a similar vein, Jeffrey L. Dunoff and Joel P. Trachtman propose a functional approach, advocating a “check list” which will enable the academic to identify norms that serve a constitutional purpose. This rather cautious, functional approach may also be of relevance when analyzing the role of law in global crises situations. In the domestic sphere, constitutional norms are designed as fundamental norms able to withstand any crisis not amounting to outright revolution. Norms of this kind are also needed in


For recent contributions to the debate, see J. L. Dunoff & J. P. Trachtman (eds), supra note 33; J. Klabbers, A. Peters & G. Ulfstein, The Constitutionalization of International Law (2009), V. Jackson, Constitutional Engagement in a Transnational Era (2009). Other disciplines have also dealt with the question, cf. e.g. J. Habermas, Der gespaltene Westen (2004), 113-193.


Paulus, supra note 32, 69, 71.

Dunoff & Trachtman, supra note 33, 3, 9.
international crises management and prevention. They may constitute a “backbone” structure of international law, holding together the different subsystems of the international legal system.

Although it is by no means clear that domestic constitutional principles will serve the same function in the international sphere, this nevertheless seems to be at least a good assumption to start off with. After all, the principles identified have been developed in hundreds of years of constitutional practice and thus stood the test of time on the domestic level.\textsuperscript{40} In contrast, the genuinely international principle of state sovereignty is neither able to guide the solution of international conflicts, nor is it helpful when allocating scarce resources.\textsuperscript{41} Moreover, although some of the principles are clearly not neutral formal principles, but rather rooted in the western democratic tradition,\textsuperscript{42} in the absence of any competing constitutional models that have proven to be more successful it seems to be a plausible assumption to operate with these concepts.

Consequently, these functional approaches may help to identify norms that are likely to stand the test of global crises. Norms of a constitutional character are less likely to fall prey to a state-of-the exception rhetoric aimed at shaking off all legal bonds. However, this is exactly what some authors (and probably some politicians) seem to prefer, when declaring that in times of crisis, (international) law has to remain silent. This idea is not only dangerous, but in effect contrary to the whole idea of international law as a set of rules making behavior predictable and manageable even and especially in times of crisis. On the contrary, times of crises are times of law. This is why the study conducted by Maria Agius is such a timely contribution to the debate.\textsuperscript{43} She outlines that law may indeed exert influence on the actors in times of crisis, despite the constant temptation to

\textsuperscript{40} Paulus, supra note 32, 90.
\textsuperscript{42} B. Fassbender, ‘Rediscovering a Forgotten Constitution’ in Dunoff & Trachtman, supra note 2, 133, 139-140.
revert to a claim of a state of emergency. However, she also points to the fact that law, to be effective in times of crisis, has to provide a necessary degree of flexibility in order to allow for the accommodation of extraordinary interests in exceptional situations.

In sum, we are connecting to the ongoing debate about and the continuing development of the concept of global governance in three aspects:

1. An understanding of the global system as a complex multi-layered structure containing different types of social regulation, which go beyond the scope of state-based authority and market-based coordination.
2. Understanding the concept of governance as a bridging-concept capable of bringing together scientific results of various disciplines by focusing on the importance of institutions for the implementation of governance mechanisms, by looking at governance from a structural perspective and viewing it as a theory of regulation.
3. Stressing the need to connect the discussion about global governance to the debate about the fragmentation or constitutionalization of international law, with a particular focus on studying principles that enable norms to guide behavior even in times of crisis.

Not only is a better understanding of global governance in times of crisis needed, but also a better understanding of how norms operate in these situations and how they should be designed so as to remain operable even under intense pressure. Research presented at the workshop demonstrates that both aspects may be successfully pursued. In particular, two layers of the current global order were studied during the workshop, namely global actors with a focus on the G20 and regional initiatives. Consequently, we will turn to these actors in greater detail in the following parts.

III. The Developing Role of the G20

The 1970s were a challenging decade for the industrial countries due to the oil price shock of 1973, the first repercussions of economic and financial globalization following the abolition of the Bretton Woods system and the first appearances of recession. In 1978 German Chancellor Helmut Schmidt and French President Giscard d’Estaing initiated the formation of
the Group of Seven (G7), consisting of the then major world economies United States, Japan, Germany, France, United Kingdom, Italy and Canada. Its aim was to strengthen global economic governance through regular meetings of the member’s finance ministers and heads of state. Furthermore, the G7 was devoted “[…] to diffuse globally its core principles of ‘open democracy, individual liberty and social advancement.’”

In the 1990s the G7 was expanded to the G8 by the inclusion of Russia. Due to the rapid economic development of countries in South America, the Middle East and Asia and their ever growing integration into the international financial system, it became necessary to broaden the membership of the G8. In 1999, after testing summits like the G22 or the G33, the G20 emerged, in part also as an answer to the Asian financial crisis in 1998-99. The first meeting was held in Berlin on December 15-16 under the chair of the Canadian and German finance ministers. The aim of the creation of the G20 was to take account of the changing distribution of international economic importance and widening its scope beyond the strong Anglo-American influence on agenda- and norm setting. In this regard, it was expected by some scholars that “[t]he focus of the new G-20 forum would be on global economic governance broadly constructed to include trade, finance, health, environment, education, human security, poverty reduction, and conflict resolution, thereby extending beyond the realm of ministers of finance.”

After its creation the activity of the G20 was based on regular meetings where the agenda was increasingly set by members outside the G8. The G20 became more open to ideas from its new members. Despite open organizational issues concerning a possible

46 See the G20 Homepage http://www.g20.org/about_what_is_g20.aspx (last visited 29 January 2010) as well as Bradford & Linn, supra note 44, 2-6.
47 Id., 6.
permanent secretariat or an annual head of state meeting,\textsuperscript{48} it became an important enhancement of the G8.\textsuperscript{49}

However, the financial crisis of 2007-9 sheds new light on the aim, membership, organizational structure and policy scope of the G20. Is the G20 able to become an institution that reflects and incorporates the ongoing transformation of the global system and the changing shift of economic and political power?\textsuperscript{50} The expectations were high, as experts referred to Bretton Woods\textsuperscript{51} to articulate the importance of the G20 meetings during the peak of the financial crisis 2007-9 and to evaluate their outcomes. The logic behind these expectations seems to be that a financial crisis of such an enormous scale has to be followed by the institutionalization of more effective and better enforceable global norms for the financial markets. A review of the literature on the financial regulation by the G20 demonstrates some contours of what seems necessary and possible.\textsuperscript{52}

First of all, the G20 remains in narrow contact to technocratic international bodies of the world finance architecture and remains in most cases reliant on their expertise and infrastructure to pass declarations. A very important institution in this regard remains the Financial Stability Forum (FSF, established 1999, now FSB),\textsuperscript{53} which in the wake of the financial crisis made about 60 recommendations concerning global financial regulation. In its final declaration the “G20 Leader Summit on Financial Markets and the World Economy” in Pittsburgh 2008 heavily relied on these recommendations made by the FSF.\textsuperscript{54} This is emphasized by Régis Bismuth’s contribution to this volume where he outlines the technocratic power of international bodies such as the International Organization of Securities Commissions (IOSCO) or the Basel Committee on Banking

\textsuperscript{48} Id., 7.
\textsuperscript{49} Kirton, supra note 45, 20.
\textsuperscript{50} In his contribution to this special issue of the GoJIL Luca Schicho points at the important role of Sovereign Wealth Funds (SWFs); an issue that until now has not been included into the scope of the G20 ‘Pride and Prejudice: How the Financial Crisis Made Us Reconsider SWFs’, 2 Goettingen Journal of International Law (2010) 1, 63-92.
\textsuperscript{52} A thorough evaluation will be provided in our empirical section D.
\textsuperscript{53} The FSF has been transformed into the Financial Stability Board (FSB) after the G20 meeting of 2 April 2009.
\textsuperscript{54} Helleiner & Pagliari, supra note 51, 276-277.
Supervision (BCBS) in creating internationally recognized standards for international finance without being subjected to democratic legislative processes.\textsuperscript{55}

Secondly, the ongoing transformation of the global system has been accelerated by the financial crisis with fierce repercussions on the fiscal stability of Western governments\textsuperscript{56} and left countries at the fringe of bankruptcy. These states, therefore, might lose their central power position in the system of global governance, which in the past was backed by their economic performance and the dominance of their models of financial and economic regulation. It is not yet clear if the G20 will be able to include ideas and policy concepts of members like Brazil, India and China to connect those regions more efficiently into the global economic and financial system and step in where the Anglo-American concept of international finance lost its integrative function in the system of global governance. The trend toward regional fragmentation in the governance of economic and financial issues grows stronger and as a consequence it might become ever more complicated to regulate those issues on a global scale.\textsuperscript{57}

Therefore, and despite its outstanding position in the system of global governance and its ability to transmit decisions regarding the global economic and financial system into international organizations like the World Trade Organization (WTO) or the International Monetary Fund (IMF), the G20 faces serious challenges created by the financial crisis 2007-09 and the power shift in the global system. At the same time, it remains to be seen if the G20 will strengthen or undermine the United Nations and the legal order centered on the UN. Moreover, the G20 will also have to face serious questions as to its representativeness and consequently also to its legitimacy.


IV. Aspects of Regionalism

Even though emerging countries like Brazil or Indonesia are now members of the G20, developing countries like Cambodia, Ecuador or Senegal are not represented. Developing countries are internationally less integrated and have only little influence on other international institutions, like the World Bank, IMF and WTO. In addition, the impact of global crises is felt differently in developing countries. Thus, it can be expected that solution strategies proposed by the G20 do not consider comprehensively their special problems. Therefore the question has to be asked how they may successfully deal with global crises.

The present financial crisis affects developing countries even though they are only weakly connected to the international financial market. They are not fully detracted from the breakdown of the American subprime market but rather influenced by the side-effects of the financial disturbances. The transmission channels are the decrease of remittances, the decline of capital flow as well as the impact on trade and international prices of primary products.\(^58\) Remittances decline due to a worse labor market in the industrialized countries. Capital flows decrease because international investors have a strong need for capital. Therefore, they absorb the losses caused by the subprime market crash rather than invest in new projects in developing countries. Uncertainty and increased capital costs reduce consumption and investment. Consequently, international trade declines and the prices for primary products, which are mainly exported by developing countries, decrease. Overall, the financial crisis reduces private income and GDP growth, which in turn may lead to an increase of social tensions. In other types of crises, such as pandemics or climate change, developing countries are affected worse, simply because they lack the necessary financial and technological means to deal with the effects of these crises. Consequently, it is crucial to examine how to reduce the vulnerability to occurrences of global crises and how to respond, if a global crisis starts to affect their domestic economy and society.

There are relevant arguments that regional cooperation of countries makes local economies more robust in respect to external shock like global

crises. Moreover, such cooperation supports sustainable development. A free trade and free capital flow area increases the market size for companies, which only have operated in their home country before. Thus, companies can better make use of economies of scale and increase sales volume. Capital can be used where it is more productive. Moreover, the level of competition increases, since foreign companies enter the domestic market. All mechanisms force companies to produce more efficiently. In addition, harmonized standards, less trade barriers as well as less capital controls reduce bureaucracy related transaction costs. Overall, a plus of efficiency increases the per capita income of the local population.

However, changes of the economical environment might be accompanied by harmful adjustment processes for at least part of the society. Some sectors may fail to face growing competition with the result of job losses and others may unreasonably take profit of new chances of economic development.

A country with low economic power has no influence on the conditions of the global world market. Therefore, a quick integration in the global economy might go hand in hand with uneven economic development. The advantage of regional coordination is that thereby even states with a small economy are able to influence the rules of transition in dealing with its regional partners. Consequently, painful adjustment processes can be stretched over a longer period of time, which allows companies to improve productivity and people to adapt to new economic environments.

Nevertheless, game theory proposes that negotiation may fail, if countries profit differently from regional cooperation treaties. If this happens, there are incentives for countries to take into account only their own advantage in the negotiation process. Hence, negotiations fail or the


overall outcome of regional cooperation is less than optimal. Franziska Müller concludes that in the case of the Southern Africa Development Community only a small part of the potential of regional co-operation is exploited. This is due to the diversity of the participating states, which leads to differing state interests. However, new international institutions like the African Development Bank start to play the promising role of an external adviser, bringing countries together in order to find overall efficient strategies.

An important precondition for regional cooperation is that the local institutions are able and have the power to effectively enforce agreements on a local basis. In addition, local regulatory institutions need to keep pace with companies increasingly challenged by competition. It is probable that market deficiencies are exploited to a greater extent if every amount of return is potentially crucial for the continuance of business activities. Thus, especially markets with sensitivity to market failures need to be soundly regulated in a competitive environment. This is particularly the case for financial markets because of their addiction to information asymmetries, moral hazard, non-fundamental speculation and excessive risk-taking.

Laurissa Mühlich analyses cases of regional monetary cooperation in South East Asia, South Africa as well as Central and South America. Regional monetary cooperation may lead to deeper financial markets which ease credit taking and reduce financial volatility. However, for success a role model seems to be crucial that offers sound regulation practices other countries can easily rely on.

In the middle of a crisis, regional cooperation may lead to information sharing and a pooling of resources for concentrated action. Partners can profit on the mutual experience of solution strategies. Again it must be avoided that countries take into account their own advantage only and apply

---

“beggar thy neighbor” strategies.66 International actors with local ties like regional development banks might coordinate proceedings to reach overall efficient arrangements.

In the context of the global governance architecture regional cooperation is a promising tool to avoid and fight against negative impacts of global crises. The more willing countries are to cooperate and the better local institutions are able to conduct negotiated decisions, the more effective it is. Role models and “neutral” mediators help to exploit the whole potential. For developing countries, it is one important tool for sustainable development. And having the success story of the EU in mind, which is now by itself a member of the G20, regional cooperation may be an approach to take over a part of global economic as well as political significance in the future.

D. The Global Financial Crisis 2007-9 as a paradigm

Taking the workshop results into account, we encounter several questions regarding the mechanisms apt to control global crises. Multi-level-governance, as well as G20-related and regional solutions are on the table. Turning to our paradigmatic case, namely the financial crisis of 2007-9, it manifested as a clearly global phenomenon in our above definition. Recent studies have highlighted that causes as well as effects had undeniable national variations, but also that the turmoil as such clearly exhibits that spill-over effects such as the US-American sub-prime crisis have spread throughout the world in hours.67

As prerequisite of an evaluation of the levels of solution mechanisms, it is mandatory to distinguish what the truly global facets of the crisis are and what we consider as constituting an international, a transnational, regional, national or local solution/prevention mechanism. While we will discuss the global magnitude of the causes of the crisis within the analysis, we want to clarify at this point that we consider a mechanism or instrument

Global Governance of the World Financial Crisis?

as international, when it is an agreement on the level of national governments of states from at least three continents that inherits at least a minimal set of binding arrangements targeted to or at least open to all states.\textsuperscript{68} Regional mechanisms differ in that they encompass only a regionally coherent group of countries that belong to one or two continents and have some common institutional or societal background. National solution and prevention is characterized by single actions of national authorities, while transnational activities are such that incorporate decision makers which are clearly separate from their national governments, but that negotiate somehow for their nations.

Our central aim is to infer from responses targeted at the current financial crisis to global crises solutions and prevention mechanisms in general. For this purpose, we build upon a secondary analysis of several investigations into the roots of the turmoil, and devise a three-dimensional categorization of the causes. Subsequently, the resulting structure can be applied to embed the reactions to the crisis witnessed so far (December 2009). In this regard, we turn to mechanisms aimed at preventing future crises as well as solutions to curbing the present one. The advantage is a clearly traceable and tractable analysis.

Reviewing the economic and political economy literature on the causes of the financial havoc,\textsuperscript{69} and deriving a bird’s-eye perspective, we sketch the crisis as one enabled by macro-imbalances stemming from a mixture of historical accident and political failure in the reaction to it, then initiated by financial market failures due to excessive risk taking and opaqueness, and finally deepened and widened through regulatory failures in supervising and preventing the havoc.\textsuperscript{70}

\textsuperscript{68} When referring to the term ‘binding’, we also include mechanisms of political and social peer-pressure, as well as market or competition-induced pressure, not only legally binding contracts.


\textsuperscript{70} Actually, we identify seven broad categories, but refrain from going into too much detail here, since the evaluation of the crisis’ causes is not our aim. For the derivation of the causes, consult the quoted contributions. The seven factors are: central bank
Turning to the prevention of future crises, as outlined above, we see *macroeconomic imbalances* at the root of the subprime crisis, as these enabled the huge asset bubbles, which burst during the turmoil, to evolve. We argue that historically relevant events and political reactions to these events enabled financial markets to grow beyond reasonable market size: In reaction to the Asian financial crisis in 1997-8, as well as to the dot.com-crisis and to the terrorist attacks of 9/11 central banks around the globe, but particularly the US Federal Reserve Bank (Fed), reacted with the injection of increased liquidity into financial markets in order to prevent severe economic downturns. This central bank capture resulted eventually in the origination of excess liquidity. The evolving credit bubble in the US and other developed economies was furthermore fuelled by global accounts of payment imbalances. Bluntly put, the emerging economies in East Asia, Eastern Europe and elsewhere with their high saving rates and their transfer through the international capital markets have fed the systems of those states with highly developed financial services industries. The global dimension of these capital-driven roots is obvious, as the problems only arose because of the free exchange possible within global financial markets. Even though the central bank driven liquidity could also arise in an autarky, in a global capital market it almost inevitably results in international spillovers.

Yet, were the solutions and ideas for future prevention mechanisms comparably global? Yes and no. While the central bank and macroeconomic policies remain clearly within unrestricted national driven excess liquidity, global payment imbalances, sub-optimal exorbitant risk-taking of investors, opaqueness within financial firms and the system as a whole, principal-agent-related problematic of rating agencies, regulatory supervision failure; adding a further component, we see principles of financial regulation allowing the risky strategies, opaqueness, and rating-agency influence, i.e. transnational regulatory failure; the last determinant, however, is a perspective not shared by most economic analyses, but rather stems from political economy evaluations.

---


72 See e.g. Goodhart, supra note 69, 332-3, as well as Taylor, supra note 69, 2-3.


74 See Acharya et al., supra note 71, 13.

75 The following analysis of the crisis’ causes and the remedies taken is based on a thorough evaluation of national, regional and global initiatives between January 2007 and October 2009 and thereby relies on several secondary analyzes as well as official documentation (each as quoted). A protocol of the single assessments in tabular format can be obtained from the authors upon request.
authority, institutional re-arrangements have been undertaken within the field of payment disequilibria. Some coordination of central bank policies has been undertaken, informally, during the hot period of market meltdown, but in the long run no preventive coordination seems to follow, leaving this to national (or in the European case supranational regional) approaches.\textsuperscript{76} Regarding the prevention of payment disequilibria, however, some substantial institutional rearrangements are underway, mainly reforming the IMF in terms of funding and voting shares. In particular, the IMF lending facilities have been extended and made substantially more flexible.\textsuperscript{77} However, the reform remains limited, as only small voting share rearrangements at the IMF and the World Bank are underway. In sum, what we see is a multi-level regime that relies on independent macroeconomic policies, but with enhanced global emergency mechanisms, seeking to prevent global spill-overs.

These macroeconomic enablers were at the root of the financial crisis but did not initiate it. The latter happened due to \textit{financial market failures}: opaqueness and risk-taking. Global financial markets, as integrated and in some instances weakly restricted as they still are, exhibited what some would call ‘textbook market failures’: market participants took excessive risks, because the negative consequences were not felt by them but rather externalized on the whole economy; furthermore, these actors exploited the increasing opaqueness of financial markets, which originated in complex instruments and risk management mechanisms of the big international financial intermediaries, e.g. investments banks. The short-term profit orientation of financial firms led to \textit{excessive risk taking} (and thereby mis-pricing of risk). They were followed by term transformation strategies, i.e. firms and traders lent long in illiquid markets to gain the high interests and associated profits, but refinanced the necessary capital short term thereby putting heavy reliance on repo markets. Put bluntly, they leveraged their capital extremely and relied on the allegedly low risk levels of high yield assets. This was brought to perfection through high-complexity risk management via a multitude of instruments but also utilizing the


opaqueness or the lack of transparency of increasingly complex instruments and markets, i.e. sub-prime mortgages, securitization instruments, special investments vehicles, as well as the derivatives and further over-the-counter (OTC) instruments. The bankers were supported even more by problematic principal-agent issues (that further worsened opaqueness and risk taking): this encompassed the rating-agencies’ missing incentive for evaluating risk appropriately and their support of the originate-to-distribute model of mortgages, which reduced incentives of the originator to monitor creditworthiness of the borrower. Last, but certainly not least, came the short-term profit-oriented compensation schemes of financial firms.

The propagated solutions in reaction to these market failures have so far been highly path-dependent in that they are incremental with strong reference to the existing regime and mainly processed by the transnational policy community of national regulators and other technical experts who created the current regime. This regards the enhancements within banking regulation, in particular the refinement of capital adequacy rules, accounting restrictions regarding securitization, trading book and special investments vehicles, establishment of liquidity risk management, and internal risk governance best practices of financial firms. The G20 forum merely adapted these transnational approaches. Nevertheless, this may already be a relevant step forward, particularly taking into account that all G20 countries pledged to implement the Basel II standards. The few substantial reforms that were not just adjustments came from national players: over-the-counter derivative and hedge fund regulation stemming largely from US and UK initiatives. This has been mirrored by increased regional cooperation within the EU, which has also made its influence as transnational player felt: The EU has implemented a multitude of binding regulations and directives aimed at such fields as credit rating agencies, clearing and settlement of over-the-counter derivatives, accounting standards, alternative investment funds, packaged retail investment products, and remuneration of directors of listed companies and employees of financial service firms. Finally, we experienced the power that was retained by private actors in their fight for

78 Helleiner & Pagliari, supra note 51, 275.
self-regulatory freedom. Especially the accounting profession remains largely unrestricted from public political influence.\textsuperscript{82}

In sum, we see global dedication to an ideal of better regulated financial markets, but also witness the international institutional restrictions, where no sufficient expertise is outside the transnational bodies. At the same time, the pivotal domestic interests of the most powerful players (states and increasingly the EU) focus on what is most important for their domestically determined interests.

These market failures were permitted and even worsened by regulatory failure – on a national as well as on a transnational level. National regulatory regimes induced serious moral hazard through ex- and implicit guarantees for too-big-to-fail and too-interconnected-to-fail institutions,\textsuperscript{83} which enabled excessive risk taking while externalizing losses. Too-big/interconnected-to-fail problems can be broadly approached by two strategies. The first is prohibiting institutions becoming too big/interconnected. The second being to provide legal rules, institutions and instruments to resolve an insolvent institute, in order to allow politics let such firms fail without too serious social consequences. On the second issue transnational action has taken place, with adoption by the G20 once again. Working Groups around the FSB are elaborating on international supervision of large, complex financial institutions, as well as the resolution of insolvent international firms. With regard to preventing financial intermediaries from becoming too big or interconnected, strategies to deal with this delicate issue have only in rare circumstances reached official consideration, although this may change due to the recent proposals of restricting the scope of banking business by the current US president Obama and the considerations in further countries, emerging in response to the US proposals. So far states abstained from severely restricting banking business – probably due to the potentially incurred economic losses. Interestingly, this might change due to the US initiative – potentially offering evidence in favor of the remaining hegemonic dominance or market power of the US.\textsuperscript{84}

Yet, even of higher interest seems to be, if the G20 will once again pick up

\textsuperscript{82} Even though some minor adjustments had to be undertaken by the International Accounting Standards Board (IASB). See A. Nölke, ‘The Politics of Accounting Regulation: Responses to the Subprime Crisis’, in Helleiner, et al. (eds), supra note 76.

\textsuperscript{83} Consider the cases of Bear Stearns, AIG, or the German Hypo Real Estate.

\textsuperscript{84} For this line of argument, see e.g. D. Singer, Regulating Capital. Setting Standards for the International Financial System (2007), 13-35.
these ideas and lead to international cooperation. Furthermore, neither the national nor the transnational regulatory authorities accommodated the systemic risks stemming from transformed global financial markets (i.e. the spread of counterparty risk, large and complex financial institutions, and increasing interconnectedness). The latter argument has received high attention on the international level and led to the creation of the Financial Stability Board, which might be seen as the fourth pillar complementing the IFIs and the WTO as pivotal institutions in the governance of the international political economy. The strengthening of this transnational-based institution was a predominantly G20-led objective.

Hence, again, we witness inclusionary public trends on a global scale, but so far this has to build upon existent transnational structures. The unanswered question remains, if the future route goes from transnationalism to more inclusive international decision-making. Currently, there is a clear push towards more international cooperation by the inclusion of the G20 countries into the FSB as well as the transnational bodies of the Basel Committee and the International Organization of Securities Commissions and most importantly through the G20 itself as central international body.

Finally, let us investigate the nature of the solutions for suppressing the spread of the current turmoil. There have been largely three kinds of reactions identified: First, (very) short-term reactions to secure liquidity in order to prevent market breakdown; second short to medium term guarantee and bail-out actions to prevent illiquid, but solvent as well as systematically relevant firms from drowning and taking the market with them; and third, medium to long term rescue packages to keep the economy running. Evaluation of the actions undertaken by the G20, transnational, as well as regional and national initiatives suggests that the fast reactions to turmoil were almost exclusively national emergency measures, and thereby had a politically exclusive character, as the national executives took action in a relatively autonomous fashion.\(^{85}\) The acute counter-measures encompassed liquidity provisions and bail-outs as well as further guarantees to stabilize the financial system.\(^{86}\) This national domination changed only modestly with the succinct rescue packages: national authorities took the actions they deemed appropriate, but there was a global agreement that state action is necessary and that protectionist measures are to be evaded. This was


\(^{86}\) Admittedly, after the first liquidity provisions, there has been some coordination among G7 central banks.
developed in the context of the April 2008, April 2009, and September 2009 G20 Leaders’ Summits. However, there have been large differences which are difficult to resolve between the states on principles, contents, value and implementation. Duration was also controversial, but there was at least some understanding about the minimum duration negotiated at G20 level. The nation-state’s dominance is further emphasized by the fact that regional cooperation was mostly seen in Europe, and the size of it was only minimal. Furthermore, transnational cooperation has been absent, except some technical committee reports in response to the upheaval initiated by Bear Stearns in March 2008. The swift replies, necessary in such a menacing turmoil, could only be undertaken by national entities, since no appropriate institutional structures were available. The G20 agreements on preventing 1930s style beggar-thy-neighbor policies was the only limited success on a global scale. Nevertheless, within the G20 process, macroeconomic coordination and arrangements about sustained public fiscal impulse are steadily evolving.88

E. Policy Implications

What are the quintessential insights for solution and prevention strategies to deal with global crises that we can take from the paradigm of the financial crisis? Although only limited conclusions may be drawn at this time, as the crisis and the reactions are still underway, we see four interesting patterns emerging: (1) increased global coordination and possibly the establishment of new legal rules, (2) currently states newly included into the global governance regime merely take over the rules devised by others, (3) transnational domination due to lack of international alternatives, and (4) domestic powers behind substantial change combined with some extended regional cooperation.

The strategies for encountering the ongoing financial crisis as well as the currently debated political measures to prevent such crises in the future demonstrate a particular feature, namely international coordination in combination with pragmatic transnational detailing and implementation work. While the current level of international coordination seems far-reaching in historical dimensions, it also has enlarged the circle of decision-takers by including important emerging countries along the G20 lines. We

see an increased global coordination in order to solve (and prevent) the (future) global financial crisis (crises), but, at the same time, we witness the lasting, and potentially increasing importance of transnational codification and implementation by private and public transnational bodies.  

However, multilateral, inclusive governance is currently limited to agreements on basic principles and some loose form of coordination. The example of the three G20 summits in 2008 and 2009 suggests that a rather small group may provide leadership by setting standards and principles and by developing new rules which may then be discussed and agreed upon with other affected actors. At least this crisis has changed the status of several emerging countries to become rule-takers, but whether these countries will have a significant impact in the future and thereby transform prevention and solution strategies to global mechanisms remains to be seen.  

This in turn then strengthens, (at least it did within the context of the current crisis), the transnational bodies of international financial regulation like the Basel Committee and the Financial Stability Board. We may be experiencing an intermediate stage of altered global governance reality: On the one hand, a move towards more inclusion on a somehow (more) international scale, while, on the other hand, the structures, actors, and institutions are not ready or even in place yet. This is why other actors and institutions fill the gap of implementing what a new “global club” (the G20) has coordinated in principle. These are national, regional and transnational actors. Furthermore, we see a mixture of private and public players. Maybe this is all we can currently ask for in terms of global solution and prevention strategies given the dense time frame. This is illustrated by an interesting comparison with the Bretton Woods initiative in 1944, when it took two years and a large number of specialists to prepare the conference, compared to the rather short periods before the last G20 Summits. Projecting this insight onto other policy fields, we need to consider carefully how the institutional settings and capacities differ, as this will impact on the global decision-making capabilities.

90 Confirming this analysis with regard to the first summit in November 2008 are Helleiner & Pagliari, supra note 51, 275.
91 Some even see the G20 as a hindrance towards new global regulatory approaches, as it undermines the club model approach of the G10 that characterized financial market regulation throughout the last three decades, and thereby renders international agreement impossible, see e.g. D. Singer, ‘Uncertain Leadership: The US Regulatory Response to the Global Financial Crisis’, in Helleiner, et al. (eds), supra note 76.
92 Helleiner & Pagliari, supra note 51, 275, 283.
Partially due to the sustained agenda-setting power of the transnational regulatory circles, we only see incremental changes in the technicalities. Yet in substance path-dependencies remain regarding the general principles, as is observable in the negligible adaptations in the accounting field, as well as in the further strengthening of value-at-risk based modeling and risk management. In other words, the existing financial governance system remains uncontested – there is no trend to the establishment of classic hard law instruments such as multi-lateral treaties.

The far reaching reforms underway stem from national or, in the European case, regional initiatives, where domestic or supranational interests are the main driving factors. Moreover, we witnessed that the existent global arrangements are not capable of coping with short-term, sudden global shocks, as the pressure for short-term reactions is too demanding for international or even transnational structures.

In sum, solutions to the global crises will require a complex mixture of global, regional, national and transnational rules. The quint-essence is that global mechanisms are needed but that these can only be viable, if solutions are chosen that rely on national, regional or transnational actors in terms of implementation and the constellations of institutions and the interests of their actors are taken into consideration. In essence, a complex web of governance is pragmatically inevitable. However, the decisive concern is not on what level these decisions are taken, but rather how issues of accountability, transparency and legitimacy are taken into account. Although we have seen a major system failure, our evaluation of the current financial crisis indicates that the processes of financial regulation are still largely determined by the same highly organized particularistic interests.

Finally, if we put these results into a more general framework, we can derive at insights for other global challenges. Financial regulation became an international challenge that was handled by cohesive groups of highly specialized actors. This leads to path-dependencies (as described above) and makes it hardly possible to substantially restructure the system, as it would be dependent on the technical expertise of the system’s actors. Thought a step ahead, we ask what we can expect for other policy fields that

---

93 Nölke, supra note 82.
are susceptible to global crises, while at the same time increasingly becoming subject to regulation by expert-led networks. In such a scenario it is therefore indispensable to carefully consider, if and what particularistic interests are dominant within the regulation of global issue areas.
The National Environmental Premium in Germany: A Rapid Reaction to the Financial Crisis at the Expense of Democracy?

Julia Becker*, Marcus Höreth**, Jared Sonnicksen***

Table of Contents

Abstract ............................................................................................................................................. 45
A. Introduction .................................................................................................................................. 45
B. The National Environmental Premium and its Origin................................................................. 46
   I. Definition ..................................................................................................................................... 47
   II. Chronology of the Introduction of the Environmental Premium .............................................. 47
C. Legislative and Executive Law-Making......................................................................................... 49
   I. Distinguishing Between Parliamentary Laws, Regulations and Directives .............................. 49
      1. Acts of Parliament ..................................................................................................................... 49
      2. Regulations ............................................................................................................................... 50
      3. Administrative Rules, in Particular: “Directives” ................................................................. 51
   II. Considerations on Separation of Powers and Democratic Theories ......................................... 51
D. On the Democratic Legitimacy of the Environmental Premium .................................................. 53

* Georg-August University Göttingen, Department of Political Science.
** Rhenish Friedrich-Wilhelms-University Bonn, Department of Political Science and Sociology.
*** Rhenish Friedrich-Wilhelms-University Bonn, Department of Political Science and Sociology.

doi: 10.3249/1868-1581-2-1-becker
I. Operationalisation.................................................................53
   1. Determination of Authorization to Enact Regulations ..........54
   2. Participation of the Bundestag and the Bundesrat in Regulation Setting......................................................54
   3. Public Discourse ..................................................................55

II. Analysis of the Democratic Legitimacy and Examination of the Criteria.................................................................55
   1. The Scope Determined by the Authorizing Decisions........55
   2. Participation of the Bundestag and the Bundesrat – “Collaborative Standard-Setting”?......................................58
   3. Public Discourse as a Source of Legitimacy ......................59

E. Conclusion.................................................................................61
Abstract

Can it be confirmed that times of crisis are times of executive dominance, as the general hypothesis expressed in the public discourse suggests? The Economic Stimulus Package II had been Germany’s reaction to the current financial crisis placing nations all over the world under dramatic pressure. In that case, executive federalism, a trademark of the German political system, should be expected to manifest itself. At the same time – and this shall also be investigated as the flip side of efficient performance of governments – is it possible that the normative, i.e. the constitutionally prescribed standards of democracy have, if not violated, then at least been neglected in these times of crisis? If so, that would certainly indicate “depolaritisation”. The latter has been increasingly viewed as a result of the executive dominance in Germany’s cooperative federalism model, even though the popularly elected parliaments should have a wide-ranging, substantive regulatory power. We address this dual issue by focusing on the policy-making process leading to the introduction of the National Environmental Premium. We will look both empirically at its political and legal background as well as its legal precursors set through federal law and European law principles. In doing so, the democratic legitimacy of the Environmental Premium can be scrutinized.

A. Introduction

The current financial crisis places nations all over the world under pressure. The political reactions thus far are being heavily discussed in media and science, seeming as controversial as the reasons that triggered the crisis. Academic analysis, results and evaluations of the economic measures differ among the various scientific disciplines. This is due not least of all to the temporal proximity of the introduction of these measures and thus results are still largely tentative.

In this paper we are concerned from a political science perspective with the Economic Stimulus Package II of Germany as a reaction to the financial crisis. In particular, we focus on the policy-making process leading to the introduction of the National Environmental Premium and pursue a critical, analytical investigation. Can it be confirmed that times of crisis are times of executive dominance – as the general hypothesis expressed in the public discourse suggests? In that case, executive federalism, a trademark of the Germany political system, should be expected to manifest itself. At the
same time – and this shall also be investigated as the flip side of efficient performance of governments – it is possible that the normative, i.e. the constitutionally prescribed, standards of democracy have, if not violated, then at least been neglected in these times of crisis. That would certainly indicate “deparliamentarization”. The latter has been increasingly viewed as a result of the executive dominance in Germany’s cooperative federalism model, even though “the directly elected parliaments should have a wide-ranging, substantive regulatory power”\textsuperscript{1}.

We address this dual issue by introducing briefly first the “Environmental Premium” and its origins (B). Then we will recapitulate the basis of the distinction between legislative and executive lawmaking, the normative standards of both the Constitution and “simple” law, which are required for the adoption of regulations (C). The focus lies in the question of how many and which substantive rules are allowed to be made by a regulation. And when is explicit and specific prior permission or consent by the parliament as a legislator needed? In other words: how much clearance does the Constitution provide for executive lawmaking? What must already be covered to be a legal basis for an ordinance? And what is allowed to be new in addition to the regulation given by the executive? After addressing this law-issue, we examine the “Environmental Premium” in the next step on the basis of the previously compiled criteria. We will look empirically both at its political and legal background as well as its legal precursors set through federal law and European law principles (D). Above all we try to test the democratic legitimacy of the Environmental Premium. In conclusion, we summarize our analytical results and provide a short outlook (E).

**B. The National Environmental Premium and its Origin**

In the following section, we will define the National Environmental Premium with regard to three issues: *the aims, the content description* and *the impacts*. Then we reconstruct the adoption and implementation over time to track the political decision-making process in detail.

\textsuperscript{1} R. Johne, ‘Bundesrat und parlamentarische Demokratie: Die Länderkammer zwischen Entscheidungshemmnissen und notwendigem Korrektiv in der Gesetzgebung’, B 50-51 *Aus Politik und Zeitgeschichte* (2004), 16. Translations from the original German texts are done by the authors.
The National Environmental Premium in Germany

I. Definition

In accordance with the “Directive to Encourage the Sale of Passenger Cars”2 adopted by the federal government, the Environmental Premium can be defined as follows: The goal of the premium is to promote the concomitant scrapping of old cars and sale of new cars. With the payment of a premium of 2,500 Euros per vehicle, an incentive will be set to replace older and hence stronger polluting vehicles with newer, environmentally cleaner ones and also strengthen the overall economic demand.3 Applications must be submitted – since March 30th 2009 exclusively online – to the Federal Office of Economics and Export Control4, which is responsible for paying out the premium. The applicant must have been the owner of the car for at least 12 months. A new or one-year-old vehicle5 must then be bought between January 14th and December 31st. The old car must have been initially registered at least nine years ago. The process of scrapping must occur between January 14th and December 31st 2009.6 The premium is financed through a special investment fund: “Investment and Sinking Fund”, which is laid down in the Economic Stimulus Package II7 and, after an increase in April 2009, the fund amounts to a total of 5 billion Euros. The increase from 1.5 billion to 5 billion Euros stems from the decision of the Federal Government and the subsequent approval by the Federal parliament. In the following chapter, we retrace all relevant decisions and developments leading to the premium.

II. Chronology of the Introduction of the Environmental Premium

In October 2008, Matthias Wissmann, President of the Association of the Automotive Industry (VDA), called for the creation of an Environmental Premium. The introduction of a national “scrappage” scheme is based on the

2 Richtlinie zur Förderung des Absatzes von Personenkraftwagen (FöAbsPkWRL), BAnz 2009, 835.
3 Id.
4 Bundesamt für Wirtschaft und Ausfuhrkontrolle (BAFA).
5 The car is required to have an emission standard of at least Euro 4.
6 Art. 6 para. 3 sec. 3 sentence 1 Gesetz zur Errichtung eines Sondervermögens „Investitions- und Tilgungsfonds“ (ITFG) Art. 6 Gesetz zur Sicherung von Beschäftigung und Stabilität in Deutschland (BStabSichG), BGBl I 2009, 416.
7 Id., Art. 6.
idea of scrapping old, high-polluting cars and setting at the same time incentives for new investments. The Federal Foreign Minister at the time, Frank-Walter Steinmeier, made this suggestion in December 2008 and the idea of a premium became the subject of political debate in Germany for the first time. Despite differing views in the various political parties, associations and the media, the federal government decided in January 2009 to introduce the Environmental Premium and set a funding framework amounting to 1.5 billion Euros. The Directive to Encourage the Sale of Passenger Cars was decided by the federal government in February. This directive establishes the detailed rules of the Environmental Premium.

In the same month the German federal parliament passed the Economic Stimulus Package II. The Environmental Premium is part of the Stimulus Package II. The second chamber of parliament, the Federal Council (Bundesrat), approved the Economic Stimulus Package II and therefore implicitly the introduction of the Environmental Premium. Finally, the directive entered into force in March. The federal government passed the Second Regulation amending the Regulation ELV to facilitate the smooth implementation of the Environmental Premium. The eligibility period was extended and December 31st, 2009 was set as a new final date for the applicability of the premium. In April, the federal government amended the Directive to Encourage the Sale of Passenger Cars: The funding was increased from 1.5 billion to 5 billion Euros.

The relevant statutory amendment – Act amending the Act Establishing a Special Fund from 1.5 billion to 5 billion Euros – was passed by the German Bundestag in May. In July, the Act to amend the Act Establishing a Special Fund in the amount of 5 billion Euros came into force. In the beginning of September 2009 the funds appropriated for the National Environmental Premium were exhausted. An extension or renewed increase was rejected by the federal government.

---

8 BStabSichG, supra note 6.
9 The original law was from June 21, 2002: Gesetz über die Entsorgung von Altfahrzeugen (AltfahrzeugG), BGBl I 2002, 2199-2211.
10 The first amendment of the ELV regulation was in October 2006. Art. 7a Änderung der Altfahrzeug-Verordnung, BGBl I 2006, 2332.
C. Legislative and Executive Law-Making

Parliamentary law, regulations and administrative directives shall be defined subsequently, firstly to present the distinctions and secondly to explain the interaction of these respective instruments. Building upon that, we offer comments about separation of powers as well as democratic aspects.

I. Distinguishing Between Parliamentary Laws, Regulations and Directives

1. Acts of Parliament

The German Bundestag, the federal parliament, is the core legislative body in the parliamentary system. It has however frequently been reminded by the Federal Constitutional Court (Bundesverfassungsgericht) of its need to fulfil its decision-making duties as a legislator. The Parliament makes key decisions for the state in the form of legislative acts, even though more than 75 percent of all draft legislation the Bundestag deals with has been developed in advance from the ministerial administration. Moreover, the Bundestag is not entirely free in deciding whether there is a need for legislation or regulation. There are frequent cases in which the parliamentary legislature is essentially required to adopt laws.

This is a result mainly from international and European law obligations that require a normative transposition into national law. In particular, Article 249 TEU sets forth a binding provision on the legislatures to implement legal directives of the European Communities in national law. According to the so-called Wesentlichkeitstheorie or “Essentiality Principle” of the Federal Constitutional Court, “significant decisions” must be taken by the Parliament itself. This means that the legislature may delegate the enactment of regulations (or of autonomous statutes) to the administration. But key decisions are subject to parliamentary scrutiny reservation. Accordingly, all issues are “essential” that, due to their political importance, affect the foundations of the social community, as well as all basic-right relevant provi-

sions belonging to the undefined requirements of the Federal Constitutional Court.\textsuperscript{15} The base rule is: The more essential an act of public intervention in the rights of others, the more detailed the law’s development through parliamentary procedures needs to be.

2. Regulations

Regulations constitute legal principles with a general binding effect that are passed by agencies of the executive who have been expressly empowered to that end. From a political science perspective, the relationship between the parliamentary legislature and the regulator can be described as a simple principal-agent model. The right to legislate via regulations is a law-making power conferred from the legislature (in this case the “Principal”) to the executive (here the “Agent”), which will primarily serve the purpose of carrying out activities for the parliamentary legislator. Regulations are ranked in the hierarchy of legal sources below law (in the sense of a parliamentary act), but create generally binding law nonetheless. Once the parliament has defined the framework, the regulator maintains a degree of latitude or discretion, within which independent political action is possible. However, the regulator may not take decisions concerning particular issues or political intent of decisions, and must act within the framework of a statutory program. The underlying principle to this theory is the reservation of the law, meaning that in addition to legal reservations with regard to basic rights, certain measures from the state require authorization via a formal parliamentary act that, in turn, must also conform to the constitution and democratic principles.\textsuperscript{16}

Following the constitutional theory, regulations are not intended to replace parliamentary law, but include only technical details and ephemeral schemes with a low level of policy-making details. Therefore, a moderate application of statutory law can hardly lead to a loss of parliamentary power. In practice, however, there is increasing doubt that the politically important decisions are taken in the parliamentary act, which are then ‘merely’ specified and implemented through corresponding regulations and

\textsuperscript{15} BVerfGE 33, 125-171. BVerfGE 47, 46-85. BVerfGE 49, 89-147.
administrative measures. Especially where the state seeks to regulate economic processes, parliament has come to be widely restricted to formulating highly abstract principles and goals that subsequently require extensive specification and more detailed formulation through regulations. However, the parliament also has rights of participation in designing regulations. Often an act of parliament and the relevant regulations constitute an indissoluble unity, made together by the parliament and government. But it is often the case that “significant” regulations subject to the parliamentary reservation are taken, not in the parliamentary act, but in a subsequent regulation.


Directives serve as administrative and general abstract instructions to department officials with no external legal effect. The legal foundation for directives is laid down in the Federal Budget Code (Bundeshaushaltsordnung, BHO). The BHO is a formal federal law that regulates budgetary activity of the federal government. If the “directives” – which are to have “only” internal administrative affect – imply administrative measures that, for example, involve special services or payments to third parties, then a specific legal authorization by the (parliamentary) legislator is necessary, as with conventional regulations.

II. Considerations on Separation of Powers and Democratic Theories

In particular, the distinction between “law” and “regulation” can only be understood against the background of the German constitutional development of the separation of powers: “Only with [...] the distribution of the institutional power of norm setting on various institutions, the distinction between law and regulation has gained a fundamental and central importance for the state constitution.” In the constitutional monarchy and even during the Weimar Republic, however, there were basically no limits on the

19 Art. 80 I GG.
20 F. Ossenbühl, ‘Rechtsverordnung’, supra note 13, 266.
setting of regulations under the pressure of political and economic events – what the Nazis ultimately were able to exploit to overturn the Weimar democracy.

On the one hand, the German Basic Law effectively put a stop to this problem with Article 80, paragraph 1.²¹ The transfer of legislative power to the executive is now allowed only in a certain form of content and limited amount. Due to the strongly worded parliamentary reservation, it is supposed to secure the rule of law in general and to uphold the democratic requirement of the Basic Law in particular. Nevertheless, the “simplified legislation”²² is – even in modern democracies – legitimized by executive norm setting through the traditional empirical proposition that “the necessity [...] breeds executive dominance”.²³ Even in Germany, the deep-seated suspicion towards executive lawmaking has meanwhile largely relaxed. It was not a democratic-orientation that led to the rethinking, but rather the matured recognition, born in the 70’s, that the Parliament would be overwhelmed in an increasingly complex world with many questions and problems if it were expected to manage all necessary rules and regulations. As in other democracies like Britain, France and the USA,²⁴ regulations are now the most common source of legislation in Germany, even if they are perceived as more politically significant than the underlying parliamentary act itself.

Consequently, legal studies are increasingly taking the approach of viewing executive legal regulation separately from the delegation stemming from parliamentary legislative power and instead more as an inherent authority and competence of the executive branch.²⁵ The relationship between law- and rule-making is now conceived as a “cooperative norm-setting”, though – as is typical for jurisprudential analyses of this kind – it remains unclear who empirically dominates in this form of cooperation. In a parliamentary system of government such as the Federal Republic of Germany for

²¹ “By law, the Federal Government, a Federal minister or state governments may be empowered to adopt ordinances too. The content, purpose and extent of the authorization granted in the law to be determined. The legal basis must be stated in the regulation. If a law provides that such authority may be further delegated, it needs to transmit a statutory authorization.” Art. 80 I GG.
²³ Id.
²⁵ Id., 304-305..
instance, the executive tends to dominate the ordinary legislative process on account of this system’s functional logic. In light of that, one can assume that the legislature, especially in “cooperative norm-setting”, only plays a minor role.

This evidently raises constitutional and democratic theoretical questions (because of Article 70 paragraph 1 GG). Indeed the primacy of law and thus also of the parliamentary legislature over the executive regulatory power is theoretically indispensable: The delegation of legislative powers to the executive branch can hence be withdrawn at any time and the relevant regulations can be adopted by the parliament itself again. This widespread (theory? consensus?) among legal scholars still idealizes an “old” separation of powers of dualism between parliament and the government, which no longer corresponds to political realities. But given the conditions of the “new dualism”, i.e. the fused unit of government and parliamentary majority, it is hardly imaginable that the majority of the Bundestag could decide to disavow the government of its support by depriving it of authority it has already been assigned. Ordinances can therefore fully demonstrate a democratic deficit, which could emerge more clearly, the stronger the government resorts to decision-making via regulation. And that presumably occurs more frequently in times of crisis than in “normal” times since, then, the parliamentary majority sees even less cause to narrow “its” government through excessive parliamentary scrutiny.

D. On the Democratic Legitimacy of the Environmental Premium

The following chapter deals with an operationalisation of the study subject and, building upon that, will review whether the example of the Environmental Premium and its political implementation could be deemed a case of democratic law-making practice.

I. Operationalisation

In order to evaluate how “democratic” the practice of norm-setting and the ministerial decree of “regulations” are – and, for our study, particularly in the context of the Environmental Premium and its accompanying

regulations – the following three criteria seem to be appropriate for the analysis:

1. Determination of Authorization to Enact Regulations

   It is essential to investigate whether the content, purpose and extent of the statutory authorization to adopt the environmental incentive in the law were adequately defined, or whether it rather involved a constitutionally and democratically questionable “carte blanche”. According to the Federal Constitutional Court, to be “sufficiently defined” means the powers delegated to the regulator must be delineated with regard to the program and its implications to the extent that the authorization itself makes the results recognizable and predictable for citizens.\(^\text{27}\) Conversely, it needs to be examined whether the regulator has produced its regulation, the “Scrapped Cars Act”\(^\text{28}\), in a manner compatible to the limits set by the legislature in the “Scrapped Cars Act”\(^\text{29}\), or whether the regulation follows a very different purpose, as it has been outlined in the Parliament Act as “sufficiently precise”. This also applies to the content and dimension of the relevant rules: According to the “Essentiality Principle”, the decision by the regulator to introduce a 5 billion euro program like the Environmental Premium would need to have been authorised beforehand in a parliamentary decision (for example in the Economic Stimulus Package II), both in regard to its content and the extent of the program.

2. Participation of the Bundestag and the Bundesrat in Regulation Setting

   The next step involves examining whether and how the Bundestag and its committees were involved, not only in the authorising parliamentary act (The Act on Scrapped Cars, for instance), but also in the drafting of the regulation.\(^\text{30}\) The more the Bundestag, and in particular its committees, participate in the regulation setting process, the higher the value of democratic

\(^{27}\) BVerfGE 55, 207, 226.
\(^{28}\) Richtlinie zur Förderung des Abstatzes von Personenkraftwagen (FöAbsPkWRL), BAnz 2009, 2264.
\(^{29}\) Richtlinie zur Förderung des Abstatzes von Personenkraftwagen (FöAbsPkWRL), BAnz 2009, 2264.
\(^{30}\) For the different participation opportunities, see F. Ossenbühl, ‘Rechtsverordnung’, \textit{supra} note 13, 289.
legitimacy for the Environmental Premium. The involvement of the Bundesrat (by consent) should also be examined as it follows from the requirement in Article 80 paragraph 2 GG. In particular, the question also emerges as to whether the Federal Council (Bundesrat) has contributed perhaps even more than the Bundestag and its committees to the drafting of the Environmental Premium, which in turn would be typical for "executive federalism".

3. Public Discourse

Finally, the level of democratic legitimacy that can be ascribed to the Environmental Premium also depends on the presence of a public discourse by civil society organizations and interest groups, not least because these channels offer substantial opportunities to participate in the political decision-making process.

II. Analysis of the Democratic Legitimacy and Examination of the Criteria

The following is a systematic testing of the criteria above. After this step, the issues of the analysis raised above should be answered.

1. The Scope Determined by the Authorizing Decisions

The “Directive to Encourage the Sale of Passenger Cars’ from 20th of February 2009 with amendments to the directive of the 17th of March 2009 and 26th of June 2009”, 31 was adopted by the Federal Government in line with the “Pact for Employment and Stability in Germany”, which was adopted into law by the Bundestag with the consent of the Bundesrat and entered into force on March 5th 2009. 32 Although the Environmental Premium was discussed with great interest to the public, the premium is considered merely an internal administrative order to the office responsible for deciding at its official discretion on the approval of paying out the premium – in this case the Federal Office of Economics and Export Control (BAFA) 33.

31 FöAbsPkWRL, supra note 28.
32 BStabSichG, supra note 6.
33 Id.
Thus, this policy will have no external legal effect. Its legal basis derives from the Federal Budget Code as determined by section 3.1 of the Directive itself. Since the directive, with its merely internal effects on the administration, concerns an administrative action which is connected with benefits to third parties, namely the “Environmental Premium”, a statutory authorization of the (parliamentary) legislator is required. This statutory authorization is without doubt granted by the aforementioned Act on Employment and Stability. This also provides in Article 6 for a law establishing a special fund, “The Investment and Sinking Fund” (ITFG), which is intended to finance the measures in line with the Federal Government’s stimulus plan with up to a maximum funding of 16.9 billion Euros. Art. 6, Para. 2, Indent 3 also announces a “program for strengthening the demand for passenger cars with up to 1.5 billion Euros”. More details on this program are written in Art. 6, Para. 3, Section 3 of the “Act to Ensure Employment and Stability in Germany”.

In addition, the Bundestag expressly authorizes the Federal Ministry of Finance to cover the cost of incorporating these loans. It likewise provides details on the issue of amortization, which will be provided through allocations from the federal government budget, and the estimate of all revenues and expenditures of the fund in a specially prepared business plan. However, it became apparent that the funds for “strengthening of car demand” had to be substantially increased due to the popularity of the program among citizens. Therefore, the “law in the law” – the “ITFG” in line with the “Employment and Stability Act” – was modified again by the law of June 25th, 2009. Now, the Bundestag decided that the program to strengthen the demand for cars could cost up to 5 billion Euros. This shows that the “Directive to Encourage the Sale of Passenger Cars” the federal government passed is based on a sufficient determination of content from the authorizing provisions through the Employment and Stability Act as well as by the law incorporated in it, the “ITFG”.

34 Id., 417-418.
35 Id., 418, Art. 6 para. 5.
36 Id., 418, Art. 6 para. 6.
37 Id., 418, Art. 6 para. 7.
38 It is common practice in Germany to combine several laws into one law.
39 Gesetz zur Änderung des Gesetzes zur Errichtung eines Sondervermögens “Investitions- und Tilgungsfonds”, supra note 11.
40 FöAbsPkWRL, supra note 2.
The question is still whether the “Second Regulation to Amend the Directive of Scrapped Cars” was determined sufficiently in content to amend the directive by Act of Parliament. The legal basis of the Second Regulation is based less on the “Act on the Disposal of Old Vehicles”, which was decided on June 21st, 2002 by the Bundestag with the consent of the Bundesrat, and by that also less based on the implementation of the ELV Directive by the EU in September 2000. Rather, this regulation is based formally on the “Law on the Promotion of Recycling and Ensuring Environmentally Sound Waste Disposal”. The fact that the “Recycling and Waste Management Act” determined neither the content nor the purpose and extent of the “Environmental Premium” can be considered unproblematic insofar as the “Second Regulation amending the Directive on Scrapped Cars” only guaranteed the smooth flow and the prevention of abuse of the “Environmental Premium”. Only a very insignificant detail in the Directive on Scrapped Cars was changed. Therefore, it hardly can be deemed a violation of the “Essentiality Principle” of the Federal Constitutional Court.

Overall, one could conclude that the previous authorizing norms provide a sufficiently reasonable determination of content for the “Environmental Premium”. So in particular, the “Act to Ensure Employment and Stability in Germany”, which was decided by the Parliament with the consent of the Bundesrat, cannot be accused of uncertainty in content. The provisions regarding the content, purpose and scope of the statutory authorization to adopt the Environmental Premium and corresponding regulations introduced to serve its smooth implementation are hardly causes for criticism. Concerning the tendency and the program, the national support measures implemented by the federal government were even closely regulated by the parliamentary legislator. This applies also and especially for the extension of the adopted incentive measures - for example, the Bundestag explicitly consented to increasing the financial supplement of the Environmental Premium to 5 billion Euros by amendment.

42 Zweite Verordnung zur Änderung der Altfahrzeug-Verordnung, BGBl I 2009, 738
45 Kreislaufwirtschafts- und Abfallgesetz (KrW-/AbfG), BGBl I 1994, 2705.
46 Zweite Verordnung zur Änderung der Altfahrzeug-Verordnung, supra note 42.
47 BStabSichG, supra note 6.

As illustrated above, the German parliament was involved in the introduction of the National Environmental Premium explicitly and sufficiently. The following will examine the extent to which a political discourse has taken place in the German parliament and, depending on that evaluation, whether it constitutes a strengthening or weakening of democratic legitimacy. This could be assessed from the media coverage of the committees and of the plenary debates. There is a wealth of materials encompassing statements, recommendations for decisions and detailed motions that document the controversial debates leading up to the adoption of the “Act to Secure Employment and Stability” in Germany.

For example, following the law to establish a special “Investment and Sinking Fund”, the recommendation of the Committee for Economy and Technology notes in the sub-report that the Legal Committee, the Finance Committee, the Budget Committee, the Committee on Labour and Social Affairs, the Committee on Transport, Building and Urban Affairs, and the Committee on Environment, Nature Conservation and Nuclear Safety all submitted their opinions on the draft law. The submission and consideration of the recommendations indicate that a substantive discussion had taken place in the committees listed. To that extent, it can also be assumed that the Environmental Premium was taken up for discussion as the subject of the committees’ work because the premium derives its funding solely from the investment and sinking fund. Another example is the report by the Budget Committee of February 12th, 2009 to the draft law on securing employment and stability in Germany: a total of 14 of the 22 standing committees submitted their opinions.

According to the “new dualism”, there should have been a discussion between government and opposition parties. This can be gauged on the basis of corresponding resolutions. In such motions, for example, positions on the draft law amending the “Act Establishing a Special Investment and Sinking Fund” are taken and arguments made in nine sub-items against the introduction of the Environment Premium. Other motions and corresponding reasons for their rejection refer to the draft “Law to Ensure Employment and

---

48 Id.
49 BT-Drs. 16/11825.
50 Art. 6 BStabSichG, supra note 6.
51 BT-Drs. 16/13229.
Stability in Germany”. Consequently a discourse between government and opposition parties has been demonstrated, at least in the written correspondence.

As explained in D.I.2, it is necessary to examine above all to what extent the Bundestag and Bundesrat were equally involved in the development of the relevant regulation, and if the Bundesrat was possibly more strongly involved in the decisions than the Bundestag committees. If that is the case, a strengthening of executive federalism at the cost of a democratic deficit could be attested. To answer this question, a decision recommendation and a report of the Committee on the Environment, Nature Conservation and Nuclear Safety of March 18th, 2009 can be consulted. It is explicitly concerned with the Second Regulation Amending the ELV Regulation. In this context, the opinions of the committees (Economic, Technology and Transport, Building and Urban Affairs) are listed in the consultation process with its conclusions documented. Furthermore, the Regulation of the Federal Government was forwarded to the Bundesrat on March 20th, 2009. The accompanying letter from the chancellor to the president of the Bundesrat states that the German Bundestag approved the Regulation on the previous day. Based on these findings, one cannot read a tendency for greater Bundesrat involvement in comparison to the Bundestag.

In light of the above, a political discourse has taken place regarding the introduction of the Environmental Premium in the German parliament. Its intensity is documented in records, reports, recommendations and resolutions of the committees. Moreover, the decision-making process has not confirmed our initial hypothesis of an obvious imbalance in participation between the Bundestag and the Bundesrat, so a typical characteristic of executive federalism dominance cannot be confirmed in this case. The presumption of democratic deficit seems weaker after our examination of participation by the Bundestag and the Bundesrat.

3. Public Discourse as a Source of Legitimacy

An important purpose of public discourse is making the political decision-making processes more transparent and therefore more accessible to a broader audience. It is a main – and for some, the only – (occasion?) for interest groups, civil society organizations and citizens to review and moni-
tor policy. The media bear a special responsibility here because, through their coverage, they communicate information and content, generate public pressure and are consequently intensely involved in the political decision-making process. Therefore it is important to analyze how national media have reported on the introduction of the National Environmental Premium and whether and in what way organizations have been involved in the political process, for example, through hearings and positions.

The national media reporting has commented on and continues to discuss the possible economic impact and the budgetary consequences of the National Environmental Premium. Thus, according to the data obtained via press reporting, it can be summarized that the coverage of the political decisions taken in Berlin concentrated primarily on the implementation procedures and the implications for citizens. However, one finds essentially no report offering a detailed breakdown of the decision-making process. If the political discourse is reported on, it remains primarily limited to the negotiation and decisions of the federal government and, at most, the statements by party-group leaders. “The agreement has been reached: [...] According to Wilhelm, present at the meeting were – besides Merkel – Finance Minister Peer Steinbrück, Vice-Chancellor Frank-Walter Steinmeier [...], the Head of the Chancellor’s Office Thomas de Maizière [...] and via telephone the Minister for Economic Affairs Karl-Theodor zu Guttenberg (CSU). The new regulation was discussed with the Party-Group Leaders, Volker Kauder (CDU), Peter Struck (SPD) and Peter Ramsauer (CSU)”.

An overview of parliamentary debates on the introduction of the National Environmental Premium was nowhere to be found in the press reports studied. But the Parliament as a legislator was essentially involved in the introduction of the Environmental Premium.

In conclusion it is obvious that the political decision-making process as well as the contrasting positions of the participating and responsible actors has not been made transparent enough in the context of media communication. Media reports on the reactions of different interest groups and organizations on the establishment of the National Environmental Premium address, unsurprisingly, the economic benefits and the positive and negative environmental effects. Yet the political process that led to its introduction has not been questioned from a democratic or legitimacy standpoint. Regarding the involvement of civil society, interest groups and organizations

---

55 Spiegel Online, Regierung begrenzt Abwrackprämien-Summe (sic!) auf fünf Milliarden Euro (7 April 2009) available at http://www.spiegel.de/politik/deutschland/0,1518,618023,00.html (last visited 18 January 2010).
in the implementation process of the Environmental Premium, several public hearings have taken place in the Bundestag, where invited organization as well as non-invited organizations and individual experts could express their opinions. An example of such a hearing is summarized in the materials of the Committee on Labour and Social Affairs. Of the nine organizations which had been invited, the Confederation of German Tradesmen and Tradeswomen made a statement explicitly regarding the government’s Environmental Premium on February 9th, 2009. Therefore, organized interest groups were not excluded from the policy formulation process. On the contrary, the political process of drafting and passing the Environmental Premium could be described, despite the short drafting phase, as remarkably transparent.

E. Conclusion

In this paper we have examined the political decision-making process for the introduction of the National Environmental Premium in Germany. Firstly, the double hypothesis we posed initially could not be confirmed by the analysis - it has not been confirmed that the National Environmental Premium is the exclusive product of the executive branch as it has been suggested in media. Secondly, in this case the German Federal Republic’s system of government with its peculiar executive federalism did not hinder the problem-solving process, nor was the political decision-making process fraught with particular democratic deficits. Even in these times of “financial crisis”, the normative, i.e. constitutional democratic standards prescribed by the constitution which all legislation and the enactment of regulations and directives in the parliamentary system of government must adhere to, have not been violated or neglected. In addition, a broad public discourse has taken place which has provided the drafting and enactment of the National Environmental Premium with additional democratic legitimacy.

The democracy of the constitution has proved surprisingly robust in the process of introducing the Environmental Premium. This is illustrated in three aspects: First, the government was able to demonstrate the ability to decide and act especially in times of crisis – regardless of what might be said of the economic, financial or ecological effects of the Environmental Premium. Second, we showed that the German federal parliament, which is at the centre of the legislative process, even in times of crisis hardly did not

56 BT-Drs. 16(11)1291.
take a back-seat approach and did not merely delegate decision-making to the federal government. In both laws, the Environmental Premium derives its authorization from - namely the Stability and Employment Act and the Act for the Establishment of an Investment and Sinking Fund - the Bundestag strictly ensured that no action by the executive circumvented the parliament. Third, the “new dualism” unity of parliamentary majority and government was shown as exceptionally effective.

Based on these results, we confront the widespread accusation made in the literature that the system of government has been and is experiencing “deparliamentarization”. While there is no denying that this phenomenon is occurring at multiple levels, in multiple places, for no less multiple reasons, it does not seem to apply across the board. And this seems all the more surprising in a case where circumstances prevail, in which one would most likely expect that parliaments play only a supporting role: like in times of a global financial crisis that is far from being finished.
Pride and Prejudice: How the Financial Crisis Made Us Reconsider SWFs

Luca Schicho*

Table of Contents

Abstract ........................................................................................................................................... 65
A. Introduction ...................................................................................................................................... 65
   I. Leading Concepts of the Paper ................................................................................................. 65
   II. The Financial Crisis ..................................................................................................................... 67
   III. SWFs and the Financial Crisis ................................................................................................... 68
B. The Pre-Crisis Situation .................................................................................................................. 71
   I. Hostile Attitudes Towards SWFs ............................................................................................... 71
   II. Controversies Involving State-Owned Investors ...................................................................... 72
       1. The Unocal Controversy ......................................................................................................... 73
       2. The Dubai Ports World Controversy ....................................................................................... 74
       3. Comparison and Conclusions ............................................................................................... 76
C. National Regulatory Frameworks .................................................................................................. 77

* Dr. iur. candidate, Universität Wien (Austria). I owe thanks to Christoph Schreuer, my thesis advisor, for encouragement and support, Jose Alvarez for his inspiring lecture and discussions concerning the topic during the Hague Academy Public International Law Programme 2009, and Wolfango Piccoli for valuable insights into SWF investment policies. Particular thanks go to Diana Ionescu and Sara Bazoobandi for sparking my interest in the topic, helpful comments on earlier drafts and a stimulating discussion at the University of Exeter last May. I would further like to thank my colleagues Jakob Wurm and Oleg Temnikov for their support, research advice and feedback.

doi: 10.3249/1868-1581-2-1-schicho
I. United States ..................................................................................... 78
II. Canada ............................................................................................ 83
III. France ............................................................................................ 85
IV. Japan .............................................................................................. 87
V. Conclusions ..................................................................................... 88
D. The Crisis or Post-Crisis Situation .................................................. 90
Abstract

The article analyzes the interrelation of the financial crisis and the regulation of state-owned investors: For a number of years, Western states raised protectionist fears by publicly debating an increasingly “tough” line on state-owned investors, in particular SWFs from the Middle East and East Asia. But after the dawning of the crisis in summer 2007, SWFs made a series of substantial and urgently needed investments in the Western financial sector. This development necessitated a process of reconsideration of these protectionist tendencies and is gradually leading to a new consensus where legitimate concerns of states are fairly balanced with the indispensable freedom of investment. The article first outlines the pre-crisis situation and its protectionist tendencies, then describes the development of selected national regulatory frameworks and finally dwells on the current situation and the challenges facing states and SWFs in the future: States will have to create clear rules for regulating such investments, while state-owned investors will need to improve their transparency and independence to alloy public concerns over their activities.

A. Introduction

I. Leading Concepts of the Paper

It is a popular saying that every challenge is an opportunity. The challenge posed by the current financial crisis is no exception to the rule: It is an opportunity for Western states to reconsider their protectionist pride and prejudice towards state-owned investors, in particular Sovereign Wealth Funds [hereinafter “SWFs”]. After the dawning of the crisis in summer 2007, Western states raised protectionist fears by publicly debating an increasingly “tough” line on state-owned investors, in particular SWFs from the Middle East and East Asia. But after the dawning of the crisis in summer 2007, SWFs made a series of substantial and urgently needed investments in the Western financial sector. This development necessitated a process of reconsideration of these protectionist tendencies and is gradually leading to a new consensus where legitimate concerns of states are fairly balanced with the indispensable freedom of investment. The article first outlines the pre-crisis situation and its protectionist tendencies, then describes the development of selected national regulatory frameworks and finally dwells on the current situation and the challenges facing states and SWFs in the future: States will have to create clear rules for regulating such investments, while state-owned investors will need to improve their transparency and independence to alloy public concerns over their activities.
2007, SWFs have made a series of substantial and urgently needed investments in the western financial sector. These investments allowed states to postpone their stabilization measures and showed the important role state-owned investors can play, in particular in a financial crisis. This has lead to a reconsideration of the formerly hostile views of state-owned investors.

The purpose of this paper is to outline the interrelation of the financial crisis and regulatory tendencies: For a number of years, Western states raised protectionist fears by publicly debating an increasingly “tough” line on state-owned investors, in particular SWFs from the Middle East and East Asia. While many of the concerns raised were legitimate, e.g. concerning transparency and independence of SWFs, there was an unmistakably discriminatory element in these considerations. The financial crisis now necessitates a process of reconsideration of these hostile and discriminatory tendencies. This is gradually leading to a new consensus where legitimate concerns of states are fairly balanced with the indispensable freedom of investment. States will have to create clear rules for this purpose, while state-owned investors will be confronted with the challenge to improve their transparency and independence.

For these considerations, the following four aspects will be reviewed by the present paper. First, the impulse for the alleged change, the financial crisis; the pre-crisis situation, in particular the above mentioned controversies and underlying protectionist concerns; the development of national regulatory frameworks and their evolution during the crisis; and

---


finally the possible post-crisis outlook. This review will cover political, legal and economic factors involved, with particular attention dedicated to the political background of the changes in regulatory frameworks.

II. The Financial Crisis

The current financial crisis began with the subprime mortgage crisis that rose into view in the summer of 2007. Since then, the crisis has been gradually evolving, resulting in volatility of global financial markets and undermining confidence in the growth perspectives of the world economy. The first result of the crisis were extensive losses from the surge in defaults suffered by financial institutions that had specialized in the mortgage and subprime mortgage sectors, starting with the more exposed and overleveraged market participants, but soon spreading to all financial institutions involved. This in turn led to substantial losses for virtually every financial institution operating in the U.S. market, when the defaults started trickling into the more sophisticated securitization products based on subprime mortgages, such as Mortgage-Backed Securities and Collateralized Debt Obligations.

These losses in themselves have already led to a substantial contraction of liquidity in the financial markets. The problems are aggravated by the presence of numerous overleveraged financial institutions, whose losses necessitate a deleveraging process, which forces them to sell off financial assets in their balance sheet to regain liquidity. This process further lowers the value of the capital market, resulting in a liquidity squeeze and the so-called “credit crunch”.

---

III. SWFs and the Financial Crisis

Due to the liquidity squeeze in the financial markets, the two main sources for the urgently needed capital injections are domestic measures and “external measures” in the form of foreign investment in the capital markets. Domestic measures range from the rate adjustments of the U.S. Federal Reserve and other central banks to the so-called “bailouts” of threatened financial institutions. An essential part of the “external measures” were capital injections by SWFs, as sketched in the table below.

<table>
<thead>
<tr>
<th>Recent investments by SWFs (2007-2008 Q1)</th>
<th>Acquired Company</th>
<th>Transaction Value</th>
<th>USD Billion</th>
<th>% of firm value</th>
</tr>
</thead>
<tbody>
<tr>
<td>GIC (Singapore)</td>
<td>UBS</td>
<td>9.8</td>
<td>8.6</td>
<td></td>
</tr>
<tr>
<td>Abu Dhabi Investment Council</td>
<td>Citigroup</td>
<td>7.6</td>
<td>4.9</td>
<td></td>
</tr>
<tr>
<td>GIC (Singapore)</td>
<td>Citigroup</td>
<td>6.9</td>
<td>4.4</td>
<td></td>
</tr>
<tr>
<td>China Investment Company</td>
<td>Morgan Stanley</td>
<td>5.0</td>
<td>9.9</td>
<td></td>
</tr>
<tr>
<td>Temasek (Singapore)</td>
<td>Merrill Lynch</td>
<td>5.0</td>
<td>11.3</td>
<td></td>
</tr>
<tr>
<td>KIA (Kuwait)</td>
<td>Merrill Lynch</td>
<td>3.4</td>
<td>7.0</td>
<td></td>
</tr>
<tr>
<td>China Development Bank</td>
<td>Barclays</td>
<td>3.0</td>
<td>3.1</td>
<td></td>
</tr>
<tr>
<td>China Investment Company</td>
<td>Blackstone</td>
<td>3.0</td>
<td>10.0</td>
<td></td>
</tr>
<tr>
<td>Investment Corporation of Dubai</td>
<td>London Stock Exchange</td>
<td>3.0</td>
<td>28.0</td>
<td></td>
</tr>
<tr>
<td>KIC (Korea)</td>
<td>Merrill Lynch</td>
<td>2.0</td>
<td>4.3</td>
<td></td>
</tr>
</tbody>
</table>


How the Financial Crisis Made Us Reconsider SWFs

<table>
<thead>
<tr>
<th>SWF Name</th>
<th>Financial Institution</th>
<th>Investment Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temasek (Singapore)</td>
<td>Barclays</td>
<td>2.0</td>
</tr>
<tr>
<td>Qatar Investment Authority</td>
<td>London Stock Exchange</td>
<td>2.0</td>
</tr>
<tr>
<td>Undisclosed “Middle East investor”</td>
<td>Standard Chartered</td>
<td>2.0</td>
</tr>
<tr>
<td>Abu Dhabi Investment Council</td>
<td>Carlyle Group</td>
<td>1.4</td>
</tr>
<tr>
<td>Investment Corporation of Dubai</td>
<td>Och-Ziff Capital Management</td>
<td>1.3</td>
</tr>
<tr>
<td>China Citic Securities</td>
<td>Bear Stearns</td>
<td>1.0</td>
</tr>
<tr>
<td>Borse Dubai</td>
<td>Nasdaq</td>
<td>1.0</td>
</tr>
<tr>
<td>GIC (Singapore)</td>
<td>Merrill Lynch Financial Centre</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Sources: ECB 2008

As the table shows, the years 2007 and 2008 saw a substantial surge of investments by SWFs in financial institutions, perceived, at the time, as only temporarily affected by the subprime woes. This climate of “investment opportunity” led numerous previously cautious SWFs to invest in the financial sector. Many of these investments resulted in substantial losses during the crisis, when, even after receiving these capital injections from SWFs, financial institutions such as Citigroup, Merrill Lynch and UBS continued to disclose additional losses.

If the approximately U.S. $44.9 billion invested by SWFs in financial institutions between March 2007 and April 2008 had been invested half a year later, the investors would have been able to invest at substantially lower prices. For example, after the China Investment Corporation invested in Blackstone, the market value of the company dropped over 50 percent, thereby turning the China Investment Corporation into a prominent victim of the subprime mortgage crisis. This has led to substantial domestic

---

11 European Central Bank, 2008, supra note 2, 20; Moshirian, supra note 2, 16.
13 Zhang & He, supra note 6, 110.
criticism of SWF’s investment strategies, which may discourage SWFs from undertaking such substantial investments during periods of high market volatility in the future.\textsuperscript{14}

Nonetheless, this series of investments allowed states, in particular the United States, to postpone their stabilization measures for a certain period. It was after this period, in February and March 2008, that the first large scale domestic measures became necessary: The nationalization of Northern Rock by the British government in late February\textsuperscript{15} and the coordinated rescue of Bear Sterns by the Federal Reserve and JP Morgan in the United States in late March 2008.\textsuperscript{16}

After this date, domestic measures to prevent the collapse of overleveraged and highly interconnected financial institutions became day-to-day business\textsuperscript{17} in numerous Western states, which were suddenly forced to become partial or full owners of numerous financial institutions. The recently commemorated collapse of Lehman Brothers, considered by many a highly damaging but politically an inevitable reaction to public outrage over the “bailouts”,\textsuperscript{18} would have certainly occurred much sooner without the intervention by SWFs in 2007 and early 2008.


How the Financial Crisis Made Us Reconsider SWFs

B. The Pre-Crisis Situation

I. Hostile Attitudes Towards SWFs

The question is whether, in the words of Prof. Ming, states should perceive an investing SWF as an “aggressive white shark or an amiable blue whale?” The question is and remains controversial. Protectionist regulatory tendencies in Western states have moved in the ambivalence and contradiction between general commitments to open investment climate for SWFs as promoted by the OECD, the acknowledgement of their economic importance for Western countries and public statements endorsing a “tough” line on state-owned investors. While some of the debates are based on entirely legitimate concerns, such as doubts about the transparency and independence of SWFs and other state-owned investors, there are also discriminatory elements in these considerations as manifested in two exemplary cases, the Unocal and Dubai Ports World controversies.

19 Zhang & He, supra note 6, 102.
24 Georgiev, supra note 21, 125.
II. Controversies Involving State-Owned Investors

Why should this and the following chapter be named “controversy” and not “affair” or “case”? Controversy is a freely chosen term, and affair or case could equally be used. However, avoiding the use of the term “case” seems appropriate to clarify that no judicial proceedings took place (which are in fact not provided for under the US regulatory framework). It is an important characteristic of both the Unocal and Dubai Ports World controversies that no such proceedings took place. The term “affair” would be another option, but due to its usual connotation of involving something illegal or illegitimate it is less precise. It is specifically the conformity of the investors conduct with the provisions and procedures established under U.S. law that makes these controversies so interesting. Finally, the term “controversy” most clearly implies the debate and conflict of opinions that played the decisive role for the failure of both the Unocal and the Dubai Ports World transactions.

While the two state-owned entities involved in the two controversies are not SWFs (they both operate businesses rather than acting as investment funds by acquiring and holding assets for long-term purposes), the concerns and objections raised concerning the transactions are very similar to those relating to investments by SWFs. In the absence of comparably controversial and highly publicized controversies relating to actual SWF investments, the author therefore uses these as reference points, in particular due to the fact that the investors were attacked explicitly due to their status as state-owned enterprises.\(^\text{25}\)

The controversies brought to the surface lingering feelings of hostility and protectionism which equally apply to investments by SWFs, even though these generally attract less public attention due to their focus on minority share investments. Consequently, the political pressure exerted on SWFs in relation to their investments will take more subtle forms, which are less suitable for analysis compared to the Unocal and Dubai Ports World controversies.

1. The Unocal Controversy

The Unocal Controversy took place in 2005 and involved 3 entities, the U.S. enterprises Unocal and Chevron Texaco and the state-owned Chinese National Offshore Oil Company [hereinafter “CNOOC”]. Unocal was a major petroleum explorer and marketer founded in 1890 and mainly active in the US and Central Asia. After an extended bidding contest, CNOOC topped Chevron Texaco's last $ 17.1 billion bid for Unocal with a $ 18.5 billion bid in June 2005. In July 2005, the Unocal board of directors accepted the bid and took the necessary steps to submit the decision to a vote by stockholders. Meanwhile, CNOOC was in regular contact with the Committee on Foreign Investment in the United States [hereinafter “CFIUS”] and discussing the possible conditions imposed on the transaction. However, the vote by stockholders was pre-empted by CNOOC’s unexpected decision to withdraw its bid, citing the “unprecedented political opposition that followed the announcement of our proposed transaction, attempting to replace or amend the CFIUS process that has been successfully in operation for decades” and concluding that this pressure presented an “unacceptable risk to our ability to secure this transaction.”

The cited opposition essentially focused around a series of concerns raised by U.S. policymakers, mainly members of congress. The concerns can be summarized in three main categories: Explicit security concerns arising from Unocal’s possession of critical technologies; trade and competition policy concerns related to alleged “unfair advantages” of CNOOC in the bidding contest due to government funding; and in particular strategic concerns about investments in the energy sector. The transaction

was attacked due to the lack of reciprocity in opening the energy sector, which remains strictly regulated in the People’s Republic of China. Furthermore, Unocal was considered, due to its involvement in the highly sensitive and political Trans-Afghan pipeline project,30 “off hands” for foreign investors, in particular when originating from competing players in the race for central Asian energy resources.31

2. The Dubai Ports World Controversy

The entities involved in this controversy were the British Peninsular and Oriental Steam Navigation Company [hereinafter “P&O”], the Singaporean PSA International, United Arab Emirates Dubai Ports World [hereinafter “DP World”] and the American Insurance Group’s International Group. DP World is a holding company owned by the government of Dubai in the United Arab Emirates which was created by a merger between the Dubai Ports Authority and the enterprise DPI Terminals in 2005.32

Negotiations between DP World and P&O began in 2005. DP World, which managed numerous port facilities worldwide, intended to acquire P&Os North American port assets.33 In October 2005, DP World approached the CFIUS to clear possible regulatory obstacles to an acquisition of these facilities. Separately, in December 2005, a group of Coast Guard officials raised the possibility of security risks associated with management of the port facilities by a company from the United Arab Emirates.

In early February 2006, the stockholders of P&O agreed to the sale to DP World after a bidding contest with PSA International. Shortly after this, in mid February 2006, Ellert & Company, a business partner of P&O North

33 Ionescu, supra note 1, 71.
America, became aware of the planned transaction and, feeling reluctant to become closely connected with DP World, decided to hire lobbyists to rally opposition to the transaction. These rapidly contacted Senator Schumer and journalists from Associated Press. After a short but highly effective lobbying campaign, a number of senators began asking for a “more thorough review” of the transaction. The campaign also attracted the White House’s attention. Fearing the long-term impacts of a protectionist backlash to the transaction, President Bush joined the fray and on 22 February issued a statement threatening to veto any legislation blocking the transaction as “it would send a terrible signal to friends and allies”. Smelling hope, DP World started its own “charm offensive” and tried to turn the tide in Congress. It engaged its own team of lobbyists and on 23 February volunteered to postpone its takeover.

However, neither the President’s nor DP World’s efforts were sufficient to stop the growing opposition to the transaction. Senator Levin issued a statement accusing the White House and CFIUS of having adopted a “casual approach to reviewing the sale of U.S. port facilities to a country with an uneven record of combating terrorism”. On 8 March, the respective House Panel voted 62-2 to block the transaction. On the following day, DP World admitted defeat, releasing a statement announcing

to turn over operation of U.S. ports to a “US company”. As became known later, this entity was American Insurance Group’s International Group.

3. Comparison and Conclusions

The DP World controversy differed from the Unocal controversy in 3 decisive respects. First, it concerned an already concluded transaction and resulted in a forced sale of the already acquired company to a third entity. Second, the transaction in question did not constitute a transfer of control over an enterprise from a U.S. to a foreign company, but from one foreign company to another. Unocal had always been a U.S. enterprise and its acquisition by CNOOC would have indeed meant the transfer of control to a foreign entity. But in the case of DP World, the questioned sale took place between two foreign companies, the British P&O and the United Arab Emirates owned DP World. The debate was therefore not framed in terms of national ownership policy, but explicitly targeted DP World for being based in a Muslim and Arab country. The discrimination prevalent in the public debate was also criticized by a series of observers.

Third, the concerns raised about the transaction were not of a general strategic nature, as in the case of Unocal, but in specific terms of security policy. While ownership and control of infrastructure is generally considered to have important strategic implications, the DP World transaction gave rise to much more concrete concerns: The specter invoked by numerous senators and journalists was of an immediate threat of terrorist attacks in case U.S. ports were managed by an “Arab company”. In the exuberant words of Senator Lautenberg, “We wouldn’t transfer title to the Devil; we’re not going to transfer title to Dubai.” The security concerns raised by senators and congressmen also evidenced their desire to play a larger role in the regulation of foreign investment. The lack of involvement of Congress was most prominently criticized by Senator Levin, who complained that “[w]e weren’t notified at all, unless watching CNN and

39 Byrne, supra note 29, 879.
41 CFIUS, supra note 28, 166.
42 Byrne, supra note 29, 879.
reading the morning paper constitute notification. More to the point, Congress should have been consulted, not merely notified."\textsuperscript{44}

Apart from creating legal uncertainty concerning the finality of decisions by CFIUS, the controversy led to substantial losses of foreign investments, including a loss of foreign investment in the United States originating from the United Arab Emirates alone of about $1 billion in 2006. The DP World Controversy showed that a balanced and comprehensive review mechanism is not enough: The mechanism also needs the confidence of policymakers, otherwise its more controversial decisions will always entail a risk of highly damaging political backlashes. To analyze this particular problem, the next chapter will address a series of national regulatory frameworks and their aptitude to avoid such backlashes.

C. National Regulatory Frameworks

National regulatory frameworks for foreign investment have long existed in countries open to foreign investment.\textsuperscript{45} They are, as lawyers would put it, the inevitable and necessary companion to the liberalization of foreign investment. These regulatory frameworks vary in many respects, such as their scope of application, the authorities responsible for applying them, the timeframes provided for and, in particular, the transparency requirements for the regulating authority. Some of these frameworks, such as the CFIUS in the US, explicitly address state-owned investors while others, such as the frameworks Canada and France, do so only indirectly, by providing for criteria likely to be invoked in case of state-owned investors.

It is the author’s view that the financial crisis has acted as a catalyst to the evolution of provisions relating to state-owned investors such as SWFs. The highly visible and urgently needed investments by SWFs since the outbreak of the crisis led to surprise and a public debate on the role of state-owned investors, in particular SWFs, in today’s investment landscape. One defining feature of this debate was a broad consensus for creating clear legal frameworks which would allow such investment to play its useful role while addressing domestic concerns to prevent protectionist backlashes.\textsuperscript{46}

Therefore, this chapter will be dedicated to a series of national regulatory frameworks and their historical development, including the changes these have undergone since the beginning of the crisis. The main

\textsuperscript{44} Senator C. Levin, supra note 38.
\textsuperscript{45} Cohen, supra note 1, 721.
\textsuperscript{46} Cohen, supra note 1, 715.
focus will be on the U.S. regulatory framework, while other national frameworks will be briefly described in comparison to the U.S. and with emphasis on recent trends. This focus is necessary both because of the particular importance of the U.S. as a case study concerning political backlashes, as evidenced by the two controversies discussed above, but also because the U.S. framework is frequently used as a reference point when assessing other regulatory frameworks.47

I. United States

The body responsible for the monitoring and regulation of foreign investment, including investment by SWFs, in the United States is the Committee on Foreign Investment in the United States (CFIUS), an interagency body created in 1975.48 In 1976, the President’s power to intervene to block foreign investment was formalized in the International Investment Survey Act 1976. However, the President could only act by declaring a national emergency or if regulators found a violation of federal antitrust, environmental or securities laws.

The next step in the evolution of the regulatory framework came in the 1980ies as a reaction to growing fear over Japanese takeovers in the United States.49 To address these, a system of formal review was introduced under the 1988 Exon-Florio Amendment to the Defense Production Act of 1950.50 Under the amendment, the President could investigate foreign acquisitions to assess their impact on U.S. national security, thereby greatly expanding the scope of his powers.

Another step came in 1992, when the Byrd Amendment imposed on CFIUS the obligation to investigate transactions where the acquirer is “controlled by or acting on behalf of a foreign government” and “seeks to acquire or merge with a U.S. firm producing defense-related

47 Georgiev, supra note 21, 130; Cohen, supra note 1, 722.
49 Georgiev, supra note 21, 127.
How the Financial Crisis Made Us Reconsider SWFs

The amendment was a response to political pressure exerted by U.S. enterprises Martin Marietta and Lockheed, whose joint bid for the missile division of U.S. defense contractor LTV Aerospace and Defense Company had been topped by a bid by French state-owned Thomson-CSF. The enterprises successfully argued that the transaction would detrimentally affect U.S. national security, forcing Thomson-CSF to withdraw its bid before the CFIUS recommendation due in July 1992.

The investments subject to review by CFIUS are mergers, acquisitions, and takeovers by foreign persons which could result in foreign control of U.S. corporations. The Amendment is therefore equally applicable to SWFs, other state-owned investors or private foreign investors. The review is not limited to any specific sectors, as provided for by other regulatory frameworks – investments in any sector might be scrutinized under the Amendment, unless the transactions involve no more than 10% of shares, in which case they are exempted from review altogether.

The President is empowered to block the foreign acquisitions of a U.S. company in case national security is threatened. There is a list of factors that must be taken into account in the assessment, including: domestic production needed for current and projected national defense requirements and the control of that production, potential effects of an acquisition on sales of military equipment or technology to countries supporting terrorism or raising proliferation concerns and potential effects on U.S. technological leadership in areas affecting national security. The main review process is carried out by CFIUS, an interagency body consisting of twelve members and chaired by the Treasury Secretary. The other members include the Secretaries of State, Defense, Homeland Security, and Commerce; the U.S.

---

54 However, this exemption does not apply in case the transaction involves additional rights not usually awarded to similarly situated shareholders, such as special voting rights or rights to appoint members of the Board.
56 Muchlinski, supra note 53, 181.
Trade Representative; the Chair of the Council of Economic Advisers; the Attorney General; the Directors of the Office of Management and Budget and of the Office of Science and Technology Policy; the Assistant to the President for National Security Affairs; and the Assistant to the President for Economic Policy.

The review process before CFIUS is usually started by a voluntary filing by the investor, which is strongly encouraged by CFIUS. In case a transaction is not filed for review, CFIUS can initiate a review proprio motu. The standard review to determine whether a transaction could pose a threat to national security lasts up to 30 days. If after this period CFIUS concludes that no threat exists, the review process ends and the transaction can take place. Otherwise, CFIUS undertakes a 45 day investigation. After the investigation, CFIUS is required to submit a report to the President, who then has 15 days to decide on the fate of the acquisition.

The President may directly grant or forbid an acquisition or impose specific conditions. In case the respective transaction has already been concluded, a negative decision means that the entire transaction has to be unwound. For this reason, foreign investors considering a review by CFIUS possible will usually file voluntarily to implement the conditions at the earliest stage or at least minimize the costs of aborting the transaction. Furthermore, CFIUS can provide an investor with guidance on taking precautions to ensure that his transaction does not raise national security concerns. There are no legal remedies against and no further judicial review of the decision.

The only case that has been officially blocked by CFIUS yet occurred in 1990, when the China National Aero-Technology Import and Export Corporation, a purchasing agent for the Chinese Ministry of Defense, attempted to acquire a U.S. aerospace parts manufacturer. Interestingly, it has been suggested that the main motivation behind this decision were not actual national security concerns, but a desire to rebuke the Chinese government for the Tiananmen crackdown in June 1989.

58 Jackson, supra note 25, 12.
59 Georgiev, supra note 21, 128.
Japanese Nikon was preparing to file its planned acquisition of the semiconductor division of U.S. firm Perkin-Elmer to CFIUS, but withdrew from even filing when it was informed of massive congressional opposition to the transaction, upon which the acquisition was made by a California-based firm.\(^62\)

This regulatory regime was modified in 2007 by the Foreign Investment and National Security Act (FINSA). The Act was adopted by the House of Congress in its final form on 11 July 2007, and implemented by an executive order issued by President Bush on 23 January 2008.\(^63\) Overall, the act strikes “a careful balance between the need for greater transparency and more detailed review on the one hand, and the interest in promoting foreign investment on the other.”\(^64\) By increasing transparency and public confidence in the procedure, a repetition of cases like the DP World controversy will hopefully be avoided.

The act provides for increased scrutiny of acquisitions in critical infrastructure and critical technologies,\(^65\) which would cover sectors such as port facilities, rail networks, energy, IT and telecommunications.\(^66\) This is achieved by expanding the factors to be considered in evaluating transactions, specifically mentioning potential effects on critical energy assets and long-term projections of U.S. energy requirements,\(^67\) sales of military goods or technology to countries posing a regional military threat to the United States or countries with lacking track-records in their counter-terrorism efforts\(^68\) and prevention of diversion of military technologies.\(^69\)

Earlier proposals for a ranking of countries according to their non-


\(^{63}\) Jackson, \textit{supra} note 26, 8.


\(^{66}\) Ionescu, \textit{supra} note 1, 79.

\(^{67}\) The argument implicitly used in the Unocal controversy in 2005.

\(^{68}\) The main argument used to stop the DP World transaction in 2006.

\(^{69}\) Georgiev, \textit{supra} note 21, 131.
proliferation and counter-terrorism efforts, were rejected, thereby preventing an excessive formalization of the procedure.

The act also increases the role of Congress, by adding reporting requirements for CFIUS, which must now submit annual reports to Congress. Furthermore, CFIUS must report to selected members of Congress whenever a review or investigation comes to a decision allowing the transaction. These reports must elaborate on the factors leading to the Committee’s decision that the transaction does not constitute a threat to national security. Calls for providing Congress with the right to block specific transactions or to move the chairmanship from the Treasury Department to the Department of Defense or the Department of Homeland security were, in the author’s view fortunately, not needed. These changes will help CFIUS to be better prepared to face opposition from Congress in case of controversial transactions and contribute to raising confidence in its work.

Another change is the codification and formalization of the involvement of intelligence agencies in the procedure: Under the new act, the Director of National Intelligence becomes a non-voting member of the Committee and has to provide an analysis of national security implications of transactions under review. Thereby, the already existing cooperation with intelligence agencies is expressly acknowledged, contributing to alleviate fears about a lack of concern for national security due to the leading role of the Treasury.

Since the DP World Controversy in 2006, the number of annual filings by investors and reviews by CFIUS has steadily increased. This evidences a main characteristic of the CFIUS procedure: It provides certainty to foreign investors concerned that their investment may be perceived as a “national security threat”. In the light of increased political and public

71 Georgiev, supra note 21, 131.
72 Holtz-Eakin, supra note 70.
73 Byrne, supra note 29, 907.
74 Prabhakar, supra note 53, 24; Georgiev, supra note 21, 132.
75 Georgiev, supra note 21, 133.
attention to the topic, highlighted by events such as Unocal and DP World controversies, the number of voluntary filings therefore increased significantly. At the same time, however, the cooperation and dialogue concerning individual transactions between CFIUS and investors has suffered from the loss of credibility resulting from the DP World controversy.77

II. Canada

The first national regulatory authority in Canada was the Foreign Investment Review Agency, which was created by the Foreign Investment Review Act in 1974 following growing concerns about the drastic increase of foreign takeovers in the 1970’s, expressed most prominently in the 1972 Gray Report.78 The Foreign Investment Review Agency was responsible for reviewing all foreign direct investment in Canada, which could only proceed after receiving approval by the Cabinet Council after receiving a report from the agency. This restrictive framework contributed to a decrease in foreign investment inflows in the 1980’s, leading to its removal in 1984 when a conservative government came to power.

The new government introduced the Investment Canada Act 1985 [hereinafter “ICA 1985”], under which transactions are reviewed to assess whether they constitute a “net benefit” to Canada.79 The new framework was significantly more investor-friendly as it simplified and shortened procedures and raised the transaction value threshold for review. The review under the ICA 1985 is undertaken by the Ministry of Industry, whose officials may invite additional ministries to participate in the review in case the transaction specially affects their responsibilities.80 All transactions are subject to a duty to notify the ministry, but only those surpassing an asset

80 With the exception of cultural investments, for which the Ministry of Canadian Heritage is responsible.
value of Can $ 295 million are subject to a review. The final decision to block or allow a transaction lies with the Ministry of Industry. The assessment of the “net benefit” is based on factors including the impacts on employment, competition and exports, the contribution to technological development and innovation, compatibility with Canadian national industrial, economic, and cultural policies and Canadian participation in the business enterprise.

National security is not an explicit part of the regulatory framework under the ICA 1985. Instead, a series of special provisions regulate foreign investment in specific sectors, such as the requirement for government approval for investments in uranium production, financial services, transportation services and cultural businesses. In other sectors, such as telecommunications, there are ownership restrictions ranging between 25% and 33%. The review process is initiated upon submission of an application, which must be filed before undertaking the investment. The application is to contain information about the investor and the planned investment, to which the investor can further attach a part giving particular reasons why the transaction should be approved. After the filing of a complete application, the ministry has 45 days to review the investment. If the 45 days elapse and the investor has not received a notice, the application is considered approved. During the 45 days the responsible ministry can unilaterally extend the review period by 30 days. Any further extensions are only permitted in case a respective agreement is reached with the investor. Over the period from 2003 to 2007, average review periods have been 52 days for

---

81 For an investor from a WTO country in 2008, transactions from non-WTO countries are lower, Can$5 million for direct investments and Can$50 million for indirect transactions.

82 Or the Ministry of Canadian Heritage, respectively.

83 There was an attempt in 2005 to pass a bill including provisions to allow the government to review foreign investment based on national security concerns. The main motivation behind the bill were concerns about a growing number of attempts by Chinese firms to acquire Canadian enterprises in the energy sector. However, a change in government and opposition by officials prevented further consideration of the bill. See C. Sosnow et al., 'Canada: Foreign State-Owned Investors Spark "National Security" Concerns', Blakes Bulletin on International Trade, 23 Oct. 2007, available at http://www.mondaq.com/article.asp?articleid=53328 (last visited 24 March 2010).

the Ministry of Industry and over 75 days for the Ministry of Canadian Heritage.

Investments will be approved in case the reviewing ministry is convinced that the investment will result in an overall net benefit to Canada according to factors listed above. The ministry might also impose certain conditions for approval, including Canadian participation on the acquired company’s board and management, planned research and development expenditures as well as minimum employment levels.85

In December 2007, the Canadian Government published clarifications to the act,86 specifying how the rules should apply to state-owned enterprises, including sovereign wealth funds. Concerning these, particular consideration should be given to the investor’s adherence to Canadian corporate standards of transparency, good governance, and free market principles.87

Further changes were introduced after the April 2008 decision to block the takeover of the space-technology division of Vancouver-based MacDonald, Dettwiler and Associates Ltd by a U.S. company. The main motivation behind the decision was concern about the removal of research and development facilities from Canada resulting in the loss of high-paid employment opportunities. However, the transaction also raised concerns about investments in “highly sensitive sectors”, such as space technology.

Therefore, an amendment to the ICA 1985 was introduced in March 2009. It provided for a special review process for investments that could be injurious to national security. The term “national security” was left ambiguous, remaining open to wide interpretation and allowing a wide discretion in deciding about investments. To balance this stricter approach, the transaction value threshold for reviews was raised.

III. France

In France, in December 2005, the Government passed Decree No. 1739 on foreign investments.88 It provides for 11 economic sectors which might affect national interest and in which therefore the acquisition of

86 Cohen, supra note 1, 722.
88 Cohen, supra note 1, 722.
controlling stakes by foreign parties requires the authorization from Ministry of Economy, Finance and Employment. These sectors are: defense related industries, information systems and technologies and gambling. Interestingly, the energy sector is not included in the list. EU investors are exempted from the regulatory regime concerning all sectors except defense related industry. No denial of a specific transaction under the decree has occurred yet.

Another recent development in the field of reacting to foreign investment was the creation of an own SWF, the Fonds Strategique d’Investissement (FSI) in November 2008. The Fund, for which plans had previously been discussed for months, has the mission to invest in “strategic companies” which might otherwise need to have recourse to foreign investors. It has been perceived as a measure to block foreign investments in strategic or symbolic French companies. The investments by the fund are intended to be only temporary and limited to periods of falling stock prices during which such companies would be disproportionately vulnerable to takeovers. The plan has been widely criticized as promoting economic isolationism and as going against the principles of EU economic policy. However, until now, the Fund has alleviated these concerns by concentrating on co-investments with foreign investors. In May, it signed an agreement for joint investments with

90 Ionescu, supra note 1, 77.
91 Steinitz & Ingrassia, supra note 65, 12.
Mubadala Development, an SWF from Abu Dhabi. It is currently negotiating for a joint bid for French nuclear group Areva SA’s (ARVCY, CEI.FR) transmission and distribution business together with U.S.-based General Electric Co. (GE) and private equity firm CVC Capital Partners.

IV. Japan

In Japan, the Japanese Foreign Exchange and Foreign Trade Act requires investors investing in sensitive industries, including those related to national security, to notify the government. After notification, the transaction is reviewed, taking into account whether it might imperil national security, disturb public order or public safety, or adversely affect the Japanese economy. The originally restricted field of application was expanded in September 2007 to include dual use technology and accessories or equipment designed for the production of aircraft. Recent measures include the block of an attempt by the UK-based “Children’s Investment Fund” from increasing its shares in an electricity company under the Foreign Exchange and Foreign Trade Act.

A different recent measure intends to, uncharacteristically, influence foreign investments by enticements rather than restrictions or sanctions: In the beginning of 2009, an amendment was passed to relax rules that have imposed a huge tax burden on foreign funds investing in Japan. The amendment was drafted by the Ministry of Economy, Trade and Industry and the Ministry of Finance. Under the amendment, foreign investors will be exempt from the significant burden of capital gains tax on investments, as long as their individual stake in a Japanese company remains below 25%.

---


101 Ionescu, supra note 1, 81.

The background of this measure are long-standing concerns about Japan’s ability to attract foreign investment,\(^{103}\) in particular due to a trend by multinational enterprises to bypass Japan in favor of the rapidly growing markets of emerging economies such as China and India.\(^{104}\) Due to the financial crisis, the Japanese economy is in urgent need of additional funds which could be provided by sovereign wealth funds from Middle Eastern countries, which hitherto avoided investments in Japan as their home countries lack tax treaties with Japan that would exempt them from the capital gains tax.\(^{105}\) The tax incentives intended to channel foreign investment into minority share acquisitions, thereby reducing domestic concerns and avoiding a regulatory debate which might further deteriorate Japan’s attractiveness for FDI.

A 2008 proposal by senior politicians to create a sovereign wealth fund to diversify Japan’s reserves (which currently rely mainly on US Treasuries) was rejected, citing the risk of public backlash in case of losses incurred by the fund and a “growing international criticism” concerning SWF’s lack of transparency and their “increasingly negative image”.\(^{106}\)

V. Conclusions

There are some general conclusions that can be drawn from a comparison of these regulatory frameworks. A characteristic all frameworks have in common is the attempt to balance legitimate domestic concerns about foreign investment with a continued commitment to an investment-friendly climate.

The core question is that of allocation of regulatory authority. While in the ideal case, the primary responsibility could be granted to an independent body of experts under supervision of a ministry, it seems more

---


realistic to expect a higher degree of political influence. This is either achieved by entrusting a joint body including officials from different branches of administration, such as the CFIUS in the review and investigation process or the Foreign Investment Promotion Board in India. Concerning the latter, or by directly empowering a specific organ or ministry, such as the US President after the review and investigation process or the respective ministries in Canada, France and Japan.

The greater the influence of politics on the process, the more urgent is the need for safeguards against abuse. This is a result of the fundamental dilemma that a politician will rarely be in a position to genuinely balance his or her regard for hostile public opinion with the long-term impacts of any decision on foreign investment in his country. If, however, sufficient safeguards are in place, in particular in the form of an exhaustive list of criteria on which the decision must be based, this increased concern for public opinion can be a valuable asset: By paying heed to such concerns, even when they may be out of place in the light of the actual transaction at stake, a politician can prevent a backlash against the regulatory authority (as was seen during the DP World affair). This is essential for maintaining the bodies’ authority, as each backlash or circumvention of the review process creates insecurity for potential future investors. Therefore, as authors have repeatedly emphasized in relation to CFIUS, the determining factor for the success of any regulatory framework is its ability “to inspire and maintain public confidence” in review procedures.

Another important element is that foreign investors should be encouraged to file for review, as provided for under the U.S. regulatory framework, because this promotes cooperation between investors and the regulatory authority, allowing faster and more cost-effective reviews. The main incentive for filing would be the legal certainty of being able to undertake the transaction and the opportunity to include the necessary adaptations to conditions as early and effectively as possible in case conditions are attached to the authorization of the transaction. Equally, in case of a negative result, it is important for an investor to be informed of this circumstance as early as possible to minimize costs from aborting the transaction.

107 E.g. see Steinitz & Ingrassia, supra note 65, 16.
108 Georgiev, supra note 22, 134; Byrne, supra note 30, 907.
D. The Crisis or Post-Crisis Situation

Is the crisis gradually leading to a new consensus on state-owned investments, in particular by SWFs? This remains to be seen, however, it is the authors view that the crisis has functioned as a strong catalyst to resolve outstanding conflicts between policies designed to encourage foreign investments and mechanisms for the protection of national security in the wider sense. Concerning this concept of “national security in the wider sense” it must be noted that besides the financial crisis, an important factor that continues to influence changes in the regulatory framework in the US are ongoing security concerns dating back to the September 11 attacks. It has been argued that protecting national security from the threat of terrorism, in light of the attacks of September 11, inevitably comes into conflict with a commitment to an open investment policy.\(^{109}\) This conflict requires legislators to strike a balance between the promotion of investment and the protection from perceived threats to national security.\(^{110}\) An example for this conflict and the difficulties in balancing between investment-openness and taking into account domestic concerns is the DP World controversy, where an important factor contributing to opposition to the transaction was the fact that some of the September 11 hijackers were of the same nationality as the foreign investor involved.\(^{111}\)

It is certainly true that the shock of the September 11 attacks still has great influence on threat perception and national security thinking in the US. However, rather than directly changing the domestic concerns about foreign investment, this development has expanded the already existing group of countries considered “suspicious” or possibly threatening: While, e.g. investors from the People’s Republic of China always faced suspicions due to political and ideological tensions between the US and China or Japanese investors were confronted with fears of a “buyout” in the 1980’s,\(^{112}\) Middle Eastern investors were taken less notice of until the September 11 attacks.\(^{113}\)

\(^{109}\) Byrne, supra note 30, 850.

\(^{110}\) Cohen, supra note 1, 714.

\(^{111}\) Byrne, supra note 30, 879.

\(^{112}\) Jackson, supra note 26, 4; Georgiev, supra note 22, 127.

\(^{113}\) A development criticized by investment analysts who argue that the greatest risk to the US is one of economic security, that is, the risk that the erection of unnecessary barriers to the free flow of capital would negatively impact the global and in particular the US economy; see E. M. Truman, ‘Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications’, Testimony before the Committee on Banking,
Therefore, the primary aim of the regulatory changes is to increase trust in and transparency of existing procedures. The mechanisms provided for this purpose include involving policymakers in the procedure to prevent them from pursuing a populist public debate on transactions they consider sensitive. This involvement requires a mutual effort to increase transparency, which is also the spirit permeating the International Working Group on Sovereign Wealth Funds’ Santiago Principles.

First SWFs are required to respect transparency standards to on the one hand ensure that they contribute to a stable financial system and on the other hand to dispel national concerns which in themselves could result in protectionist backlashes through intransparent policies. This is particularly evident in Principle 17:

Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.

The investor’s lack of transparency is the cover which allows protectionism to entrench itself with these policies which lack transparency. An effective transparency policy by SWFs would show that in the vast majority of cases, SWFs consistently pursue commercial, not political objectives. It would show that these entities, even though commanding undeniably vast resources, act under the same precepts and principles as all other market actors. Combined with the strong tendency of SWFs to invest


passively,\textsuperscript{118} this shows that SWFs do not constitute threats to “national interests” but rather bring substantial benefits to the global markets.\textsuperscript{119}

This leads to the second part of the quest for transparency – the necessity for national regulatory frameworks to be transparent, predictable and effective. These frameworks need to balance legitimate concerns of the public with freedom of investment\textsuperscript{120} and would result in a transparent framework preventing arbitrary and discriminatory decisions and policies.

To return to the metaphor of sharks and whales, the main challenge today is to promote clear and transparent waters. Murky waters may provide an excuse to mistake a whale for a shark, and therefore transparent waters are the precondition to allow SWFs to play the role not merely of sideline actors but of valuable pivotal players in overcoming the crisis.

\textsuperscript{118} Rose, ‘Sovereign Wealth Funds: Active or Passive Investors?’, supra note 116, 108.
\textsuperscript{119} Santiago Principles, supra note 121, 3.
The Independence of Domestic Financial Regulators: An Underestimated Structural Issue in International Financial Governance

Régis Bismuth*

Table of Contents

Abstract ................................................................. 94
A. Introduction .......................................................... 94
B. The Facets of Independence .......................................... 96
C. The Risks of Independence ........................................... 99
   I. The Loss of State Unity on the International Stage ........... 99
   II. The Circumvention of National Democratic Processes ........ 101
       1. The Recognized Risk of Circumvention ....................... 101
       2. The Unequal and Insufficient Democratization of
          Standard-Setting Procedures ..................................... 102
   III. The Circumvention of the European Democratic Process ...... 105
       1. Asymmetry: Domestic Regulators v. European
          Regulation ............................................................. 105
       2. Comitology: European Regulators v. European
          Institutions ........................................................... 107
D. A Proposal: The Establishment of an International Standard-
   Setting Organization .................................................. 108

* Ph.D. (Université Paris 1 Panthéon-Sorbonne), LL.M. (Columbia Law School, Harlan Fiske Stone Scholar). Research and Teaching Fellow in Public International Law, Université Paris 1 Panthéon-Sorbonne, Centre d’Étude et de Recherche en Droit International – CERDIN (since 2004). The author may be contacted at regis.bismuth@gmail.com.

doi: 10.3249/1868-1581-2-1-bismuth
Abstract

Among the myriad of institutions involved in the reshaping of the international financial system, several standard-setting bodies (the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors) present the distinctive feature of being comprised of national independent regulatory authorities. The international activity of these independent authorities has complicated and blurred several aspects of the standard-setting process of the aforementioned international institutions. Despite being the product of a soft law process, international financial standards are in practice influential international rules. Given this de facto predominance, these standards result in a fait accompli for domestic or regional authorities which have no choice but to implement them, therefore bypassing the traditional democratic dimension of the law-making process. Although the standard-setting activities have progressively included consultation procedures, they have not completely corrected this flaw. Another problem stems from the presence of several domestic regulatory authorities representing the same state and rendering the decision-making process more complex at the international level. For these reasons, this article aims to demonstrate that the establishment of an international financial organization may correct these institutional gaps without necessarily call into question the soft law nature of the standard-setting process.

A. Introduction

While public attention following the recent financial unrest has mostly focused on the Group of Twenty (G20) summits, this latter collective action at the intergovernmental level should not eclipse the long-lasting normative activity of key standard-setting bodies such as the Basel Committee on Banking Supervision (the “Basel Committee”), the International Organization of Securities Commissions (“IOSCO”) and the International Association of Insurance Supervisors (“IAIS”). Among the myriad of institutions involved in international financial governance,¹ the distinctive feature of the

The Independence of Domestic Financial Regulators

Basel Committee, IOSCO and the IAIS is their membership, almost exclusively comprised of independent domestic financial regulatory authorities. Occurring outside the customary diplomatic channels, these processes of cooperation have been described by some authors as “transnational” or “transgovernmental regulatory networks”\(^2\). While raising some interesting issues of accountability, most of this literature has not precisely assessed the potential disruptive impact of the independence of domestic financial regulators on the effectiveness of international financial governance structures. Before discussing this issue in greater detail, the importance and influence of these standard-setting bodies shall be pointed out.

Despite remaining in the shadow of more notorious institutions, the Basel Committee, IOSCO and the IAIS have devised influential international financial standards favoring the harmonization and the mutual recognition of domestic regulations. In spite of their soft law nature, these standards have not only enjoyed wide implementation in domestic laws but have also been adopted or used as an assessment device by several international institutions such as the former Financial Stability Forum,\(^3\) the IMF and the World Bank,\(^4\) and the WTO.\(^5\) Reflecting this growing de facto influence, the G20 has recently invested the Financial Stability Board (FSB) – established as the successor to the Financial Stability Forum – with the mission of

---


Actually, the soft law nature of these standards is incidental given the authority they unquestionably enjoy in practice. However, this unchallenged influence is not free from problems – some structural governance issues stemming from the international activity of independent regulators have arisen. The international impact of an ill-controlled separation of powers in national legal orders has indeed complicated, blurred and even made questionable several aspects of the standard-setting activity of the Basel Committee, IOSCO and the IAIS, the underlying issue being to what extent should these international norms be solely defined by independent experts.

Before pointing out the possible risks weighing on the legitimacy of these international normative processes (C.), it is necessary to highlight the scope of domestic financial regulators’ independence and its institutional impact on standard-setting bodies (B.). These analyses will be used to suggest possible avenues for reform that have been overlooked by the G20 (D.).

B. The Facets of Independence

While it should be noted that financial regulators could not be classified in a single kind of public entity given the significant institutional differences between them,\footnote{For example, see, C. Hadjiemmanuil, ‘Institutional structure of financial regulation: A trend towards “Megaregulators”?’, Yearbook of International Financial and Economic Law (2000-2001), 127-190; D. Masciandaro (ed.), Handbook of Central Banking and Financial Authorities in Europe. New Architectures in the Supervision of Financial Markets (2005). More generally, see, M. Andenas et al. (eds), Independent Administrative Authorities (2004).} it is possible to highlight a similar status of independence to governmental authorities, although not of the same degree. In this respect, three dimensions of independence shall be pointed out: institutional, budgetary and regulatory.\footnote{M. Quityn & M. W. Taylor, Should Financial Sector Regulators Be Independent? (2004), 6.}

Institutional independence to the executive and legislative branches is generally ensured by the specific modalities of appointment of regulators’ officials and the extremely narrow basis for their dismissal. For instance, in the United States, the members of the Board of Governors of the Federal
Reserve System, the commissioners of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), the Acting Director of the Office of Thrift Supervision (OTS) and the Comptroller of the Currency (OCC) are nominated by the President and confirmed by the Senate. Most of these appointments are made in such a way as to prevent the complete renewal of the regulators’ executive board in one presidential term of office. Specific provisions also aim to ensure that regulators remain non-partisan: no more than three Commissioners (out of five) of the SEC and the CFTC may belong to the same political party. Moreover, these officials can be dismissed for serious misconduct only and never for political purposes. In a nutshell, as pointed out by the US Supreme Court in Humphrey’s Executor, officials of such agencies “shall be independent of executive authority except in its selection, and free to exercise its judgment without the leave or hindrance of any other official or any department of the government.” The institutional independence does not mean that financial regulatory authorities operate in complete insulation. They are all accountable, at some level, to the executive and legislative branches, notably through their annual reports.

**Budgetary independence** is based on the level of financial autonomy and depends “on the role of the executive or the legislative branch in determining the agency’s budget and how it is used.” Most of the financial regulators are funded through fees paid by entities subject to their supervision. It is the case for the French Autorité des Marchés Financiers (AMF), the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) or the British Financial Services Authority (FSA). Unlike these regulators, the

---

16 Quityn & Taylor, supra note 8, 8.
18 Gesetz über die Bundesanstalt für die Finanzdienstleistungsaufsicht (FinDAG), § 13(1).
19 Financial Services and Markets Act, Schedule 1, Part III, § 17.
budget of the SEC is not based on a levy on the regulated firms and is subject to the consent of Congress.\textsuperscript{20}

*Regulatory independence* reflects the political latitude of the regulator to adopt, implement and enforce adequate rules for the supervision and control of financial institutions, instruments and transactions. These missions are usually accomplished by authorities other than central banks. It is for instance the case for the British FSA,\textsuperscript{21} the French AMF\textsuperscript{22} and American financial markets and banking agencies.\textsuperscript{23} In Germany, the regulatory power has been originally vested in the Federal Ministry of Finance but with the option to be delegated to the BaFin\textsuperscript{24} and, in practice, the Ministry has regularly let the BaFin exercise this power, thus allowing an author to point out that the latter has “an important regulatory role to play.”\textsuperscript{25}

This multidimensional independence of domestic regulators has been justified by the necessity to insulate financial regulation from short term politics, supposedly inducing financial instability.\textsuperscript{26} However, domestic regulators have not only enjoyed significant latitude at the domestic level, they have also exploited it at the international one.\textsuperscript{27} While they have established cross-border relations with their foreign counterparts, this financial diplomacy has occurred outside customary diplomatic channels.

Financial regulators have undertaken bilateral agreements (known as Memoranda of Understanding) and have established permanent multilateral forums for cooperation such as the Basel Committee, the IOSCO and the IAIS. However, given that national regulators lack treaty-making power, these international agreements and the functioning of these institutions are not covered by international law.\textsuperscript{28} This uncontrolled polycentrism has en-

\textsuperscript{21} Financial Services and Markets Act, Part X, Chapter I.
\textsuperscript{22} Code Monétaire et Financier, art. L. 621-7.
\textsuperscript{23} See for instance, 12 U.S.C. § 3907(a).
\textsuperscript{24} Gesetz über den Wertpapierhandel (WpHG), §9(3), §9(4); Gesetz über das Kreditwesen (KWG), § 29(4); Gesetz über die Beaufsichtigung der Versicherungsunternehmen (VAG), Section 5(6)
\textsuperscript{26} Quityn & Taylor, supra note 8, 3.
\textsuperscript{27} For instance, see the interesting contribution of Stephan Handke to this volume, and especially the passage on the international activities of BaFin.
\textsuperscript{28} For an overview of some issues stemming from the absence of an international law framework, see, C. Möllers, ‘Transnationale Behördenkooperation. Verfassungs- und
gendered various risks on the international stage, several regulators acting on the behalf of the same state and adopting international standards without legal authority to that purpose.

C. The Risks of Independence

Three types of problems can be identified: the potential loss of state unity on the international stage (I.), and the circumvention of domestic (II.) and regional (III.) democratic processes.

I. The Loss of State Unity on the International Stage

The risk weighing on state unity has been mostly exemplified in the context of federalism by the possible contradictions between the foreign policies of states (if any) and of the federal government. This risk exists not only in the case of territorial divisions but can also manifest itself through governmental fragmentation when centralized government power has been distributed to multiple domestic regulatory authorities representing the same state on the international stage for a similar issue. Previous experiences have indeed shown that separation of powers between entities not necessarily sharing the same point of view on financial regulation renders the decision-making process more complex at the international level.

This has been the case within the framework of the negotiation of the Basel II agreement when divergences between the several US banking regulators members of the Basel Committee became obvious. The Federal Reserve Board strongly supported the new Basel regulatory framework, whereas the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) criticized the complexity of the new standard. The same differences in points of view became apparent when US banking regulators were heard in Congress, leading one author to point out that “US negotiators at Basel speak for themselves, not the United States […]”.

31 Barr & Miller, supra note 30, 34-35.
A bill was presented before the US Congress in 2003 and 2005 in order to put an end to this conflict. Its objective was to establish “a mechanism for developing uniform United States positions on issues before the Basel Committee […] [and] require a review on the most recent recommendation of the Basel Committee for an accord on capital standards, and for other purposes.”\(^\text{32}\) It planned to institute an inter-agency committee known as the “United States Financial Policy Committee” comprised of the Secretary of the Treasury (who would have served as the chairperson of the Committee), the Chairman of the Board of Governors of the Federal Reserve System, the OCC, the Chairperson of the FDIC and the Director of the Office of Thrift Supervision. Pursuant to this bill, this new committee would have met before any meeting of the Basel Committee and each of its members should have adhered to its positions in any negotiations. Moreover, if its members would have been “unable to agree on a uniform position on an issue, the position of the Secretary of the Treasury [should have been] determinative.”\(^\text{33}\) By threatening to substitute the Secretary of the Treasury for the US banking regulators, this experience has highlighted the potential power of domestic parliaments to oversee the international activity of independent domestic regulators but has also demonstrated that the risk of loss of state unity on the international stage is not purely theoretical.

It could be argued that this issue is specific to the US regulatory regime given the complexity of its institutional design comprised of a half-dozen influential domestic regulators, not to mention the absence of federal regulation of the insurance sector.\(^\text{34}\) To some extent, it is true given the current trend towards the “single regulator” model.\(^\text{35}\) However, states that have adopted this model may find that what they gain in terms of unity and consistency is offset by losses in terms of domestic transparency. As pointed out by professors Barr and Miller, “[t]he division among regulators may enhance transparency, public engagement and dialogue, as well as accountability and rationality at the international level as compared with transnational regulation developed by monolithic regulators within each country.”\(^\text{36}\) However, while the “multiple regulators” model may facilitate transparency,


\(^{33}\) Id.

\(^{34}\) See infra note 74.

\(^{35}\) Hadjiemmanuil, supra note 7, 127-190.

\(^{36}\) Barr & Miller, supra note 30, 33.
it does not reduce the risk of circumvention of national democratic processes.

II. The Circumvention of National Democratic Processes

1. The Recognized Risk of Circumvention

As already pointed out, the normative activity of standard-setting bodies is not covered by international law and, as non-legally binding norms, the procedure under which international financial standards are adopted should not raise any issue. However, these standards are intended to be implemented in domestic legal orders, notably – but not exclusively – through the autonomous regulatory power of financial regulators.\(^{37}\) Once adopted at the international level, they are presented to the private sector and national political authorities as a \textit{fait accompli}.\(^{38}\) It would be simplistic to put forward the non-binding character of these standards in order to shrug off this critical issue. In that respect, Professors Barr and Miller rightly noted that:

“Critics also contend that ‘home country enactment is simply a formality’. Thus, opponents of global regulation, in this view, cannot effectively challenge transnational regulation at the domestic level. International rule-making becomes a way of circumventing legislative oversight because Congress will not undo complex international agreements, and a way of bypassing real administrative rule-making because the domestic notice and comment rule-making will simply rubber stamp the decisions made by the regulators during their international negotiations.”\(^{39}\)

\(^{37}\) Professor Stewart noted that “[i]mplementation at the domestic level of policies and measures agreed to by networks depends on and can generally be accomplished by the initiative of the relevant participating national officials, often through the exercise of their existing administrative authority”; R. B. Stewart, ‘US Administrative Law: A Model for Global Administrative Law’, 68 Law & Contemporary Problems (2005), 63-108, 68.


\(^{39}\) Barr & Miller, \textit{supra} note 30, 20-21.
As pointed out by these authors, this problem is not limited solely to the circumvention of congressional oversight, but also affects existing domestic administrative consultation procedures giving the private sector the opportunity to comment on proposed regulatory reforms. For instance, it has been demonstrated that the US banking authorities used the Basel Committee in 1988 to their own advantage in order to impose capital adequacy norms on domestic banks, which had expressed their reluctance to adhere to such standards. Indeed, while the Basel I agreement had been adopted in July 1988, some US regulators released it for comments pursuant to the Administrative Procedure Act only in December 1988, it being understood that comments would concern only the domestic implementation of Basel I and not its content. Likewise, the confidential negotiations of the 1975 and 1983 Basel Concordats sparked off a fierce controversy in the US Congress.

2. The Unequal and Insufficient Democratization of Standard-Setting Procedures

In response to this lack of transparency, the practice of standard-setting procedures has progressively been democratized since the nineties in order to involve more actively and effectively private actors as well as public institutions. However, some important differences exist between the change in practice of the Basel Committee, IOSCO and the IAIS.

The Basel Committee has shown since the early nineties its willingness to make more open its standard-setting activity, reflecting “a maturation of the Basel process” and “a possible movement towards increased pluralism”. The capital adequacy standards overhaul through the Basel II process best illustrates this trend. The Committee launched an extensive consultation process involving domestic regulators, financial institutions, professional associations and academics. The 2004 Basel II agreement pointed out in that respect that “the Committee has benefited greatly from

40 Zaring, supra note 38, 574.
41 Id.
45 Barr & Miller, supra note 30, 25.
its frequent interactions with industry participants and looks forward to enhanced opportunities for dialogue.” More importantly, it has also acknowledged during this negotiation “the importance of national rule-making processes underway in several jurisdictions, and that it will need to consider the outcome of these national processes within this timeframe,” thereby demonstrating that the openness of the standard-setting procedure does not necessarily result in an increasing risk of regulatory capture by private interests. This broad openness to external actors has not been limited to capital adequacy standards. For instance, the consultative document issued by the Basel Committee within the framework of its “Core Principles for Effective Banking Supervision” noted that “[b]efore finalizing the text, the Committee conducted a broad consultation that was open to national supervisory authorities, central banks, international trade associations, academia and other interested parties.”

Basel II marks, however, a crucial turning point in the practice of the Committee given that, since then, it has always sought the comments of the international financial community on each of its projects.

Since the 2000s, IOSCO has also spontaneously launched consultations on ongoing projects. The general implementation of this practice took place in 2005 when it adopted its “Consultation Policy and Procedure” through which the organization “encourages all interested parties to submit

49 For a recent example, see, Basel Committee, International Association of Deposit Insurers, Core Principles for Effective Deposit Insurance System – Consultative Document (March 2009) available at http://www.bis.org/publ/bcbs151.pdf (last visited 8 March 2010).
comments on its Consultation Reports.”

The declared objectives of this instrument were, among others, “to benefit from the expertise of the international financial community”, “to increase transparency regarding IOSCO’s activities” and “to obtain information and views on the potential impact, benefits and costs of any proposed standards and principles.” Despite showing remarkable progress in terms of transparency, this approach, focusing on private actors, gives the impression that it aims more to take the place of domestic administrative consultation procedures rather than to take into consideration national rule-making processes.

The democratization process undertaken by the IAIS remains the most questionable since the opportunity to comment on future standards is limited to institutions enjoying the status of observer. The IAIS bylaws were amended in 2004 and now provide that “[t]he Association will consult widely amongst its members and observers and make its consultation procedures transparent.” In order to put into practice the principles laid down in the by-laws, the IAIS adopted in 2005 a “Policy Statement on the Scope of Observers’ Participation” which has surprisingly never been made public by it. Despite the status of observer being accessible to a large category of public and private institutions, the policy pursued by the IAIS makes the involvement of external actors in its consultation procedures dependent on

52 Id.
56 The IAIS By-Laws (see, supra note 54, art. 7(1)) provide indeed that “[t]he following persons are eligible to be an observer: (a) an international, regional or national organisation, a component element of which has an interest in insurance and insurance supervision regardless of whether the organisation is directly responsible for insurance law or its administration; (b) any other person, entity, or organisation, private or public, with an interest in the business or supervision of insurance, and includes any company, association, educator, educational institution, or natural person.”
an onerous observership fee. In this respect, it is noteworthy to mention that the observership fees account for about a third of the IAIS annual operating revenue, thereby giving rise to the suspicion – legitimate or not – that this financial dependence increases the risk of regulatory capture by private interests and affects the democratic nature of its standard-setting activity.

Admittedly, the opportunity given by the Basel Committee and IOSCO to comment on the proposed international financial standards is a progress towards an increased transparency of standard-setting bodies. While it has improved the democratic nature of the standard-setting process, these consultation procedures, however, do not alone make them fully compliant with existing domestic democratic processes and have not corrected the democratic flaw from which these institutions initially suffer.

Before putting forward possible avenues for reform, assessing the impact of independent financial regulators at the European level is interesting in highlighting the potential normative influence of such actors in processes of regional integration.

III. The Circumvention of the European Democratic Process

1. Asymmetry: Domestic Regulators v. European Regulation

European community law constitutes the main source of development in financial laws in the Member States. Unlike the American model, where financial regulators involved in standard-setting bodies spatially coincide with domestic political authorities, the European financial regulation has introduced a spatial asymmetry between national financial authorities taking part in the international standard-setting activity on the one side, and European institutions having the authority to define and adopt financial regulations on the other. Given that the main European institutions are not directly involved in the standard-setting activity, they do not bear the moral obligation to implement the international financial standards when they fall within

---

57 The observership fee for 2010 has been set to 14,500 Swiss Francs by the association. See, IAIS, Application for Observership (2010) available at http://www.iaisweb.org/index.cfm?pageID=303 (last visited 8 March 2010).

58 IAIS, Annual Report 2007-2008 (2008) 17, available at http://www.iaisweb.org/__temp/2007-2008_Annual_report.pdf (last visited 8 March 2010). This annual report shows that in 2007 the total amount of the observership fees collected was CHF 1,244,250 and the total operating revenue CHF 3,998,076.
the scope of their competence. This asymmetry gave European institutions a political asset allowing them to greatly influence the work of standard-setting bodies.

This influence manifested itself with regard to Basel II in the form of a regular monitoring of the negotiations of the agreement between banking regulators under the auspices of the Basel Committee. While European institutions have agreed to postpone the reform of its banking prudential framework until the final adoption of Basel II, thereby implicitly acknowledging the international value of this agreement, they also expressed serious concerns about it, in doing so echoing the criticisms of the then German Chancellor Gerhard Schröder who considered that the agreement would affect the financing and therefore, the competitiveness of German medium-sized enterprises.\textsuperscript{59} For instance, a resolution of the European Parliament emphasized “that the cost impact of [Basel II] on firms of all sizes and from all affected sectors must be properly assessed”\textsuperscript{60} and considered “that the possibility that the new rules will generate procyclical effects has not been completely eliminated.”\textsuperscript{61}

Even more interestingly, the European Parliament tackled a more structural issue when it expressed some doubt about the democratic character of the international activity of independent regulators. Indeed, in the same resolution, it

“[r]egret[ed] that the Basel Accord and other international agreements laying down a framework for legislation at EU level came into existence without any form of democratic mandate or control by the European Parliament; [and] expresse[d] the view that, in future, questions with such far-reaching political implications should not be determined in advance by expert committees alone.”\textsuperscript{62}

This risk of democratic deficit is all the more clear given that the standard-setting bodies themselves make no secret of their desire to insulate themselves from domestic or regional democratic processes. Responding to the criticisms raised by Gerhard Schröder, Andrew Crockett, the then General Manager of the Bank for International Settlements, the international

\textsuperscript{59} Wood, supra note 43, 141.
\textsuperscript{61} Id., § 3.
\textsuperscript{62} Id., § 4.
organization hosting the Basel Committee, explicitly stated that “[o]ne of the reasons politicians and governments delegate to speciali[z]ed institutions [...] is to take those technical debates out of the political arena,” thereby justifying the international independence of financial regulators as a natural consequence of their domestic independence.

2. Comitology: European Regulators v. European Institutions

Moreover, the growing influence of domestic financial regulators on the European regulatory process through comitology procedures is likely to increase this democratic deficit despite every indication to the contrary. As part of the Lamfalussy process, the European Commission established several committees of experts comprised of national financial regulators and mirroring the international standard-setting bodies: the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The primary role of these committees is mainly both advising the Commission during the preparation of community legislation and contributing to the development of a common and uniform implementation of this legislation.

While, on paper, these missions suggest that these European Committees have no power to set the European legislation, the practice of comitology has shown their substantial influence in that respect. Interestingly, in a recent reform of these committees in 2009, the issue of their accountability has been raised. Three European Commission decisions reforming these committees all indicate that “[t]he accountability of the Committee towards the Community Institutions is of high importance and should be of a well

---

established standard while respecting the independence of supervisors.\(^{69}\) However, this amended legal framework has consolidated rather than reappraised their *de facto* control over the European regulatory process with regard to financial law, thereby acquiescing in the loss of power of European institutions to the great benefit of independent regulators.

**D. A Proposal: The Establishment of an International Standard-Setting Organization**

Thus, the independence of domestic regulators has engendered several risks with regard to the existing standard-setting processes. In our opinion, these flaws, affecting the overall effectiveness of an emerging international financial governance, have insufficiently been taken into account in the latest reforms. Instead of devising a genuine multilateral financial architecture capable of democratically generating in the long run an effective financial regulation, the G20 efforts have mostly been concentrated on the development on new norms for the financial sector. This almost exclusive attention to the substantive aspect of international financial regulation has eclipsed broader institutional issues.

Admittedly, the G20 has entrusted the Financial Stability Board with the mission of monitoring the standard-setting activity and has mandated the Basel Committee, IOSCO and the IAIS (among others) with the task of developing new rules. However, this choice seems more a quick-fix than a sustainable strategy. It will neither preserve state unity on the international stage, nor solve the issues of circumvention of national and regional democratic processes.

In our view, the establishment of an international financial standard-setting organization is one potential way of correcting these flaws. It should be done in respect of two major political constraints: maintaining the domestic independence of regulators and preserving the soft law nature of the standard-setting process. Consequently, this organization would have nothing to do with the setting up of the so-called “World Financial Authority” recommended by John Eatwell and Lance Taylor.\(^{70}\) Under their – unrealistic

---


yet notorious – proposal, this institution would have acted as an international financial regulator and also undertaken the tasks of authorizing and controlling financial institutions, instruments and transactions. Rather, it is possible to suggest the merger of existing standard-setting bodies within a single international organization covering the whole financial sector. Our proposal revolves around four basic principles.

It should be a genuine multilateral organization whose membership would be open to all states rather than restricted to a G20 basis such as the Financial Stability Board or the Basel Committee. More than one hundred states are represented in the IAIS and IOSCO and these institutions have demonstrated that a broad membership does not impose an unbearable burden on the standard-setting process. This multilateral dimension would improve the feeling of “policy ownership” towards financial standards, thereby favoring their implementation in developing countries, and would also ensure a better compatibility with the multilateral framework of the liberalization of trade in financial services conducted under the auspices of the WTO.

The representation in this organization should be limited to one delegate per state so as to force every member to unify their position on an issue and avoid potential divergences of point of view between different regulators of the same country. Such a measure would also simplify the current representation of the several US financial regulators in the Basel Committee and in the IAIS.


Delonis, supra note 4, 618.

This issue is discussed in greater detail in Bismuth, supra note 5.


Given the absence of a federal regulatory framework, regulation of the insurance industry in the US is exercised by fifty state insurance departments and commissioners (For an overview of the American system, see, S. Randall, ‘Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners’, 26 Florida State University Law Review (1999), 625-699). The National Association of Insurance Supervisors (NAIC) was established in 1871 in order to coordinate the policies of state insurance regulators. Despite its private status (thereby guarantying its independence vis-à-vis the federal government) the NAIC has played on the international stage a similar role to other federal regulators and, in this
The existing consultation procedures would be expanded in order to prevent the risk of regulatory capture such as within the IAIS where the access to the standard-setting procedures is limited to the IAIS members and observers. This would not prevent private actors from influencing the normative activity of the future organization but it would ensure that every interested person or entity has an opportunity to comment upon the proposed new financial standards.

This organization should be established by a treaty so as to prevent the risk of circumvention of domestic or regional democratic processes. Indeed, it would subject the international activities of domestic regulators to the control of their national governments. The mere fact that the organization would be treaty-based does not, of course, ensure that its functioning would be fully democratic. However, this treaty would clarify the legal framework of the standard-setting process and avoid suspicious situations such as the absence of legal personality for the Basel Committee for more than thirty years, the fact that the IOSCO constituent charter is not a public document, and the aforementioned questionable opacity of the IAIS standard-setting activity. This “hard law” institutional framework would not affect the soft law nature of the standard-setting process given that the organization would have only the power to issue recommendations on which domestic regulations should be based. Moreover, it would not affect the independence of regulators under domestic laws.

These are the basic principles that should guide the establishment of an international standard-setting organization for the financial sector. Turbulent and crucial times call for more than quick fixes, hasty remedies and best-endavor commitments. Courageous measures and a long term strategy are needed and, in our view, the establishment of such an organization is a critical step towards a more democratic, transparent and effective international financial governance.
Yes, We Can (Control Them)! – Regulatory Agencies: Trustees or Agents?

Stefan Handke*

Table of Contents

Abstract .................................................................................................................. 112

A. Introduction ........................................................................................................ 112

B. Types of Delegation ......................................................................................... 114
   I. Principal-Agent Theory .............................................................................. 115
   II. Trust Theory .............................................................................................. 117

C. German Financial Market Regulation ......................................................... 120
   I. BaFin as the German Authority ................................................................. 121
   II. BaFin as Agent or Trustee ........................................................................ 123
       1. Legal Basis ............................................................................................. 123
       2. International Activities .......................................................................... 125
           a) Basel II ............................................................................................ 125
           b) Solvency II and Lamfalussy Procedure ......................................... 127

III. Influence of BMF and Political Actors ...................................................... 129

IV. The Crisis as a Window of Opportunity .................................................... 131

D. Conclusion ....................................................................................................... 134

* The author is a research assistant and Ph.D. candidate at the Institute of Political Science at the Leibniz University Hannover.

doi: 10.3249/1868-1581-2-1-handke
Abstract

This article raises the question over whether there have been changes in the mode of delegation between national executives and national regulatory agencies in the financial sector caused by the financial market crisis. Illustrated by the case of Germany, the two following ideal types of delegation are elaborated and applied to the case of the German supervisory authority BaFin: principal-agent theory and trust theory. For the periods before and after the crisis, political influence on the agency is examined and – with its intentions and results – assigned to one of the two ideal types. With this approach the financial market crises cannot be identified as the trigger for changes in the mode of delegation but merely as a kind of catalyst.

A. Introduction

Until the emergence of the financial market crisis in August 2007, financial market regulation in the European Union was characterised by efforts of national regulatory agencies to establish supervisory regimes for banks, pension funds and insurance companies. As agents of their governments they not only fulfilled supervisory tasks in the member states but also represented national interests at the supranational level. However, at the level of the EU, the agencies did not negotiate as controlled agents, rather, to the contrary, in Lamfalussy committees they were even able to act more or less unimpeded by governmental oversight. However, the recent financial market crisis forced governments to rethink the existing way of delegating tasks to regulatory agencies. In the face of only limited success in preventing the collapse of banking systems, governments announced their intention of improving the supervisory structures and strengthening the agencies. In fact, they are now trying to shift regulatory decisions from the agencies to the political sphere and to reshape the delegated competences. Therefore, the relationship between governments and agencies is changing from a more unconstrained mode of delegation, a trusteeship, to a stricter one, a principal-agent relationship.

This proposition is well illustrated by considering the example of Germany. This article demonstrates that the Federal Ministry of Finance (BMF; Bundesministerium der Finanzen) is trying to increase control over the Federal Financial Supervisory Authority (BaFin; Bundesanstalt für Finanzdienstleistungsaufsicht) with the aim of modifying supervision and impinging on supranational developments. BaFin is no longer regarded as a
trustee, mandated to act with a free hand in negotiations on regimes like Solvency II. The agency is now becoming a generic agent of its principal. However, the question that has to be answered is whether this change in delegation is a direct reaction to the crisis or not. Whilst financial market regulation has not been a predominant policy area for the Federal Government, it had to react rapidly when the crisis came up. Even though it did not strengthen BaFin with additional resources, as one would have expected. Under plans which are being considered, the Federal Government and BMF will not put BaFin in a position of fulfilling tasks better, but are merely focussing on intensifying technical oversight (Fachaufsicht) and on enlarging supervisory competences of the agency on a case-by-case basis. Briefly, as one element in response to the crisis, the BMF is trying to control BaFin as an agent by reorganising the agency’s management and by insisting on elements of functional supervision. As a second element, BaFin is losing its status as the main authority in regulatory questions, because external experts in law firms are complementing its work.

In this paper it is argued that the crisis did not cause several political reactions affecting BaFin, but that the crisis just promoted them. To show this and to answer the question on the mode of delegation and the associated changes in dependence on the financial market crisis, this paper is organized as follows. In the first section, two types of delegation are discussed, which are described in terms of the principal-agent theory and the trust theory. Here it is important to outline not only the criteria characterising each type, but also to point out the respective limitations of control. The second section focuses on BaFin as the main actor in financial market regulation and on the relationship between the BMF and BaFin. In particular, it will be illustrated how the mode of delegation changes over time and which influence the crisis had on the strategies of the government and other political actors. Finally, the last section offers some concluding remarks regarding the role of BaFin in the crisis.

Against this background, the article does not present an empirical study on delegation in financial regulation in the first place, but a conceptual approach which uses empirical findings to elucidate political measures in the aftermath of the financial crisis. Therefore, it can, at best, serve as a basis for further research, where the theoretical framework can be tested systematically.
B. Types of Delegation

Delegation is a widely discussed issue in political science, economics and other disciplines. In each of these areas, not only are interpersonal relations covered but also relations between institutions. Governments, for example, use delegation to agencies for diverse reasons. These could include, for instance, ensuring a sufficient expertise in decision making, to provide themselves with the possibility of shifting blame for unpopular policies, to increase the efficiency in policy making, or even to enhance the credibility of their commitment.¹

In the relevant literature, two main versions of the concept of delegation can be found. Many authors use the principal-agent theory as a functional description of delegation in the political or economic arena; to a lesser extent the trust theory is used to characterise the relationship between actors. However, both concepts are useful tools for a systematic reflection of the premises and consequences of delegation. Given the fact that agencification with a variety of different types of agencies disseminates in the European Union and the European member states for years, each relationship should be examined as an individual case and analysed with reference to one of the two delegation modes.²

For the purpose of this article, it is useful not to start by highlighting the differences but rather to begin on common ground. One similarity of almost every delegation is that whenever competences are delegated to an outsourced administrative unit, the problem of control crops up.³ To begin with, depending on the contractual design and the properties of the actors, not only the formal and real autonomy of an agency but also the principal’s ability to exercise control can differ. In this notion, delegation to an agent is not the same as to a trustee, because the measures of control and their effec-

---

tiveness vary significantly. Predicting or explaining political behaviour on the basis of the classification of government agencies according to the ideal types of delegation – to be either an agent or a trustee – is therefore an appealing idea. In order to apply these findings to recent developments in financial market regulation, it is necessary to define the characteristics and implications of the principal-agent and the trust theory first. Therefore, this section does not confine itself to regulatory agencies in financial markets, but serves as a starting point that is applicable to most agencies, including a short description of both approaches.

I. Principal-Agent Theory

The most common way of describing delegation in social relationships based on the division of labour, which is only briefly dealt with in this section, is the principal-agent theory. It is applied to political, economic or interpersonal relations and follows a rational-choice perspective of human behaviour. When using the principal-agent theory as a starting point, authors usually try to analyse the problem of control in situations where responsiveness of the agent to the preferences of the principal is aspired to. Control problems are usually examined in relationships, which are “based on highly rational and instrumental considerations” where all the actors “pursue their own, often contradictory preferences”. The simple principal-agent relationship arises when one actor (principal) mandates another actor (agent) to act on his (the principal’s) behalf and when the agent agrees to be subject to the principal’s control. Within this relationship, which is constituted by contract, several ingrained problems exist. This is due to the information asymmetries between the principal and its agent. As a rational agent, the agent’s information advantage could either be used to defraud his principal (moral hazard) or at least to minimise his own effort (shirking). Due to the principal’s lack of information, this becomes possible despite its rational endeavour to control the agent. The principal’s ability to control is therefore limited and necessarily selective by reason of the logic of the division of labour. Thus, an agent is able more or less to use the ample scope which is

---


open to it by virtue of limited control along with incomplete contracting. This problem is known as agency loss when applied to principal-agent relationships in general or bureaucratic drift in the sphere of public administration. In this sense, government agencies as agents can employ meaningful discretion in “the departure of agency decisions from the position agreed upon by the executive and legislature at the time of delegation and appointment”. This problem for a principal can be anticipated and partly limited by contractual arrangements or ultimately by the dismissal of the agent. The latter option, which is to “[remove] all the authority delegated to the agent” is an option of last resort. As every unplanned termination of a relationship and the substitution by a new one causes expense (transaction costs), principals try to prevent hidden actions of agents in the first place.

Following Kiewiet and McCubbins, the problem of agency loss can be countered with “four major classes of [...] measures: (1) contract design, (2) screening and selection mechanisms, (3) monitoring and reporting requirements, and (4) institutional checks”. Referring to this, Busuioc emphasises three types of control for agencies, namely, ex ante control, ongoing control and ex post control.

Both typologies highlight the contract between principal and agent as key to the whole relationship, because the rights and obligations of each partner are laid down in this contract and determine the future relationship. If the principal does not have the same information as the agent at this time (hidden information) the contract can also contain certain sanctions, guarantees and other commitments binding or incentivising the agent. Such contracts are not restricted to individuals but can also exist between collective actors. To illustrate with an example, in the case of government delegation, contracts are equivalent to the constituting law (Errichtungsgesetz) of an agency. In this situation, the principal lays down the rules on appointments,

7 Id., 149.
budgetary decisions, personnel and rights for final decision making. Complementary to contractual decisions are screening mechanisms and reporting requirements which both fall into the category of ongoing controls. On the one hand, the enhancement of transparency by periodic surveillance and reporting reduces the principal’s information gap. On the other hand, however, these mechanisms produce costs for the principal and show the agent that it is – whether justifiably or not – not trusted. As a result, mutual trust in such a relationship proves to be elusive. The fourth measure is finally to exert institutional checks as a form of ex post control, which helps to absorb or to amend any defects in the performance of the agent. The principal or even the other actors – at the institutional level, e.g. courts or audit courts – are able to alter or overrule decisions of the agent. This however has a twofold effect. It not only prevents agency loss but can also provoke a limited degree of pre-emptive obedience due to the shadow of hierarchy and thus affect the agent’s professional work.

Finally, as mentioned above, a principal is free to cancel the contract and to abandon the relationship with the agent or even to mandate a new one. The decision to terminate is part of the principal’s sole responsibility – or for the agent vice versa – and can be chosen regardless of the interests of third parties. As will be shown in the following section, this is one serious difference between principal-agent and trustee delegation.

II. Trust Theory

Just as in the principal-agent theory, the trust theory too has its origins in business management. Early applications are already found in the works of Berle who used trust for his description of corporate management where managers are the legal trustees of the property of stakeholders. However, trust theory was not confined only to economics and management but spread to other spheres.

For the most part – from the actor’s preference to certain control mechanisms – trusteeship is a special form of principal-agent relationship.

For example, the trustee and agent have similar preferences but admittedly reverse preference orders. In the principal-agent theory the utility function of the agent is characterised as a simple pursuit of its own benefit. This is more than merely striving for material advantages but covers intangibles, too. However, these are secondary in contrast to the trust theory where they play a crucial role. Rasmusen therefore puts the preferences of trustees into the taxonomy of the “Four P’s of Trustee” which are policy, pride, place and power. While the last two P’s, place and power, mean that the trustee wants to keep his position and a high discretionary power, are shared with agents, the first two P – policy and pride – are not shared in the same way. Given that the trustees believe in this notion, they are more interested in policy-seeking and the realisation of their ideas and values rather than the agents. This is closely interlinked with the trustee’s effort to underpin his reputation for competence.

The similarities between principal-agent and trustee delegation should not be neglected, but it is more relevant at this juncture to emphasise their distinctions. Principal-agent and trustee delegation differ from each other in three main characteristics: (1) the scope of the fiduciary relationship, (2) the content of delegation, and (3) the control over the delegate.

Regarding the first criterion, a trustee has to act on behalf of a third actor, the beneficiary, that is not congruent with the principal. By contrast, in a well-defined scope of duties an agent has to operate solely for the principal’s benefit. Hence, depending on the mode of delegation, different actors are chosen. Whereas a principal will only mandate an agent who has largely the same preferences, in a trusteeship, a trustee with deviating preferences can be chosen if these preferences match those of the beneficiary. Instead of adverse selection in principal-agent theory, one can make the selection according to the highest professional reputation in trust theory. This leads to the conclusion that whenever “the Principal selects the ‘Agent’ because of the authority and legitimacy they bring with them, we have delegation to Trustees”.

The second aspect concerns the scope of delegation. An agent is normally not entrusted with the management of a whole domain as in the case of trusteeship. It is therefore easier to define standards for an agent’s work.

15 Rasmusen, supra note 9, 7-8.
17 Alter, supra note 4, 41.
than for a trustee’s, because the latter cannot be bound \textit{ex ante} for any contingency of its large remit.

The most crucial distinction between the modes of delegation is the third characteristic, which touches upon the control exerted by the principal. An agent can be considerably controlled with the help of the above mentioned mechanisms as has been elaborated upon by Kiewiet and McCubbins. But to exercise control over a trustee is more difficult. Not only is the wide autonomy of the trustee an impediment but also, above all, the influence of the beneficiary and the trustee’s professionalism restrict the principal’s arsenal of sanctions.\(^\text{18}\) Once appointed, a trustee can neither be directed against the wishes of the beneficiary, nor be sanctioned just because of a deviation from the principal’s ideas. Some authors even go so far as to say that the terms of a trust relationship cannot be altered at all by the principal or the beneficiary.\(^\text{19}\)

The consequences of such a mode of delegation are described with lesser rigidity by Alter when she states “that calling an actor a Trustee is [of course] not the same as asserting that a Trustee is ‘out there’ beyond anyone’s influence”.\(^\text{20}\) Nevertheless, hardly any robust sanctions are applicable and it is a “far more likely political response […] to circumvent a Trustee whose decisions one does not like; new tasks will be given to other Trustees or Agents and issues will be settled outside of the realm of the Trustee to avoid their interference”.\(^\text{21}\) This is – among others mentioned in table 1 – a very decisive aspect, which has to be taken into account when political decisions about BaFin are analysed in the following section.

<table>
<thead>
<tr>
<th>Table 1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Agent</strong></td>
</tr>
<tr>
<td><strong>Scope of fiduciary relationship</strong></td>
</tr>
<tr>
<td><strong>Selection criteria</strong></td>
</tr>
<tr>
<td><strong>Guiding orientation</strong></td>
</tr>
</tbody>
</table>

\(^{18}\) Id.


\(^{20}\) Alter, \textit{supra} note 4, 44.

\(^{21}\) Id.
C. German Financial Market Regulation

Generally speaking, regulation can be grouped into risk regulation and market regulation.\textsuperscript{22} As the first one deals with protection against material perils such as epidemics or natural disasters, the second aims at the creation and perpetuation or the correction of economic markets. It comprises of, first, the supervision of market participants and second, the implementation of rules with incentives or sanctions.\textsuperscript{23} Financial market regulation has been greatly discussed since the collapse of Lehman Brothers in the USA or Hypo Real Estate (HRE) in Germany. Existing supervisory and regulatory arrangements were called into question and supranational as well as national actors are today looking for better solutions. Before examining the political strategies in the aftermath of the financial market crisis, we have to take a closer look at the mechanisms of national regulation. Although it would be interesting to compare the “greatly differing national starting positions” of regulation, this article restricts its focus to the German method of financial market regulation only.\textsuperscript{24} Germany is one of the most important financial centres of the EU and can thus serve as an exemplary case for regulatory strategies. Nevertheless, it cannot serve as a blueprint for reforms in supervisory structures in general, as from a global perspective, hardly any determinants or equal strategies of national executives can be observed.\textsuperscript{25}

\begin{table}
\centering
\begin{tabular}{|l|l|l|}
\hline
\textbf{Content of delegation} & Authorisation for single purpose & Authorisation for larger remit; Management of property rights \\
\hline
\textbf{Control over fiduciary} & Principal’s instruction & Principal’s and beneficiary’s request \\
\hline
\textbf{Agency problem} & Shirking; Agency loss & Shirking; Agency loss \\
\hline
\textbf{Measure of last resort} & Re-contracting; Dismissal & Circumvention; Dismissal \\
\hline
\textbf{Preference order} & Power – Place – Pride – Policy & Policy – Pride – Place – Power \\
\hline
\end{tabular}
\end{table}

\textsuperscript{23} L. Frach, Finanzaufsicht in Deutschland und Großbritannien (2007), 22.
\textsuperscript{24} A. Busch, Banking regulation and globalization (2009), 15.
I. BaFin as the German Authority

Not only in Germany, but also in a majority of the member states of the European Union, regulatory agencies or supervisory authorities are entrusted with the regulation of financial markets. Some member states decided in favour of sectoral supervision with separated institutions for banks, insurances and securities. Others chose a single supervision system (*Allfinanzaufsicht*) with one integrated supervisory agency for all branches. Examples of the former model are Spain, Italy and Romania, the latter model can be found in Great Britain, Austria and Germany.

In 2002, the German Bundestag passed the *Finanzdienstleistungsaufsichtsgesetz* (FinDAG),\(^{26}\) which amalgamated the Federal Banking Supervisory Office (*Bundesaufsichtsamt für das Kreditwesen – BAKred*), the Federal Securities Supervisory Office (*Bundesaufsichtsamt für den Wertpapierhandel – BAWe*) and the Federal Insurance Supervisory Office (*Bundesaufsichtsamt für das Versicherungswesen – BAV*) to bring the three branches within the ambit of the newly constituted BaFin.

To a certain extent, the creation of BaFin as a new form of administration followed the *Zeitgeist*, which favours independent and specialised institutions. Principally speaking, BaFin and other integrated supervisory agencies have been established in response to changes in financial markets. The distinction which existed between banks, insurance companies and other business areas have all been blurred since the number of financial conglomerates increased. Subsequently, sectoral supervision was considered to be insufficient due to high transaction costs resulting from duplicated supervision and costly coordination between sectoral agencies.\(^{27}\)

The organisational structure and the legal status of the new *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) resulted in a change to the traditional typology of German administrative bodies. BaFin has been constructed as a government agency under the aegis of the minister of finance and was given substantial discretion. On the one hand, its legal status as a public-law institution (*Anstalt des öffentlichen Rechts*) avoids placing a burden on the federal budget and the application of complex labour law for its higher ranking positions. It also enables BaFin to act in its own name and

---

\(^{26}\) *Gesetz über die Bundesanstalt für Finanzdienstleistungsaufsicht (Finanzdienstleistungsaufsichtsgesetz)*, 22 April 2002, Bundesgesetzblatt I, 1310.

\(^{27}\) Frach, *supra* note 23, 26.
under its own responsibility. On the other hand, BaFin is subject to far-reaching control by the BMF, because the tasks performed by it are said to be sovereign functions (hoheitliche Aufgaben).

Since financial market regulation has not been a major issue for German politicians during the last few years, it is hard to say whether the construction of BaFin followed political considerations or whether it was a result of bounded rationality where “institutional choices [were] based on no or low preference decisions”. Whichever is considered applicable, before analysing the mode of delegation and political strategies concerning BaFin, a few facts on the organisation should be added without going into too much detail.

The formal structure of BaFin is segmented into four directorates of which three represent the regulatory sectors of the agency. In addition, there are several cross-sectoral departments with tasks which must be coordinated. Each directorate is headed by a director who is a member of the collegial board of directors headed by the president, which has been the case since August 2008, whereas the agency was managed by a presidential structure in the original architecture. The whole agency has about 1,750 employees who are either engaged in the three regulation directorates or in cross-sectoral departments. Staffing, however, has been a problem for the agency for years since it has proved to be hard to find qualified employees since these are also recruited and better paid by banks and insurance companies. With its limited budget and the legal restrictions of wage agreements, BaFin is unable to compete with commercial enterprises. This leads to an interesting detail of BaFin’s organisation, namely, its financing. According to § 13 FinDAG, BaFin is funded by the fees and contributions from the institutions it supervises, so that it is not financed by public means from the federal budget. This can already be used as a significant element for the interpretation of the delegation scheme.

29 Döhler, Vom Amt zur Agentur, supra note 3, 28.
30 Döhler, Institutional Choice, supra note 5, 103.
II. BaFin as Agent or Trustee

Analyzing the formal mode of delegation on the basis of the FinDAG, BaFin is neither a pure agent nor a pure trustee. The situation is quite complex because characteristics of both types can be found in the agency. However, going beyond the mere legal interpretation by also analysing international activities, the claim that BaFin tends to be a trustee can be corroborated. This section therefore focuses on the legal basis of BaFin and on its participation in negotiations on international supervisory regimes in order to identify indications for one of the types of delegation.

1. Legal Basis

From the beginning, BaFin was designed as a formal agent of the BMF, as § 2 FinDAG subordinates the agency to ministerial legal and technical oversight (Rechts- und Fachaufsicht). While legal oversight covers only ministerial authority to supervise the legality of BaFin’s activities, technical oversight is considerably more extensive. As Döhler puts it, it is “a remarkably indeterminate piece of public law that allows ministerial departments to issue instructions on virtually every substantial aspect of agency activities, including the reversal of single decisions”. 33 Despite the above mentioned deviations from traditional administrative designs, BaFin is subordinated to this strict kind of oversight which makes it look like a typical agent. The oversight in fact covers all elements of what McNollgast calls “agenda control” and with it the common practice of running an agency at arm’s length. However, in an answer to a parliamentary question (Kleine Anfrage) of the Green Party, BMF concedes that the implementation of directives is not exercised on a case-to-case basis. 34 As is the case with many agencies within the hierarchy of ministerial bureaucracy, BaFin has some discretionary power that is not under the permanent control of a superior authority. This is certainly not a criterion which distinguishes it from other agencies, as Döhler expresses it as a general insight: “It must be added, however, that the day-to-day work of most agencies is not greatly subject to interference by ministerial instructions. Agencies may be left

33 Döhler, Institutional Choice, supra note 5, 104.
34 Rolle der Bundesregierung bei der Rechts- und Fachaufsicht der Bundesanstalt für Finanzdienstleistungsaufsicht, Drucksache 16/3253 (06 November 2006), 4.
alone for long periods, either because there is no need for closer inspections, no interest, or no personal capacity.”

Yet, several other features of BaFin confer a status on it that is beyond the mere principal-agent relationship. In defiance of its very formal construction as an agent, it has notable traits of a trustee; this is in line with Majone's conclusion that “a trustee is an agent and something more.” Amongst other things, this “surplus” can be seen in BaFin’s funding, mission and political property rights.

First, BaFin is financed by contributions of supervised market participants and not from the BMF’s budget. Since funding does not rely on the public but solely on charges for agency acts, it is difficult to use budgetary restrictions as a kind of sanction. The only way for the BMF to influence BaFin’s budget is to change the scale of charges and fees according to § 14 (2) FinDAG. Second, BaFin is not committed to act for the benefit of the BMF or the executive in general. In fact, BaFin is obliged to “[operate] only in the public interest. Its primary objective is to guarantee the proper functioning, stability and integrity of the German financial system. Bank customers, insurance policyholders and investors are meant to be able to trust the financial system.” In contrast to a principal-agent relationship, this is characterised by the fact that the agent acts on behalf of the principal, in a trusteeship the agent acts on behalf of one or more beneficiaries. Finally, § 4 FinDAG gave BaFin almost sole responsibility for financial market regulation in Germany with the exception of certain tasks in banking supervision that are fulfilled by the central bank. Thus, practically all political property rights in this area have been transferred to BaFin. To summarise, “[whenever] property is transferred to [an actor] who is supposed to manage it for the benefit of a third [actor], we have not an agency but a trusteeship relation”. This is supported by central organisational characteristics and even more so by BaFin’s participation at the international level.

---

35 Döhler, Institutional Choice, supra note 5, 116.
39 Majone, supra note 37, 113.
2. International Activities

Apart from national regulatory activities, BaFin has joined a number of international cooperative bodies like the International Association of Insurance Supervisors (IAIS) or the International Organization of Securities Commissions (IOSCO). Therefore, not only the organisational factors mentioned indicate that BaFin is close to being a trustee, but especially its behaviour in policy-making above the national level provides another significant clue. Here, it does not act as the agent of the German government but as a trustee safeguarding the interests of national market participants. It suffices to use two examples for illustration. The role of BaFin in banking and insurance supervision at the supranational and EU-level is marked first by its activities in negotiations on Basel II and Solvency II and second, by its membership in the three level 3 committees (L3L) of the Lamfalussy process.

a) Basel II

The first negotiations on an international regime where BaFin took part as a German representative were the negotiations during Basel II. This framework of measures and minimum standards for capital adequacy, which have been developed by the Basel Committee on Banking Supervision as an organisation hosted by the Bank for International Settlements (BIS), laid down important requirements for banking activities. With its so called “three pillar” structure, which this article does not intend to elaborate upon, the revised Basel Accord relies on capital adequacy requirements, centralized supervision and market discipline. All these instruments, which have been developed in order to stabilise the international banking business by ensuring the solvency of banks, became part of EU law in 2006.

During the Basel II negotiations, BaFin proved to be a competent party and even “displayed more institutional clout than its predecessor, the BAKred, which had taken part in the negotiation of Basel I in 1988”. Al-

---

40 Lütz, supra note 28, 153-155.
though BaFin was a new agency, it was staffed by experienced personnel of the former public authorities, so that it was able to get to work quite quickly. In this context, it is interesting to note that these employees behaved in two new ways. First, the officials in the Basel II negotiations acted unaccompanied by BMF officials, because the ministry was short of suitable personnel. This fact gave them a new discretionary power which, second, they did not use in order to operate as national representatives but as representatives of a public authority that “acted as [a] self-interest [bureaucracy], trying to pursue [its] institutional preferences, successfully safeguarding [its] competences in this area”. In this sense particularly, the striving to build a reputation is a distinctive feature of a trustee.

Of course, the BMF has nonetheless been formally involved in the Basel II process, but in practice, the ministry did not have a hand in the technical details of the subject. As a consequence of BaFin’s unintended achievement of independence, in 2005 the ministry issued detailed rules for the exercise of the legal and technical oversight over BaFin. These guidelines, which have even been published on the website of BaFin, consist mainly of specifications concerning reporting obligations of the agency. In terms of the delegation theory, this can be interpreted as an attempt to re-contract and to discipline BaFin as an agency which used its leeway as a free trustee and not as a responsive agent. Whether trustee or agent, these “standard monitoring solutions to the principal-agent problem, which include political oversight in the form of hearings […], are costly and hence imperfect solutions”, because the problem is not a lack of information in the ministry but the assessment of incoming information. Hence, BaFin was able to act in the Solvency II process similarly to the way it acted in Basel II. As long as the ministry’s capacity for oversight does not increase in terms of more ministerial finance professionals, it will not be able to control such a specialist agency like BaFin in a comprehensive way.

43 Döhler, Vom Amt zur Agentur, supra note 3, 35.
44 Quaglia, supra note 42, 60.
45 Döhler, Vom Amt zur Agentur, supra note 3, 35.
b) Solvency II and Lamfalussy Procedure

The Solvency II negotiations took place under the direction of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), which is one of the level 3 committees besides the Committee of European Banking Supervisors (CEBS) and the Committee of European Securities Regulators (CESR). The L3L are networks of national regulators which have been established according to a plan of Alexandre Lamfalussy who suggested an improvement of EU law-making procedures in the financial sector. Following the structure of Basel II, the supervision of insurance is also based on the three-pillar approach, which contains quantitative requirements for financial resources, supervisor review with capital evaluations and disclosure requirements with supervisory reporting. Since 2002, the new mode of governance covers all three financial sectors and is called the Lamfalussy procedure. According to this process, the EU institutions adopt framework legislation from the Commission (level 1), which also prepares the implementation measures for this legislation with the help of four specialist committees staffed by national ministry officials (level 2). On level 3, the above-mentioned L3L provide technical advice for the implementation. Against this background, these committees are staffed with high-ranking experts from the national supervisory authorities.

Coen and Thatcher consider L3L to be the most powerful transnational regulatory networks, because they not only help to improve the implementation of EU law, but also, “these networks have [in fact] evolved very quickly beyond what the Commission and the member states envisaged in terms of organization and goals”, so they “appear to be emerging as highly significant actors in the development of European regulation”. This applies first and foremost to CEIOPS and the Solvency II negotiations. The committee did not confine itself to compiling facts for implementation, but instead formulated the rules. Although the Lamfalussy process distinguishes

---

between framework principles at level 1, implementation measures at level 2, and consultation tasks at level 3, CEIOPS did not adhere to this structure in Solvency II. It was the first time that such a committee took higher framework decisions and achieved “the blurring of the boundary between L1 and L2 in the activities of CEIOPS”.\textsuperscript{51} Finally, due to their deliberative autonomy, their expertise and their work for the benefit of market participants, there is some evidence that L3L themselves are trustees of the EU member states.\textsuperscript{52}

Within these committees, BaFin and other national regulators are largely unaffected by national executives, so they are able to carry out their technical tasks according to professionalised ideas, even though the issues discussed have political relevance.\textsuperscript{53} Such a situation makes BaFin a trustee of the BMF in EU negotiations and allows the ministry only slight control by way of monitoring and reporting requirements.

Moreover, the position of BaFin in CEIOPS is exceptional, because BaFin’s chief executive director responsible for insurance supervision, Thomas Steffen, chairs the committee. This personal interconnection weakens BMF’s influence additionally. Since Steffen as a senior representative of BaFin holds a leading position in CEIOPS, he is a crucial member of a committee with certain policy-making powers. One the one hand, the BMF could try to influence the committee via this way, because in “the level 3 committees, the chair plays an important role”\textsuperscript{54} and has sole decision-making power, including setting the agenda. On the other hand – and this appears more convincing – Steffen is bound to the way of thinking and acting of the epistemic community of regulators of which he is a member and by whom he was elected.

Personal integrity as well as the reputation of the whole agency is an important factor for BaFin’s work within regulatory networks. The professionalisation of BaFin and its personnel, on the one hand, explains the prior elements of their preferences from a trustee perspective, namely, to ensure the continuation of the agency and to further its reputation.\textsuperscript{55} On the other hand, from the principal’s point of view, the same attitudes cause problems,

\textsuperscript{51} Visscher et al., supra note 16, 40.
\textsuperscript{52} Id., 35.
\textsuperscript{54} Id., 574.
because the “result of empowering professionals in an agency is to lose much hierarchical control over that agency”. 56 This happened to BaFin, since the agency was able to emancipate itself from the BMF. Due to this, political actors – as will be outlined in the next passage – tried to revise decisions, which had been made when BaFin was established. It is worth mentioning, that there was no reason for acting equally in other cases of risk regulation like food safety or licensing of drugs. Although there had been plans to re-organise regulation, agencies in these cases were not as independent as BaFin. For example, a decision to replace the Federal Institute for Drugs and Medical Devices (Bundesinstitut für Arzneimittel und Medizinprodukte, BfArM) with an independent agency (Deutsche Arzneimittelagentur, DAMA) was being considered in 2005. However, this plan was scrapped a few years later, due to the threat of agency capture.

III. Influence of BMF and Political Actors

Not only in its international activities, but also in its capacity as supervisor, is BaFin interested in maintaining (or even enhancing) its reputation as a highly competent authority. Whenever an agency succeeds in doing this, it can achieve a level of prestige which causes a problem for executives striving for influence, because it is possible “that citizens are willing to turn out governments that abridge [the] independence” of such an agency. 57 Therefore, in order to reduce the power of an agency in general, the government has had to restrain itself owing to the influence of beneficiaries. Even if they are not entirely satisfied in the case of BaFin, they can at least judge its work very favourably. This is particularly due to the fact that not only business associations but even consumers’ associations share this opinion. This is an important factor, which limits political influence. 58

Not only since the financial market crisis but even before, political actors had more or less ambitious plans for BaFin and national supervision of

56 Knott & Miller, supra note 55, 404.
57 Keefer & Stasavage, supra note 1, 421.
the financial sector. To reiterate certain measures which have already been considered in this article: First, an attempt was made to retrain BaFin with the help of explicit guidelines for legal and technical oversight, since it had gained more discretionary power than intended. Second, the presidential structure was replaced by a collegial structure of management in order to disempower BaFin’s president Sanio de facto.59 These two measures had already been pre-announced in vaguer terms in the coalition agreement of the governing parties in 2005.60 Finally, the ministry of economics (BMWi) – representing an idea of the conservative party – maintained a permanent threat to divest BaFin of its responsibilities in banking regulation and to transfer them to the central bank.61

In fact, apart from the executive, every single party in the German Bundestag in recent debates has its own strategy for the regulation of financial markets and the institutionalisation of supervision. As political actors play an important role in designing institutions in financial market regulation, the preferences of rational vote-seeking politicians and political parties should be taken into consideration. On a theoretical basis, following the economic approach, two kinds of politicians with different preferences can be distinguished. On the one hand, helping hand politicians who try to act in the general public interest; on the other hand, grabbing hand politicians who try to promote the interests of their clientele within the electorate. With regard to financial market regulation, helping hand politicians do not want to be heavily involved in regulatory details and are not in favour of a fragmentation of supervision; grabbing hand politicians can be considered as seeking separate power and limiting the power of single authorities.62

In practice, these characterisations of political preferences can be observed in the positions of the two main German political parties. The helping hand strategy is pursued by the Social Democratic Party (SPD), which

Regulatory Agencies: Trustees or Agents?

131

does not want to change the institutionalisation of supervision fundamentally. The SPD rather focuses on the improvement of supervisory powers for BaFin and leaves the details of dealing with the agency to the SPD-led BMF. In contrast, the Christian Democratic Union (CDU) planned to re-shape powers, especially in banking regulation, in favour of the German central bank (Deutsche Bundesbank). This illustrates a grabbing hand strategy, which tries to strengthen the position of the central bank at BaFin’s expense. At the same time, these plans of the CDU can be interpreted as an effort to circumvent the trustee BaFin. After the federal elections in September 2009, the new federal government formed by the CDU and the Free Democratic Party (FDP) stated in their coalition agreement to relocate banking supervision to the German central bank. However, all measures against a trustee are normally hard to implement and can be taken only in cases of misconduct. The financial crisis offered the opportunity to do this.

IV. The Crisis as a Window of Opportunity

With the financial market crisis one could have expected that the government would try to strengthen BaFin by eliminating deficits like the personnel shortage. But, in contrast to the announcement that financial market regulation and supervisory authorities should be strengthened, the crisis was used as a window of opportunity to override the trustee in the long term. This attempt can be explained by the experience of increasing independence – perhaps a perceived agency loss – of BaFin and the development of the agency into a trustee. The BMF and other political actors therefore pursue three strategies to achieve their goal.

First, the BMF shifts part of the blame onto BaFin for the HRE collapse and criticises BaFin for having neglected its reporting duty. Such allegations are expected from the parliamentary opposition, but even the minister of finance at that point of time, Peer Steinbrück, aimed his criticism at

65 Pellegrina & Masciandaro, supra note 61, 293.
BaFin and its president when interrogated in the parliamentary committee of enquiry on HRE.\(^\text{67}\) With this, BaFin lost any political backing and was marked as a – partly – failed agency. Without appreciating its authority, it has been treated as an ordinary administrative unit and not as a competence centre in financial market regulation.\(^\text{68}\)

Second, this weakened the reputation of BaFin as a reliable agency that fulfils its tasks carefully. Furthermore, not only did the shifting of blame affect its reputation, but also the assignment of tasks incidental to the HRE committee. In May 2009, the situation reached its peak when BaFin reported that it was nearly paralysed due to the parliamentary committee of enquiry on HRE. The agency had to assist the BMF in preparing for this committee to such an extent that no personnel capacity for day-to-day supervisory business was left.\(^\text{69}\) This is in line with Asimov’s description that, under such conditions, an agency can fulfil only a few urgent and salient tasks.\(^\text{70}\) However, instead of improving the tools at BaFin’s disposal, new requirements were introduced. For example, the agency has to review the qualifications of supervisory board members of banks and insurance companies, which seems to consume considerable capacity.\(^\text{71}\) Beyond that, the BMF did not support BaFin in this grave situation, but instructed it to reform its internal organisation to meet all its requirements.\(^\text{72}\)

Third, the full usage of BaFin’s available capacity even provided an argument for the circumvention of BaFin in the policy-making process on financial market laws. Circumvention, as mentioned above, is not only a plan of the conservative party but also the course of action of the government and the BMF. BaFin was not even involved in formulating policy on financial market laws.


certain laws to answer the crisis – e.g. the Financial Market Stabilization Act (FMStG; Finanzmarktstabilisierungsgesetz), the Rescue Takeover Act (RettungsG; Gesetz zur Rettung von Unternehmen zur Stabilisierung des Finanzmarktes) and the Financial Market and Insurance Oversight Act (Gesetz zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht). Instead, the BMF tried to rise to the challenge with the ministry’s own resources and some external advice. But due to a significant number of employees with only legal training, it still seems to be true that civil servants of the BMF are unable to cope with the technical details of financial market regulation, as Lütz already stated shortly after the installation of BaFin. Again, the reaction to the severe distortions in financial markets was not to consult BaFin or to develop solutions within the BMF, but instead the formulation of laws on banking regulation has been outsourced to law firms like “Freshfields Bruckhaus Deringer”. In the case of the Gesetz zur Ergänzung des Kreditwesengesetzes, the government even appointed the BMWi to carry out this task instead of the BMF that was really responsible. The BMWi, however, also delegated the task of policy formulation to the law firm “Linklaters”.

Overall, one could assume that political actors took advantage of the weaknesses of BaFin with the aim of harming its reputation. From an external perspective, its performance in the fulfilment of its tasks became worse and its reputation impaired; this is either aimed at or at least accepted by the BMF and other actors. Therefore, the financial market crisis should not be seen as a trigger to intensify control over BaFin and to change the mode of delegation from trust to agency. Rather, the crisis can be interpreted as a window of opportunity for political actors to revise former decisions leading to the trustee delegation scheme of BaFin. The behaviour of BMF and conservative political parties cannot be traced back principally to the collapse of the banks and the breakdown of the global financial system, but it is definitely in line with their long-term ambitions.

73 Lütz, supra note 28, 153.
75 Antwort der Bundesregierung auf die Kleine Anfrage der Fraktion Bündnis 90/ Die Grünen, Drucksache 16/13983 (04 September 2009).
D. Conclusion

Strategies for solving the global financial market crises are currently manifold. Not only is the establishment of new international regulatory regimes under discussion, but also the rearrangement of organisational supervisory structures. This directly affects the mode of delegation – principal-agent relation or trusteeship – that characterises the relationship between governments and regulatory agencies.

In relation to the case of Germany, this paper illustrated that BaFin used its legal basis and its integration into international networks to emancipate itself from the BMF as its principal. The agency therefore gained the status of a trustee with large discretion ary power; this motivated the BMF to take counter-measures in order to prevent a perceived agency loss. However, such measures are restricted in trusteeships and cannot be expanded without good reason. The financial market crisis however, offered such a reason. With certain measures like the outsourcing of policy formulation or the assignment of additional tasks to BaFin, the executive not only reacted to the crisis but also used the opportunity to treat BaFin as a trustee in a way that is possible only in exceptional cases.

Nonetheless, one can expect that national governments will continue to establish regulatory agencies due to their advantages, especially regarding professionalisation and efficiency. It is important to note that on the other hand, politicians will hardly give away the option of shifting the blame onto a formally independent agency. However, they are also likely to restrict their actual independence as much as possible.
South-South Regional Monetary Cooperation: Mere Myth or New Opportunity for Financial Stability?

Laurissa Mühlich*

Table of Contents

Abstract .......................................................................................................................... 136
A. Introduction ............................................................................................................. 136
B. Literature Review and Theoretical Considerations ........................................... 139
   I. Financial Market Development and Financial Dollarization ........................................ 139
   II. Regional Monetary Cooperation ........................................................................ 141
   III. Interim Conclusions: Financial Market Development and Regional Monetary Cooperation ......................................................................................... 142
C. South-South Regional Monetary Cooperation in South East Asia, South Africa, and South America ................................................................. 144
   I. Intra-Regional Characteristics ............................................................................. 146
      1. ASEAN/ASEAN+3 ......................................................................................... 146
      2. CMA ........................................................................................................... 150
      3. MERCOSUR ............................................................................................... 153
   II. Inter-Regional Characteristics .......................................................................... 155
D. Conclusions ............................................................................................................. 165

* Freie Universität Berlin, School of Business & Economics, Institute for Latin American Studies, Rüdesheimer Straße 54-56, 14197 Berlin, Germany, E-mail: laurissa.muehlich@fu-berlin.de.

doi: 10.3249/1868-1581-2-1-muehlich
Abstract

Small and undiversified financial markets remain a characterizing monetary policy constraint and impediment for financial stability for the majority of developing countries and emerging markets. Does south-south regional monetary cooperation mitigate these problems? The paper presents a comparative perspective on regional monetary cooperation in South East Asia, South Africa and South America, and its potential contribution to financial market development and de-dollarization.

A. Introduction

The number of regional monetary cooperation arrangements in the developing world is on the rise, and gaining new momentum with the ongoing turmoil in international financial markets. The promise of regional monetary cooperation as a safeguard against macroeconomic crises has increased accordingly. Particularly developing countries and emerging market economies recently reclaimed plans for enhanced regional cooperation with the explicit aim to reduce their economies’ vulnerability to external monetary and trade shocks.

Yet, whether the stabilizing potential of regional monetary cooperation between developing countries and emerging markets remains merely a promise or whether it will deliver on expected outcomes is still unknown. Are the currently articulated high expectations in terms of macroeconomic stabilization and financial crisis buffering appropriate?

For which countries and under which conditions can regional monetary arrangements in the developing world – ranging from regional liquidity funds to intra-regional exchange rate pegs – be expected to have net benefits for the participating countries? I argue that the degree to which south-south regional monetary cooperation arrangements contribute to financial stability largely depends on whether they support local and regional financial market development and de-dollarization.

Developing countries and emerging markets face specific monetary policy constraints that are mainly caused by financial dollarization and

---

1 Cf. P. Honohan ‘Dollarization and Exchange Rate Fluctuations’ The Institute for International Integration Studies Discussion Paper Series (IIS Discussion Paper), (2007) No. 201. Here, the term ‘dollarization’ refers to partial or ‘de facto’ dollarization. I do not refer to the unilateral adoption of a foreign currency as a legal tender.
small size of financial markets. ² It is in this context that this paper explores south-south regional monetary cooperation as an available monetary policy strategy that may mitigate monetary policy constraints, in particular for countries that do not consider full dollarization on one hand or a fully flexible exchange rate on the other hand as a viable policy option. I argue that under these conditions, giving up monetary policy autonomy in a regional monetary cooperation arrangement may eventually be less costly than traditionally assumed for industrialized countries with more mature financial markets.³

The idea of this study is to explore whether – and if so how – south-south regional monetary cooperation contributes to regional financial market development, and thus increase financial stability. “Southern” economies with small and undiversified financial markets or a certain degree of financial dollarization are particularly vulnerable to changes in the exchange rate. Under these conditions, exchange rate volatility quickly boosts overall solvency and liquidity risk and thus jeopardizes financial stability.⁴ My hypothesis is that regional monetary cooperation can indeed provide a viable monetary policy strategy for increasing financial stability if it contributes to financial market development, either by successful intra-regional exchange rate stabilization or by joint efforts targeted at developing regional financial markets.

I define south-south regional monetary cooperation (SSC) as comprising a wide range of regional monetary cooperation arrangements whose dynamics are not predetermined: at shallow levels, it may consist of regional swap arrangements or regional reserve pooling; deeper forms of cooperation involve regional exchange rate target zones or the fixing of intra-regional (full or ‘de jure’ dollarization) unless otherwise stated. For the theoretical argument, I use the terms dollarization, financial dollarization, and deposit dollarization interchangeably to express the same concept: the holding of a significant share of market participant’s assets and liabilities in the form of foreign currency denominated instruments. Cf. T. J. T. Baliño, E. Borensztein, A. Bennett, ‘Monetary Policy in Dollarized Economies’, International Monetary Fund Occasional Paper (1999) No. 171.

exchange rates. I determine the assignment of a country to the typological categories of ’south’ or ‘north’ by the share of foreign currency denominated debt and financial assets in the portfolios of private and public economic entities: while ‘northern’ economies are not dollarized at all, ‘southern’ economies are typically dollarized by shares between 10% (low) up to 70% (high) dollar denominated deposits in total deposits and more. I find the same typological pattern when I determine the categorization by a country’s ability to accumulate debt or financial assets in its own currency (‘north’), or predominantly in a foreign currency (‘south’). Based on this categorization, I examine three SSC in South East Asia (Association of South East Asian Nations, ASEAN), South Africa (Common Monetary Area, CMA), and a case of non-cooperation in South America (Mercado Común del Sur, MERCOSUR).


Cf. B. Eichengreen & R. Hausmann, Other People’s Money – Debt Denomination and Financial Instability in Emerging Market Economies (2005), I analyze SSC as a second-best monetary policy option compared to north-south cooperation (NSC) as the ‘best of all worlds’, in particular for financially dollarized countries: bilateral integration with the currency in which their debt is denominated turns their external debt into internal debt denominated in the countries’ own currency, reducing net balance sheet effects to zero (as for example in the Eastern enlargement of the Euro zone). In this case, the ‘northern’ central bank expands its lender of last resort function to a ‘southern’ economy – which is not a readily available option for most countries in the developing world today. Thus, I analyze SSC in comparison to other available monetary policy options such as a unilateral integration into a ‘northern’ key currency bloc (‘dollarization’ or ‘euroization’) or a unilaterally floating exchange rate regime (cf. also B. Eichengreen, Can Emerging Markets Float? Should They Inflation Target? (2002)).
Following this introduction, the paper is organized as follows: Section 2 reviews the literature on financial development, financial dollarization and monetary integration theory. I propose possible links between these strands of literature and interim theoretical conclusions. These are tested empirically with a brief comparison of intra-regional constellations of the aforementioned cases in Section 3. Section 4 concludes by summarizing main observations.\footnote{As a final introductory remark I consider important to note that the decision for regional monetary cooperation, or even integration, is of course not entirely based on economic considerations, but rather motivated by political aspects, as it involves not only monetary policy autonomy but also issues of national sovereignty. Nevertheless, this paper elaborates on economic and specifically monetary policy aspects of regional monetary cooperation.}

B. Literature Review and Theoretical Considerations

I. Financial Market Development and Financial Dollarization

Financial market development plays a major role in economic development: a larger, more liquid, capitalized, and more efficient financial market provides market participants with more specialized and more sophisticated financial institutions and instruments. Financial market development is understood here as the development of size, liquidity, capitalization and efficiency of domestic and regional money (market for short term credits and commercial papers), credit (market for medium to long term credits), and capital markets (market for long term financing, separated into equity (stocks) and debt (bonds) financing).\footnote{I consider financial market development to be a complementary process of both capital and banking market development, cf. E. Borensztein et al., Building Bond Markets in Latin America, Inter-American Development Bank Research Paper (2006), available at http://www.econ.berkeley.edu/~eichengr/research/build_bond_mkt_LA.pdf (last visited 07 December 2009), 5. Nevertheless, this study focuses on those financial market components where long term funds are raised by private and public entities.}

Under these conditions, less transaction costs, less volatility and a broader spectrum of hedging possibilities facilitate market transactions. Thus, more developed financial markets also contribute to mitigating monetary policy constraints that particularly developing countries and emerging markets are faced with.\footnote{B. Eichengreen & R. Hausmann, Other People’s Money – Debt Denomination and Financial Instability in Emerging Market Economies (2005); E. Borensztein et al.,}
highly dollarized economies. At the same time, the latter have an especially difficult stand in developing domestic financial markets and de-dollarizing their economies out of their own due to their small economic size.\textsuperscript{10}

McKinnon (1973)\textsuperscript{11} and Shaw (1973)\textsuperscript{12} laid the grounds for a rapidly growing body of research on the effects of liberalized and well-developed financial markets on overall economic growth and development. They highlighted the importance of market liquidity and capitalization for economic development by showing that higher credit/GDP ratios would substantially increase economic growth. Not only had numerous studies followed in exploring the relationship between financial market development and economic growth, but the developing world also followed the trend and the advice of international financial institutions concerning financial liberalization. However, the experience of severe banking crises in major Latin American countries in the 1980s, among others, due to the fact that their underdeveloped financial systems had been rapidly opened and thus exposed to external shocks, gave rise to a discussion about the appropriate sequencing of financial liberalization reforms.\textsuperscript{13}

What followed were studies on the relation between financial market development and financial and currency crises, in particular in the aftermath of the Asian financial crisis. They pointed to the higher vulnerability that particularly financially dollarized economies with less developed financial markets are exposed to. Studies on net balance sheet effects in the presence of major exchange rate revaluations in dollarized economies\textsuperscript{14} caused a growing interest in examining causes and consequences of financial dollarization.

\textsuperscript{12} E. S. Shaw, \textit{Financial Deepening in Economic Development} (1973).
In addition, more recent and technically elaborate studies confirm the original notion of the importance of mature financial markets for overall economic development, as they find a strong link between credit volume and overall economic growth. A more developed financial market, comprising both capital and banking markets, is expected to deliver more trading partners in the same market at less setup, settlement and clearing costs. Issuance, trading and hedging operations are thus more costly in countries with less developed financial markets.

II. Regional Monetary Cooperation

Regional monetary integration literature originates in the Optimal Currency Area Theory (OCA) developed by Mundell (1961, 1973). The OCA framework determines the costs of giving up monetary policy autonomy that are associated with creating or joining a regional currency union. Its major argument being that the more similar the integrating countries are in terms of their reaction to external shocks, the less costly a common currency would be, as monetary policy decisions would serve the same needs.

Yet, more recent debates challenge traditional OCA theory by showing that countries may align economic conditions ex-post introducing a common currency or a regional monetary cooperation scheme. Frankel/Rose (1997) evidenced stimulating effects of a common currency on trade and financial integration. In addition to that, it has been found that the costs of tying monetary policy to a regional monetary cooperation arrangement are thus lower than suggested in the originally developed OCA mindset.

---

“Removing exchange rate variation between the members is likely to boost trade and capital flows between them. [...] In many cases, such considerations outweigh any possible advantages of using an independent monetary policy to offset idiosyncratic external shocks.”

This holds true in particular for financially dollarized economies that are exposed to net balance sheet effects. In this case, flexible exchange rates may rather be a source of economic disruption or at least less disposable as a monetary policy tool than OCA theory suggests. Thus, dollarized economies have more fragile capital and banking systems, and are more exposed to the contractionary nature of exchange rate devaluations, to capital flow volatility, and to public debt and banking crises.

III. Interim Conclusions: Financial Market Development and Regional Monetary Cooperation

We can conclude that if stabilized intra-regional exchange rates can be achieved, particularly small and highly dollarized economies may gain from regional monetary cooperation. Smaller countries are more dependent on intra-regional trade, and may find more accessible regional financial markets in domestic or a regional currency a viable monetary policy option to enhance domestic financial market development as they are less integrated internationally. For low dollarized large economies, regional market dominance and market diversification may be a beneficial outcome of regional monetary cooperation. While these economies can be assumed to have access to international markets, being a strong economy in a strong region...
on the basis of regionally diversified investment opportunities, a diversified capital and banking market and more or less stable exchange rates with the own currency as the regional anchor currency in the region may be a profitable outcome for these countries.

Regional monetary cooperation can of course not be assumed to come without costs. Necessarily, economic adjustment costs are involved, in particular if the participating countries are diverse. Adjustment costs need to be dealt with particularly by the smaller countries, in order to catch up with the larger regional partner countries. Larger countries are burdened with the costs that are involved in taking on a regional currency leadership role that includes a regional lender of last resort function and monetary policy setting for the region as a whole. Additional costs arise from introducing, maintaining, and developing regulatory and supervisory regional financial and monetary policy instruments and institutions, independent from the level and form of regional monetary cooperation.

Yet, more recent contributions to economic literature find that these costs may be outweighed by the beneficial effects of macroeconomic stabilization in developing countries and emerging markets, more than in the case of Europe, for example.\(^\text{22}\) Ending beggar-thy-neighbor policies through competitive devaluations would prevent costs of severe economic crises, as for example in the MERCOSUR region at the end of the 1990s.\(^\text{23}\)

Further to this, regional and domestic financial market development may be a major beneficial outcome of SSC. The latter may support regional and domestic financial market development by:

- diversifying hedging opportunities for domestic market participants with access to regional financial debt markets in their own currency – this raises a currency’s attractiveness as a unit of account and storage of value rises with the development of liquid and deep financial markets offering a broad range of hedging and investment opportunities.\(^\text{24}\)

---

\(^{22}\) Cf. for instance Hawkins & Klau, *supra* note 9.


facilitating the issuance of local currency denominated public bonds, as is the case in ASEAN/ASEAN+3; or by enhancing the denomination of financial instruments in a regional anchor currency, as is the case in CMA – rising public bond issues enable the development of benchmarks for corporate bond issues, and encourage regional investment; enhancing the implementation of regulative standards and institutions by means not only of cooperation and information sharing but also by competitive regulative policy implementation\textsuperscript{25}.

C. South-South Regional Monetary Cooperation in South East Asia, South Africa, and South America

In the first subsection, I draw particular attention to different constellations of financial market development and financial dollarization within each region: Each region comprises countries with high (70\% and more) and low (10\% and less) levels of financial dollarization – measured as share of foreign currency deposits in total deposits. Also, each region comprises countries with relatively small (less than .3 credit to GDP ratio) and large (more than .3 to .4 credit to GDP ratio) financial markets. In addition, the regions display different intra-regional constellations with regards to the existence or non-existence of a potential regional anchor currency. In the second subsection, I compare the aforementioned intra-regional differences inter-regionally. The examined SSC projects are:

the Association of South East Asian Nations (ASEAN) in South East Asia where I also include ASEAN+3\textsuperscript{26};
the Common Monetary Area (CMA) in South Africa\textsuperscript{27};


\textsuperscript{26} While ASEAN plus three including the “northern” partner country Japan is a major driver of the South East Asian monetary cooperation, the region so far faces an unresolved regional currency leadership dilemma between China and Japan. This circumvents a clear-cut conclusion about the influence of Japan. For a discussion of different facets of Japan’s role in South East Asian monetary cooperation; see H. Dieter, ‘Monetary and Financial Cooperation in Asia. Motives, Sequencing and Political Obstacles’, \textit{GARNET Working Paper No}: 16/07, available at http://www.garnet-eu.org/fileadmin/documents/working_papers/1607.pdf (last visited 25 December 2009).
and the Common Market of the South (MERCOSUR) in South America as a case of non-cooperation.

Table C.1 provides an overview about member countries and regional monetary cooperation or non-cooperation in each region.

<table>
<thead>
<tr>
<th>Regional monetary cooperation arrangement</th>
<th>Mercado Común del Sur (MERCOSUR)</th>
<th>Common Monetary Area of Southern Africa (CMA)</th>
<th>Association of South East Asian Nations (ASEAN)/ (ASEAN+3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participating countries</td>
<td>Brazil, Argentina, Paraguay, Uruguay</td>
<td>South Africa, Namibia, Lesotho, Swaziland (plus Botswana)</td>
<td>Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam China, Republic of Korea, and Japan in ASEAN +3</td>
</tr>
<tr>
<td>Level of monetary cooperation</td>
<td>None Consideration of a common currency, “Monetary Institute of MERCOSUR”</td>
<td>Fixed but adjustable exchange rates</td>
<td>Liquidity Fund (NSC ASEAN+3) Asian Bond Market Initiative I (USD) and II (local currencies) Consideration of a common currency basket arrangement ASEAN+?</td>
</tr>
</tbody>
</table>

Source: Author.

ASEAN/ASEAN+3 comprises a regional liquidity fund without involving any deeper form of regional exchange rate arrangements – despite repeated announcements that point in this direction. ASEAN is greatly supported by a regional bond market development initiative including the ASEAN+3 countries.

CMA is the longest standing and deepest form of regional monetary cooperation, with bilaterally pegged but adjustable exchange rates.

In contrast to that, MERCOSUR does not involve any regional monetary or financial cooperation arrangement, despite frequent announcements of deeper regional monetary integration purposes.

I. Intra-Regional Characteristics

1. ASEAN/ASEAN+3

The Association of South East Asian Nations was set up in 1967 between the ASEAN-5 Thailand, Indonesia, Malaysia, the Philippines and Singapore with the objective to support economic and social development, and political stability. Since the Asian financial crisis at the end of the 1990s, ASEAN monetary and financial integration is supported by strong engagement of its neighboring ‘plus-three’ partners, China, Korea and the ‘northern’ partner country Japan, with the objective of financial crisis prevention. In 2000/2001, the 10 ASEAN countries together with their plus-three partners initiated a multilateral regional swap arrangement for members facing temporary liquidity or balance of payments problems (‘Chiang Mai Initiative’). The latter was transformed into a multilateral regional liquidity fund of about USD 80 billion in 2005, and is being multilateralized and increased to a volume of up to USD 150 billion since 2008.

The ASEAN region is characterized by strong intra-regional differences with regards to the countries’ financial market sizes and with regards to financial dollarization. The picture looks different though when it comes to economic size: Malaysia, Singapore, and Thailand, which stand out in terms of financial market development, low levels of dollarization and inflation levels, do not have comparable economic weight. While these countries also stand out in terms of lower levels of external indebtedness, and with regards to reserves holdings, if any, Indonesia dominates the region in terms of economic size. GDP size of the more developed countries of Singapore and Malaysia do not compare to the economic weight that for example South Africa has in the CMA region.28

28 Of course, this perspective changes when the plus-three partner countries are included (not displayed here). Japan clearly dominates the region in terms of economic size, whereas China’s rapidly increasing reserve holdings of about 1.25 in months of imports (Japan 1.62, Korea 0.8) in 2006, and its strong economic growth (around 11% GDP per capita in PPP terms growth in 2006, Japan 2.2%, Korea around 5%) somewhat challenged Japan’s position in the region over the last few years. The leadership dilemma between China and Japan seems to be an open question that fits into the overall picture of less clear-cut intra-regional hierarchies in ASEAN.
Figure C.1 ASEAN/ASEAN+3 regional GDP % shares (USD billion in 2006)

At the same time, with the creation of the Asian Bond Funds I and II in 2003 and 2004 (with the size of 1 USD bill. and 2 USD bill. respectively), ASEAN and ASEAN+3 countries have made enormous progress in regional as well as domestic financial market development and regional financial market integration.\textsuperscript{29} Thus, despite a missing regional currency leadership, regional financial markets grew rapidly. Together with overall market growth, the share of local currency denominated financial instruments increased as well\textsuperscript{30}.

\textsuperscript{29} The development of regional financial markets through issuance of – and investment in – local currency denominated government bonds under the Asian Bond Market and Bond Fund Initiatives (ABMI and ABFI+II) is a major pillar of regional financial cooperation. The overall objective of these initiatives is to mitigate problems of currency and maturity mismatches in local balance sheets. Cf. B. Eichengreen \textit{et al.}, ‘A Tale of Two Markets: Bond Market Development in East Asia and Latin America’, paper prepared for the Seoul National University Conference on China and the World Economy, 7-8 May 2006.

\textsuperscript{30} Cf. Eichengreen \textit{et al.}, supra note 3.
Table C.2 Economic Overview ASEAN 2006

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>7.26</td>
<td>0.37</td>
<td>6%</td>
<td>51%</td>
<td>4.71</td>
<td>0.15</td>
<td>0.08</td>
<td>95%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>364.46</td>
<td>0.44</td>
<td>25%</td>
<td>38%</td>
<td>13.11</td>
<td>0.35</td>
<td>0.23</td>
<td>18%</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>3.40</td>
<td>0.26</td>
<td>0%</td>
<td>99%</td>
<td>6.8</td>
<td>0.15</td>
<td>0.06</td>
<td>61%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>156.09</td>
<td>0.61</td>
<td>22%</td>
<td>36%</td>
<td>3.61</td>
<td>1.16</td>
<td>1.10</td>
<td>3%</td>
</tr>
<tr>
<td>Myanmar</td>
<td>n.a.</td>
<td>0.40</td>
<td>23%</td>
<td>n.a.</td>
<td>20</td>
<td>n.a.</td>
<td>n.a.</td>
<td>1%</td>
</tr>
<tr>
<td>Philippines</td>
<td>117.56</td>
<td>0.34</td>
<td>8%</td>
<td>47%</td>
<td>6.24</td>
<td>0.47</td>
<td>0.24</td>
<td>31%</td>
</tr>
<tr>
<td>Singapore</td>
<td>136.57</td>
<td>0.58</td>
<td>n.a.</td>
<td>n.a.</td>
<td>1.02</td>
<td>1.07</td>
<td>0.92</td>
<td>n.p.</td>
</tr>
<tr>
<td>Thailand</td>
<td>206.70</td>
<td>0.43</td>
<td>32%</td>
<td>n.a.</td>
<td>4.64</td>
<td>0.94</td>
<td>0.87</td>
<td>1%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>61.00</td>
<td>0.24</td>
<td>12%</td>
<td>34%</td>
<td>7.39</td>
<td>0.46</td>
<td>0.64</td>
<td>36%</td>
</tr>
</tbody>
</table>


Despite overall progress in regional financial market development, smaller countries in the region with smaller financial markets, such as Cambodia, Laos and Vietnam are still highly dollarized. Only in Vietnam, we see a recent take off with rapid financial market growth, accompanied by a decrease in the level of financial dollarization. At the same time, financial market development in the ASEAN-5 founding countries, Thailand, Singapore and Malaysia, is even close to figures of industrialized countries.

\textsuperscript{31} Levy-Yeyati, \textit{supra} note 10.
South-South Regional Monetary Cooperation

Figure C.2 ASEAN financial market size and financial dollarization per country 1990-2006

Cambodia

Indonesia

Lao

Malaysia

Myanmar

Philippines

Singapore

Thailand
Vietnam

Source: FSDI 2008; Levy-Yeyati\(^{32}\); own calculations; blue line: private credit/GDP, red line: foreign currency deposits/total deposits.

2. CMA

The Common Monetary Area was founded in 1986 as a framework for regional coordinated exchange rate policy, based on the former Rand Monetary Area. The objective of the CMA is the provision of sustained equally distributed economic development in the region. National currencies of the smaller countries are pegged at par to the Rand, while these countries still issue their own currencies, and are responsible – albeit to a very limited extent – for their national monetary policy. In Lesotho and Namibia, the South African Rand serves as legal tender; Swaziland abolished the legal status of the Rand in 1986, although it is de facto still widely used.

Bilateral agreements govern the smaller countries’ access to the South African foreign exchange market. South Africa determines the reference values regarding inflation and intra-regional exchange rates for the CMA and – since the South African rand follows a managed floating exchange rate regime – regarding extra-regional exchange rates as well.\(^{33}\)

\(^{32}\) Levy-Yeyati, supra note 10.

The CMA region is clearly dominated by South Africa as the outstanding regional power in economic, monetary, and financial terms. South Africa counts for more than 90% of the sum of the region’s GDP. Its financial market size comes close to levels of industrialized countries, and its level of financial dollarization is low. Only in terms of foreign exchange reserves is South Africa outperformed by the large reserves holdings of Botswana, probably due to the latter’s diamond mining business income.

Table C.4 Economic Overview CMA 2006

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Botswana</td>
<td>11.01</td>
<td>n.a.</td>
<td>0.30</td>
<td>43%</td>
<td>4.64</td>
<td>0.71</td>
<td>1.04</td>
<td>2%</td>
</tr>
<tr>
<td>Lesotho</td>
<td>1.49</td>
<td>0%</td>
<td>n.a.</td>
<td>0.08</td>
<td>0.08</td>
<td>n.p.</td>
<td>n.p.</td>
<td>n.p.</td>
</tr>
<tr>
<td>Namibia</td>
<td>6.57</td>
<td>n.a.</td>
<td>36%</td>
<td>5.05</td>
<td>n.p.</td>
<td>n.p.</td>
<td>n.p.</td>
<td>n.p.</td>
</tr>
<tr>
<td>South Africa</td>
<td>254.99</td>
<td>43%</td>
<td>n.a.</td>
<td>0.30</td>
<td>0.11</td>
<td>0.21</td>
<td>0.21</td>
<td>n.p.</td>
</tr>
<tr>
<td>Swaziland</td>
<td>2.78</td>
<td>9%</td>
<td>14%</td>
<td>5.3</td>
<td>0.21</td>
<td>0.21</td>
<td>n.p.</td>
<td>n.p.</td>
</tr>
</tbody>
</table>


34 Levy-Yeyati, supra note 10.
Intra-regional financial markets in the CMA region are liberalized, providing market access among the member countries. The CMA can be considered as one regional financial market. While South African financial institutions dominate regional financial markets, the smaller countries in the CMA region seem to gain significantly from regional monetary cooperation in terms of financial market development. Swaziland (and Botswana) show more dynamic financial market growth recently (no data for Namibia available). This is supported by a low level of interest rates and increasing macroeconomic stability, compared to other countries in Sub-Saharan Africa outside the CMA region with similar economic characteristics. Financial dollarization in these countries remains at very low levels, probably due to the bi-currency system with the South African Rand.

Figure C.4 CMA Financial market size and financial dollarization per country 1990-2006

Botswana

Lesotho

South Africa

Swaziland

South-South Regional Monetary Cooperation

Source: FSDI 2008; E. Levy-Yeyati\textsuperscript{36}; own calculations; blue line: private credit/GDP, red line: foreign currency deposits/total deposits; no data available for Namibia.

3. MERCOSUR

The Common Market of the South was founded in 1991 with the objective to (1) enhance the size and economic development and growth of the member countries, and to (2) support their integration into international markets. In contrast to its ambitious goals that include monetary coordination and even a common regional currency, MERCOSUR currently represents no more than a half-way customs union, characterized by repeated episodes of beggar-thy-neighbor policies concerning regional trade-related conflicts\textsuperscript{37}.

Figure C.5 MERCOSUR regional GDP % shares (USD bill. in 2006)

The MERCOSUR region is clearly dominated by Brazil in terms of economic size. The country counts for around 80% of the region’s GDP. Brazil also stands out with low onshore dollarization levels, while offshore dollarization is much higher. While exact data are not available, a level of 10% entirely offshore held dollarized deposits to total deposits on- and offshore can be assumed\textsuperscript{38}. Recently, Brazil reached comparatively low exter-

\textsuperscript{36} E. Levy-Yeyati, supra note 10.


\textsuperscript{38} Exact data are not available, a level of 10% entirely offshore held dollarized deposits to total deposits on- and offshore can be assumed. Cf. E. Borensztein \textit{et al.} (2004): ‘Building Bond Markets in Latin America’, \textit{Inter-American Development Bank Research Paper}, p. 52.
nal debt levels. Moreover, the country further increased its foreign exchange reserve holdings. In 2008, the country therefore was hailed as net creditor country for the first time in its economic history.

Table C.5 Economic Overview MERCOSUR 2006

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>214.24</td>
<td>0.95</td>
<td>29%</td>
<td>59%</td>
<td>10.9</td>
<td>0.21</td>
<td>0.11</td>
<td>29%</td>
</tr>
<tr>
<td>Brazil</td>
<td>1067.82</td>
<td>0.69</td>
<td>10%</td>
<td>19%</td>
<td>4.18</td>
<td>0.52</td>
<td>0.32</td>
<td>n.p.</td>
</tr>
<tr>
<td>Paraguay</td>
<td>9.28</td>
<td>0.34</td>
<td>21%</td>
<td>37%</td>
<td>9.59</td>
<td>0.17</td>
<td>0.16</td>
<td>57%</td>
</tr>
<tr>
<td>Uruguay</td>
<td>19.31</td>
<td>0.79</td>
<td>23%</td>
<td>52%</td>
<td>6.4</td>
<td>0.43</td>
<td>0.25</td>
<td>86%</td>
</tr>
</tbody>
</table>


Yet, regional differences in financial market development are far less pronounced than, for example, in the ASEAN region. Brazil does not stand out in terms of financial market development, as does for example Malaysia or Singapore in the ASEAN region. Also, Brazil looks back on a history of high and volatile inflation and exchange rates that repeatedly deteriorated trade-related regional integration initiatives in the MERCOSUR.

---

40 Intra-regional trade disputes were caused by uncoordinated exchange rate policies: In face of the Brazilian devaluation of the Real in 1999, the already overvalued Argentinean Peso threw Argentina in a severe economic crisis which resulted in a breakdown of its currency board regime. Paraguay and Uruguay experienced similarly severe economic downturns with heavy deterioration of Uruguay’s financial market. Cf. Fernández-Arias et al., supra note 19.
II. Inter-Regional Characteristics

The aim of this subsection is to identify major similarities and differences between the regions by looking at simple averages of regionally aggregated data in addition to the country specific data discussed above.

Figure C.7 shows intra-regional trade shares. The most dynamic trade integration process is happening in ASEAN with the highest intra-regional trade shares compared to other regions.\textsuperscript{42} Albeit on a lower level, trade shares in the CMA region have been mostly rising steadily as well.

\textsuperscript{41} Levy-Yeyati, supra note 10.
\textsuperscript{42} Of course, this is still low compared to EU intra-regional trade levels of more than 45% in 2006.
Initially, MERCOSUR trade was similarly dynamic until the region underwent major intra-regional trade disputes at the end of the 1990s. Average intra-regional trade shares of the Southern African Customs Union (SACU) that comprises the CMA member countries and Botswana are relatively low. Yet, regional trade is particularly important for the smaller member countries which depend on close trade links with South Africa. Intra-regional trade is characterized by manufacture exports from South Africa to the smaller SACU member countries.43

Figure C.7 Intra-regional trade share by region 1970-2007

Source: UN Comtrade ITS index: intra-regional trade as a percentage share of the region’s total trade (regional total imports plus regional total exports) 1990-2006. ASEAN plus-three partner countries data are not available. Originally founded in 1910, the South African Customs Union (SACU) renewed statutes in 1969 and 2002 most recently. Member countries are Botswana, Lesotho, Namibia, South Africa, and Swaziland.

43 Cf. UNCTAD 2007, supra note 35, p. 98.
Figure C.8 displays simple average exchange rate volatility in each region, measured as the average standard deviation of the annualized depreciation rate of monthly bilateral nominal exchange rates vis-à-vis the US dollar, starting with the year when the respective regional arrangement officially came into existence until 2007. On average, the MERCOSUR region displays highest standard deviations. Most volatile episodes stem from MERCOSUR countries’ adoption of flexible exchange rate regimes at the end of the 1990s, and after the breakdown of the Argentinean currency board system in 2001/2002. In the CMA region, exchange rate movements are rather characterized by small temporary exchange rate depreciations. The change from Rand Monetary Area to Common Monetary Area in 1986 is the reason for a peak in the middle of the 1980s. In the ASEAN region, exchange rate volatility measured by the average regional standard deviation of nominal US dollar exchange rates considerably decreased since the end of the 1990s, and remained even lower than in the CMA region. During the Asian financial crisis in 1997, most countries experienced a crisis induced free fall of their exchange rates, and subsequently adopted what has been coined as the “informal dollar standard” by McKinnon (2005). ASEAN exchange rate policies are in their majority geared towards China’s exchange rate policy that is in essence pegged to the US dollar.

---

44 These measures can of course only serve as an approximate estimation of intra-regional exchange rate volatility. Nevertheless, bilateral US dollar exchange rates may resemble intra-regional exchange rates to a certain extent as most of the countries have a strong orientation towards the US dollar, except member countries of the CMA in South Africa.

Figure C.8 Nominal exchange rate volatility by region

ASEAN (2000-2007)

CMA (1974-2007)

MERCOSUR (1990-2007)

Source: IMF’s IFS 2008.
The picture is much clearer though when considering more sophisticated measures: the index of exchange rate flexibility, developed by Calvo/Reinhart (2002)\textsuperscript{46}, measures the ratio of the monthly variance of the nominal exchange rate depreciation in relation to the variance of the nominal interest rate\textsuperscript{47} and the variance in foreign exchange reserves of country $i$ in month $k$. It takes on values between zero and infinity.

Table C.9 displays simple summary statistics of the Calvo/Reinhart (2002) exchange rate flexibility index. I compare mean values of each continent for the total time period 1960-2007, as well as for the time period of the existence of either CMA (starting 1974), ASEAN (starting 2000), or MERCOSUR (starting 1990).

**Table C.9 Calvo Reinhart (2002) index per region 1960-2007**

<table>
<thead>
<tr>
<th>Region</th>
<th>Obs</th>
<th>Mean</th>
<th>Std.Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing countries and emerging markets in Africa, South East Asia, and Latin America</td>
<td>1787</td>
<td>3.253875</td>
<td>74.1306</td>
<td>0</td>
<td>2880.554</td>
</tr>
<tr>
<td>Sub-Sahara Africa &amp; North Africa</td>
<td></td>
<td>4.558015</td>
<td>98.49335</td>
<td>0</td>
<td>2880.554</td>
</tr>
<tr>
<td>Sub-Sahara Africa (starting 1974)</td>
<td>886</td>
<td>4.977119</td>
<td>104.0541</td>
<td>0</td>
<td>2880.554</td>
</tr>
<tr>
<td>Sub-Sahara Africa (starting 1974, without CMA)</td>
<td>768</td>
<td>5.661577</td>
<td>111.7546</td>
<td>0</td>
<td>2880.554</td>
</tr>
<tr>
<td>Sub-Sahara Africa &amp; North Africa</td>
<td>989</td>
<td>4.558015</td>
<td>98.49335</td>
<td>0</td>
<td>2880.554</td>
</tr>
<tr>
<td>Sub-Sahara Africa &amp; North Africa (starting 1974)</td>
<td>970</td>
<td>4.646926</td>
<td>99.45222</td>
<td>0</td>
<td>2880.554</td>
</tr>
<tr>
<td>Sub-Sahara Africa &amp; North Africa (starting 1974, without CMA)</td>
<td>768</td>
<td>5.661577</td>
<td>111.7546</td>
<td>0</td>
<td>2880.554</td>
</tr>
<tr>
<td>CMA member countries</td>
<td>118</td>
<td>.522346</td>
<td>5.961512</td>
<td>0</td>
<td>14.44755</td>
</tr>
<tr>
<td>East Asia Pacific</td>
<td>346</td>
<td>1.107161</td>
<td>5.037686</td>
<td>0</td>
<td>87.29896</td>
</tr>
<tr>
<td>East Asia Pacific (starting 2000)</td>
<td>119</td>
<td>.704882</td>
<td>2.115285</td>
<td>0</td>
<td>18.86017</td>
</tr>
<tr>
<td>East Asia Pacific (starting 2000, without ASEAN)</td>
<td>60</td>
<td>.6435772</td>
<td>2.563941</td>
<td>0</td>
<td>18.86017</td>
</tr>
</tbody>
</table>

\textsuperscript{46} Calvo & Reinhart, supra note 21.

\textsuperscript{47} Instead of the money market interest rate I include the deposit interest rate whenever money market rate data are not available.
These rough regional averages suggest that exchange rate flexibility is lower among CMA and ASEAN member countries. On average, exchange rates are least flexible among CMA member countries, with .52 index points, compared to a mean flexibility index of 3.25 for the whole sample, and compared to an average 4.56 for the neighboring African countries. Similarly low is the flexibility index of the ASEAN member countries of about .69 index points, although these countries do not follow an explicit intra-regional exchange rate arrangement. However, average index levels are rather low among East Asian countries in general. ASEAN member countries thus meet the mean flexibility level of East Asia Pacific countries in the sample of .70, and are slightly above the index value of their neighboring countries if only considering the time period starting 2000. Interestingly, the picture looks completely different when turning to Latin America where exchange rate volatility is almost three times higher in the MERCOSUR countries than in Latin America as a whole.

Table C.10 shows financial dollarization as shares of foreign currency deposits in total deposits by country, averaged over the period from 1970 to 2004. As a comparative figure, I include the composite dollarization index developed by Reinhart et al. (2003), which also includes countries for which financial dollarization shares are not available in Levy-Yeyati (2006). Among highly dollarized economies (above 10-30 per cent of foreign currency deposits in total deposits), I find mainly smaller ASEAN countries - Cambodia, Laos and Vietnam as well as the smaller MERCOSUR member countries, together with Argentina, the Philippines and Indonesia. Larger countries, such as Brazil in Latin America and Singapore and Thailand in

<table>
<thead>
<tr>
<th>ASEAN member countries</th>
<th>75</th>
<th>.6990318</th>
<th>1.580992</th>
<th>0</th>
<th>11.08957</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America Caribbean</td>
<td>380</td>
<td>2.310767</td>
<td>23.73992</td>
<td>0</td>
<td>364.5331</td>
</tr>
<tr>
<td>Latin America Caribbean (starting 1990)</td>
<td>321</td>
<td>2.654348</td>
<td>2.581351</td>
<td>0</td>
<td>364.5331</td>
</tr>
<tr>
<td>Latin America Caribbean (starting 1990, without MERCOSUR)</td>
<td>252</td>
<td>1.903601</td>
<td>18.04005</td>
<td>0</td>
<td>250.894</td>
</tr>
<tr>
<td>MERCOSUR member countries</td>
<td>69</td>
<td>5.396207</td>
<td>43.87161</td>
<td>0</td>
<td>364.5331</td>
</tr>
</tbody>
</table>

Source: IFS, own calculation.

South East Asia stand out with very low levels of financial dollarization. In contrast, CMA countries are among the least dollarized economies throughout, probably due to the fact that the South African Rand is used as second legal tender in the smaller CMA countries rather than the US dollar.

Table C.10 Financial dollarization per country and region

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>92%</td>
<td>96%</td>
<td>15</td>
</tr>
<tr>
<td>Uruguay</td>
<td>77%</td>
<td>89%</td>
<td>21</td>
</tr>
<tr>
<td>Laos</td>
<td>57%</td>
<td>90%</td>
<td>17</td>
</tr>
<tr>
<td>Paraguay</td>
<td>45%</td>
<td>67%</td>
<td>15</td>
</tr>
<tr>
<td>Vietnam</td>
<td>37%</td>
<td>45%</td>
<td>11</td>
</tr>
<tr>
<td>Argentina</td>
<td>34%</td>
<td>74%</td>
<td>20</td>
</tr>
<tr>
<td>Philippines</td>
<td>25%</td>
<td>33%</td>
<td>10</td>
</tr>
<tr>
<td>Indonesia</td>
<td>20%</td>
<td>28%</td>
<td>12</td>
</tr>
<tr>
<td>China</td>
<td>7%</td>
<td>9%</td>
<td>2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3%</td>
<td>4%</td>
<td>7</td>
</tr>
<tr>
<td>South Africa</td>
<td>2%</td>
<td>6%</td>
<td>2</td>
</tr>
<tr>
<td>Korea</td>
<td>2%</td>
<td>5%</td>
<td>4</td>
</tr>
<tr>
<td>Myanmar</td>
<td>1%</td>
<td>2%</td>
<td>0</td>
</tr>
<tr>
<td>Thailand</td>
<td>1%</td>
<td>1%</td>
<td>9</td>
</tr>
<tr>
<td>Botswana</td>
<td>n.a.</td>
<td>n.a.</td>
<td>0</td>
</tr>
<tr>
<td>Brazil</td>
<td>n.a.</td>
<td>n.a.</td>
<td>7</td>
</tr>
<tr>
<td>Lesotho</td>
<td>n.a.</td>
<td>n.a.</td>
<td>0</td>
</tr>
<tr>
<td>Singapore</td>
<td>n.a.</td>
<td>n.a.</td>
<td>2</td>
</tr>
<tr>
<td>Swaziland</td>
<td>n.a.</td>
<td>n.a.</td>
<td>0</td>
</tr>
</tbody>
</table>

Sources: Own calculation based on *E. Levy-Yeyati50: Bank deposits denominated in US dollars as share of total bank deposits 1970-2006, **Reinhart et al.51: (a) normalized sum of bank deposits in foreign currency as a share of broad money, (b) total external debt as a share of GNP, and (c) domestic government debt denominated in (or linked to) a foreign currency as a share of total domestic government debt; each component is previously transformed into an index that can take a value from 0 to 10; the CDI measures the degree of partial dollarization on a scale that goes from 0 to 30; the variety of dollarization prevalent in each country at any point in time is determined on the basis of two separate criteria: the degree of domestic dollarization and the amount of foreign borrowing by the private sector.

Figure C.10 shows simple regional annual averages of financial market development and financial dollarization levels over the period from 1970 to 2007. Apart from the ASEAN region, the volume of private credit

50 Levy-Yeyati, supra note 10.
51 Reinhart et al., supra note 48.
in each region is below the sample mean credit to GDP ratio between .3 and .4, indicating the underdeveloped state of the regions’ financial markets.\footnote{See also Levine \textit{et al.}, \textit{supra} note 15.}

In the case of CMA, South Africa’s more mature financial market shows a huge influence in overall financial development in the region, growing more dynamically in recent years. In the ASEAN region, we see that the region’s financial markets are benefiting greatly from the joint financial market development initiatives put forward in the region, displaying rather high credit to GDP ratios close to industrialized countries’ levels. The downturn at the end of the 1990s is related to the Asian financial crisis in 1997. Average financial dollarization remains low in both the ASEAN and the CMA region, neglecting strong intra-regional differences however (see table \textit{C.9}). The MERCOSUR region displays the highest average levels of financial dollarization. Interestingly, MERCOSUR member countries also stay behind in terms of financial market development. The sharp decline of foreign currency deposits in 2000/2001 is related to the re-denomination of assets and liabilities in Argentina during the economic crisis. In general, we thus see lower average levels of domestic financial market development occurring together with higher average financial dollarization levels – this picture can also be found in theoretical and empirical dollarization studies.

\textbf{Figure C.10. Financial Market Development}  
\textbf{ASEAN (2000-2007)}
Further to this, I compare regional averages of the credit to GDP ratio in the three regions and their respective neighboring countries (see table C.11).

<table>
<thead>
<tr>
<th>Obs</th>
<th>Mean</th>
<th>Std.Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing countries and emerging markets in Africa, South East Asia, and Latin America</td>
<td>2911</td>
<td>.23667777</td>
<td>.2223164</td>
<td>.0001282</td>
</tr>
<tr>
<td>Sub-Saharan Africa &amp; North Africa</td>
<td>1336</td>
<td>.1580206</td>
<td>.1307789</td>
<td>.0001282</td>
</tr>
</tbody>
</table>

Source: Financial Sector Development Indicators, World Bank 2008; E. Levy-Yeyati\(^3\); blue line: private credit/GDP, red line: foreign currency deposits/total deposits.

Levy-Yeyati, supra note 10.
The strongest difference in financial market size can be found between Southern African countries and CMA member countries. The latter show credit to GDP ratios of about .24 on average compared to an average .13 ratio in its neighboring countries. The same holds true for the ASEAN member countries where credit to GDP ratio means a revenue on average almost twice as high as in other countries in South East Asia. In contrast to that, in the MERCOSUR region credit to GDP ratios are on average only about two-thirds of the size of Latin American countries’ financial markets.
D. Conclusions

Expectations about the merits of south-south regional monetary cooperation are on the rise, in particular in the developing world. The ongoing international financial crisis has fuelled the promising power of regional monetary cooperation even further. In this context, I explain the conditions under which these expectations could be met in two SSC in South East Asia (ASEAN), Southern Africa (CMA), and a case of non-cooperation in South America (MERCOSUR). I argue that regional monetary cooperation may indeed have a buffering effect against external monetary and trade shocks if it supports the development of local financial markets.

At the very least, the rather rough description of average data provided in this paper supports expectations associated with south-south regional monetary cooperation in terms of potential financial stabilization. However, more sophisticated empirical analysis is needed to investigate potentially underlying causal relationships between stabilized exchange rates and financial development. Out of the sketchy glance taken at the regions, I consider the following observations to be remarkable with regards to potential benefits of the SSC:

First, I find a tendency for countries in regional monetary cooperation projects to show larger average financial markets that are associated with lower average levels of financial dollarization. That is, in particular ASEAN/ASEAN+3 and partly also CMA countries are characterized by relatively large and developed financial markets, while MERCOSUR financial development remains far below these levels. While the latter show higher levels of financial dollarization, ASEAN/ASEAN+3 and CMA are low dollarized on average.

Second, exchange rates are more volatile in the MERCOSUR region than in South East Asia and in Southern Africa. ASEAN bilateral exchange rates fairly stabilized since a decade ago. This seems to be related to the so-called “informal dollar standard” in South East Asia, which is a common orientation towards the US dollar despite the absence of any formal intra-regional exchange rate arrangement. I find even more stable exchange rates in the CMA region, with frequent but temporary exchange rate adjustments that are coordinated, due to the fact that exchange rates are formally pegged to the South African Rand. This is the regional anchor currency and its Central Bank serves as a regional lender of last resort.

Third, intra-regional differences between member countries seem to matter for the process of regional monetary cooperation: In the CMA region, we find very strong intra-regional hierarchies, both in terms of sheer
economic size as well as in terms of financial market size. South Africa clearly dominates the region economically, monetarily and financially. CMA countries are among the least dollarized countries, and the smaller countries have access to a larger regional financial market dominated by South Africa. In the other regions, intra-regional hierarchies are less pronounced. While Singapore, Malaysia and Thailand stand out in financial and monetary terms in the ASEAN region, they do not stand out with substantial economic size – though not considering Japan or China. In the MERCOSUR region, Brazil stands out in terms of economic weight but falls short on financial stability and market size.

Comparing intra-regional constellations in the three regions shows that in order to take on a regional currency leadership role, a country not only needs to have a certain economic weight within the region in terms of sheer economic size. Rather, its distinct role emerges from lower financial dollarization levels, larger financial markets, higher foreign exchange holdings, and maintaining a certain degree of inflation and exchange rate stability.

Summing up, I argue that two major conditions are necessary for potential benefits of SSC to materialize: (a) The existence of a regional anchor currency that is in the position to take on a regional lender of last resort function, as in the case of the CMA. (b) Alternatively, regional financial market development initiatives, as pushed forward in the ASEAN region, contribute to financial development – in particular if a region lacks a straightforward regional anchor currency.

All in all, I see tangible indication of a stabilizing potential for regional monetary cooperation between developing countries and emerging markets if exchange rate variation between the member countries can be removed. I conclude that less volatile intra-regional exchange rates may indeed contribute to increasing capital flows that give rise to financial market development and diversification, including enhanced use of local currency denominated financial instruments. These potential benefits may not only outweigh traditionally considered costs of giving up independent monetary policy, but also increase regional financial stability.
Storming, Norming, Performing – Implications of the Financial Crisis in Southern Africa

Franziska Müller*

Table of Contents

Abstract ......................................................................................................................... 168
A. Introduction ............................................................................................................. 168
B. Liberalising Goods, Trading Norms – EU-Africa Trade Relations ......................................................... 171
C. Regional Context: Integration and Liberalisation Processes in the SADC Region ......................................................... 174
D. “Storming” – Economic Implications of the Financial Crisis ............................. 179
E. Norming and Performing? Trade Policies in Times of Crises ............................. 185
F. Conclusion ............................................................................................................. 188

* Franziska Müller, M.A.; TU Darmstadt, Department for Political Sciences.

doi: 10.3249/1868-1581-2-1-mueller
Abstract

Southern Africa seems to be a remote region. Far away from stock market crashes, bank runs and toxic assets, one might assume at first sight that the financial crisis would hit the developing and least developed countries less hard. Yet, reality tells a more ambivalent story, as Southern African states have been affected in different ways and have found specific ways of dealing with the consequences of the financial crisis. This article explores implications of the financial crisis on the Southern African Development Community (SADC), a supra-national community in Southern Africa, which has undergone massive liberalisation and restructuring processes during the last decade. Factors such as

- trade policy norms (liberal trade policies versus protectionist trade policies),
- economic diversification and integration (world market versus regional markets, namely South-South cooperation),
- political and regulative capacity (good governance versus weak governance)

shape the vulnerability, capability and performance of SADC states and allow for certain policy strategies – be it State Keynesianism, South-South cooperation, incrementalism or regional integration. The cases of South Africa, Angola and Botswana serve as examples for different forms of managing, regulating and interpreting the financial crisis and its consequences.

A. Introduction

Southern Africa seems to be a remote region. Far away from stock market crashes, bank runs and toxic assets, one might assume that the financial crisis would hit the developing and least developed countries less hard. In fact, the implications for Southern African states may be less noticeable, but by no means less direct. Onflow effects such as limitations on regulative capacity, decreasing governmental revenues, highly volatile prices for mineral and agricultural resources and declining foreign direct investment all pose threats for vulnerable developing countries. Acknowledging that trade policy paradigms such as classical trade liberalism or respectively protectionism have already been losing trust and compliance, this ‘normative vacuum’ in trade policies has been widened due to the financial crisis. Neither the protectionist trade policy paradigm of Lomé nor its liberalised version
negotiated in the policy process for Economic Partnership Agreements are able to offer a coherent response in the current situation. Thus, Southern African states find themselves choosing between the old recipes of trade liberalisation and world market integration on the one hand, and potential strategic alternatives such as South-South cooperation and regional integration on the other. For some states, intensified South-South cooperation allows for a re-interpretation of economic policy and gives way to alternative development paths in order to overcome the worst effects. At the same time, other states experience only limited policy space due to the path dependencies of classical North-South trade relations.

My paper focuses on the implications of the financial crisis on the Southern African Development Community (SADC), a supra-national community in Southern Africa, which has undergone massive liberalisation and restructuring processes during the last decade. In the course of policy processes hitherto, for instance during the negotiations for Economic Partnership Agreements with the European Union, the EU has acted as a “normative power”1 pushing forward market liberalisation and beyond-border measures. Following this impetus, nearly all SADC states have started to cut down tariffs and quotas, while some even began to liberalise capital movements, investment conditions and service sectors. Yet these paradigmatic policy changes towards market liberalism have been contested in the SADC region. Market-opening policies eventually found the consensus of most SADC states, following a long period of lobbying and policy pressure imposed by the EU’s Directorate-General for Trade. Although any beyond-border policies were adamantly refused by SADC, on an individual basis, some policy transfer towards this kind of “deep trade integration”2 has taken place. However, this economic transition is still in the implementation stage. Thus, in the current situation the financial crisis not only has a severe economic impact on the SADC region, but also influences policy-making on the discursive and normative level. The cases of SADC states such as South Africa, Angola and Botswana can serve as examples for different forms of managing, regulating and interpreting the financial crisis and its consequences. Factors such as

- normative aspects (liberal trade policies versus protectionist trade policies),

2 R.Z. Lawrence, Regionalism, Multilateralism and Deeper Integration (1996), 10-20.
- economic diversification and integration (world market versus regional markets, namely South-South cooperation),
- political and regulative capacity (good governance versus weak governance)
- shape the vulnerability, capability and performance of SADC states dealing with the crisis and allow for certain policy strategies – be it State Keynesianism, South-South cooperation, incrementalism or regional integration.

In the next sections, my aim is to give an overview of the implications the financial crisis has had for South Africa, Botswana and Angola. This is followed by an analysis of the policies these states chose as a response to the financial crisis, and by a look at the activities happening on the regional level. Theoretically, my paper is situated in the field of International Relations and Public Policy Analysis and uses elements of argumentative discourse analysis in order to identify relevant trade policy discourses, their structures and the discourse coalitions that represent and articulate them. Drawing on policy analysis theorist John W. Kingdon, I take the financial crisis as a “policy window” that allows for rapid policy changes amidst an otherwise incremental policy development process – at least if “policy entrepreneurs” use the window in order to push forward their agenda and their specific policies. Earlier policy windows had paved the way for certain transfers of liberal norms and ideas from the EU to the ACP states – processes in which the EU played the role of a “policy entrepreneur”, using normative power in order to liberalise external trade and export certain liberal, social and environmental norms. Certain policy narratives and storylines, such as ‘world market integration’ or full reciprocity’ have gained relevance since the end of the Lomé era. They now offer distinctive interpretations of trade relations, and are increasingly shared by the different European and Southern African members of the discourse coalitions that shape the EU-ACP / EU-Africa relations. At the same time, the so-called ‘Spirit of Lomé’ and its ideas of non-reciprocity, non-alignment, protectionism and stable terms of trade has lost its meaning and can no longer serve as a discursive bridge within North-South relations. These political and discursive transfers have until now been only partly successful and have led to a

5 Id., 179-183.
patchwork of policies that lacks coherence. Yet, the current state of crisis has created a ‘normative vacuum’ that remains to be filled. The question that is still open is which norms, ideas and concrete policies will be the ones that prove to offer strategic alternatives in times of crisis.

B. Liberalising Goods, Trading Norms – EU-Africa Trade Relations

Many Southern African states underwent a massive economic transformation during the 1990s. Following the end of the Cold War and its geostrategic shifts, the European Union’s search for a new role in its foreign policies made way for a thorough reform of the relations between the EU and its former colonies in Africa, the Caribbean and the Pacific islands. Both the European Union and rising powers such as the BRIC states changed their geostrategic interests with a focus on agrarian and mineral resources from Sub-Saharan Africa. Yet up until now, duty obligations, import quotas and limited freedom of establishment formed hindrances for foreign investors. A shift took place from trade protectionism, which had been the dominant policy paradigm in the era of the Lomé and Yaoundé Conventions between 1963 and 1998, towards market liberalism, but only in the form of incremental policy changes. The search for a new trade policy paradigm between the EU and the ACP countries (later with a specific focus on Southern African countries) started with the Mid-Term Evaluation of Lomé IV in 1995. The results gave credence to the assumption that the protectionist trade policies had neither been successful in integrating the ACP states into the world economy, nor in creating a stimulating environment for regional integration. Furthermore, the results of the Uruguay Round and

6 The Acronym ‘BRIC’ stands for the four ‘rising powers’ Brazil, Russia, India and China. It was first introduced in 2001 in an analysis of the consulting agency Goldman Sachs, which focused on changes in international and external trade relations.


9 Lome IV, supra note 7.

the establishment of the WTO also allowed for a more critical look at trade protectionism. Here, the articles 1 and 24 of the General Agreement on Tariffs and Trade (GATT)\(^\text{11}\) form the basis for liberal trade policies. Specifically, the GATT states that any preferences given by WTO members to others must either be non-discriminatory (Art. I) or fully comprehensive and reciprocal in order to qualify as a customs union or free trade area (GATT Art. XXIV). Following changes in firm preferences towards an aggressive export orientation in the 1980s, an “embrace of liberal ideas”, especially at the Directorate-General for Trade, has emerged in the mid-1990s.\(^\text{12}\) It led to the adoption of the Cotonou Agreement\(^\text{13}\) in 2000. Being an agreement full of ambiguities, Cotonou functions as a discursive bridge between the former ‘Spirit of Lomé’ and the yet-to-be-realized Economic Partnership Agreements. As it focuses both on liberal trade policies, especially on the idea of reciprocal liberalisation, and on developmental and social issues, it bridges the gap between the consistent aspects of those ideas and seeks to achieve a compromise between the different bundles of liberal, social and developmental norms. First of all, the Cotonou Agreement extends the classical aims of liberal trade policy ideology to ACP-EU relations. The preamble speaks of a “smooth and gradual integration into the world market economy”\(^\text{14}\) and thus strives for a non-reciprocal trade agreement compatible with GATT Art. XXIV. Second, the concept of “deep trade integration”\(^\text{15}\) for the first time is embedded into a framework agreement with developing countries. This concept goes ‘deeper’ than classical trade liberalisation does, as it espouses trade policies that do not aim just at trade distorting measures occurring at the border, such as tariffs, taxes and quotas, but places emphasis on harmonising trade issues ‘beyond borders’, such as the liberalisation of services, investment conditions, public procurement and the establish-

---

13. Partnership Agreement Between the Members of the African, Caribbean And Pacific Group of States of the one Part, And The European Community And Its Member States, of the other Part, 23 June 2000, OJ L317/3 [Cotonou Agreement].
14. Id., Art. 34.
15. R. Z. Lawrence, supra note 2, 10-20.
Implications of the Financial Crisis in Southern Africa.

ment of strict intellectual property rights. As all of these measures influence the national sovereignty of states and the freedom to define one’s own trade policy agenda, the so-called ‘beyond-border issues’ have not found their way on the WTO agenda, due to strong opposition by developing countries. Thus, they have been re-introduced in bilateral negotiations for free trade treaties. Third, Cotonou also focuses on environmental and social issues such as labour standards, consumer policies and environmental issues.

Technically speaking, Cotonou paved the way for the still-ongoing negotiation process for Economic Partnership Agreements (EPAs) between the EU and the ACP States. These agreements aim at creating another trade regime that allows for more coherence between trade and developmental policies – hence resulting in a ‘mainstreaming’ of market liberal norms and ideas. Here, the shift towards reciprocal and progressive liberalisation and the “smooth and gradual integration into the world economy” became clearer. The mandate of the EU Commission for the EPA negotiations reveals a concretisation of the diffuse “cocktail of ideas and interests” that characterised Cotonou. The EPA agenda confirms the classical liberal aim to foster the smooth and gradual integration of ACP States into the world economy and takes regional integration as a key instrument for the integration of ACP countries into the world economy. At the same time, it indicates that from a European perspective, compatibility with WTO standards as such is not sufficient. In fact, the free trade agreement with the ACP states is anticipated to go beyond WTO provisions, as the concept of progressive and reciprocal liberalisation had been carefully chosen in order not only to underline compliance with WTO rules as a minimum, but also to reaffirm the intrinsic dynamics of liberalisation. Also in the EPA negotiations, the ‘deep integration agenda’ was made more concrete, but remained contested, especially among African ACP states. Due to their objections, only interim free trade agreements with a number of African states including most SADC states were initialled between December 2007 and June 2008. They now pave the way for the irrevocable abolition of

---

16 Cotonou Agreement, supra note 13.
tariffs and quotas, and also contain tight schedules for the opening of service sectors, investment conditions and capital movements. Regarding the normative and discursive dimension, they function as the concrete result of a partly successful normative transfer. Following a 15-year process of political communication and policy entrepreneurship, the market liberal norms of ‘full reciprocity’ and ‘smooth and gradual world market integration’ have been finally transferred into the political agendas of several ACP states, but are yet to be implemented into concrete policies.

C. Regional Context: Integration and Liberalisation

Processes in the SADC Region

These shifts in economic and foreign policy interests, and the associated processes of trade liberalisation in Sub-Sahara Africa and especially in the SADC region altogether, influence the political positioning and vulnerability of SADC states in the current situation of financial crisis. These developments can best be explored by taking a closer look at the SADC region. SADC is a regional supranational community that was established in 1992, in order to strive for closer regional and political integration in Southern Africa. It encompasses both developing countries such as South Africa, Namibia, Botswana and Mauritius, and some of the world’s poorest countries, e.g. Tanzania or Malawi. States like Angola are extremely export-dependent, while others such as South Africa have a highly diversified economy. Some SADC countries like South Africa, Botswana or Mauritius have been stable democracies for the last 15 years, whereas the Democratic Republic of Congo and Zimbabwe can be labelled as ‘failing states’. These regional disparities, together with high differences in wages, education, health, prosperity and political stability, mean that conflicts between economic and developmental policies affect the way and pace of integrating national policies.

Despite these diversities, SADC has always put strong emphasis on regional integration, yet from a quite functionalist and abstract perspective, which was often limited to mere lip service. In the SADC charter the member states commit themselves to equal treatment, support of freedom and security, promotion of universal human rights and democracy. The main

---

19 Member states are: Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.
objective of the cooperation lies in the establishment of liberal democracies and a single market, although this transformation should bear more policy space and domestic regulative capacities than the typical structural adjustment programmes or WTO obligations had intended. While cooperation focused mainly on infrastructural issues during SADC’s early years, trade and financial policies as well as security issues have been the subject of intense debate during the last couple of years, and have resulted in a number of treaties with a set of shared norms and ideas. In the field of trade policies, the SADC states agreed on the implementation of two far-reaching development plans: the Regional Indicative Strategic Development Plan aims at the creation of a customs union and a single currency by 2018. Tariffs should be abolished for 85% of internally traded goods by 2010. A free trade area has been proclaimed in 2010; an extension to the East African regional communities, East African Community (EAC) and Common Market for Eastern and Southern Africa (COMESA), is underway. Another common initiative encompasses finance and investment policies. The SADC Protocol on Finance and Investment came into force in August 2006. Its objective is to enhance the attractiveness of the region for foreign investors through further liberalisation and deregulation. Therefore a number of measures have been scheduled:

- anti-corruption strategies
- deregulation of capital movements
- banking supervision in the SADC region
- harmonisation of financial and monetary policies
- centralised coordination of taxation
- common investment policies on the supra-national level.

At this point, the implementation of this protocol is not yet completed. A coordinated collaboration exists only in the field of banking supervision, where the SADC Subcommittee of Bank Supervisors serves as a common supranational institution. In general terms, commitment for regional integration and common trade and financial policies in SADC has grown, but concrete outcomes are still low. Openness to regional integration has increased, but the pace and extent are still controversial issues. The diversity of the region, for example regarding conflicts between import-oriented and export-oriented countries, limits the possibility of compromise.

In the field of external trade policies, SADC countries have acted in even more diverse and ambiguous ways, reflecting the still-weak integration, and leading to higher vulnerability of the region as a whole. The his-
History of bilateral negotiations with the EU evidences a destabilisation in shared interests, norms and ideas during the last couple of years. For the EU, SADC is of particular strategic and economic interest. Following the Lomé era, the EU’s search for a new external identity that reflects the EU’s global role and “normative power” resulted in stronger offensive and defensive economic and strategic interests for this region. This encompasses resources such as copper, gold, platinum, uranium and coltan, but increasingly also the service sector, such as financial and telecommunications industries as well as biofuels. At the same time, the EU – especially the Directorate-General for Agriculture and Rural Development, or DG Agri – holds a protectionist agenda, due to highly competitive agricultural goods such as sugar, wine, beef, fruits and vegetables exported by the SADC. This increased interest is visible not only in the field of changing trade policies, but also regarding concrete monetary flows. Foreign Direct Investment (FDI) in the SADC region had been constant between 1995 and 2000, but has been continuously rising since then. In the years 2007 and 2008 FDI flows were higher than the annual official development aid flows. SADC states such as South Africa, Botswana, Namibia, Mauritius and Angola have increasingly been regarded as attractive targets for foreign investment. Explaining factors for this trend are the growing political stability (e.g. the independence of Namibia and Botswana, the end of Apartheid, the end of the civil wars in Angola and Mozambique), the establishment of regional facilities for investment support between EU and SADC and the ongoing processes of liberalisation and deregulation in the region. New discoveries of mineral

---

20 I. Manners, supra note 1, 238-244.
resources, for example in Botswana and Angola, are another influential factor. All these developments result in intense political pressure by the EU in order to achieve fast policy change, a trend that became visible during the EPA negotiations. Yet the SADC as a community has always remained critical towards a fast-paced liberalisation schedule. The negotiation agenda of the SADC in the EPA negotiations provides a good example, as it reveals that there are only a few areas of consensus on trade policies, and that the normative gap between the EU and SADC is difficult to overcome. Regarding the classical goals of liberalisation, the negotiation framework still allows for some common ground, as the idea of reciprocal liberalisation is shared by both actors. SADC declared their openness for liberalisation, but during a longer period of time than the EU, and with a schedule based on a weaker interpretation of the “substantially all trade” phrase in GATT Art. XXIV.24 Regarding the ‘new generation issues’, SADC officials state that they should not be part of a free trade agreement, but should be subject to non-binding cooperative arrangements in order to allow time for building institutional capacity at national level, and should find a political consensus on the supra-national level later. Thus, no agreement on the supranational level could be signed. In autumn 2008, after five years of negotiations, SADC had been divided into several smaller groups of states, each one with a separate liberalisation schedule, and each one separated from the other parties’ commitments and capacities. The different bilateral interim agreements with states such as Botswana, Swaziland, Lesotho, Namibia and Mosambique, the ‘walk-out’ of South Africa,25 and the preference of alternative trade regimes with fewer obligations such as Everything but Arms by Angola and Sambia all reflect painstakingly, that trade policy norms and trade policy paradigms are no longer shared by the region as a whole. Instead, some SADC member states have already included some ‘deep integration’ issues into their trade policy agendas, and liberalised on an individual basis, based on their individual economic interests, and


24 From SADC’s perspective, referring to the Trade Development and Cooperation Agreement this would cover only 86% of all imports, whereas the EU mandate takes 90% as a minimum.

25 South Africa had been taking part in the EPA negotiations since 2004 with the intention to be part of an EPA in order to strengthen regional integration. After no consensus with the EU regarding the ‘deep integration’ agenda and some tight liberalisation schedules could be reached, they decided to walk out of the negotiations and only remain as an observer. This move led to a severe loss of negotiation capacity.
sometimes with extremely tight schedules, resulting in massive losses of governmental revenues due to the sudden loss of import taxes. In terms of governance, this means that policy-making in the field of external trade policies has become an issue that is dealt with individually and mainly on a national level. Today, in the field of external trade policies, a variety of ‘policy paths’ can be found, which differ significantly in terms of market opening, trade policy norms, role of the state and policy instruments. In times of crisis, this lack of supranational regulative and governmental capacity adds to the already extant economic vulnerabilities, as the three cases of Botswana, South Africa and Angola will show.

Botswana represents moderate and selective external trade policies. While Botswana’s industries are extremely export-oriented, the opening of markets for foreign investors is happening only slowly and only in the field of certain key industries, such as diamonds, gold, copper and some tourism sectors. Under the presidency of Festus Mogae, the abolition of capital controls in 1999 led to a gradual opening of financial markets, but the interest of foreign investors in the local currency (Pula) remained low most of the time. FDI flows only rose in the last years. Both FDI flows from the European Union (approximately US$400 million in 2007) and intra-African FDI flows (approximately US$300 million in 2007) have reached a significant level and seem to back the ongoing regional integration of the country. At the same time, the presence of the public sector in key industries has remained important. Here a number of joint ventures between state-owned mines and foreign investors, e.g. the diamond company DeBeers, have taken place. Access to branches such as retail, the building sector or food processing, where the presence of numerous small and medium-sized enterprises creates a diversified business environment, has been denied to foreign investors. In the current situation this selective liberalisation strategy has its merits, while its outcomes are limited by marginal political capacities and possibilities for governmental intervention.

South Africa has gradually moved away from this policy path. A move towards market liberal and diversified trade policies was made already under the Mandela presidency. Despite unemployment rates rising to 30%, the political objectives of a low inflation rate and a budgetary deficit of less than 3% have been retained unchanged. The implementation of the

Implications of the Financial Crisis in Southern Africa.

Basel-II guidelines has also been part of this liberal strategy. Since 2000 South Africa has been regarded as an attractive ‘emerging market’ for business and private investors alike, and FDI flows to the banking and automotive sector have grown continuously. At the same time, South Africa is very proactive in various areas of South-South cooperation, for instance in the IBSA Forum with India and Brazil, in cooperations with the states of the common market Mercado Común del Sur (Mercosur) and in a number of resource transfer agreements with Venezuela and Russia. Thus it is one of the few SADC states which has truly diversified its external trade relations.

In contrast to these policy paths, Angola keeps an agenda of radical liberalisation and export orientation. While 27 years of civil war had isolated the country almost completely, Angola strives since 2002 to get access to world’s resource markets. Import duties had been cut and now average 15%, which is a relatively low rate for a Sub-Saharan country. Extreme concentration on oil and diamonds results in serious dependency on the two main importers, USA and China. Annual growth rates of approximately 20% were achieved due to the exploitation of these resources. Due to this strong concentration on resource exports, Angola is a classical example for the “Dutch disease”, which means in the present case that the domestic sectors, such as the agricultural sector, suffer from lack of investment and weak governmental capacity.

D. “Storming” – Economic Implications of the Financial Crisis

The financial crisis affected the SADC region in at least four ways. In the finance sectors, the subprime effects were of less significance than in the global North; because most SADC states are not intensively involved in global monetary flows, the ‘contagion’ was of limited extent. The less complex financial architecture of SADC states proved to be an advantage in the current situation. In contrast to business conduct in the European and Northern America banking sectors, bundling of assets is rarely practised in South-

ern Africa. However, in a number of areas, such as overseas investments in pension funds, public and private budgets in SADC states have come under threat. Additionally, stock markets were hit as in any other place of the world. Another effect in the financial sector was the decline of FDI flows, as investments were cancelled or postponed. For Southern Africa as a whole, FDI has declined by 36% in 2009.\(^\text{29}\) This might lead to credit crunches in the SADC region too, and will further limit investments. Yet the most severe effects were clearly experienced in the field of resources. While the resource boom of the last few years contributed to rises in the gross domestic products of some emerging markets, in the middle of September 2008 mineral and agrarian resources were the first sectors to be targeted. After prices for mineral resources such as copper, platinum or nickel had reached an all-time high during the first two quarters of 2008, prices now became highly volatile, and between September and November 2008 they fell to only a third or quarter of their primary values.\(^\text{30}\) Gold prices were less affected, but they also lost about a quarter of their value.\(^\text{31}\)

---


Implications of the Financial Crisis in Southern Africa.


Source: Cairns, 2008


Two other monetary flows have been affected by the financial crisis, but are of lesser importance for SADC than for other African regions. According to the World Bank’s Migration and Remittances Team, remittances of migrant workers are expected to fall by 5 - 8% from 2008 to 2009. Yet, the SADC area is not hit as much as some remittance-dependent regions, such as West African countries like Senegal or Guinea-Bissau, where remittances contribute to the gross domestic product at a rate of 15 to 25% of all export earnings. Another financial resource, Official Development Aid (ODA) has contributed significantly to the gross domestic product of some aid-dependent SADC economies such as Angola and Malawi. At the moment it is still not possible to estimate to what extent the financial crisis will result in a reduction of ODA. Yet, as many countries calculate their ODA budgets as a percentage of their annual GDP a decline is plausible.

In South Africa the mining industry was especially affected, for instance gold and platinum extraction, steel production and automotive industries. According to estimations of the National Union of Mineworkers, between 20000 and 50000 jobs of a total 300000 were at risk. In the automotive industry a decline in sales of about 25% was recorded. This decline also affected the demand for platinum used in catalytic converters, which meant that prospected exploitations of further platinum deposits in 2009 and 2010 had to be postponed or were cancelled completely. In the finance sector, ABSA, the country’s largest bank was directly affected by the banking crisis, as the British Barclays Bank holds 58% of the shares. In February 2009, the rating agency Moodys downgraded ABSA’s credibility due to the unsta-


The financial crisis has had significant implications in Southern Africa. While most smaller South African banks have not been hit as hard, as capital controls hindered them from investing in complex assets, yet FDI flows have been a target of financial crisis. In 2008, capital outflows rose to 5.7 billion Rand, and FDI inflows fell from 22.4 billion Rand in the third quarter to only 3.3 billion Rand in the fourth quarter of 2008. Another crisis-related effect has received little attention outside of South Africa: Similar to countries such as the US, Britain or Spain, private investment and public building projects led to a rapidly increasing real estate appraisal, eventually resulting in a housing bubble. While real estate prices reached their maximum in 2004, the financial crisis led to a rapid decrease. From 2007 to 2008, houses lost about 15% of their earlier value, while at the same time mortgage dept rose.

In Botswana, trade in diamonds, of which Botswana is the world’s largest exporter, came under threat. Diamonds contribute about 70% of Botswana’s total exports; the European Union is the largest importer, representing about 65% of all sales. After exports declined by 20% in autumn 2008, mining company Debswana, a joint venture between the state of Botswana and DeBeers, decided to close all mines for the first two quarters of 2009. Hence, DeBeers depended on loans from its shareholders in the amount of US$500 million. The subsequent slump in economic activity (from 5% growth in 2007 to 3.3% growth in 2008) can be traced back to this decline in resource extraction.

---

consequences will become more visible in 2009 and 2010. Decline in productivity of state-owned companies will affect public revenues. Thus, the GDP has decreased by 7% from 2008 to 2009.\textsuperscript{43} However, due to extreme volatility, a higher demand in diamonds led to the resumption of production.\textsuperscript{44} In the financial sector, one of the most serious consequences is that pensions of employees are now at risk. Pension funds were allowed to invest up to 70% of their assets in foreign bonds. Those pension funds now have to face a loss of about US$300 million due to risky investments in European and US private equity funds.\textsuperscript{45}

Angola’s resource markets are much more severely affected than those in Botswana and South Africa. The OECD’s Africa Economic Outlook predicts a negative economic growth of 7%.\textsuperscript{46} The extreme concentration on oil and diamonds had already resulted in high external trade surpluses, high volatility of currency and neglect of investment in domestic trade sectors. In autumn 2008 the price for Angolan crude oil fell from US$98 to US$55 per barrel. Nevertheless, oil production was increased even more in order to keep public revenues stable. Even so, the rapid fall of prices led to deficits in public budgets. Direct consequences in the financial sector did not occur, due to its peripheral status and a still ‘post-colonial’ finance architecture. At present there exists no stock exchange, and foreign relations have only been maintained with Portuguese banks. This might have the dramatic consequence of leading to the cancellation of oil field development, which would directly affect public budgets.


\textsuperscript{44} Mining Journal, \textit{supra} note 39.


\textsuperscript{46} OECD, \textit{African Economic Outlook} 2009 (2009), 49.
E. Norming and Performing? Trade Policies in Times of Crises

The financial crisis has impacted the SADC in a period characterised by weakened regional integration and still-fragile world market integration. Middle-income developing countries have been hit especially hard, due to their more intense relationship with global markets. In many cases, crisis management on a national level poses difficulties, due to a lack of financial and political room for manoeuvre. Thus, each state faces difficult choices in order to conceptualize trade and developmental policies for overcoming the crisis. Adding to this difficulty, changes in trade policies over the past fifteen years fail to offer political solutions for the current situation. Most SADC states have committed themselves to a fast reciprocal market opening, and are now in the middle of implementing tight liberalisation schedules, which will result in revenue losses especially between 2009 and 2012 due to the abolition of import duties. This will further limit governmental capacities regarding counter-cyclical measures such as fiscal stimuli and deficit spending. Crisis-related decreases of FDI and export earnings will add to these revenue losses. Meanwhile, bilateral trade negotiations are still deadlocked, and the negotiation capacity available here is missing in other political arenas, especially regarding strategic alternatives such as regional integration and South-South cooperation. Thus, SADC states find themselves in a ‘normative vacuum’. Neither liberal nor earlier protectionist policies seem to offer a coherent set of norms, values or ideas that can help to overcome the financial crisis. Normative transfers have only partly been successful, as only some liberal norms have been incorporated into political agendas, but have not yet found their way into concrete and coherent policies. At the same time regional integration has been thwarted, and the old set of pan-African norms that worked as a belief system shared by the SADC members is also difficult to reinstate. Thus, the current situation opens up debates and discourses on trade and developmental paradigms. Modernised concepts of South-South cooperation might offer an alternative set of trade and development policy norms. Yet whether financial crisis will

be used as a policy window for change depends on the presence of potential policy entrepreneurs who promote such concepts.

Until now, ways out of the crisis have been sought by states on an individual basis. At least partly path-dependent, our three cases have been following piece-meal approaches situated between economic stimulus packages, Keynesianism, market radicalism and South-South cooperation. South Africa, being the state with the most diversified external trade relations, seeks to foster South-South cooperation with India and Brazil and with Mercosur states. Domestically, an economic stimulus package (the “Framework for South Africa’s Response to the international financial crisis” issued by the Department of Trade and Industry in February 2009) worth 800 billion Rand aims to tackle unemployment in the construction and transport sector. This plan is mainly focused on job creation, but puts little emphasis on social policies and fails to address external trade relations and international financial governance.

Botswana keeps to Keynesianist strategies. Public deficit spending and the use of public financial reserves should fund the operating costs of the mining industry and prevent redundancies. Yet in contrast to earlier governmental statements, Botswana was not able to support the resource sector on its own. The state had to apply for a loan at the African Development Bank in order to balance its budgetary deficits. The loan, in the amount of US$1.5 billion, is the highest the bank had ever approved, and will result in accrued liabilities running for 15 years.

In Angola, instead of counter-cyclical measures, the radical market liberal course was fostered to an even greater extent in order to enable the state to stay solvent in spite of price deterioration. However, South-South cooperation is gaining relevance in Angola as well, as revealed in an OECD report on the Brazilian oil company Petrobras who plans to invest US$800 million in Angola from 2009 to 2013.

Speaking of ‘performing’, it is still too early to interpret these political reactions as signs of successful regulation or further destabilization. However, a striking aspect is that all of them remain limited to the level of individual policy-making, whereas regional answers to the financial crisis from official sides are almost completely absent. SADC officials’ statements have failed to address the effects of the financial crisis on the SADC region as a whole. A regional answer will be necessary to deal with effects that impact the whole region, such as falling commodity prices, unemployment and related migration flows. But the political will to foster regional integration has been thwarted in the last years, as the EPA negotiations resulted in individualised trade policy-making. States that share a common border now belong
to three different external trade regimes (the Interim Economic Partnership Agreement between EU and SADC, Everything but Arms, and the Trade and Development Cooperation Agreement between South Africa and the EU (TDCA) while some of them are also members of a local customs union, the Southern African Customs Union (SACU). Therefore they are all subject to different conditions when it comes to export and import regulations, relations with trade partners or the collection of common external tariffs. These points need to be solved juridically in the years to come, but they already bear a strong political dimension, as they lead to differing trade strategies and thus pose severe difficulties for the development of common policies at the SADC level. In times of crisis this makes regional responses and supranational policies difficult.

Nevertheless, since spring 2009 an alternative discourse with a more optimistic interpretation of the crisis has gained some relevance, as revealed by media analysis of South African and Botswanan newspapers between autumn 2008 and summer 2009. While at first, media coverage adopted a distant stance and portrayed the crisis as something happening in the remote global North, in winter and spring greater emphasis was placed on the social consequences of the crisis for the SADC region. Following this period, some change in the media discourse has now become visible. Increasingly the crisis is presented as a chance to change external relations, for instance to advance the consolidation of cooperation between SADC states and China. Here, attention is directed to institutions such as the African Development Bank. Unlike the SADC, this bank might play the role of an actor in favour of a policy change free from ideological quarrels. A closer look at the African Development Bank supports this possibility. Founded in 1964, the bank was for most of the time a financial actor of minor relevance, but of high moral credibility, being an African actor and thus significantly differing from both the World Bank / International Monetary Fund and Southern, ideologically-driven donors such as the OPEC Fund for International Development. Since 2005 the bank’s budget has expanded considerably, to

about a quarter of the World Bank’s budget. Recently the bank developed a set of instruments that exceed its normal loan scheme, encompassing for instance the ‘Emergency Liquidity Facility’, an emergency program worth US$1.5 billion targeted at the needs of middle income countries, the Trade Finance Initiative, worth US$500 million, used for the support of banks and a ‘fast track’ that allows easier access to credit. As one of the very few Southern actors of its kind, the bank interprets the financial crisis as a “social development crisis”, and has openly criticised SADC states for the short-sightedness of their crisis management and its lack of mid- and long-term policies and counter-cyclical action. Increasingly, the African Development Bank plays the role of an emerging donor that is politically active in institutions in the global financial and developmental sphere, such as the New Partnership for African Development and the G-20 initiatives. Thus it might have the ability to shape discourses and exert the role of a “policy entrepreneur” that actively campaigns for changes in global financial governance, including reforms of the IMF’s decision-making structures.

F. Conclusion

One year after the financial crisis, the SADC region resembles a policy patchwork. States belong to different trade regimes and thus have little interest in a search for common solutions that go beyond lobbying institutions such as the G-20. Speaking of ‘performing’, there is quite some reason to hope that countries such as South Africa and Botswana will be able to deal with the economic and social consequences in an adequate and sustainable manner. Still, the prospects for a regional answer to the crisis are low, as the limited governmental capacities and scarce crisis reactions of SADC show. The financial crisis adds to the already partially thwarted commitment for regional integration. However, there are some signs for alternative ways of crisis management. The crisis can be regarded as a policy window that might allow for fast policy shifts, whereas in the years before, trade policy-making in SADC was subject to incremental and often stalled policy processes. However, this only happens if policy entrepreneurs or normative entrepreneurs make productive use of this policy window in order to ask for alternative regimes of global and regional financial governance. Until now, SADC states seemed to miss this opportunity, as no intensified activities in

49 African Development Bank, supra note 42, 6.
50 J. W. Kingdon, supra note 4.
the field of South-South cooperation, regional integration, or institutions of global financial governance have been visible. Yet the emergence of new supra-national institutions, such as the African Development Bank, that actively exert their political role in international financial institutions might act as a signal for change in regional trade governance. But policy windows stay open only for a short period of time. 2010 will show whether the ‘normative vacuum’ will eventually be filled with ideas, norms and discourses on trade and financial governance from an African perspective.
Who Guards the Guardians: Legal Implications for the Operation of International Financial Institutions in Times of Financial Crisis

Jakob Wurm*

Table of Contents

Abstract .............................................................................................................................. 192
A. Introduction .............................................................................................................. 193
B. Basic Parameters for the Operation of IFIs .............................................................. 195
C. Measures Directed Against IFI Member States to Redress the Impact of the Financial Crisis............................................................................................................. 201
D. Measures Directed Against IFIs to Redress the Impact of the Financial Crisis................................................................................................................................. 210
E. Conclusion.................................................................................................................. 216

* Project assistant at the Department of European, International and Comparative Law at the Law School of the University of Vienna, Austria.

doi: 10.3249/1868-1581-2-1-wurm
Abstract

The impact of the current global financial crisis gravely affects not only states but also International Financial Institutions (IFIs). They are international organizations addressing financial and monetary issues such as development banks or monetary institutions and typically engage in lending operations with states or regulate their monetary policies. This contribution seeks to undertake a legal analysis of available responses for IFIs to increased insolvencies of their “typical clients” from a law of international organizations perspective.

Obviously, an IFI can be exposed to the risk of dissipation of assets as a creditor, or as a debtor when it is unable to fulfil its own financial obligations. Conceivable legal responses can take the form of either purely internal character or are “external” and thus involve third parties.

Internal measures are notably budgetary decisions in reaction to financial shortcomings. The typical handling of budgetary problems by “standard” IOs applies only partially to IFIs as they typically have more extensive capital demands. These clearly cannot be satisfied by membership contributions and thus expose IFIs to volatility risks on the financial market. Accordingly, in order to remedy the crisis-induced loss of all forms of “capital claims” of IFIs, standard mechanisms for ensuring compliance with membership payments will be imperfect. In addition, in exceptional cases, Member States can successfully invoke the turmoil of international financial markets to justify the non-performance of their membership obligations.

Any measure of external scope will have to respect immunity considerations according to which the operation of an IFI may not be impeded, such as by increasing its burdens, either financially or by national law. Consequently, resources of IFIs have „international character“ and are in principle protected by immunity. Nonetheless, specifically the arguments of the UK House of Lords In re International Tin Council (22 January 1987, 77 ILR (1988)) support the view that IFIs can indeed be declared insolvent and that their assets can be subjected to liquidation according to national bankruptcy laws. Situations of financial stress certainly do not mitigate this tension.
A. Introduction

It is challenging to give a precise definition of International Financial Institutions (IFIs) as this notion is used with considerable variation depending on the circumstances even in the UN context. In this contribution, the term IFI refers to international organizations that are “international” since they are typically created by a treaty and usually operate on the global level to the benefit of more than one state and that are “financial” due to their mandate, which defines their activity as in particular aiming at lending operations with states or at undertaking regulative measures impacting on state’s monetary policies. IFIs are thus characterized by their specific objectives that concern financial and monetary as well as developmental issues. Even though it is correct to broadly speak of IFIs as development banks and monetary funds, there are considerable differences with regard to essential issues such as the exact focus of their activities, purpose or membership.

---


2 The already difficult undertaking to define IFIs is further complicated by the fact that in the field of international institutional law, no generally accepted definition of “international organizations” exists. Regularly, international organizations are referred to as legal entities of a certain permanency and vested with a minimum of organs resulting from the will of States as formulated in an instrument binding under international law. See on the attempt to conclusively define the constituent elements of international organizations: A. Reinisch, International Organizations Before National Courts (2000) 5; R. Bindschedler, International Organizations, General Aspects, II EPIL 1289 (2nd ed., 1995) (“The term international organizations denotes an association of States established by and based upon a treaty, which pursues common aims and which has its own special organs to fulfil particular functions within the organization.”); Restatement (Third) of the Foreign Relations Law (1986), § 221 (“‘international organization’ means an organization that is created by an international agreement and has a membership consisting entirely or principally of states.”); ILA Committee on Accountability of International Organisations, Final Report 2004, Report of the 71st Conference Berlin 4 (2004) (“‘intergovernmental organisations in the traditional sense, i.e. created under international law by an international agreement amongst States, possessing a constitution and organs separate from its member states.’”).

3 For instance, some IFIs operate on the regional or sub-regional level, such as the four Regional Development Banks; namely the 1959 established Inter-American Develop-
Particularly in view of their quasi-universal membership and their impact on the global level, the *International Bank for Reconstruction and Development* (IBRD) – member of the five legal entities constituting the World Bank Group⁶ – and the *International Monetary Fund* (IMF)⁷ are the prototypes of IFIs that can be described as “guardians” of the international financial structure since they are having a considerable impact on their member states and how they deal with debt crises. Their operation therefore is in the main focus of this contribution which seeks to look into the specific elements of the legal, i.e. international law, framework in which IFIs operate in times of financial crisis.⁸

Finally, for the present purposes, the term “financial crisis” is understood broadly as an economic condition in which member states of an IFI have reached an unstable phase that is likely to result in an undesirable outcome unless quickly resolved.⁹ In particular, times of financial crises are situations when IFIs are faced with insolvencies of their typical “clients”, i.e. states, due to their inability to pay or when they are otherwise unable to comply with their financial obligations. In this situation, the ancient ques-
tion of “*quis custodiet ipsos custodes*”?\(^{10}\) is used as a guiding interrogative pattern to generally ask for the kind of legal rules that form the normative framework for the conduct of IFI in times of financial distress.\(^{11}\)

From the perspective of the IFI, different types of measures can in principle be conceived as a reaction to the financial crisis. First, they can have purely “internal” character, i.e. taken by the IFI vis-à-vis their own member states with the aim of inducing the state to comply with their financial obligation in relation to the IFI (Part B.). Second, any measure concerning an IFI which does not only relate to member states, but either involves third parties or even addresses the IFI itself, such as for instance when domestic bankruptcy proceedings are instituted against it, are referred to as measures of “external scope” and will be described in (Part C.). These will provide evidence that legal rules applicable to the “guardians” in the broader international law context might equally result in subjecting them to particular domestic proceedings. Before discussing the alternatives in detail, a brief look on the general elements of the legal framework in which IFIs operate is merited.

**B. Basic Parameters for the Operation of IFIs**

For the purpose of analysing legal rules shaping the *modus operandi* of IFIs, the principal point of reference is their constituent documents, i.e. treaties establishing the IFI in question. In the majority of cases, the “Articles of Agreement” contain important parameters for the operation of IFIs as they in particular define their objectives, confer legal personality to them and specify the extent to which IFIs are exempt from domestic jurisdiction.

Yet, in addition to rules explicitly contained in agreements relating to IFIs, they are – as subjects of international law – also bound by international customary law\(^{12}\), which constitutes a legal basis for the creation of legal

---

\(^{10}\) *Quis Custodiet Ipsos Custodes* (“But who guards the guardians?”), Decimus Junius Juvenal, Satires VI, 347.

\(^{11}\) This understanding complements existing approaches referring to the notion of “who guards the guardians” notably in the context of (human rights) accountability of international organizations. See A. Reinisch, Securing the Accountability of International Organizations, *Global Governance* (2001) 2, 131-149, at note 4, citing further literature.

\(^{12}\) See for instance the statement of the International Court of Justice on the matter: “[…] *International organizations* are subjects of international law and, as such, are bound by any obligations incumbent upon them under general rules of international law, under their constitutions or under international agreements to which they are parties.” *Inter-
obligations distinct from those based on treaty law. Thus, important customary international law principles such as *pacta sunt servanda* and *rebus sic stantibus* do apply to IFIs irrespective of the actual entry into force of treaties that codify these principles, such as the 1969 Vienna Convention on the Law of Treaties (VCLT) and the 1986 Vienna Convention on the Law of Treaties Between States and International Organizations or Between International Organizations. In the majority of cases, however, it can be argued that the more specific rules regarding the operation of IFIs are contained in treaty law, in particular in their Articles of Agreement.

In view of the fact that there exists a considerable variety of IFIs, also their constituent documents contain different purposes and functions, but principally conceive the promotion of international monetary cooperation as

---

13 See most prominently the distinction between “international conventions” and “general principles of law recognized by civilized nations” as two separate “primary” sources of international law according to Article 38 para 1 (a) and (c) Statute of the International Court of Justice.

14 According to this principle “Every treaty in force is binding upon the parties to it and must be performed by them in good faith.” See Article 26 of both the *Vienna Convention on the Law of Treaties*, 23 May 1969, 1155 U.N.T.S. 331 and the *Vienna Convention on the Law of Treaties Between States and International Organizations or Between International Organizations*, 21 March 1986, 25 ILM 543.

15 This principle refers to a “fundamental change of circumstances” subsequent to the entry into a contractual obligation and justifies the non-performance of treaty obligation under specific conditions, it is thus an exception to the *pacta sunt servanda* principle, see Article 62 of both the 1969 and the 1986 Convention.

16 See *supra* note 14.

17 The *1986 Vienna Convention on the Law of Treaties Between States and International Organizations or Between International Organizations*, see *supra* at note 14, has not yet entered into force as it has not reached the required ratification of 35 States. No IFI has become party to the 1986 Convention, but this has precluded IFI from invoking those articles that are commonly regarded as reflecting customary international law. See on this matter M. Ragazzi, *International Financial Institutions*, *supra* note 1, 22.
their main financial aim. In addition, a developmental objective is included in many treaties establishing IFIs.\textsuperscript{18}

Accordingly, the constituent instruments of the most important IFIs, the World Bank Group Members, and in particular of the Articles of Agreement of the International Bank for Reconstruction and Development (IBRD) and of the International Monetary Fund (IMF) contain the aim of mutual cooperation on the financial level along with a prominently placed mandate for post-war recovery measures.\textsuperscript{19} This reveals that they were created as a reaction to World War II as one of the most severe crises in the 20th century. Based on the understanding that more balanced economic development and stable international monetary system were means to ensure that no new wars and crises occurred, this mandate was complemented with the responsibility to promote and facilitate the balanced growth of international trade.\textsuperscript{20} In this vein, the IMF is charged with overseeing the international monetary system, promoting exchange stability and orderly exchange arrangements among members so as to facilitate the exchange of goods,

\textsuperscript{18} Depending on the IFI in question, the ‘development objective’ as prescribed in the constituent document can take many forms and operational focuses, reaching from the promotion of investments to the co-ordination of development policies, the provision of technical assistance to stimulating the development of capital markets. One of the most far-reaching example is the European Bank for Reconstruction and Development that is not only mandated to operate according to sound banking principles, but also to promote private and entrepreneurial initiative in countries committed to ‘multiparty democracy, pluralism and market economics’ Agreement establishing the European Bank for Reconstruction and Development, 29 May 1990, Art. 1, 1646 U.N.T.S. 97.

\textsuperscript{19} See notably Articles of Agreement of the International Bank for Reconstruction and Development, 27 December 1945, Art. 1, 2 U.N.T.S. 134, (IBRD Articles of Agreement) which proclaims that the first objective of the IBRD is to “(i) assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war”. Further goals contained in the first paragraph are: “(ii) [t]o promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources” and “[t]o promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labor in their territories.”.

\textsuperscript{20} See for instance Art 1 (iii) IBRD Articles of Agreement, supra note 19.
services and capital. This also includes an assessment whether the member states comply with their obligations under the Articles of Agreement.

In addition, both the IMF and the IBRD are authorized to extend financial assistance to their member states by making available foreign exchange resources. This financial support is linked to member states’ commitments to implement sound macroeconomic adjustment measures and to fulfil other performance criteria or conditions. The actual financial measures available differ.

In the case of the IMF, a member is entitled (under specific conditions) to draw upon the resources of the Fund by purchasing the currencies of other members in exchange for an equivalent amount of its own currency to solve a short-term balance-of-payment need. The IBRD has chosen a different approach and provides loans or extends guarantees for the purpose of the accomplishment of investment, reconstruction or development projects. Thus, financial assistance is linked to certain types of measures of the

---

21 According to Article 1 of the Articles of Agreement of the International Monetary Fund, 27 December 1945, Art. 1, 2 U.N.T.S. 40, (IMF Articles of Agreement), the purposes of the International Monetary Fund are: (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.

22 The IMF exercises this task by “surveillance” which, in accordance with Art IV Section 3 (a) IMF Articles of Agreement, see supra note 21, entitled “Surveillance over exchange arrangements” comprises the obligation to “[...] oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.”. The surveillance requirement also includes regular consultations (usually once a year) on the economic and financial policies of a member state which typically lead to observations and recommendations on each member state’s economic and financial policy performance. See Art IV Section 3 (b) IMF Articles of Agreement, supra note 21.

23 See in particular Art V IBRD Articles of Agreement on “Operations and Transactions of the Fund”, supra note 21.
member states, i.e. those that fulfil “productive purposes”. However, in “special circumstances” such financial assistance may be given also for other purposes.\textsuperscript{24} This “special circumstances” criterion provided an important formula for addressing financial crises of the IBRD member states.\textsuperscript{25}

The IBRD loan agreements are not only concluded with the Member State of the Bank, but sometimes also with a public or private entity on the territory of the member.\textsuperscript{26} The specific legal framework applicable to IFIs takes account of this fact, i.e. that some lending operations also involve contacts with private actors.

It thus provides for two elements necessary to deal with this kind of situations specific to IFIs, i.e. the conferral of legal personality to IFIs – and for some IFIs – a waiver of immunity for lending and borrowing activities, which is a deviation from the immunity from legal process normally enjoyed by international organizations.

With regard to the first element, typically, the constituent documents, headquarters agreements, and other treaties addressing the status of IFIs\textsuperscript{27}, accepted the need to ensure that IFIs are endowed with legal personality according to national law in order to enter into contracts, i.e. private law relationships for their procurement needs, and to be able to pursue their rights before national courts, such as settling their delictual claims.\textsuperscript{28}

\textsuperscript{24} Art. 3 (vii) of the IBRD Articles of Agreement states that “Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development”. See also supra note 19.

\textsuperscript{25} This is because it was seen sufficient to provide loans on the “special circumstances criterion” if a debtor country had a sound financing plan and a satisfactory adjustment program, the loans were legally justified if it could be demonstrated that the debt reduction would have a material effect on the country’s investment prospects and overall development plan.

\textsuperscript{26} In this case, i.e. when the borrower is not a member state, the loan must be fully guaranteed by the member state. See Art. III Section 4 (i) IBRD Articles of Agreement, supra note 21, entitled “Conditions on which the Bank may Guarantee or Make Loans” which states: “When the member in whose territories the project is located is not itself the borrower, the member or the central bank or some comparative agency of the member which is acceptable to the Bank, fully guarantees the repayment of the principal and the payment of the interest and other charges to the loan.”.


\textsuperscript{28} A typical provision of such domestic legal personality can be found in the IMF and the IBRD Articles of Agreement which both provide: “The Fund/Bank shall possess full juridical personality and, in particular, the capacity: (i) to contract; (ii) to acquire and dispose of immovable and movable property; and (iii) to institute legal proceed-
Second, as regards the immunity provisions relating to IFIs, most of them do not enjoy the same broad jurisdictional immunity as other IOs. In other words their scope of immunity is limited.

According to their constituent agreements most international development banks can be sued before domestic courts by private parties but not by member states. The rationale of this provision is obvious: international development banks finance their lending operations to a substantial part through borrowing operations on the financial markets. It is important to attract lender confidence and they thus have to ensure that private parties have access to the courts. Accordingly, international development banks usually can be sued before the national courts of member states.

By contrast, other IFIs like the International Monetary Fund enjoy the “usual” functional immunity, i.e. the immunity necessary for the fulfili...
ment of their purposes. The waiver of domestic jurisdiction in relation to IFI, and International Organizations in general, is generally seen as a crucial element to avoid the otherwise possible interference of national courts in the affairs of IOs. It practically amounts to an unqualified, hence absolute, immunity from suit. As it is the case with the conferral of legal personality to IFIs, often this immunity is made more precise in further treaties on general privileges and immunities or headquarters agreements.

Building on these general parameters for the operation of IFIs, more specific measures responding to a situation of financial crisis exist.

C. Measures Directed Against IFI Member States to Redress the Impact of the Financial Crisis

One of the many conceivable forms of the financial crisis’ impact on the financial performance of an IFI consists in member states not complying with their financial obligations towards the organization.

While IFIs do not exclusively depend on mandatory or voluntary contributions from their members and satisfy their capital demands through resources that are usually not available to other international organizations – such as borrowings from the international capital markets through global offerings and bond issues, paid-in capital or quotas, repayments from financing to their borrowers – they can also be exposed to the general problem that their Member States do not comply with their financial obligations, such as the payment of interest – a situation which is clearly exacerbated in times of financial distress.

32 See for instance Article 105(1) Charter of the United Nations, 24 October 1945, 1 U.N.T.S. XVI (“The Organization shall enjoy in the territory of each of its Members such privileges and immunities as are necessary for the fulfilment of its purposes.”).


34 Cf. Article II Section 2 Convention on the Privileges and Immunities of the United Nations, 13 February 1946, 1 U.N.T.S. 15 (“The United Nations, its property and assets wherever located and by whomsoever held, shall enjoy immunity from every form of legal process except insofar as in any particular case it has expressly waived its immunity shall extend to any particular case it has expressly waived its immunity. It is, however, understood that no waiver of immunity shall extend to any measure of execution.”).
Possible measures available for an IFI in this situation towards the non-performing Member State share similarities to the standard responses of International Organizations to budgetary problems caused by non-payment of membership contributions. International organizations’ constituent documents in this case sometimes foresee specific measures. The most prominent example is contained in Article 19 UN Charter which provides:

“A Member of the United Nations which is in arrears in the payment of its financial contributions to the Organization shall have no vote in the General Assembly if the amount of its arrears equals or exceeds the amount of the contributions due from it for the preceding two full years. The General Assembly may, nevertheless, permit such a Member to vote if it is satisfied that the failure to pay is due to conditions beyond the control of the Member.”

The sanction of the loss of the voting rights in the General Assembly in case of non-payment of membership contributions for two years is subject to the exercise of discretion, i.e. it is permissive rather than mandatory. Since the budget of the UN, which is primarily comprised of obligatory contributions of the members, is also subject to a decision by this plenary organ, this measure also amounts to a deprivation of deciding on the budget pro futuro. Yet, a certain degree of flexibility is ensured by taking into account a waiver of the sanction when the Member State can furnish proof that non-payment was a result of circumstances that it could not influence.

36 In UN history, it has been controversial whether the loss of the right to vote occurred ipso facto or whether a constitutive resolution of the General Assembly was required. This controversy dates back to the mid 1960s and was unleashed by the issue of the financing of two controversial UN peace-keeping operations in the Congo and Near East (UNEF I and ONUC). The now overwhelming (Western) doctrine takes the view that the effects of Art 19 occur directly when the substantive requirements are met and that thus no implementing decision is required. Conversely, a state recovers its right to vote as soon as it makes the required payments. See C. Tomuschat, Article 19, in: B. Simma et al (eds.), The Charter of the United Nations: Commentary, at note 13 and 22, 332 et seq.
37 See Art 17 UN Charter, supra at note 35, according to which the General Assembly is competent to “consider and approve the budget of the Organization” and further has the right to apportion the expenses of the Organization (“The expenses of the Organization shall be borne by the Members as apportioned by the General Assembly.”).
Similar provisions exist also for IFIs. For instance, the third amendment to the IMF Articles of Agreement\(^{38}\) introduced rules on the suspension of voting rights and modified compulsory withdrawal from IMF membership. It now provides that

“[i]f a member fails to fulfill any of its obligations under this Agreement, the Fund may declare the member ineligible to use the general resources of the Fund. […]”

If, after the expiration of a reasonable period following a declaration of ineligibility […], the member persists in its failure to fulfill any of its obligations under this Agreement, the Fund may, by a seventy percent majority of the total voting power, suspend the voting rights of the member. […]“\(^39\)

Thus, the IMF may refer to different measures in relation to a non-performing member: It can primarily suspend its voting rights or declare this party ineligible to use the general resources of the Fund. In contrast to the original IMF Articles of Agreement, the ineligibility to use Fund resources of a member state that does not meet its overdue financial obligations to the IMF is not automatic, but requires an affirmative decision by the Fund. Thus, in this respect, the IMF rules share similarities with the procedure foreseen for a UN member in arrears with payments associated with its membership.

Since they exclude or restrict the participation of defaulting states from the internal policy-making process, such sanctions for overdue financial obligations are of a rather severe character. These exclusionary measures\(^40\) however, might not practically induce the debtor states to effectively pay.

This problem is of course to a certain extent mitigated by the fact that – as outlined above – the resources of IFIs do not exclusively stem from contributions of their members, but to a large extent originate from operations on the financial market and thus in principle the issue of non-payment does not put the operation of an IFI as much under pressure as other international organizations. The turmoil of the international financial markets of course will put the advantage of diversified origins of the IFI resources into perspective. Even if the risk is spread, the financial crisis’ very nature af-

---

\(^{38}\) See \textit{supra} at note 21. The third and so far latest amendment to the IMF Articles of Agreement became effective on 11 November 1992. They had been approved by the IMF Board of Governors in Resolution No. 45-3, adopted June 28, 1990.

\(^{39}\) Art XXVI IMF Article, see \textit{supra} at note 21.

\(^{40}\) See \textit{supra} text at note 35 and 39.
fects all sources of capital available to IFIs. Differently put, the negative
effects on the financial market result in aggravated conditions affecting the
IFIs’ financial operation, such as through below-expectancy performance of
funds or increased interest rates for borrowing activities on the international
capital market as well as in the impediment of member states to comply
with their obligations.

These issues are somehow softened by the fact that the IFI’s enjoy a
special credit ranking status due to their specific financial set-up that in-
cludes “guaranteed capital”, i.e. the portion of the IFI’s capital that is exclu-
sively reserved to meet obligations incurred on borrowed or guaranteed
funds. This allows IFIs to borrow from the capital market at a low cost and
apply a low interest rate to their borrowers.41

However, in order to generally maintain a IFIs’ financial operational
capability, it is important to effectively ensure that members in financial
difficulty comply with their obligations towards the organization, which is
endangered by the relative ineffectiveness of “internal measures” outlined
above.

Therefore, other measures could be conceived, such as vesting IFIs as
creditors of sovereign states with a preferred creditor status. In doing so,
they are legally given priority among individual creditors or classes of cred-
itors in relation to the settlement of external debt.42 As attractive this option
might appear in principle, it is only an optional standard for a specific inter-
national behaviour. Thus, without an explicit agreement or a unilateral act of
the debtor, the creditor IFI will not be able to claim any preferences. This is
in line with the provisions of the IMF Articles of Agreement for instance,
which do not foresee such an option.43 Accordingly, this alternative will
presumably not be overly helpful in times of financial turmoil.

41 See M. Ragazzi, International Financial Institutions, supra at note 1, 17.
42 See R. Martha, ‘Preferred Creditor Status under International Law: The Case of the
International Monetary Fund’, 39 International & Comparative Law Quarterly (1990),
806.
43 Id., 810. According to the IMF Articles of Agreement before the third Amendment,
i.e. as amended by the modifications of the original Articles of Agreement approved
by the IMF Board of Governors in Resolution No. 23-5, adopted on 31 May 1968 and
entering into force on 28 July 1969 as well as by the modifications approved by the
IMF Board of Governors in Resolution No. 31-4, adopted on 30 April 1976 and enter-
ing into force on 1 April 1978, there existed the option for the Fund to become a pre-
ferred creditor by requiring a collateral security from the purchasing member (old Art
IV section 4 IMF Articles of Agreement). The IMF, however, has never used this
power. See R. Martha, supra note 42, 814.
Of course, more severe measures exist under general international law. According to the fundamental conceptions of the international law on state responsibility for breaches of international obligations as codified in the ILC Draft Articles on State Responsibility drafted by the International Law Commission, it is in principle perfectly possible to hold an IFI member responsible under international law for injury caused to the IFI by a breach of the member’s obligation. On the background of the ILC Draft Articles, also earlier pertinent case law is relevant to clarify the status of an IFI vis-à-vis its non-performing member:

First, regarding the status of an IFI and its right to sue, the ICJ’s advisory opinion on the Interpreta tion of the Agreement of 25 March 1951 between the WHO and Egypt confirmed that the breach of an international obligation by the member can be brought by the international organization.

Further, when an international organization suffers from financial damage resulting from a breach of the member’s international obligation, the organization is in principle entitled to obtain reparation, which must, as far as possible, rectify all the consequences of the breach and re-establish the situation which would in all probability have existed if that act had not been committed. On this understanding of full compensation rests also the entitlement to claim interest on account of delay, which formed the exclusive subject matter of the international dispute which led to the famous Russian Indemnity case where the Permanent Court of International Arbitration found that the wrongfulness of Turkey’s failure to meet its financial

---

45 Provided that the conditions foreseen by the ILC Draft Articles, supra note 44, are fulfilled, see the axiomatic conception of the provisions contained in Chapter I of Part One of the Articles. It would go too far in the present context to allude to these in detail.
46 ICJ Advisory Opinion, ICJ Reports 1980, 73, supra note 12.
47 See the famous Case Concerning the Factory Chorzów, PCIJ Series A, No 17 (1928), 47. See also Article 36 (2) of the ILC Draft Articles, supra note 44.
48 See the reference to this principle in Article 34 of the ILC Draft Articles, supra note 44.
49 See Article 38 ILC Draft Articles, supra note 44.
50 Russian Claim for Interest on Indemnities (Russia v. Turkey), Award of the Tribunal., 11 November 1912, IX UNRIAA (1962) 421, also in: J.B. Scott, Hague Court Reports (1916), 298.
obligation towards Russia was to be understood in light of the fact that Russia consented to the breach. Therefore, no interest was due.\(^51\)

Another instance in which consent allows for a deviation from the general rule of international responsibility for delayed payments, i.e. in which an IFI cannot take measures against nonperforming Member States\(^52\) is particularly relevant in times of financial crisis, namely when the postponement of payment has been authorized by the IFI, i.e. when consent is given.\(^53\) In fact, to allow debtors with present or imminent insolvency to delay the date of actual payment has become an accepted practice for IFIs.\(^54\)

Absent such agreement, debtor states will try to invoke their inability to pay based on the changed factual circumstances of economic emergency. Such arguments referring to a situation when the compliance with treaty obligations becomes overly burdensome or even impossible have been recognized in treaty law by concepts such as the \textit{rebus sic stantibus} rule\(^55\), as well as the reference to supervening impossibility of performance.\(^56\) These

\(^{51}\) See ILC Yearbook 1979, Vol II, part 2, 111.

\(^{52}\) On the invocation of circumstances precluding wrongfulness by the debtor state see \textit{supra} note 61.

\(^{53}\) Differently put, in this context, the principle of \textit{volenti non fit iniuria} applies.


\(^{55}\) According to Article 62 of the Vienna Convention on the Law of Treaties, \textit{supra} note 14, “1. A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty. 2. A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty: (a) if the treaty establishes a boundary; or (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty. 3. If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending the operation of the treaty”.

\(^{56}\) According to Article 61 of the Vienna Convention on the Law of Treaties, \textit{supra} note 14, “[a] party may invoke the impossibility of performing a treaty as a ground for terminating or withdrawing from it if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending the operation of the treaty. 2. Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty
considerations of justice, however, clash with the necessity to guarantee predictable treaty relations over time (such as between the IFI and a particular member state) and thus collide with other fundamental treaty law principles, i.e. the *pacta sunt servanda* rule.\(^{57}\) The difficult exercise of striking a balance between these concepts will have to consider the exception-to-the-rule character of norms derogating from the general rule of compliance with treaty obligations. Thus, only in very narrow and qualified circumstances of sufficient seriousness a deviation from this standard regime is permissible.\(^{58}\)

But not only general treaty law or specific treaty provisions applicable to the relationship between member states and (specialized) international organizations\(^{59}\) foresee the possibility to defer to changed circumstances in case of emergencies. Also according to customary law – which is applicable to subjects of international law, i.e. in particular states and international organizations\(^{60}\) – a necessity defence can be invoked in case of an economic crisis, as has been most prominently done by Argentina during its financial and economic crisis in the late 1990s and early 2000s.\(^{61}\)

If the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.\(^{57}\)

\(^{57}\) See Article 26 of the Vienna Convention on the Law of Treaties, *supra* note 14, which specifies that ‘Every treaty in force is binding upon the parties and must be performed by them in good faith’.


\(^{59}\) See *supra* note 12 on the applicability of international law to the operation of IFIs. In this context, it is interesting to note the importance of international law in relation to the specific credit agreements of IFIs such as the IBRD with its member states, see on this issue A. Broches, ‘International Legal Aspects of the Operations of the World Bank’, 98 *Recueil des Cours* (1959) 3, 297 and J. W. Head, ‘Evolution of the Governing Law for Loan Agreements of the World Bank and other Multilateral Development Banks’, 90 *American Journal of International Law* (1996) 2, 214. An example of a specific treaty provision which refers to (external) conditions impeding a Member State to pay its membership contributions has been already been made short reference to *supra* note 35.

\(^{60}\) See *supra* note 12.

\(^{61}\) Following the invocation of national emergency/state of necessity by Argentine in after it had taken restructuring measures to address the economic and financial crisis at the end of the 1990s that notably disadvantaged foreign investors, around 40 cases have been brought against Argentina (see the ICSID website available at http://icsid.worldbank.org/ICSID/Index.jsp and the Investment Treaty Arbitration website available at http://ita.law.uvic.ca/ (last visited 5 February 2010). Of the cases already decided, notably the following decisions have spurred intense scholarly discussion: LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v Ar-
The necessity defence under customary international law is codified restrictively in Article 25 of the ILC Draft Articles on State Responsibility drafted by the International Law Commission, and regulates circumstances in which a state may rely on necessity in order to preclude the wrongfulness of an act which would otherwise constitute a violation of international law.

Yet, the invocation of Article 25 is rather difficult as all criteria must be fulfilled cumulatively.

1. Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act: (a) is the only way for the State to safeguard an essential interest against a grave and imminent peril; and (b) does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole. 2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if: (a) the international obligation in question excludes the possibility of invoking necessity; or (b) the State has contributed to the situation of necessity. Article 25 Draft Articles on Responsibility of States, see supra note 44.

The non-performance of the relevant obligation must be the only way for the State to safeguard an essential interest against a grave and imminent peril. In addition, the act must not seriously impair an essential interest of the State(s) towards which the obligation is owed, or of the international community as a whole. Further, the Reliance on necessity is precluded if excluded by the international obligation (the treaty), or if the State has contributed to the situation of necessity. Finally, reliance on necessity can never justify the derogation from peremptory norms (Article 26 of the ILC Articles).

In the Argentinean example, some holdings confirmed that the requirements were met: “[…] in the first place, Claimants have not proved that Argentina has contributed to cause the severe crisis faced by the country; secondly, the attitude adopted by the Argentine Government has shown a desire to slow down by all the means available the severity of the crisis. The essential interests of the Argentine State were threatened in December 2001. It faced an extremely serious threat to its existence, its political and economic survival, to the possibility of maintaining its essential services in operation, and to the preservation of its internal peace. There is no serious evidence in the record that Argentina contributed to the crisis resulting in the state of necessity. In this cir-
When indeed defaulting states can in some instances successfully invoke necessity in order to preclude the wrongfulness of their non-performance, the further legal implications are not entirely clear, in particular whether this results in an entitlement to compensation under customary law on the basis of Article 27 of the ILC Draft Articles.\(^{66}\)

Even if this question is answered in the affirmative, the practical consequences of such establishment would likely not yield a strengthened situation of trust between the IFI and the member state in question.

Therefore, further possible responses of IFIs to sovereign debt crises of their member states could refer to their constituent documents in order to identify particular provisions on the matter. Yet, unfortunately there is no explicit mandate contained in these international legal materials which would allow them to become involved in reducing the commercial bank debts of their members. Yet, some of these international organizations engaged in such action based on an extensive interpretation of their documents. For instance, the IMF was able to justify debt related actions arguing that this was covered by Article 1 (v) of its Articles of Agreement and its mandate to help countries to deal with balance of payment problems.\(^{67}\)

**circumstances [sic.], an economic recovery package was the only means to respond to the crisis. Although there may have been a number of ways to draft the economic recovery plan, the evidence before the Tribunal demonstrates that an across-the-board response was necessary, and the tariffs on public utilities had to be addressed. It cannot be said that any other State’s rights were seriously impaired by the measures taken by Argentina during the crisis. Finally, as addressed above, Article XI of the Treaty exempts Argentina of responsibility for measures enacted during the state of necessity.”**

\(^{64}\) LG&E Energy Corp., see supra note 61, paras 256 -257.

\(^{65}\) See already the statement of the ICJ in the *Gabčíkovo-Nagymaros Project (Hungary v. Slovakia)*, Judgement, ICJ Reports 1997, 1. The reason for referring to this authority decided before the finalization of the ILC Draft Articles relies on the fact that Article 25 reflects customary international law which renders also historical cases on the issue of necessity relevant.

\(^{66}\) Article 27 of the ILC Articles, *supra* note 44, read as follows; “Consequences of invoking a circumstance precluding wrongfulness in accordance with this chapter is without prejudice to: (a) Compliance with the obligation in question, if and to the extent that the circumstance precluding wrongfulness no longer exists; (b) The question of compensation for any material loss caused by the act in question.” While this question is already unclear in “classical” investment law, yet with a favour of assuming a duty to compensate in doctrine (see for instance R. Dolzer & C. Schreuer, *Principles of International Investment Law* (2008), 170; A. Bjorklund, “Emergency Exceptions: State of Necessity and Force Majeure” in P. Muchlinski, F. Ortino & C. Schreuer (eds) *Oxford Handbook of International Investment Law* (2008), 459, 510), the issue is even more uncertain in relation to IFIs.

\(^{67}\) See *supra* note 19.
D. Measures Directed Against IFIs to Redress the Impact of the Financial Crisis

While the foregoing analysis has put the focus on measures that IFIs can conceive in relation to member states, this is obviously not the only possible approach. In fact, in times of financial collapse, the discussion of establishing responsibility for acts that have caused such a situation involves both IFIs and Member States. Often, the precise attribution is rather difficult, and the problem can be viewed from either the IFI’s or the Member State’s perspective. Differently put, the intensely debated topic circles around the relationship between International Organizations and Member States for the establishment of responsibility for wrongful acts, and in particular – notably in the present context – around the question of a possible subsidiary or even joint or “joint and several” responsibility for private law debts. Notably the domestic litigation on who should ultimately bear the

---

68 See in a similar vein the discussion of the more general issue of establishing international responsibility of international organizations for wrongful acts of states provided that their involvement with the commission of these unlawful acts by states is sufficiently high, Third report on the responsibility of international organizations by G. Gaja, Special Rapporteur, ILC Fifty-Seventh Session 2005, UN Doc A/CN.4/553, at 11.

69 It has to be clarified that the issue of “Responsibility of International Organizations” which denotes the legal consequences of non-compliance with an international obligation by conduct that is attributable to the organization (see James Crawford, The International Law Commissions’s Articles on State Responsibility: Introduction, Text and Commentaries 77-80 (2002)) is to be distinguished from “accountability” which is used without a clear definition in a variety of contexts, including that of non-state actors such as NGOs. Based on its practical use, “accountability” seems to refer to the need to attribute certain activities under international law to actors as a precondition for imposing on them responsibility under international law. See G. Hafner, Can International Organizations be controlled? Accountability and Responsibility, ASIL Proceedings 2003, 237.

70 It needs to be stressed that it is beyond the present contribution’s topic to enter into the general growing academic debate on the human rights accountability of IFIs in relation to financed projects that infringe upon human rights. See on this issue for instance C. Barry & A. Wood, Accountability of the International Monetary Fund (2005); D. Bradlow, Private Complaints and International Organizations: A Comparative Study on the Independent Inspection Mechanisms in International Financial Institutions”, 36 Georgetown Journal of International Law (2005) 2 403; M. Darrow, Between Light and Shadow. The World Bank, the International Monetary Fund and International Human Rights Law (2003).
costs of the bankrupt International Tin Council has brought this issue to the fore.\footnote{In re International Tin Council, High Court, Chancery Division, 22 January 1987; 77 ILR (1988), 18; J H Rayner (Mincing Lane) Ltd. v. Department of Trade and Industry, House of Lords, 26 October 1989, [1990] 3 W.L.R. 969, 81 ILR (1990), 670.}

Before discussing respective details, emphasis needs to put on the fact that such litigation is in contrast to the basic principle of functional immunity protection of IFIs.\footnote{See supra note 31.} In this context reference is also made to the notion of \textit{ne impeditatur officia}.\footnote{See the United Nations Conference on International Organizations (UNCIO), Report of the Rapporteur of Committee IV/2, oc. 933, IV/2/42 at page 3 stating that “[…] no Member state may hinder in any way the working of the Organization or take measures the effect of which might increase its burdens, financial or other.”.} Pursuant to this notion, the functioning of an IO may not be hindered in any way, such as by increasing its burdens, financial or other. Accordingly, resources of IOs have “international character” and are covered by immunity protection. Yet, times of financial crises might reinforce the debate on the protection of the assets of IFI. Such arguments in favour of declaring international organizations insolvent and subjecting their assets to liquidation according to national bankruptcy laws stress were also brought forward in Tin Council proceedings.

attributed to it was no longer seen “absolute” and the possibility of holding member states responsible caused intense debates on the “piercing of the corporate veil” of this organization.\textsuperscript{75} The various decisions on the matter did however not provide for a clear-cut answer.\textsuperscript{76} Similar issues were raised in the \textit{Westland Helicopters} arbitration.\textsuperscript{77}

It can be inferred from this strand of case law as well as from a few specialized treaty provisions\textsuperscript{78} that the concurrent or joint responsibility of member states for the wrongful act of an international organization is not as such inconceivable. Yet, it is clearly the exception to the general rule\textsuperscript{79} according to which the sphere of an international (financial organization) and its member state is to be separated.

A similar issue is the question whether national law may interfere with the internal legal order of an international organization. Clearly, the common rationale is the notion that states must not interfere with the internal legal order of an international organization. This was precisely also at the issue in the \textit{Tin Council} litigation. One of the courts stressed the general principle of non-applicability of national insolvency law, since such exercise of jurisdiction

“would constitute an interference by the Court with the ability of the executive, albeit in a limited sphere, to conduct its relations with foreign states, a function which under our constitution is reserved to the Royal Prerogative, and with the ability of other sovereign states to conduct their relations with each other. It would alter the status of the organisation charged with the function of administering the provisions of an international treaty


and would be incompatible with the independence and international character of the organisation.\textsuperscript{80}

Based on this finding, it is all the more interesting that there exist a number of cases which subject IFIs under domestic insolvency proceedings.

Sometimes IFIs are sued before national courts which stems from the considerations that the immunity of IFIs should be waived when their involvement in the activities of their “clients” subsequent to the initial agreement is sufficiently qualified.\textsuperscript{81} Of particular importance is this argument in bankruptcy proceedings where bankruptcy creditors are faced with the risk of being ultimately unable to recover assets. A few domestic cases involving IFIs in bankruptcy proceedings can be identified that subject their assets to domestic insolvency proceedings. It is likely that these will increase in numbers as the impact of the financial crisis will expand.\textsuperscript{82}

For instance, a bankruptcy proceeding before US courts was instituted in the \textit{Kaiser}\textsuperscript{83} case, concerning the involvement of the International Finance Corporation (IFC) subsequent to the grant of a loan for a project relating to the construction of a steel mill in the Czech Republic. In the bankruptcy proceedings initiated by Kaiser, the IFC was accused to have allowed improper draws on its letter of credit and thus to have been actively involved in the financial collapse of the project. The IFC stressed that by not immediately invoking immunity but filing a proof of claim because it sought recovery from Kaiser, it did not consent to the jurisdiction of the claim with respect to Kaiser’s accusations for the improper draw of the letter of credit. The IFC thus file a motion to dismiss the initial order of the US bankruptcy

\textsuperscript{80} \textit{In Re International Tin Council} [1987] 1 Ch. 419, 451.
\textsuperscript{81} An illustrative example is case \textit{Ashford v. World Bank Group} before the U.S. District Court Northern District of Georgia, Atlanta Division, 24 March 2006; 2006 U.S. Dist. LEXIS 17286.
\textsuperscript{82} See R. Martha, ‘International Organizations and the Global Financial Crisis: The status of their Assets in Insolvency and Forced Liquidation Proceedings’, \textit{6 International Organizations Law Review} (2009) 1, 117 who provides a detailed picture of domestic court involvement of IFIs depending on various factors, such as notably the different types of assets concerned.
court. Finally, the US Court of Appeals for the Third Circuit reversed the District Court’s judgment and remanded the case to the Delaware bankruptcy court for a decision on the merits.

One of the most publicly discussed bankruptcy cases in the US was at the turn of the century. The collapse of the American energy company Enron Corporation (Enron), in 2001, also involved the IFC as a bankruptcy creditor. While the Enron v. IFC decisions did not particularly consider questions of immunity of an IFI, they nonetheless serve as an example for the breadth of the involvement of IFIs in domestic (bankruptcy) proceedings.

Interestingly, in a case involving the collapse of a Uruguayan bank (Banco Montevideo SA), the question was raised whether third parties could involve an IFI in disputes before national courts based on the specific relationship of an IFI to their contracting party. One of the harmed individuals by the transaction of the contracting party of the IFI invoked liability of the IFC as it had “failed to supervise the functioning of the bank and neglected to appoint a director as its investment agreement authorized it to do.” However, the US District Court for the Southern District of New York did not follow this reasoning, but referred to functionality considerations to emphasize the immunity of the IFC. Since Banco de Seguros did not belong to “the types of persons, and their claims are not the types of claims for which IFC has waived immunity in Article VI Section 3 of its Articles of Agreement,” the IFC had to remain immune from suit.

Even though the number of cases involving IFIs in bankruptcy proceedings is relatively limited, it is clear that the attempt to bring IFIs before domestic courts will increase in times of heightened possibility of further

---

89 Banco de Seguros del Estado v. IFC, U.S. Dist. LEXIS 69741 at 23. The text of Article VI Section 3 IFC Articles of Agreement is identical to the wording of Article VII Section 3 of the IBRD Articles of Agreement. See supra note 30.
insolvencies. Also, it must be stressed that along the lines of the domestic bankruptcy model, a call for the establishment of a sovereign debt adjustment procedure has been voiced. 90 Indeed, a proposal for the development of a Sovereign Debt Renegotiation Mechanism (SDRM) has been presented to the IMF, but so far has not yet been implemented. 91

In general, it is interesting to note that measures taken by the IFIs themselves that could be perceived as measures that may be interpreted as “self-guarding” or directed at reviewing their acts are a relatively recent phenomenon. One of the most prominent examples of a review mechanism allowing to re-consider the acts of an IFI on the benchmark of internal rules exist notably in the form of the World Bank Inspection Panel. 92

As regards more specific measures specific to the financial crisis, several developments towards an increased governance and co-ordination among IFIs merit attention, in particular the transformation of the intergovernmental forum “Financial Stability Forum”, created after the Asian economic crisis in the mid-1990s with the aim to promote the international financial system needs to be mentioned. It has recently been reorganized as the “Financial Stability Board”, along with the transformation, it has been vested with new competencies that intend strengthen co-operation with the objective to avoid regulatory failures estimated to have substantially contributed to the most recent crisis. 93

---


92 The World Bank Inspection Panel was established in 1993 to provide an independent forum to private citizens who believe that they or their interest have been or could be directly harmed by project financed by the World Bank. See for details for instance R. Steinhardt, ‘Corporate Responsibility and the International Law of Human Rights: The New Lex Mercatoria’, in: P. Alston (ed.) Non-State Actors and Human Rights, (2005), 177.

E. Conclusion

The attempt to answer the question of “Who guards the guardians” started from the assumption that this query could serve generally as a benchmark for rules relating to the operation of IFIs in times of financial crisis.

Starting from specific elements of the legal setting in which IFIs operate that are shaped by international law, the first category of rules that determine the operation of IFIs concerns the relation to their Member States. It was argued that times of financial crises result in a lesser degree of (financial/contractual) compliance of member states towards IFIs. Accordingly, it was investigated which measures are available to IFIs to induce state to comply with their obligations. The options range from suspending Member States from the internal decision-making process within the organization, to declaring the states ineligible to use the general resources of the IFI or vesting an IFI with a preferred creditor status. It cannot be empirically proven whether these measures will effectively result in better compliance. Yet, also according to general international law strong coercive options exist, especially according to the rules on state responsibility based on a violation of the international law obligation of the IFI member. Conceivable counter-arguments of IFI member state will include the invocation of necessity, which is however subject to the fulfilment of restrictive criteria or the reference to general principles of treaty law such as the rebus sic stantibus rule (changed circumstances). Some IFIs, such as the IMF engage in a direct involvement in the restructuring of their member’s commercial bank debts based on an extensive interpretation of their constituent documents.

Conversely, measures that address IFIs themselves will refer to the Tin Council litigation that can be invoked in order to allow for a “piercing of the corporate veil” of the organization and thus blur the principle of the strict divide between assets of the organization and that of the Member States. Another instance in which measures address IFIs directly are domestic court proceedings instigated against them, such as bankruptcy proceedings according to national law that exceptionally bypass the immunity protection of these international organisations. However, to generally state that domestic courts serve as “guardians” for the operation of IFIs in times of financial crises since their acts can be subjected to national jurisdictions is not merited as the proceedings involving IFIs in domestic courts that relate to the financial performance of IFIs is comparatively low. Yet, it would be no surprise if the current financial crisis triggered a call for a “revision” of
the scope of application of bankruptcy laws in relations to IFIs in order to hold them liable.

It is important to see the Janus-faced element of the attempt to establish domestic court’s competence for acts of IFIs in times of financial crises: the gain of increased judicial review must be weighed against a decrease in the operational independence of IFIs.

In conclusion, the initial question is perhaps most promisingly answered by the attempts by the IFIs to find measures of self-regulation by themselves, which is in turn corrected by the rapidly evolving rules on responsibility and accountability of international organizations.
Dying a Thousand Deaths: Recurring Emergencies and Exceptional Measures in International Law

Maria Agius*

Table of Contents

Abstract ........................................................................................................................................... 220
A. Introduction ................................................................................................................................. 220
B. Two Perspectives on Exceptional Measures in International Law ........................................... 222
C. International Incidents Pertaining to Exceptional Measures ................................................. 226
   I. Iceland 2008: The Icesave Incident ...................................................................................... 226
      1. Facts and Relevant Norms ................................................................................................. 226
      2. Reactions and Responses ................................................................................................. 228
      3. Analysis ............................................................................................................................. 231
   II. Influenza 2009: Swine Flu A (H1N1) .................................................................................. 233
      1. Facts and Relevant Norms ................................................................................................. 233
      2. Reactions and Responses ................................................................................................. 236
      3. Analysis ............................................................................................................................. 238
D. Conclusions .............................................................................................................................. 239

* LL.D. Candidate in International Law; LL.M; University of Uppsala. I am grateful to panel chair Jörn Müller and the participants of the workshop on Strategies for Solving Global Crises (Göttingen, October 2009) for their helpful suggestions. Further, I want to extend my gratitude to LL.D. Candidate Magnus Gulliksson for an inspiring discussion that tremendously contributed to improving an early draft of this paper; to Associate Professor Daniel Stattin for reassuring commentary; and to LL.D. Candidate Cyril Holm for some interesting suggestions for literature.

doi: 10.3249/1868-1581-2-1-agius
Abstract

Crises, while unforeseen and exceptional, appear with some regularity. Crisis management is not exceptional, but a recurring task. This paper studies the impact of international law on how international crises are handled and the room allowed for emergency measures within international legal discourses. It outlines the relationship between an extra-legal exceptionalist perspective, where law is considered an obstacle to emergency measures, and a more constitutionalist one, where exceptional measures are included within the legal paradigms. Examples are drawn from two contemporary crises: the global financial crisis, with particular reference to Iceland and the Icesave dispute, and the treatment of global epidemics and its effect on trade, with particular reference to the pandemic swine influenza A (H1N1). It is suggested that many factors seem to influence the choice of perspective: inter alia previous deviations in similar situations and the institutional solidity of the legal environment of the rule in question. The role for international law in crisis may increase through soft law guidance and persuasive advice from credible organisations that may assess the gravity of the situation and suggest alternative courses of action within the ambit of law.

A. Introduction

The title of this paper suggests that crises, while exceptional, are regular. In order to accept that claim, the reader needs only to consider the blows dealt to this world over the past decade, in the form of global climate change, several looming pandemics, and a global financial meltdown. All these events qualify as crises for the purposes of this paper.

It is characteristic of events activating international law that they are dramatic, pertaining to e.g., war, international peace and security, claims for territory, commitments to global environment or third world development. Closer scrutiny, it is submitted, reveals that these subjects in fact carry actuality every day. Therefore, I suggest using as a basic assumption for the arguments presented, that normalcy is constantly on the brink of the extraordinary, and that there is indeed a fine line between these two stages, which may influence each other in different ways.¹

Norms are inherently aimed at maintaining normalcy. Exceptionalism disrupts that situation. If exceptional measures – by definition existing beyond what was envisaged by the norm – are facts of life, deviations from international law must be addressed and recognised as recurring events. Such deviations from international law can be regarded from different angles. In this paper, I shall explore two perspectives on derogations from international commitments in times of emergency. One is more constitutionalist, regarding exceptional measures as included within the legal system and the legal paradigm. This is represented here by exceptional measures clauses or exceptions, and legal justification or excuse doctrines such as necessity or other circumstances precluding wrongfulness in the international law of state responsibility. The other is represented in an extra-legal paradigm. Law is perceived to be ill-equipped to tackle the problem and consequently irrelevant as regulator of the situation. This is essentially a state of exception. The basic theoretical framework in this regard draws on the work of Giorgio Agamben, set in relation to my own previous and ongoing work on the state of necessity.

Exceptional measures and states of emergency are traditionally associated with violent situations, evident from its close ties to martial law and states of siege. Equally dramatic, but less explored from this angle, are the contemporary problems of global financial meltdown or raging epidemics. In fact, such internationally ‘contagious’ problems may turn the very crisis international, and may be impossible to combat without engaging the international community and its frameworks.

This article explores what impact international law has on international crises and what room it provides for emergency measures. The ambition is to shed light on what good international law can do to resolve international crises, and where it poses an obstacle to suitable responsive action. This is illustrated with responses to a selection of events that may be labelled as ‘crises’: firstly, the contemporary international ramifications of the financial crisis in Iceland 2008; secondly, the swine influenza pandemic, and its international legal implications.

There is a general absence of judicial practice in these fields for empirical support. The events are highly contemporary and no court decisions have been issued to date. Further, some issues may be inherently extra-legal.

\(^4\) Agamben, *supra* note 2, 11-22.
and will not be settled in any court. Only a fraction of international political
and diplomatic life is in fact subject to judicial determination. However,
absence of court judgments in a field does not necessarily mean that there
are no legitimate normative expectations on the behaviour of international
actors. One way to gain insight in what those expectations are is to study
international incidents and make structured inferences from the responses
of key actors to a critical event. For the empirical sections, I will therefore
largely adopt the methodology for incident studies proposed by Reisman &
Willard.

B. Two Perspectives on Exceptional Measures in International Law

Adherence to international law is influenced by relations of power inherent in international politics. However, faith also plays a vital part in the
mechanisms of treaty observance and reinforces the sense of community. Compliance with international commitments is more than pacta sunt servanda; it is the foundation on which a cooperative world order can be built. Still, international agreements cannot foresee every possible turn of events, and states may eventually find themselves in situations where they no longer find it reasonable to live up to the bargain they entered into. Arguably, international law must therefore have contingency for exceptional events within its regulatory framework, lest states be tempted to reject the applicability of international law to the situation altogether. Without some leeway within which the state may manoeuvre, international law risks not being seen as sufficiently credible, fair, and balanced a vehicle for the management of international relations.

States by no means always comply with international law and their policies are presumably influenced by many factors. Still, the weight of international law may be measured by the use of legal language to justify their actions. That an act even requires justification indicates the presence of

---

7 J. Bodin, Les Six Livres de la Republique (1564), 189: “Faith is the only foundation and support for justice, quoted in J. Haslem, No Virtue Like Necessity: Realist Thought in International Relations since Machiavelli (2002), 43.
law. The choice of a legal justification for a course of action implies that the violation is considered an instance subject to law.

Under certain stringent conditions, the state may invoke the defence of necessity to excuse its non-observance and be relieved of liability. Necessity must not be confused with a legal exception, i.e., a norm on a similar normative level as the rule to which it is an exception, but given primacy as a _lex specialis_. Necessity only operates at secondary norm level. It excuses behaviour, rather than authorising it. It does not as such suspend the primary norm, the law. What it does is that it in dire circumstances suspends the consequences of breaching the primary norm; it thus suspends the application of secondary norms on state responsibility.

The suspension of law is a common feature of the state of necessity and its shadow image, the state of exception. The basis of the state of necessity, the ancient maxim that necessity knows no law, has however been qualified. Necessity now indeed has law, in that the heavily circumscribed doctrine of necessity may be applicable. This form of incorporation of emergency powers into the legal system in a sense introduces a constitutional model in relation to response to emergencies, by placing restraints on action that formerly was nothing more than an expression of the anarchical nature of international law. Although necessity finds itself at the border between politics and law – and closely connects with exceptionalism – recourse to exceptional measures under a legal exception or in a state of necessity is legitimised by law. Justification is offered with reference to a legal norm, and temporary suspension of the responsibility is the result of an application of a legal norm.

---

8 J. Haslem, _No Virtue Like Necessity: Realist Thought in International Relations since Machiavelli_ (2002), 20: “Unchallenged orthodoxy does not require justification”.
13 Art 27(a) ASR; cf. Gabčíkovo-Nágymaros Project (Hungary v. Slovakia), ICJ Reports 1997, 7; discussed in Agius, _supra_ note 3, in particular at 113-117.
The state of exception on the other hand provides an example of an exit from the realms of law. This contrasting perspective places derogation from international commitments in times of crisis outside the legal paradigm. This institution has been compared to a ‘standstill of the law’. Emergency is perceived as a justification for suspending international obligation altogether. This perspective has it that law is simply irrelevant in extreme circumstances, as it is incapable of accounting for the political or factual situation. Human rights advocates have cautioned against such emerging exceptionalism rhetoric, where the suspension of human rights is considered a reasonable reaction to the dangers facing our societies and liberals are forced to rebut claims that present conditions are unique.

Agamben’s exploration of this phenomenon traces its operation to the authority of the Roman Senate. This authority – being “more than advice and less than command, an advice which one may not safely ignore” – is a force ratifying the socially recognisable or military power that the popular legislative assemblies or magistrates possessed. In this capacity, authority has the competence to suspend that power. Authority, however a force that can suspend and reactivate legislative power as well as its derivative law, is notably not itself a power derived by law. Hence, exceptionalism appears as a power that is not in itself legal, but that has the power to decide on whether law should or should not be considered relevant. The state of exception in fact implies the “suspension of the entire existing juridical order”, subtract[ing] itself from any consideration of law [and hence] it cannot take a juridical form. There is no legal norm that operates to qualify the situation as a state of exception, nor to prescribe any rules to govern the situation once it has arisen.

However, law is not abrogated or deleted; nor is it a state of anarchy. Rather, it is a controlled state where the force of law loses its legal element.

14 Agamben, supra note 2, 41.
17 Agamben, supra note 2, 77-78.
18 Agamben, supra note 2, 79.
20 C. Schmitt, Die Diktatur (1921), 137. as cited in Agamben, supra note 2, 32-3.
What remains is merely the force of the executive to take necessary measures. Law becomes irrelevant to this paradigm, due to the extreme circumstances that brought it into operation. The norm that is applied to the normal situation can be suspended without annulling the juridical order because this authority represents a sovereign decision deriving its prerogative not from law, but immediately from life itself, from the facts of life. When law and life are no longer closely tied together, as they arguably are not, in a state of exception, Agamben argues that there opens a space between law and life for human action and for politics. The question that follows upon such a position is what use one may make of law when the connection between law and life has been deactivated. The following two incidents serve as practical examples of how these perspectives are present in international events. Neither of these incidents is exclusively legal in nature, but yet contains markedly legal elements and implications. The aim of these sections is to provide factual materials that illustrate the presence of either or both of the perspectives accounted for above. Thus, they may be fitted into a grander narrative of the rhetoric employed by states when describing to their peers events of international relevance that they face and when classifying these events as internal or external to law.

Agamben, *supra* note 2, 85. Oren Gross argues that in states of emergency, one can resort to extra-legal measures, coupled with *ex post* ratification, where one accepts being subjected to the scrutiny of the public when the emergency is over. However, that model still appears to employ a legal benchmarking, but postponed; when translated to international law circumstances it seems to align more closely to a state of necessity rather than a state of emergency as this is described by Agamben. The extra-legal act is consciously “disobedient”, see e.g., O. Gross & F. Ni Aolain, *Law in Times of Crisis: Emergency Powers in Theory and Practice* (2006), 134-142; that is, law would still seem to matter for the determination of the legitimacy of the action. Arguably, in a state of exception, it does not.

Agamben, *supra* note 2, 88.
C. International Incidents Pertaining to Exceptional Measures

I. Iceland 2008: The Icesave Incident

1. Facts and Relevant Norms

It will hardly have escaped anyone that the world in 2008 experienced a severe international financial crisis, rapidly spreading across the globe. One state that dramatically fell victim to the financial turmoil was Iceland, which in autumn of 2008 experienced a devastating collapse of its banking system. Icelandic banks had engaged in expansive activities abroad, incurring huge global liabilities, leaving the country very vulnerable.23 In September/October 2008, Iceland nationalised its three major banks Glitnir, Landsbanki and Kaupthing.24

As the Icelandic banking system was collapsing, particular focus came to fall on Icesave, a UK branch of Landsbanki catering to about 300,000 UK savers.25 Because of the way it was registered, it was not covered by the UK financial regulator’s compensation scheme. Instead, the first €20,000 was to be covered by the Icelandic regulator, in accordance with the Depositor Guarantee Directive,26 which has been incorporated into the legislation of the European Economic Area, and therefore applies to Iceland in the same way as to EU Member States.27

27 An interpretation that Iceland concurred with, see statement on the website of the Icelandic Prime Minister’s Office (16 November 2008) available at http://eng.forsaetisraduneyti.is/news-and-articles/nt/3229 (last visited 4 December 2009).
When Landsbanki collapsed in early October 2008, the Icelandic government initially reneged on its Directive obligation to compensate depositors of Icesave. The British Chancellor of the Exchequer was quoted saying: “The Icelandic government, believe it or not, have told me ... they have no intention of honouring their obligations”. 28 Iceland tried to explain its dilemma: according to a letter to the UK Government from the then Icelandic Foreign Minister, Ingibjörg Sólrún Gisladottir, the “total possible liabilities, if pushed to their maximum, could impose on Iceland reparations on a similar economic scale to the Treaty of Versailles”, wherefore it claimed to be incapable of reimbursing British customers.29

In order to secure funds in case Iceland made real its refusal, the UK Treasury issued a freezing order on the assets of Landsbanki on 8 October 2008, invoking the Anti-terrorism, Crime and Security Act of 2001.30 The Icelandic Government responded: “The Government of Iceland reiterates its steadfast conviction that the [freezing of bank assets] by the UK authorities was wrongful and unjustified, and has made a formal request to the UK authorities that the Freezing Order be cancelled”.31 It blamed the UK for triggering the intensified crisis that would follow over the course of October, holding that the freezing of Landsbanki assets had caused a run on its banks and was part of the cause for the suspension of the Icelandic currency.32

---

31 Mason, ‘Sue’, supra note 30.
32 Mason, ‘Sue’ supra note 30.
British depositors confusing the Icelandic banks with each other was the reason offered by Icelandic Prime Minister Geir Haarde and the executive chairman of the Kaupthing bank, Sigurdur Einarsson, for the collapse and takeover of Kaupthing. When its UK subsidiary Kaupthing Singer & Friedlander was placed into administration in the UK, Einarsson, expressed the belief “that really high up in the [UK] hierarchy there was the decision to close down everything Icelandic”. The assets of the UK division were transferred to the Dutch bank ING on 8 October 2008.

2. Reactions and Responses

The UK held Iceland liable to compensate British savers in the amount prescribed by the Deposit Guarantee Directive. It held the behaviour of the Icelandic authorities to be “completely unacceptable” and expressed frustration over the lack of information from Reykjavik. The British Government declared its intention to “tak[e] legal action against the Icelandic authorities […] showing by [its] action that [the UK would] stand by people who save”. Particular concern was for institutional depositors. Matters concerning individual and retail savers were solved within a matter of days of the diplomatic dispute unfolding. However, accounts owned by governmental, corporate or charitable entities stood to lose up to £800m.

Iceland strongly objected to the use of the Anti-Terrorism Act, arguing that it made “no sense to see an Icelandic company listed next to the Al-Qaeda and the Taleban on the Treasury website.” The UK threatened to seize assets of Icelandic companies in an attempt to recoup the £800m de-

34 Braithwaite et al., supra note 24.
37 Braithwaite et al., supra note 24.
38 Wakeford, supra note 28.
40 Braithwaite et al., supra note 24.
posited by local councils in Icelandic bank accounts. In addition, Kaupthing announced plans to sue the UK in a claim ranging in billions of pounds, holding the Transfer Order of 8 October 2008 to be unlawful as it did not fall within the Banking (Special Provisions) Act 2008.

In January 2009, Iceland held it would use “any and all possibilities” to seek redress for damage caused to the country. The UK Treasury sternly defended its position and explained its unwillingness to lift the freezing order while the terms of compensation were still under dispute, rejecting the Icelandic compensation plans. In its view, too many of Landsbanki’s assets had been placed in a new bank only for domestic customers, which left UK savers with fewer assets to cover their claims.

After a change of government, Iceland signalled a new pragmatism in February 2009, declaring that it was no longer willing to go to court over the issue. Instead it would focus on rebuilding the financial system and restore government finances. In June 2009, an agreement was finally reached between the two states and the Netherlands, who also had interests in Icesave. The Icesave deal implies that Iceland agrees to pay compensation to some 200,000 British and 120,000 Dutch Icesave depositors, taking on a €3.9bn guarantee. Britain and the Netherlands finance this by providing loans to Iceland in the same amount at 5.5 percent interest, payable within fifteen years with a seven-year grace period. UK Treasury announced at the same time that the Landsbanki UK assets would be released on 15 June 2009, adding that “[t]he Government welcome[d] Iceland’s commitment to recognise its obligations under the EC Deposit Guarantee Scheme to repay

43 Cavazza, supra note 42.
44 Mason, ‘Sue’, supra note 30.
depositors in Icesave”. This statement, with its legal references (although the solution bears marks of politics and pragmatism) illustrates how short the UK’s tolerance was for anything but a quick return to normalcy, despite the dire circumstances Iceland was in.

Although the immediate inter-state dispute seems to have been averted, the application of British anti-terrorism laws to Icelandic companies seems however to have caused a lasting feeling of resentment in Iceland. Despite the more reconciling tone, the new finance minister Steinþrúður Sigfús Ólafsson held that “[t]o apply anti-terrorist laws to freeze Icelandic assets is a long way beyond what is acceptable and it has left a lot of bad feelings”, adding that “[s]omehow we have to solve this problem in a civilised manner but the Icesave agreement is very unpopular. People feel that this imposes a terrible burden.”

The Icesave bill, ratifying the deal, nevertheless was passed by the Icelandic parliament in August 2009, after an amendment making various limitations on the payments. The Icelandic Prime Minister Jóhanna Sigurðadóttir expressed hopes for understanding and fairness from its two creditors, after the bill was passed. The two states however protested against the amendment that payments would expire in 2024, resulting in a renegotiation of the deal, to the effect that there will be extensions of the repayment guarantee as it expires. The Icelandic President Olafur Grimsson however refused to sign the bill regardless of the international pressure and the Icelandic parliament authorised the Government to hold a referendum on 6 March 2010 in order to get the view of the public. In the pre-polls, up to sixty percent of the population are expected to vote no, which will revive the rejected deal from the bill in August 2009 and is likely to incite further international dispute on the issue.

---


49 Evans-Pritchard, supra note 23.


3. Analysis

The following analysis will focus on Iceland’s compliance with international commitments. However, an interesting point to note initially in the Icesave dispute is how emergency measures can converge: the UK responding to a financial threat by making use of legislation enacted primarily in response to global terrorism.53 This substantiates some of the points to be made towards the end of this paper.

One should not ignore the political pragmatism and pressure that may have influenced the Icelandic position and the diplomatic will to reach a settlement of the dispute. Icelandic officials testified to the uncompromising ways of the UK Government, holding that Britain had employed “18th century gunboat diplomacy at every stage”.54 It is likely that Iceland’s compliance was informed by tactical considerations relating to its EU bid. To nobody’s surprise, the Netherlands asserted that arriving at the deal of June 2009 was “absolutely necessary” for any success with an Icelandic EU membership.55 Even after the swift formal acceptance of the Icelandic EU application, the Dutch Government conditioned that Iceland must repay €1.3bn to it before the EU bid goes ahead any further.56

Nevertheless, the positions of the parties are not devoid of legal argumentation. Repeated reference was made to the legal obligations of Iceland as an EEA country. The parties principally agreed that under normal circumstances Iceland was under obligation to compensate savers. In response to the Icelandic desire to balance its commitment to the Deposit Guarantee Directive against general considerations of fairness and reasonableness, there was a firm expectation from Britain and the Netherlands that this obli-

53 See G. Lennon & C. Walker, ‘Hot Money in a Cold Climate’, Public Law (2009) 37, arguing that this use of the legislation was legal, but normatively undesirable.
54 Cf. Evans-Pritchard, supra note 23.
55 BBC News, supra note 50.
gation should continue to apply even in more dire circumstances such as those experienced by Iceland.57

This is particularly interesting in relation to the diverging outcomes of the investment law cases on the Argentine financial crisis in 2001-2003, scrutinised in a series of investor-state arbitrations. Two tribunals saw the non-compliance with, foremost, the fair and equitable treatment standard required by the US-Argentina bilateral investment treaty as excusable, because Argentina was in a state of necessity.58 Therefore, the actions, while illegal, should not give rise to liability or compensation to the investors. The financial recovery plan launched by Argentina was considered a necessary measure to which there was no viable alternative. Interestingly enough, three other tribunals came to the opposite conclusion and held Argentina responsible for breach of the fair and equitable treatment of investors.59 International investment treaties however often contain clauses explicitly allowing flexibility for exceptional measures in times of crisis.60

Such flexibility does not appear to have been present in the Icesave incident. Iceland was expected by future EU partners to live up to its commitment, even at very high costs. This probably relates to the institutional solidity of the EC/EEA legal scheme and the sense of community it encompasses. Further, the Icesave incident involves an explicitly interwoven global system. Contracting parties may then be less lenient, as laxness could result in ‘catching the disease’ and risk the soundness of one’s own finances. The normalcy paradigm thus had to override the exceptionalist, and

57 Although Directive 94/19/EC, see supra note 26, is arguably envisaged for a situation where an individual bank fails, not a situation where an entire national banking system collapse, cf. the preamble of the Directive, speaking e.g., of the need to protect depositors in the event of ‘the closure of an insolvent credit institution’, para. 7.


59 CMS Gas Transmission Company v. Argentina, Award of the Tribunal, 12 May 2005, ICSID Case No. ARB/01/8; Enron Corp v. Argentina, Award of the Tribunal, 22 May 2007, ICSID Case No. ARB/01/3; Sempra Energy International v. Argentina, Award of the Tribunal, 28 September 2007, ICSID Case No. ARB/02/16.

60 Also, possibly as a result of a learning experience in international litigation, many states have chosen to make such flexibility clauses self-judging. A. Van Aaken, ‘International Investment Law Between Commitment and Flexibility: A Contract Theory Analysis’, 12 Journal of International Economic Law (2009) 2, 507, 523-527.
Iceland could not be allowed to transfer the issue to a discourse where ‘facts of life’ rule the legitimacy of the behaviour, rather than law.\textsuperscript{61}

Despite the unpopularity of the Icesave deal, one could however – given that the dispute appears to have been fully contained within the legal paradigm, leaving little room for any divergences into the realms of the extraordinary – interpret the very fact that Iceland managed to secure a loan at this difficult time as a partial win.\textsuperscript{62}

II. Influenza 2009: Swine Flu A (H1N1)

1. Facts and Relevant Norms

The financial crisis has affected some countries gravely. However, the ongoing pandemic of the swine influenza A (H1N1) has come to affect most countries. The outbreak of disease can easily become a transnational public health issue. Pandemics in particular are characterised by their very rapid spread to all parts of the world and they reoccur with intervals of one to five decades, an average of three pandemics per century.\textsuperscript{63} They have severe ramifications: increased medical needs; widespread employee absenteeism; interruption of public services; or loss of faith in government for not re-
sponding well to the crisis. Since they occur simultaneously in many countries, there are few opportunities for inter-state aid and assistance.\textsuperscript{64}

The swine influenza A (H1N1), a new form of influenza virus, broke out in Mexico and North America in spring 2009. As of 1 November 2009 there had been over 480,000 cases and 6,000 deaths, affecting almost 200 countries.\textsuperscript{65} In early June 2009, the swine influenza was alerted as Phase 6 (pandemic), making it the first pandemic of this century.\textsuperscript{66} Influenza pandemics are particularly problematic, as there is almost universal susceptibility to infection.\textsuperscript{67} In the case of this influenza, the risk of society shutdown is particularly worrying, as young, healthy populations have been particularly struck, just as in the influenza pandemic of 1918.\textsuperscript{68}

The control of infectious disease is regulated in the International Health Regulations (IHR).\textsuperscript{69} This is the only binding multilateral agreement on communicable diseases, and it is adopted by 194 states.\textsuperscript{70} The IHR in its current formulation, following revisions in 2005, apply generally to infectious diseases.\textsuperscript{71} With the revisions, the WHO Director-General was given the mandate to alert the international community of a public health situation that threatens neighbouring countries or international health.\textsuperscript{72} This was in

\textsuperscript{64} N. Khouri, ‘Bird Flu, TRIPS and the Customary International Law Doctrine of Necessity’, 5 New Zealand Yearbook of International Law (2007-2008), 37-38, with references; Murphy & Witty, supra note 15, 221.


\textsuperscript{66} “We are all in this together, and we will all get through this, together”, ‘World Now at the Start of 2009 Influenza Pandemic’, supra note 63.

\textsuperscript{67} Chan, supra note 63.


\textsuperscript{69} International Health Regulations, 2nd ed. (2005), WHA Res. 58.3 (23 May 2005), in force 15 June 2007.


\textsuperscript{71} The regulations in force prior to IHR 2005 only applied to cholera, plague and yellow fever, see Art. 1 in the 1969 International Health Regulations from 1969. D. P. Fidler, ‘Global Outbreak of Avian Influenza A (H5N1) and International Law’, American Society of International Law, ASIL Insights (January 2004) available at http://www.asil.org/insigh125.cfm (last visited 4 December 2009).

\textsuperscript{72} Art. 12 IHR; Cf. D. P. Fidler, ‘Developments involving SARS, International Law, and Infectious Disease Control at the Fifty-Sixth Meeting of the World Health Assembly’,
fact formal recognition of a power the WHO had already practised, the
ground of which had been unclear, and an important political statement,
increasing the organisation’s political persuasiveness as well as import-
ance.\textsuperscript{73} Use was made of this power in April 2009, when the outbreak of
swine flu was declared a “public health emergency of international con-
cern”.\textsuperscript{74} Thereby, the epidemic is considered an “extraordinary event which
[…] constitute[s] a public health risk to other States through the interna-
tional spread of disease and […] potentially require[s] a coordinated interna-
tional response”.\textsuperscript{75}

States parties are obliged to identify and address public health emer-
gencies of international concern.\textsuperscript{76} When an international health threat is
identified, the WHO can issue temporary recommendations advising restric-
tions on trade, based on scientific evidence, risk assessments, and the advice
of the Emergency Committee. Such recommendations can also advise the
issue of travel warnings or the screening and medical examination of travel-
ers.\textsuperscript{77} The IHR however purports “to prevent, protect against, control and
provide a public health response to the international spread of disease in
ways that are commensurate with and restricted to public health risks, and
which avoid unnecessary interference with international traffic and trade.”\textsuperscript{78}
This must be considered when making recommendations, and states that
wish to implement more strict health protection measures must demon-
strate that these are not more invasive or intrusive to persons than reasonably
available alternatives that would achieve the appropriate level of health pro-
tection.\textsuperscript{79}

\begin{footnotesize}
\textit{American Society of International Law, ASIL Insights} (June 2003) available at
\textsuperscript{73} \textit{Id.} For instance, alerts were raised in relation to the outbreak of SARS. Fidler com-
pares this power of the WHO D-G to that of the UN Security Council under Ch. VII of
the UN Charter, House of Lords Select Committee on Intergovernmental Organisa-
tions, Diseases Know No Frontiers: How effective are Intergovernmental Organisa-
tions in controlling their spread?, Vol II: Evidence, HL Paper 143-II, available at
(last visited 11 February 2010), 392.
\textsuperscript{74} Fidler, ‘Swine Flu’, \textit{supra} note 68.
\textsuperscript{75} Art. 1 IHR.
\textsuperscript{76} D. P. Fidler, ‘Influenza Vaccine Supply and International Law’, \textit{American Society of
International Law, ASIL Insights} (October 2004) available at http://www.asil.org/in
sight041020.cfm (last visited 4 December 2009)
\textsuperscript{77} Arts. 17-18 IHR; Fidler, ‘Swine Flu’, \textit{supra} note 68.
\textsuperscript{78} Art. 2 IHR, cf. Fidler, ‘SARS’, \textit{supra} note 70.
\textsuperscript{79} Arts. 17(d) and 43(1) IHR.
\end{footnotesize}
The IHR in fact applies a similar test for trade restrictions to that applied under WTO law, notably the GATT and the SPS Agreement.\(^{80}\) The purpose of the demand for scientific evidence in both these regimes is obviously to counter protectionist or discriminatory trade restrictions that are merely disguised as public health measures.

2. Reactions and Responses

The pandemic has prompted several countries to issue states of emergency and exercise exceptional powers of various sorts.\(^{81}\) Some twenty states (inter alia China, Croatia, Ecuador, Philippines, Russia, Serbia, Switzerland, Thailand) placed bans on pork imports from prominently Mexico, the United States and Canada.\(^{82}\) This was so despite repeated information from the WHO, the WTO and other organisations that there was no scientific evidence of swine flu being transmitted through pork products and hence no reason to impose trade bans.\(^{83}\) It has been argued that the bans on pork products could be in violation of the IHR.\(^{84}\)

---

\(^{80}\) Fidler, ‘SARS’, \textit{supra} note 70; cf. GATT Art. XX(b) and the SPS Agreement Arts. 2(2), 2(3) and 5(6); Fidler, ‘Global Outbreak’, \textit{supra} note 71.

\(^{81}\) See \textit{e.g.}, the list of declarations by some states compiled by the Centers for Law & the Public’s Health, Johns Hopkins and Georgetown Universities, available at http://www.publichealthlaw.net/Projects/swinefluphl.php (last visited 4 December 2009).


\(^{83}\) WHO, Joint FAO/WHO/OIE/WTO Statement on influenza A (H1N1) and the safety of pork (2 May 2009) available at http://www.who.int/mediacentre/news/statements/2009/h1n1_20090502/en (last visited 4 December 2009); “To date there is no evidence that the virus is transmitted by food. There is currently therefore no justification […] for the imposition of trade measures on the importation of pigs or their products.” See also WHO, Joint FAO/WHO/OIE Statement on influenza A (H1N1) and the safety of pork (7 May 2009) available at http://www.who.int/mediacentre/news/statements/2009/h1n1_20090430/en/ (last visited 4 December 2009), reiterating: “Influenza viruses are not known to be transmissible to people through eating processed pork or other food products derived from pigs […] Pork and pork products, handled in accordance with good hygienic practices […] will not be a source of infection.”

\(^{84}\) Fidler, ‘Swine Flu’, \textit{supra} note 68.
Five countries (Albania, China, Ecuador, Jordan and Ukraine) made a formal notification of trade measures under the SPS Agreement.85 Exporting countries (Canada, Mexico, Japan, the US, New Zealand, the EU, Brazil, Paraguay, Australia and the Dominican Republic) complained at the meeting of the SPS Committee 23-24 June 2009 that such measures were unjustified.86 Canada has been reported to be considering formal WTO action over China’s ban87 and the Canadian trade minister, Day, called on governments to “make decisions that are scientifically based”, adding that he “would expect those countries, which have gone ahead with the ban or were thinking about it, would stop and have a look at scientific guidelines and would recognise that the meat itself is not a problem”.88

Some states, inter alia India, have claimed to indeed have the required evidence.89 Others have not, and several of the formal restrictions reported to the WTO were lifted over the course of summer and autumn 2009, reportedly after more careful review of the available evidence.90 The develop-

85 See e.g. the following notifications of emergency measures: China (Mexico and US) 5 June 2009, WTO Doc. G/SPS/N/CHN/116; Ecuador (Canada) 15 May 2009, WTO Doc. G/SPS/N/ECU/82; Jordan (all trading partners) 25 May 2009, WTO Doc. G/SPS/N/JOR/20; Ukraine (Canada, Mexico, New Zealand and US) 1 May 2009. Notification is required under Annex B to the Agreement on the Application of Sanitary and Phytosanitary Measures.
88 Adomaitis, supra note 82.
89 See Business Standard, supra note 86.
90 J. T. Areddy, ‘US and China Ease a Range of Trade Restrictions’, The Wall Street Journal (30 October 2009), available at http://online.wsj.com/article/SB125680121414515403.html (last visited 4 December 2009). China has at the time of writing not formally notified withdrawal of its emergency notification to the SPS Committee. Albania, Jordan, and Ukraine have all done so, see, respectively, WTO Docs. G/SPS/N/ALB/116/Add.1, 28 September 2009; G/SPS/N/JOR/20/Add.1, 18 August 2009; and G/SPS/N/UKR/2/Add.1, 13 July 2009. However, as regards the Ukraine, the state shortly after notified that inspections would take place in relation to most kinds of imported animals and animal products “due to the complex epizootic situation in the world”, WTO Doc. G/SPS/N/UKR/3, plus Rev.1 and Rev.2, 29 July, 3 Au-
ing disputes may largely have been averted: the allegedly wrongful behaviour has ceased, and according to business news reports, pork sales were only mildly affected by the period of restrictions. However, it still appears prima facie to be a divergence from international trade obligations, with little more than the severity and emergency of the situation as basis for it.

3. Analysis

When stakes are particularly high, as they are when human life is at stake, there is a higher risk of excessive apprehensions, also in relation to statistically more improbable events.\textsuperscript{91} It would appear that the situation on trade restrictions for pork will trigger the legal mechanisms intended to contain overly excessive responses to public health threats. Also in this situation the solution is to some extent a negotiated, political one: for instance, in exchange for removal of the Chinese pork trade ban, the US agreed to remove its restrictions on Chinese poultry, introduced following the avian flu.\textsuperscript{92} The situation is nevertheless conducive to legal arguments, as the legal justification builds on standards of scientific evidence, a point on which there is room for divergent opinions.

The framework thus contains plenty of room for flexibility in itself. Further, public health law provides a legal obligation representing an opposing interest to that of free trade in a situation where disease actually can be transferred through the trade in goods. A regime for threats to public health by something as uncontrollable as a virus must probably allow for contingency measures above and beyond normalcy. However, epidemics, even of a global circulation, are rather frequent. The regulations must therefore arrive at a balance between exceptionalism and normalcy, precisely because human health is such a central and existential matter. The possibility of law to evade obligations to respect e.g., free trade requires that there is a framework in place to prevent excessive measures that cause great harm to exporting countries and their industries.

Diseases have the potential of plunging people into panic, tempting them to disregard something as mundane as legal regulation. If the early reports are right, that indeed there is no tangible evidence of swine influenza
gust and 1 Oct 2009. The EC and other in October 2009 raised this as a specific trade concern to be addressed within the SPS Committee of the WTO, holding that there is no justification for such comprehensive inspections and asking assurance that trade will not be unnecessarily disrupted.

\textsuperscript{91} Gross, ‘Chaos and Rules’, supra note 1, 1040.
\textsuperscript{92} Areddy, supra note 90.
being transmitted in pork products, the large number of states placing bans on imports of pork indicates that there is still a space that a state of exception may come to operate in, a space where legal argumentation or justification seems superfluous due to the severity of the situation. The number of states imposing a ban without claiming to have the required scientific evidence indicates a widening in the use of emergency exceptions in this field, possibly approximating the precautionary principle.93

D. Conclusions

These incidents give an idea of the degree to which international law is employed and respected in times of crisis. The exceptionalism perspective is present, but fortunately not prominent, in either incident. Exceptionalism implies suspension of helpful law for all the ‘right’ reasons, in which case international law can do little to help resolve crisis.

International law can provide an obstacle as well as a solution in relation to international crises. Normative formulations of desired behaviour will undoubtedly induce thought before action, but it seems questionable whether the illegality of an act is really decisive for the choices of actors in emergency situations. However, there is a dual role to play for international law: on the one side making room for the exceptional within law, e.g. through the necessity doctrine under the law of state responsibility, and on the other, to contain irrational measures that are motivated by a prisoner’s dilemma type of reasoning, self-serving protectionism or panic-induced opportunism.

When conflicting interests, both given voice through international commitments, are contrasted, and commitments are evaded with reference to other obligations under international law, that represents a path for preserving adherence to law, while making room for the most pressing values underlying law. It contains the settlement of a difference in a paradigm of constitutionalism, rather than exceptionalism. Between a rock and a hard place, and given the chance to justify a breach with reference to a conflicting commitment, states give voice to their truest values and allegiances.

There is however a risk that pure opportunism or protectionism will be obscured by references to legal language if placed within law.94 The merg-

93 See supra at note 82, 85 and 87 and accompanying text.
94 Cf the arguments offered by O. Gross in favour of his extra-legal measures model, see e.g. ‘Extra-Legality and the Ethic of Political Responsibility’, in: V. V. Ramraj, Emergencies and the Limits of Legality (2008), 60.
ing of exceptionalism into the legal framework, into normalcy, may in fact expand the normality that is expressed through the norm. The norm itself is incapable of defining what the normalcy it maintains is. The inclusion of exceptional measures seems to have a tendency to widen the boundaries of the norm, to increase the level of tolerance for deviation. As exceptionalism enters the scene, the perception of normality stretches, opening up within the law that familiar, yet dreaded space for politics characteristic of the state of exception. If the sense of normalcy stretches, it must be asked what the consequences are, if one accepts that crises are recurring and may even become entrenched. If one learns to live with fear and threat and that situation is normalised, the values that were embedded in the rule set aside will not be sufficiently considered.

Several factors are likely to influence how lightly one will discard an international commitment. The legitimacy of the norm may be a factor. Here, the context of commitment seems influential: a community regime like the European Community exerts considerable compliance pull. It is simply imperative for maintaining a sufficient level of faith in the project that rules are adhered to. Firm expectations of compliance at all times may serve as a push towards a more comprehensive adherence to law.

The narrative of the EC project as a positivistic cooperative regime and the character of a ‘club’ may enhance the sense of an opinio juris with (presumptive) member states. The strong institutional factor, however present in both examples, may also form part of the explanation: the goals of the regime are clearly represented in and interlinked with judicial activity in both areas; perhaps even more so in the EC.

History may also be a factor: trade rules have emerged as restrictions on the prerogatives of states to decide on their trade policies and are frequently broken and disputed. The EC in its current, elaborate form being a rather recent regime may benefit from not being as ‘broken down’ in terms of earlier non-compliances. The emergencies already faced are likely to shape expectations of future emergencies and the same could be true for

---

95 See here the use of anti-terrorism legislation to respond to the failure of the Icelandic financial market. Once rules are in place, it is tempting to put them to use, even against better judgment.
96 Agamben, supra note 2, 40.
the solutions to crises, including whether it is conceivable to stretch or break rules to respond to them.

Reflecting on the interface of trade law and public health law in the swine flu example, there may be problems in a time of fragmentation of international law. There is no guarantee that a similar or even identical wording in an exceptional measures clause will be understood in the same way when under scrutiny by bodies or actors affiliated with separate fields of international law.\(^\text{100}\)

At the stages at which these incidents are reported, there has been no reason to invoke the necessity doctrine. No international responsibility has been established and it remains to be seen whether – should there be judicial settlement of any of the incidents – such a defence will be raised. Notably, however, Iceland for instance could not permanently rid itself of its obligations under the Deposit Guarantee Directive with reference to such a doctrine, since a necessity defence would only relieve of liability for the period during which the necessity situation persists.\(^\text{101}\) Necessity could be more of interest to the trade restrictions example; however, it is a point of debate as to what degree general international law applies fully in the context of WTO law.\(^\text{102}\)

The two incidents share the common feature that they are effects of a globalisation process, whereby the interaction between individuals from different corners of the world has increased.\(^\text{103}\) In addition, both areas appear to be such that the future will only lead to further inter-state involvement, adding to the rapid international spread of problems as they occur. And as such, they are both areas where further international legal preparedness may be required.

The incidents under study illustrate some more progressive ways in which international law can mitigate crises in the global arena: as a channel

\(^{100}\) A. Khrebtukova, ‘A Call to Freedom: Towards a Philosophy of International Law in an Era of Fragmentation’, 4 Journal of International Law & International Relations (2008), 1, see in particular at 71-78 when discussing regime-interaction in terms of incommensurability.

\(^{101}\) See supra at note 10-11 and accompanying text.


\(^{103}\) “Planet Earth has never been as tiny as it is now. It shrunk – relatively speaking of course – due to the quickening pulse of both physical and verbal communication.” F. Karinthy, Chain-Links (1929), reprinted in: M. Newman et al. (eds), The Structure and Dynamics of Networks (2006), 21 arguing that everyone and everything are connected within six degrees of separation.
of communication to open up normative questions for debate\textsuperscript{104} or as a format for developing guidelines by third-party organisations providing the least subjective available proof of scientific standards\textsuperscript{105}. Such bodies serve as fora for discussion, research and risk assessment and are in a better position to get an overview of relevant values and interests and strike an appropriate balance in crises, \textit{inter alia} in the format of WHO recommendations. It may not be conceivable to confer actual power to legislate, regulate or negotiate to international institutions, in particular when dealing with situations where the state is perceived to be under threat. But authority – being the force that arguably suspends law in a state of emergency – may also be the force that brings orderliness to chaos and crisis. The intellectual leadership, global credibility and persuasive force of international organisations can present alternatives to irrational, exceptional and non-transparent responses. Increasing in this way the political space for greater compliance with common goals rather than selfish ones in times of crisis may be a more realistic ambition than to attempt to create an international law for all seasons.

\textsuperscript{104} Cf. \textit{supra} notes 61 and 91 and accompanying text.

\textsuperscript{105} E.g., the joint statement by the WTO, WHO, FAO and OIE with regards to the swine flu, see \textit{supra} at note 83.
An Unusual Suspect? Monetary Sovereignty
and Financial Instability

An Hertogen∗

Table of Contents

Abstract .................................................................................................................. 245
A. Introduction .................................................................................................... 245
B. Financial Interdependence ........................................................................... 246
C. … But Legal Independence ........................................................................... 248
   I. Monetary Sovereignty ................................................................................ 248
      II. International Law Limits on Monetary Sovereignty ............................. 249
         1. IMF Articles of Agreement ............................................................. 249
         2. The WTO ......................................................................................... 252
         3. Customary International Law and General Principles ..................... 252
            a) The Principle of Non-Intervention ........................................... 253
            b) The No Harm Principle and the Abuse of Rights
               Doctrine .................................................................................... 254
D. Sovereignty in Interdependence? ................................................................. 255

∗ LL.M. (Columbia), PhD Candidate, Faculty of Law, University of Auckland (New Zealand). Thanks to Dr. Caroline Foster, Prof. Jane Kelsey and John Ip at the University of Auckland, the participants at the “Strategies for Solving Global Crises” workshop at the Georg-August-Universität in Göttingen and the members of the Leuven Centre for Global Governance Studies for their helpful comments on earlier drafts. Any errors remain my own. E-mail: aher044@aucklanduni.ac.nz.

doi: 10.3249/1868-1581-2-1-hertogen
E. Modifying Monetary Sovereignty ................................................................. 257

I. Who Exercises Sovereignty? ................................................................. 257

II. Why State Sovereignty? ................................................................. 258

III. Sovereignty’s Substantive and Geographical Reach .................. 258

IV. How Should Sovereignty Be Exercised? ................................. 260

1. Responsibilities of Acting States ................................................. 261

   a) Duty to Co-operate ............................................................... 261

   b) Increase Accountability ......................................................... 262

2. Rights of the Affected States ....................................................... 263

F. Conclusion ....................................................................................... 265
Abstract

This article argues that, in an increasingly interdependent world, a state’s exercise of its monetary sovereignty through its monetary management policies (monetary policy, exchange rate policy and credit creation regulation) can affect financial stability abroad. Rather than looking for multilateral regulation of monetary management policies, this article argues that the rights and obligations stemming from sovereignty need to be rebalanced to ensure that state sovereignty becomes more compatible with increasing interdependence.

A. Introduction

Globalization is widely seen as eroding states’ power over their economies, but states are not powerless over the economic forces driving globalization. States remain in charge of regulating credit creation within their territories and can shape macro-economic variables, such as the liquidity available to the economy or the level of the exchange rate.

The closer integration of financial markets due to financial services trade liberalization and capital account liberalization has created linkages through which domestic monetary management policies can have an undesired impact on financial stability abroad. These policies were significant factors in the global financial crisis that started in 2007 as well as in earlier episodes of financial instability. To avoid future financial crises, states’ behaviour, even if at face value restricted to their own territories, may need to be altered. This article addresses how international law can contribute. Due to the involvement of states either as direct actors or as regulators, monetary management policies are appropriate subjects for study under international law.

The appropriate reach of monetary sovereignty in increasing financial interdependence is a central issue in this article. Given that sovereignty is not an end in itself, but a tool to protect specific values of international relations, it is explored what these values are. Are these values still


compatible with the interdependence that flows from the closer integration of financial markets or has sovereignty lost its effectiveness to protect them? Do we need to modify sovereignty to improve its effectiveness? Should states’ discretion to exercise their monetary sovereignty be limited to protect other states?

B. Financial Interdependence

This article takes as a given that international law has facilitated – for better or for worse – the closer integration of national financial systems. This is illustrated, notably, by the current global financial crisis.

The creation of a more financially integrated global economy has however been lopsided. While the regulation of global trade and of capital and investment flows has been lifted to the international level, monetary management policies are left to the discretion of states. As a result, trade, capital and investment linkages can transmit the effects of a state’s monetary management policies to other states.

Monetary management policies are those policies that manage the price of money and its aggregate supply in an economy. They are a state’s monetary policy, which is closely related to its credit creation regulation, and its exchange rate and foreign currency reserves policies.

Monetary policy aims to ensure that enough money circulates in the economy to enable economic activity, but not so much as to cause inflation. Central banks set monetary policy by providing the “monetary base”, consisting of currency and the reserves held by commercial banks with the central bank in its role as the bankers’ bank.³

The monetary base is narrower than an economy’s aggregate money supply in which commercial banks play an important direct role through the creation of credit. The central bank’s monopoly over the monetary base nevertheless allows it to indirectly influence credit creation by commercial banks by regulating the amount of reserves commercial banks have to hold (if any)⁴ or by changing the supply of central bank reserves to affect their

⁴ W. J. Baumol & A. S. Blinder, Macroeconomics: Principles and Policy, 10th ed. (2007), 270. Some states do not require their banks to hold any reserves at all, but rely on other forms of prudential regulation to ensure the safety of deposits. Reserve ratios have generally become quite low due to competitive pressures in the global market;
“price”, as expressed in the money market interest rate.\(^5\) Since banks pass on this interest rate to their customers, the central bank can indirectly control the interest rates charged to borrowers or paid to depositors.\(^6\) In recent years, credit creation has increasingly taken place on capital markets rather than through traditional commercial banks.\(^7\) Central banks exercise less control over capital market participants, such as hedge funds or investment banks, because they are not subject to the stricter prudential regulation and supervision requirements applicable to traditional banks.\(^8\)

The aggregate money supply in one state, as determined by the monetary base and the amount of credit created by financial institutions, can affect financial stability abroad. For example, if capital moves freely between two states and one has fixed its exchange rate to that of the other, the fixing state has to accept the anchor state’s monetary policies,\(^9\) regardless of whether these suit its economy. Moreover, a state’s regulatory framework governing credit creation can affect other states, as illustrated by the losses suffered by foreign investors in US mortgage-backed securities following the collapse of US sub-prime mortgages.

The currency component of the monetary base links monetary policy and exchange rate policies. Central banks intervene on the foreign exchange market to support an exchange rate peg by which the value of their currency is tied to that of another, or, to temper the volatility of a floating exchange rate. Buying the domestic currency using foreign currency reserves reduces the monetary base and, because of the increased demand, appreciates the domestic currency. Conversely, selling the domestic currency in exchange for foreign currency increases the currency component of the monetary base and depreciates the domestic currency.

---

\(^{5}\) Burda & Wyplosz, supra note 4, 212.

\(^{6}\) Id., 210.


\(^{9}\) A fundamental principle of macro-economics, known as the “Impossible Trinity”, holds that a state can only have two out of the following three policies: an independent monetary policy, a fixed exchange rate and capital mobility, see J. A. Frieden, Exchange Rate Politics: Contemporary Lessons from American History, 1 Review of International Political Economy (1994) 1, 81, 83.
As an exchange rate is by definition a bilateral relation, changes directly affect prices in both states. Moreover, decisions regarding the accumulation and management of *official foreign currency reserves* link the state accumulating the reserves and the state issuing the reserve currency, especially if the reserves are not kept in currency but are reinvested in the reserve state, as we have seen recently with Chinese investments in US assets. This strategy lowered interest rates in the US and exposed China to US monetary management policies.12

C. … But Legal Independence

I. Monetary Sovereignty

The previous section explained how monetary management policies, even if directed towards the domestic economy, can affect other states’ monetary management policies. A central question in this article is whether states should take these effects into account when deciding on their domestic monetary management policies.

The starting point is the concept of monetary sovereignty, of which monetary management policies are considered attributes.13 Monetary sovereignty translates the idea of sovereignty to international monetary relations. It finds its legal basis in an 80 years old decision of the Permanent Court of International Justice holding that “a state is entitled to regulate its own currency”.


11 IMF Initial Lessons, supra note 8.


14 *Case Concerning the Payment of Various Serbian Loans Issued in France and Case Concerning the Payment in Gold of the Brazilian Federal Loans Issued in France* (1929) PCIJ Ser A, Nos 20/21, 44.
In international law, sovereignty is traditionally seen as closely related to “independence”.\textsuperscript{15} States exercise authority within their territory to the exclusion of other internal actors (“internal sovereignty”) and of those outside their territory (“external sovereignty”).\textsuperscript{16} The delineation between internal and external sovereignty is increasingly porous as the creation of international institutions and of global markets requires internal sovereignty but at the same time affects its exercise.\textsuperscript{17} Indeed, the exercise of internal monetary sovereignty is subject to international agreements and customary international law – results of the exercise of external sovereignty.\textsuperscript{18} The next section examines international limits on the exercise of internal monetary sovereignty through monetary management policies when this has an impact on other states’ ability to exercise their monetary sovereignty.

II. International Law Limits on Monetary Sovereignty

1. IMF Articles of Agreement

The IMF’s Articles of Agreement\textsuperscript{19} contain a basic code of conduct governing the exercise of monetary sovereignty. Article IV stipulates a general duty to collaborate with the IMF and other members to ensure financial and economic stability. This duty is linked to four more specific obligations. Through its bilateral surveillance, the IMF oversees compliance with these obligations.\textsuperscript{20}

The 2007 Decision on Bilateral Surveillance over Members’ Policies\textsuperscript{21} has shifted the focus of IMF bilateral surveillance to the external impact of monetary management policies by introducing the concept of “external

\textsuperscript{15} Customs Regime between Germany and Austria (Protocol of March 19\textsuperscript{th}, 1931) (1931) PCIJ Series A/B, No. 41 [Customs Regime Case].

\textsuperscript{16} Peters, supra note , 516.


\textsuperscript{18} C. Proctor & F. A. Mann, Mann on the Legal Aspect of Money, 6th ed. (2005), 500, footnote 506.

\textsuperscript{19} Articles of Agreement of the International Monetary Fund, 22 July 1945, 2 U.N.T.S. 39 [IMF Articles of Agreement].

\textsuperscript{20} Id., Art. IV(3)(b).

stability”. This shift acknowledges the potential external effects of states’ monetary management policies on other states and brings global imbalances, such as those between the US and Chinese economies, to the forefront.

The actual obligations imposed on IMF members are however minimal. First, only a few limits apply to a state’s freedom to choose an exchange arrangement: states cannot fix their currency to the value of gold, use discriminatory or multiple currency practices except when authorized or approved by the Fund or manipulate their exchange rate. The latter has gained attention in the past years, in light of the allegations of Chinese currency manipulation.

Although the obligation to avoid manipulating exchange rates is seen as a fairly strong obligation of conduct, its application is subject to strict conditions regarding the state’s purposes and the effects of its actions. In practice, the complexity of determining an exchange rate’s “fair value” combined with a member’s entitlement to the benefit of any reasonable doubt regarding the purpose of their policies has led the IMF’s Executive Board to defer to a member’s choices about the exercise of its monetary sovereignty.

---

23 IMF Articles of Agreement, supra note 19, Art. IV(2)(b).
24 Id., Art. IV(3).
29 Id., para. 3.
Moreover, even if the IMF would be able to establish exchange rate manipulation, and thus a breach of article IV(1), the only sanction available under its Articles of Agreement is an exclusion from lending.\textsuperscript{31} This may be effective for deficit states that rely on IMF loans for funding shortfalls,\textsuperscript{32} but is toothless against states that do not require IMF funding and are often important creditors to the IMF.\textsuperscript{33}

Second, the other monetary management policies are at most subject to best efforts obligations to ensure stability\textsuperscript{34} or to recommendations to counter instability.\textsuperscript{35} In addition, specific developments, such as “fundamental exchange rate misalignment” or “monetary policies […] that provide abnormal encouragement or discouragement of capital flows”, will attract IMF scrutiny.\textsuperscript{36} However, IMF scrutiny of the acts that caused these developments does not imply that those acts are presumed to breach of article IV(1).\textsuperscript{37} The IMF will thus have to rely on its persuasive power only if it wants to change a member’s monetary management policies.

To conclude, while the IMF Articles of Agreement cover a wide range of domestic policies, states enjoy broad freedom in their monetary management policies. This freedom is strengthened by the obligation on the IMF to pay due regard to members’ circumstances and to respect members’ other policy objectives.\textsuperscript{38} This is not necessarily a bad limitation. Various policy mixes, including but not limited to monetary management policies, are possible to achieve domestic and external stability. The decision on which policies should go in this mix should in principle belong to the state. However, to the extent that decisions have a negative external impact, limitations may be required. While the 2007 Surveillance Decision with its concept of external stability is an important step in this direction, its impact on most economies is limited to whatever persuasive power the IMF may

\textsuperscript{31} IMF Articles of Agreement, supra note 19, Art. XXVI(2)(a).
\textsuperscript{34} IMF Articles of Agreement, supra note 19, Art. IV(1)(i) and (ii).
\textsuperscript{35} IMF 2007 Surveillance Decision, supra note 21, para. 14, B and D.
\textsuperscript{36} Id., para. 15.
\textsuperscript{37} IMF Companion Paper, supra note 10, para. 37.
\textsuperscript{38} IMF Articles of Agreement, supra note 19, Art. IV(3)(b); IMF 2007 Surveillance Decision, supra note 21, paras 9 and 11.
have. The degree of persuasive power depends on many factors such as whether the state is a borrower or a creditor, political considerations within the Executive Board, and the technical and communications skills of the IMF staff members participating in the surveillance mission.\textsuperscript{39}

2. The WTO

Various authors have recently explored whether WTO rules restrict states’ monetary management policies and exchange rate valuations in particular.\textsuperscript{40} They have analysed whether the negative effect thereof on other states would be contrary to WTO obligations, such as article I GATT,\textsuperscript{41} or whether they allow affected states to take unilateral actions, such as under the Subsidies and Countervailing Measures Agreement.\textsuperscript{42} Most of this research concludes that the various WTO obligations do not provide a ground for action against the trade effects of monetary management policies.\textsuperscript{43} Others argue that actions are possible, albeit difficult.\textsuperscript{44} The WTO is unable to assist states feeling the negative impact of other states’ monetary management policies due to the complexity of the relation between these policies and trade volumes.\textsuperscript{45}

3. Customary International Law and General Principles

International law’s purpose has traditionally been to regulate the peaceful co-existence between equal states. To this end, “rules of abstention” limiting a state’s exercise of its sovereignty to protect another state’s equal sovereign rights have long been part of international law. The


\textsuperscript{40} The most comprehensive analysis is Zimmermann, \textit{supra} note . Other examples are Staiger & Sykes, \textit{supra} note ; Proctor, \textit{supra} note ; M. Benitah, \textit{China’s Fixed Exchange Rate for the Yuan: Could the United State Challenge It in the WTO as a Subsidy?} (corrected version) (October 2003) available at http://www.asil.org/insigh117.cfm (last visited 24 March 2010).

\textsuperscript{41} Proctor, \textit{supra} note 27, 1345-1348; Zimmerman, \textit{supra} note 27, 18-39.


\textsuperscript{43} Proctor, \textit{supra} note 27, 1345-1348; Staiger & Sykes, \textit{supra} note 26, 28-37.

\textsuperscript{44} Benitah, \textit{supra} note 40.

\textsuperscript{45} Mattoo & Subramanian, \textit{supra} note , 10.
following sections examine these rules in the context of monetary sovereignty.

a) The Principle of Non-Intervention

The principle of non-intervention is an important corollary of sovereignty, but it is nevertheless one of the murkiest topics in international law. The General Assembly Resolutions that have tried to clarify the principle are either unclear about the precise scope of the rights and duties that give it substance or have not been accepted by a substantial group of states.

The main obstacle to applying the principle in the context of monetary management policies lies in the definition of “intervention”. Its standard definition, formulated by Oppenheim, only prohibits dictatorial interventions into the affairs of another state for the purpose of maintaining or changing the existing state of affairs. A coercive element is thus required, but it is unclear how to identify coercion in the absence of (armed) force. In the Nicaragua case, the ICJ held that the cessation of US aid to Nicaragua did not amount to a breach of the principle of non-intervention. Although it did not give reasons for this conclusion, the Court presumably was of the opinion that this particular cessation of aid was not severe enough to pre-empt Nicaragua’s sovereign will.

The principle of non-intervention therefore imposes few limits on monetary sovereignty except for situations in which states deliberately use monetary management policies to affect structural change in other states. Situations like these are not common, but instances have arisen in the past.

46 Case concerning military and paramilitary activities in and against Nicaragua (Nicaragua v. United States of America), Merits, Judgment, ICJ Reports 1986, 14, 106, para. 202 [Nicaragua Case].
51 Nicaragua Case, supra note 46, 126, para. 245.
53 Kirshner describes various instances of currency manipulation against and by Iraq in the aftermath of the first Gulf war. Due to economic sanctions, Iraq could no longer import banknotes printed in Switzerland, but had to resort to domestically printed
When the negative external impact of monetary management policies is however of a lesser degree, the principle of non-intervention would not be triggered.

b) The No Harm Principle and the Abuse of Rights Doctrine

The no harm principle expresses the maxim *sic utere tuo ut alienum non laedas*. Various international sources recognize the obligation of states “not to allow knowingly its territory to be used contrary to the rights of other states”. The no harm principle can limit monetary management policies based on their external impact when harm to the other state and a causal link to the monetary management policies can be identified. Given the complexity of the underlying macro-economic dynamics, this will be problematic.

Closely related to the no harm principle is the abuse of rights doctrine of civil law origins. This doctrine bars states from exercising their sovereign rights in such a way that impedes another state’s enjoyment of its rights or

Due to the less sophisticated printing technology, these domestic banknotes were easy to counterfeit and thus less desirable than the original “Swiss” dinars alongside which they continued to circulate. In May 1993, Saddam Hussein ruled that the Swiss dinars were no longer legal tender, but allowed the exchange into Iraqi diners at parity during one week. During this week, Iraq sealed its border with Jordan; its only open international border. This decision could potentially be seen as an intervention in another state because many Jordanians held the Swiss dinars as a store of value and saw their savings wiped out. Kirshner argues that the currency action was partly directed against the Jordanian King Hussein who had indicated his reluctance to continue supporting Saddam Hussein’s regime. In addition, Saddam Hussein closed the internal border with Kurdistan thereby blocking the Kurds from exchanging the Swiss dinars on which they had been relying. Turkey interpreted the exchange actions as a threat to its stability as it could push Kurdistan towards creating its own currency which would be a highly symbolic step towards independence. See J. Kirshner, 'Currency and Coercion in the Twenty-First Century', in D. M. Andrews (ed.), *International Monetary Power* (2006), 142-147.

---


causes injury to another state. Contrary to the no harm principle, the precise status of the abuse of rights principle in international law is not entirely clear. Nevertheless, it could provide an effective remedy to hold states accountable for their monetary management policies, even though the underlying facts required would only be met in exceptional cases and would not always be easy to establish.

D. Sovereignty in Interdependence?

The analysis of existing international obligations regarding monetary management policies shows that on balance monetary sovereignty protects acting states’ rights. While this may be inspired by a concern to shield state sovereignty from intrusions by overbearing international institutions, the one-sided focus on protecting acting states overlooks the impact that their actions can have on another state’s exercise of its sovereignty in an interdependent world. This impact might not limit the legal authority of the affected state, but the practical consequences are the same if its policy choices are effectively reduced. There is thus an imbalance in the protection of sovereignty by international law in favour of protecting the acting state’s legal authority to act and against the affected state’s de facto freedom from external interference.

Various avenues are available to states in response to this imbalance in sovereignty and to deal with the tension between legal independence and financial interdependence.

States could agree to co-ordinate the conduct of their monetary or exchange rate policies or to develop multilateral regulation through cooperation. States could achieve this by expanding the IMF’s powers or by further developing international financial market standards through the various committees of the Bank for International Settlements. International case law confirms the compatibility of sovereignty pooling with state sovereignty because of states’ consent.

This compatibility with state sovereignty is however a major obstacle to its success. No incentives exist for states whose monetary management

58 Case of the S.S. “Wimbledon”, PCIJ Series A, No. 1 (1923), 25; Customs Regime Case, supra note 15, 52.
policies have a negative impact abroad to participate in co-operative efforts. The idea of international co-operation works on the premise that participation is a privilege and that non-compliance can be sanctioned with non-participation.\textsuperscript{59} When the provision of a global public good relies on the aggregate efforts of all states or when insufficient regulation by one state can undo efforts of others,\textsuperscript{60} co-operation is not a privilege, but requires states to sacrifice individual benefits for the sake of the collective. The consent requirement grants states the freedom to decide whether or not they want to make this sacrifice.

A more fundamental response is thus required. The central argument of this article is that the international law regarding sovereignty may need to be modified. A clearer understanding of how sovereignty should be exercised in situations of interdependence can be helpful to reach a better balance between the sovereignty of all states, particularly in situations where international agreements to guide state behaviour are lacking.

Section E elaborates how this rebalancing exercise could involve changes to co-operative international law instruments. These changes could take place through amendments of the relevant treaty instrument or changed interpretations of relevant concepts in cases applying these instruments. Unfortunately, both processes are slow and haphazard in nature. The treaty amendment process moreover suffers from similar issues with consent as the development of a co-operative regulatory solution as it can be questioned whether states in whose favour the balance is currently tipped will be agreeable to change.

In addition to changing co-operative international law instruments, the article suggests a “back to basics” approach. International law emerged to regulate the peaceful co-existence of states by guiding the unilateral exercise of sovereignty through, for example, principles allocating jurisdiction and the principle of non-intervention. This goal of peaceful co-existence is still relevant even though international law today focuses strongly on developing co-operative multilateral solutions, rather than on delineating the scope for individual actions. The relevance continues because, despite closer co-operation and integration between states, differences remain. The international law of co-operation has not superseded the international law of co-existence; both are layers that

\textsuperscript{59} W. G. Friedmann, \textit{The Changing Structure of International Law} (1964), 90-93.

\textsuperscript{60} For a typology of global public goods, see S. Barrett, \textit{Why Cooperate?: The Incentive to Supply Global Public Goods} (2007).
together make up the structure of international law. \(^61\) Therefore, I suggest a critical reflection of the purpose of these principles governing co-existence to rediscover their significance for an increasingly interdependent world order. As will become clear in the next section, this effort would happen in tandem with changes to co-operative international law instruments as principles of co-existence affect our understanding of sovereignty in co-operative instruments, and vice versa.

E. Modifying Monetary Sovereignty

Four questions are relevant to give the abstract concept of sovereignty substance: who exercises it; why does it have normative value; over which areas (substantive and geographically) is it exercised; and how should it be exercised? \(^62\) Sovereignty is an inherently flexible concept allowing for different answers to these questions over time. \(^63\)

I. Who Exercises Sovereignty?

Sovereignty originally rested with the person of the sovereign, but between the 16th and the early 19th century a gradual evolution took place towards state sovereignty. \(^64\) Other actors, such as international institutions, NGOs and individuals, are emerging on the international scene. \(^65\) It is not

\(^{61}\) Friedmann, supra note 59, 64.


excluded that they will become stronger in the future.\textsuperscript{66} At this stage, however, this is speculative and premature as states still play the central role in international law.\textsuperscript{67} The modifications I propose therefore still assume that states exercise sovereignty. This does not mean that the state forms the normative justification for sovereignty. The next section deals with this question.

II. Why State Sovereignty?

Traditionally, state sovereignty has normative value in international law because it was seen as a tool towards self-determination, self-reliance and self-sufficiency, while at the same time ensuring sovereign equality between states.\textsuperscript{68}

Self-determination is still relevant in an interdependent world. The increasing interdependence between states has not reduced the cultural, religious, political and economic differences between them. On the contrary, the closer links due to increasing interdependence have made states, and their citizens, more vulnerable to sovereign decisions of others that are incompatible with their own. Proper protection of the right to self-determination therefore requires a rethink about the exercise of sovereignty to correct imbalances in sovereignty. The next two sections examine what sovereignty should be exercised over and how it should be exercised.

III. Sovereignty’s Substantive and Geographical Reach

Sovereignty is typically exercised over a state’s “domestic affairs”, i.e. matters that belong to its “domestic jurisdiction” or its “reserved domain”.

\textsuperscript{66} Sarooshi, \textit{supra} note 62,1114.


\textsuperscript{68} Delbrück, \textit{supra} note 67, 5; Besson, \textit{supra} note 63, 148, 160.
In 1923, the PCIJ issued an Advisory Opinion\(^{69}\) that is still regarded as the prevailing interpretation of domestic jurisdiction.\(^{70}\) It held that\(^{71}\)

“[t]he question whether a certain matter is or is not solely within the jurisdiction of a State is an essentially relative question; it depends upon the development of international relations. [...] It may well happen that, in a matter which [...] is not, in principle, regulated by international law, the right of a State to use its discretion is nevertheless restricted by obligations which it may have undertaken towards other States.”

Given its dependence on the evolution of international law, the definition of domestic affairs is inherently in flux. Applied to monetary management policies, the discussion in Section C.II has shown that international law recognizes the potential external impact of internal actions and prompts states not to exercise their monetary sovereignty in a way that causes a negative external impact. International law is thus moving in the direction of removing monetary management policies that cause a negative external impact from states’ domestic jurisdiction. Nevertheless, this process is incomplete, since there is very little in the way of enforceable obligations on states.

Geographically, the reach of sovereignty is traditionally defined by a state’s territory.\(^{72}\) Territorial sovereignty is still valuable for an international legal system consisting of states at different stages of development, at least as long as democratic governance is lacking at the international level. Nevertheless, territorial sovereignty can be harmful in an interdependent world as states are vulnerable to actions taken by other states within the latter’s territory in matters where this interdependence manifests itself. And the problem does not just stop at actions of states. Omissions can also cause a negative impact on other states, for example, when states inadequately regulate domestic activities that have a transnational impact, as we have seen in the current global financial crisis.

\(^{69}\) Nationality Decrees Issued in Tunis and Morocco (French Zone), Advisory Opinion, PCIJ Series B, No. 4 (7 February 1923) [Nationality Decrees].


\(^{71}\) Nationality Decrees, supra note 69, 24.

\(^{72}\) The Case of the S.S. "Lotus", PCIJ Series A, No. 10 (1927), 18-19.
Two options are conceivable to make territorial sovereignty more compatible with interdependence. First, we could restrict territorial sovereignty of the acting state to exclude actions having external effect. This could be achieved through international agreements, policy statements from international groups such as the G20, or, by modifications to the principles allocating jurisdiction as a result of objections by states affected by the exercise of territorial sovereignty. While a restriction of territorial sovereignty might seem unlikely, it should be borne in mind that this is not exceptional in international law. Restrictions for the protection of human rights can be cited as example. The second option starts from the premise that modifying sovereignty is not just about directly limiting acting states, but that limits can also be created indirectly by allowing affected states to respond. Current principles allocating jurisdiction do not bar states from exercising jurisdiction over external acts of which the impact is felt within their territory. With respect to monetary management policies, such an exercise of jurisdiction could be relevant to regulate credit creation by foreign financial institutions selling to investors within the state’s territory. However, it would face serious enforcement obstacles given that enforcement jurisdiction is strictly territorial. Moreover, exercising jurisdiction over another state’s monetary or exchange rate policies would be impossible and undesirable as this would go directly counter to the idea of the independence of states.73

IV. How Should Sovereignty Be Exercised?

As has been argued, the current rules regarding monetary sovereignty and its exercise are unbalanced due to a one-sided focus on a freedom to act compared to the responsibilities that come with such a wide freedom. As with the analysis of the reach of sovereignty, there are two paths to change how states exercise their sovereignty. First, international law could focus more on responsibilities of acting states. Second, international law could improve how affected states can exercise sovereignty when they experience the negative impact of other states’ actions.

My argument is not about doing away with legal independence altogether. Rather it wants to achieve a better balance between the legal independence of one state and the de facto independence of another state which can be curtailed by the exercise of sovereignty of another state.
1. Responsibilities of Acting States

International law should ensure that states fully internalize the negative externalities of their actions in the exercise of their monetary sovereignty. Internalization could be stimulated by an explicit duty to co-operate with other states to avoid global financial instability or a negative impact on other states. International law could also create incentives for states to internalize externalities by increasing their accountability.

a) Duty to Co-operate

Some sources suggest a duty to co-operate with other states, particularly when global public goods are involved.\textsuperscript{74} Regarding states’ monetary management policies, the IMF Articles of Agreement include a number of obligations “to collaborate” with the IMF and with other members.\textsuperscript{75}

Since a duty to co-operate with other states is difficult to reconcile with independence, existing duties to co-operate in international law are mainly of a procedural nature.\textsuperscript{76} Even if combined with the principle of good faith, these duties do not require that a solution actually be achieved.\textsuperscript{77} Often this will be difficult because states disagree on the existence of a problem, the goals of co-operation or the means towards reaching these goals.\textsuperscript{78} The end result may therefore very well be that the agreed solution reflects the lowest common denominator, if an agreement is reached at all.\textsuperscript{79} The disagreements within the G20 on how to deal with the financial crisis are illustrative in this respect.

\textsuperscript{75} IMF Articles of Agreement, \textit{supra} note 19, Art. IV(1), Art. VIII(7).
\textsuperscript{76} Buck & Verheyen, \textit{supra} note 74.
\textsuperscript{77} Proctor & Mann, \textit{supra} note 18, 562.
\textsuperscript{78} Greig, \textit{supra} note 65, 575.
\textsuperscript{79} \textit{Id.}, 570.
b) Increase Accountability

The accountability of states could be increased by providing for accountability in international instruments. For example, some authors argue for the creation of a new WTO rule to cover exchange rate manipulation. This would bring exchange rate manipulation within reach of the WTO dispute settlement mechanism.

Accountability could also be increased by providing for state responsibility when a state’s actions affect another state negatively. The International Law Commission (ILC) has already developed principles on the allocation of losses following transboundary harm caused by hazardous activities not prohibited by international law. These draft principles however would need to be modified to allocate losses caused by monetary management policies. Currently, they have the same import as the related ILC Draft Articles on Prevention of Transboundary Harm from Hazardous Activities. These are limited to the physical consequences of actions that themselves must be of a physical quality. Neither of these conditions is met in monetary relations. Monetary management policies are intangible actions and their direct consequences are not physical but pecuniary. Such consequences were explicitly excluded by the ILC as a type of harm that could trigger responsibility.

Moreover, international “rules of abstention”, used to ensure the co-existence between states, could be used to increase states’ accountability. For example, the principle of non-intervention could be expanded by adopting a less stringent definition of coercion. Currently, intent on behalf of the acting state to make a structural change in the target state is required. Removing the subjective requirement of intent, while maintaining a high threshold of structural change, could be a solution. As a result, states would

---

80 Mattoo & Subramanian, supra note , 10.
82 Id., 117-118.
84 Id., 151, point 17.
85 Id., 151, point 16.
be found to intervene in the domestic affairs of another state when their actions bring about structural changes in the affected state, even if these changes were not specifically intended.

Two problems plague the efforts aiming to increase accountability for the external effects of a state’s monetary management policies. First, the macro-economic background to establish harm and the causal link between this harm and another state’s monetary management policies may simply be too complex. No matter what legal rule is developed, if the underlying economic facts are insufficiently understood, the legal rule will have very little meaning in practice. Second, none of these rules can adequately deal with omissions, e.g. when the negative effect is caused by a lack of regulation of credit creation by financial institutions.

Maybe a solution could be to relax the requirement of causality when an action or omission can be shown to have contributed to financial instability, even if specific instances of harm cannot be linked to these actions or if the harm cannot easily be quantified. This would make it easier for states to rely on rules of abstention against other states whose monetary management policies affect them negatively. Caution should however be taken so as not to cast the net too wide and prohibit benign acts, as many acts have consequences abroad that are not always easily foreseeable.

2. Rights of the Affected States

Given the practical problems of limiting acting states’ sovereignty, this article proposes to increase the legal responses available to affected states against the negative effect of other states’ monetary management policies as an additional step in modifying sovereignty.

Changed rules of co-existence, as discussed in the section E.IV.1.b), could be used as a legal basis for claims by affected states against the acting state. Nevertheless, as pointed out, the complexity of modern interdependence is an obstacle to the effective application in practice of the causality requirement in these rules of co-existence.

Another option could lie in the application of co-operative legal instruments, particularly trade liberalization instruments. The focus on trade liberalization instruments is justified by their important contribution to stimulating the creation and growth of the global economy. Typically, they include exceptions on trade liberalization commitments when other societal
values, such as financial stability or environmental protection, are at stake. However, the problem is that these exceptions are often interpreted to favour the right to trade, even if trade imposes externalities on the trading partners. Given that the problem lies with the interpretation rather than with the actual treaty provisions, an amendment is not necessarily required. Rather, a critical reflection on the values protected by sovereignty and their continued relevance in increasing interdependence may suffice to properly inform the interpretation of the relevant provisions. Better balanced exceptions would allow the affected states to restrict trade when this is required for the protection of other societal values.

Affected states could even consider going further by boycotting any state considered to cause a negative impact. This would signal to the acting state that with trade entitlements comes the responsibility to have an appropriate regulatory framework in place for related issues, such as monetary management in the domestic economy. However, this solution leaves much to be desired for a number of reasons. First, restrictions on trade with a single state go against the idea of non-discrimination that pervades the WTO rules, even if in practice trade sanctions have never explicitly been ruled illegal. Second, boycotts have limited utility in protecting poor developing states against actions or omissions by their large trading partners. Since the highest profile current imbalances in the international monetary system are not divided along traditional North-South


87 Panel Report, United States – Measures affecting the Cross-Border Supply of Gambling and Betting Services, WT/DS285/R, 10 November 2004, para. 6.316: “sovereign right to regulate […] ends whenever rights of other members under the GATS are impaired”.

lines, boycots might still usefully come into play between the major economies. Last, but not least, even if only major economies would rely on trade sanctions, the door to potential abuse and to straight up protectionism would be wide open.

F. Conclusion

This article has argued that the current international law conception of monetary sovereignty – and sovereignty in general – favours the freedom of states to act within their territory as they see fit. This focus overlooks the negative impact state actions can have on other states who, as a result, might see their effective freedom to act reduced, even though they are still legally the highest authority. International law insufficiently recognizes how easily ostensible legal authority can become a practical fiction in situations of increasing interdependence.

Given that sovereignty is a relational concept and not an atomistic one, the rights of a state and its citizens to freely chart their economic course must necessarily be limited by the same rights of other states. This is far from a novel proposition, but instead is fundamental to international law.

To increase the compatibility of sovereignty with interdependence, this article has suggested a double rebalancing in the rights and obligations that stem from sovereignty: first, between the right of sovereign states to be free to act and that to be free from external interference, and, second, between the de iure authority to act – which is protected – and the de facto freedom to act – which is not effectively protected. The goal is to achieve a less cynical understanding of sovereignty where states cannot simply unload the costs of their actions or of providing a global public good on other states, and where states do not have to stand idly by when they experience an externally sourced negative impact.

To achieve this, this article has looked beyond directly limiting sovereignty. Limits will often be ignored when they run counter to states’ individual interests, unless they are backed up by a strong and effective compliance mechanism. Instead, this article has proposed to complement

89 Current account deficits can be found in the US, UK and Australia, while, e.g., China, Japan and Germany run current account surpluses, see United Nations Conference on Trade and Development, supra note.

limits with stronger rights for the affected states. In the end, the rebalancing exercise is a zero sum game in which some states are allowed to do more, whereas others find their current rights limited.

The end result might only be a second best alternative, but this changed dynamic could create incentives for the acting states to engage in co-operative efforts to bring about a more effective multilateral solution.
Effective Law-Making in Times of Global Crisis – A Role for International Organizations

Stefan Kirchner*

Table of Contents

Abstract .................................................................................................................................................. 270

A. Introduction: The Challenge of Legislative Responses to Crises .............................................. 270

B. Rules of International Law ........................................................................................................... 271

C. Trans-governmental Networks and the G20-hype ....................................................................... 273

D. Law-making by International Organizations ............................................................................... 277
   I. Recommendations by International Organizations ................................................................. 277
      1. General Remarks ................................................................................................................... 277
      2. The World Health Organization (WHO) ............................................................................ 278

II. Conventions Drafted by International Organizations ............................................................... 279

III. International Organizations as Law Makers .............................................................................. 281
   1. The United Nations Security Council (UN SC) .................................................................. 281
   2. The United Nations General Assembly (UN GA) ............................................................... 285
   3. The International Civil Aviation Organization (ICAO) ..................................................... 285

* Attorney-at-law (Rechtsanwalt); MJI (Giessen); Research Fellow at the Institute of Public Law, Department of Public Law, in particular Canon Law and the Constitutional Law of Religious Communities (Prof. Dr. Heinig), Faculty of Law, University of Göttingen. I am thankful to lic. drs. M. A. Ayala Delgado, LL.B. (ITESM), LL.M. (Utrecht), M.F. (ITESM), MBA (Oxon) for her valuable comments and advise.

doi: 10.3249/1868-1581-2-1-kirchner
4. Coordination Between Different International Organizations .................................................. 289

IV. A Role for International Organizations - Intermediate Conclusions................................................................. 290

E. Conclusions ........................................................................................................................................... 292
Abstract

Public International Law is often slow to react to changes and challenges. Due to the need for consensus among the subjects to which rules are meant to apply, the creation of new rules often requires more time than is available in times of crisis. At the same time, Public International Law is highly flexible and might provide alternative means for the effective and fast creation of new rules. In this article I will examine several alternatives to traditional treaty-based law-making with regard to their effective creation and operation. Alternatives could include soft law, which, although relatively fast to create, is non-binding, raising doubts as to its effectiveness for regulation in times of crisis. In the last few years, network approaches to law-making have been discussed, most recently with regard to the Group of Twenty (G20). While this approach might look modern, it raises serious questions as to the legitimacy of the rules created hereunder. A more legitimate form of law-making could be through international organizations. This leaves two options: the mere drafting of rules by international organizations, and actual legislation by them. It is the latter option which appears to be most efficient. In this text, the work of several international organizations is investigated more closely, ranging from the loose G20 to international organizations which rely on non-binding recommendations to international organizations which have an actual law-making capacity. At the center of the investigation is the question of how existing international organizations can effectively create new rules which enable states parties to react swiftly, while at the same time taking into account the technical expertise required to formulate an effective response to a global crisis. In this context, the experience of the International Civil Aviation Organization (ICAO) can serve as a model for other international organizations. The ICAO’s reaction to the threat of terrorism provides an interesting example for effective law-making in times of crisis. After a short introduction to the law-making capabilities of the ICAO, we will examine how effective it really is and whether the ICAO can serve as a model for future reactions to crises by rapidly providing new rules for a large number of member states in a field which can be technically complicated – characteristics which apply to the global financial crisis as well as global epidemics, climate change and similar issues.
A. Introduction: The Challenge of Legislative Responses to Crises

In the 1970s, Oxford University Press had a series entitled “International Crises and the Role of Law”. Back then, the crises dealt with were inter-national in the classical sense – i.e. crises between (or at least involving) states such as the Suez Crisis or the Cuban Missile Crisis. Typically, Public International Law is designed to deal with such inter-state crises. In such cases, the legal situation might be unclear, but at least in principle, current classical Public International Law is fit to address such issues. This is no longer the case. In a globalized world, crises are no longer merely international. A health problem in Mexico City or Hong Kong is soon also a health problem in New York, Frankfurt or Sydney.

Global crises require global solutions. To provide an effective response to a global crisis, a rule must not only be created without much delay, but its creation must be informed by the necessary technical expertise. In addition, it must hold an increased promise of global enforceability, if necessary against the political or economic interests of powerful states.

The 2008/2009 financial crisis caused a hype surrounding the Group of Twenty which calls for an investigation into whether this type of cooperation provides an effective way to deal with global crises, or if more institutionalized global international organizations can be utilized to provide effective answers to global crises from a law-making perspective.

International, i.e. inter-governmental, organizations are often approached from a domestic perspective by placing emphasis on the idea of state sovereignty and the vertical transfer of power from the state to the international organization. But this is just one aspect of the relationship between states and international organizations. The other main aspect is the function of international organizations, which is more easily understood from inside the international organization. The “functional finality” of in-

---


3 Notably in France and Italy this functional approach has been recognized by domestic authorities. H. G. Schermers & N. M. Blokker (eds), *International Institutional Law: Unity within diversity*, 4th ed. (2003), 10, with further references.
international organizations “embodies three normative aspects”: the authorization of the organization to act with regard to member states, the limitations of such powers and the organization’s duty to act, [and] its obligation “to perform the functions entrusted to [the organs of the organization] by the members”.4

The practical question is then: “from the moment when states have acknowledged the existence of common interests justifying the establishment of an international organization and the attribution to this organization of functions destined to be of service to them, are they still allowed to consider their sovereignty as an unlimited power to dissociate themselves and to pursue dysfunctional activities, no matter what damage might result from this for the international community to which they have adhered?”5

The answer must be a clear “no”. But the reality on the ground, of course, looks different. In general, compliance is a major issue in Public International Law, because, unlike national legal systems, Public International Law remains in an archaic state, lacking an enforcement agency, which is global both geographically and with regard to different subject matters. While rules created by international organizations are no exception, they benefit greatly from specific intra-organizational enforcement mechanisms. More advanced internal enforcement mechanisms, such as the judiciary of the European Community (EC) or the European Court of Human Rights leads to increased compliance on the part of the member states. This higher chance for compliance strengthens the case for employing international organizations for law-making purposes.

B. Rules of International Law

Article 38 of the Statute of the International Court of Justice lists all sources of Public International Law.6 Since treaties and customary international law are, practically speaking, the most important sets of rules, we will focus our investigation on them. Customary international law requires both opinio juris and state practice. The latter is often overlooked when claims are made based on alleged rules of customary international law. But customary international law “is founded on practice, not on preaching”.7 Espe-

4 Id., 11.
5 M. Virally, as quoted and translated by Schermers & Blokker, id., 13.
cially when dealing with declarations by, for example, the G20, it has to be kept in mind that it is necessary “to consider the action or practice of states, and not their promises or rhetoric”. The creation of new rules of customary international law requires a process which will often, albeit not necessarily, be time-consuming. Yet, during a global crisis, this time will often not be available to allow for the creation of new rules. If new rules are required, customary international law is hardly the best way to deal with any form of crisis. Just like recourse to general principles of the law, customary international law can be a very useful tool when we need to address new problems for which no adequate rules of Public International Law exist as of yet, in that we can draw analogies to existing rules of customary international law. But these analogies will not carry the legal strength of directly applicable customary international law and might be subject to debate as to their validity. In times of global crises, though, what is required are clear rules, which can be utilized on the spot. This is not the case with analogies to customary international law. Even customary international law proper will not be well-suited to address global crises from an international legislative point of view. Customary international law, by its very nature, will usually require a certain amount of time for its formation, especially when one takes into account that what is required is a general practice. What constitutes a general practice “much depends on the circumstances of the case and on the rule at issue. ‘General’ practice is a relative concept and cannot be determined in the abstract. This also explains how it is possible that customary international law can be created instantaneously. This happened for example in the early days of the space age with regard to the outer limits of state sovereignty and the difference between national airspace and outer space as well.

---


9 The exceptional instantaneous creation of customary international law will be dealt with later in this paragraph.


as with regard to the treatment of spacefarers in distress, not despite, but due to the fact that at that time only the United States and the USSR were capable of sending men into space. At the same time, this example illustrates that, when it comes to global problems which affect not two but almost 200 states, there can be little hope for spontaneous general practice. In fact, customary law is particular ill-fitted to deal with global crises. 13

Since instant customary law is the rare exception, treaty law or rules based on treaties, binding or otherwise, provide the only realistic and fast means of creating legal rules to address a global crisis. The more important question is, who should create such rules? Taking into account that the classical multilateral conference-style of drafting a new international treaty can take a considerable amount of time, in particular when the subject matter includes a large number of technical aspects, we need a more time-efficient manner of creating or at least drafting new rules.

C. Trans-governmental Networks and the G20-hype

One approach, which has been championed by Anne-Marie Slaughter, is that of informal trans-governmental networks. This approach is not merely a brainchild of the Internet era, although it might not have gained that much attention if we did not live in a world of networks. In this network model, cooperation is not only between states, but between officials and experts. For many foreign ministries, this kind of cooperation is part of the everyday work and indeed things are often much easier to accomplish if agreement is forged on a lower level, i.e. between bureaucrats rather than between heads of government. This kind of network is particularly helpful in the preparatory phase of a new agreement and can facilitate a fast drafting of a new treaty, but it cannot in itself establish new rules.

In the perception of the general public, this function might be fulfilled by networks of government leaders such as the G20, which was created in response to the economic crisis of the late 1990s. 14 In particular, the latter has gained a lot of prominence during the financial crisis, although it has

13 But it could be the other way around: similar responses by many states to a global challenge can amount to the state practice necessary for the creation of a new rule of Public International Law. It remains to be seen whether this practice is really based on the opinion to be obliged to take the action in question not merely for political reasons or based on domestic law, but to be obliged to do so under Public International Law.

14 ‘What is the G20’ available at www.g20.org/about_what_is_g20.aspx (last visited 21 March 2010).
been around for a decade. But it appears dubious whether the G20 can really fulfill a meaningful legislative task. G20 and the like, such as the Group of Seven (G7) or the Group of Eight (G8) are neither allies in a classical sense, nor do they represent treaty partners.\textsuperscript{15} Rather, they are more comparable to the Concert of Europe of 1815,\textsuperscript{16} - the de facto balance of power on the continent in the century between the end of the Napoleonic era and the beginning of World War II. In a reminder of the 19\textsuperscript{th} Century, the inner workings of the G20 are relatively untransparent when compared to institutionalized international organizations. While the term “network” suggests a certain degree of openness and transparency, this assumption is misleading when it comes to trans-governmental networks.\textsuperscript{17} This lack of transparency inevitably leads to questions concerning the G20’s legitimacy. Indicators for legitimacy are representation and procedural fairness.\textsuperscript{18} While the G20 is more representative than, for example, the G7 or the G8, the absence of an international treaty establishing the G20 also means that national organs (parliaments, in most states) had little or no say in a state’s membership in the G20, which started as an informal forum for finance ministers and central bank governors.\textsuperscript{19} More importantly, the representational premise on which the G20 is built is fundamentally flawed as it considers representation on the basis of economic power alone. As it describes itself, the G20’s “member countries represent around 90 per cent of global gross national product, 80 per cent of world trade (including EU intra-trade) as well as two-thirds of the world’s population.”\textsuperscript{20} This focus on economic representation leads to the conclusion that “[t]he G-20’s economic weight and broad membership gives it a high degree of legitimacy and influence over the management of the global economy and financial system.”\textsuperscript{21} This view of course is incompatible with the sovereign equality of nations and should serve as a warning

\textsuperscript{15} A.-M. Slaughter, \textit{A New World Order} (2004), 37.

\textsuperscript{16} Id.

\textsuperscript{17} Id., 219.


\textsuperscript{19} What is the G20, supra note 14.

\textsuperscript{20} Id.

\textsuperscript{21} Id.
against making the G20 “the world’s main economic governing council”, as British Prime Minister Gordon Brown envisages, whose country currently holds the rotating G20 presidency.

Apart from such fundamental issues, it also remains to be seen whether the G20 can be as efficient as the Concert of Europe, but it has to be clear that neither has had a legislative function. After all, performance and effectiveness are indicators of legitimacy, too. But the term effectiveness appears to be elusive. In the context of any legislation, effectiveness can only be reasonably measured against the goal which is pursued with the newly created rule. Key ingredients of effectiveness of new legislation, which aims at solving a global crisis, are not only the speediness of the legislative process, but also the binding nature of the rule in question. Given Public International Law’s general enforcement deficit, effectiveness requires not so much enforceability rather than a binding nature – there has to be a general understanding on the parts of the states involved that the new rule is considered binding. This is valid even if there should be no formal enforcement mechanism in place, although the existence of one would increase the norm’s effectiveness. Crises require effective legislation, both in terms of speedy creation and the promise of compliance. The G20 still has to prove that it can provide such effective rules. Given the absence of both a binding character of G20-rule and a structure to ensure compliance and thus enforce the rules, there has to be some doubt as to the G20’s ability to be an effective legislator.

Despite the political importance of the G20 member states, it lacks the power to create binding rules. The G20 is hardly able to create anything more binding than soft law and the obvious downside of soft law is its lack of enforceability. This is not to say that soft law is useless. But it will often

23 Halliday & Carruthers, supra note 18, 125.
be unclear whether a joint declaration is supposed to be binding,\textsuperscript{25} and it takes clear and binding rules to address global crises effectively.

Soft law instruments have their own functions, such as providing indicators on emerging trends in international \textit{opinio juris}\textsuperscript{26} and reflecting new concerns for the international community.\textsuperscript{27} It is the latter function which is being fulfilled by the recent G20 declarations. So far the G20 is comparable to the UN GA, albeit the GA has the benefit of near-universality and decades of experience and acceptance.

But political statements by the G20 can lead to the emergence of soft law (and potentially of customary international law). \textquote{The emergence of \textquote{soft law} also has to do with the fact that states in agreement frequently do not (yet) wish to bind themselves legally, but nevertheless wish to adopt and test certain rules and principles before they become law. This often facilitates consensus which is more difficult to achieve on \textquote{hard law} instruments.}\textsuperscript{28} Yet the G20 has failed to address important questions, such as, what happens if large banks fail in the future?\textsuperscript{29} After all, there is a global consensus that the undue bailout of banks which were considered \textquote{too large to fail} contributed to the current financial crisis\textsuperscript{30} and that the money used for bailouts directly hurt poorer countries, which are not represented in the G20. It is against this background that the G20’s statements in the wake of the 2008/2009 financial crisis must be considered. The G20 is a purely polit-

\textsuperscript{25} For example, in the Aegean Sea Continental Shelf Case, the International Court of Justice considered a joint communiqué by the Prime Ministers of Greece and Turkey to be insufficient to give the ICJ jurisdiction, while it came to the contrary conclusion regarding the minutes of a meeting between the respective Foreign Ministers in the Case concerning the Maritime Delimitation and Territorial Questions between Qatar and Bahrain. See A. Cassese, \textit{International Law}, 2nd ed. (2005), 128. In the Eastern Greenland Case (Denmark v. Norway), the Permanent Court of International Justice (PCIJ) even considered the declaration by the Norwegian Foreign Minister not to cause any \textquote{difficulties} in the matter of Greenland as a binding promise. W. Heintschel von Heinegg, \textquote{Die weiteren Quellen des Völkerrechts}, in K. Ipsen, \textit{Völkerrecht}, 5th ed. (2004), 239; \textit{Eastern Greenland Case (Denmark v. Norway)}, PCIJ Ser. A/B, No. 53 (1933), 71.


\textsuperscript{27} Cassese, \textit{supra} note 25, 160.

\textsuperscript{28} Malanczuk, \textit{supra} note 10, 54.


\textsuperscript{30} \textit{Id.}
ical enterprise which reflects the political interests of the member states and should not be expected to be more than that.

D. Law-making by International Organizations

It seems therefore that such networks like the G20 are an addition to the scene but not a replacement of existing actors. This brings us to more traditional inter-governmental organizations, which seem to have been neglected somewhat in the discussion surrounding several global crises in favor of trans-governmental networks, in this case the G20. The same happened when it came to the prevention of the proliferation of nuclear materials after 9/11, in particular with the aim of preventing nuclear terrorism. Instead of relying on existing structures, the Proliferation Security Initiative (PSI) was created for this purpose. At the center of PSI efforts is the interdiction of third party ships on the high seas for the purpose of preventing the transport of particular weapons and materials to terrorist organizations and the like.

I. Recommendations by International Organizations

1. General Remarks

Normally, international organizations do not have law-making powers, which is why they usually act through non-binding decisions. “However, the non-binding nature of decisions does not mean that a particular

---


decision is devoid of legal effect for members. Some constituent instruments oblige members to consider recommendations in good faith. For example, the ILO\textsuperscript{35} and UNESCO Constitutions\textsuperscript{36} (Article 19(b) and Articles 4(4) and 8 respectively) require member states to submit recommendations to their competent national authorities for consideration and are to report back to the organization on action taken. Furthermore, a separate international treaty may contain an obligation to have regard to (and possibility to comply with) non-binding decisions of an international organization. For example, in the WTO Agreement on Sanitary and Phytosanitary Measures (SPS),\textsuperscript{37} Article 3 encourages members to base their SPS measures on standards adopted by other international organizations. Likewise the United Nations Convention on the Law of the Sea\textsuperscript{38} obliges States to comply with standards adopted by the ‘competent international organization’ (usually the International Maritime Organization (IMO)). Additionally, it is arguable that there is a presumption that members acting in accordance with a relevant decision of an international organization are acting lawfully, at least between the members of that organization.”\textsuperscript{39}

2. The World Health Organization (WHO)

But the lack of enforcement also reduces the chance for compliance on the part of states on which the implementation of such non-binding decisions depends. Fortunately there are some exceptions, such as the World Health Organization (WHO). The WHO can adopt binding regulations\textsuperscript{40} under Art. 21 of the WHO Constitution.\textsuperscript{41} To limit their effect or to avoid being bound by these regulations, member states have to notify reservations

\textsuperscript{39} D. Akande, supra note 34, 292.
\textsuperscript{40} Schermers & Blokker, supra note 3, 781. For an insightful analysis of the decision-making at the WHO, see J. Siddiqi, World Health and World Politics: The World Health Organization and the U.N. System (1995).
or their rejection of the rule as a whole (Art. 22, WHO Constitution). But unlike the Food and Agricultural Organization (FAO), which has been involved in a number of law-making initiatives, including those concerning the protection of global fish stocks, the WHO has had “relatively little involvement in international law-making” proper. Most of the time, the WHO does not resort to binding rules but prefers to rely on its scientific reputation in hope of compliance with non-binding measures. “Even serious global health risks, such as the threat of severe acute respiratory syndrome (SARS) have been dealt with through non-binding guidelines rather than [binding] regulations.” Rather, the WHO tackles global problems with global campaigns. An example is the WHO’s campaign against selected diseases, such as malaria. These campaigns are not law-making campaigns in the classical sense, although they contain a somewhat similar aspect in that national compliance with WHO methods needs to be monitored. But since the WHO - often aided by the United Nations Environmental Programme (UNEP), the World Bank (officially named the International Bank for Reconstruction and Development or IBRD) and non-governmental organizations (NGOs) - plays a large role in funding the necessary measures, the problem is rarely legal in nature. This makes the WHO less suited for an examination of legislative solutions to global crises.

II. Conventions Drafted by International Organizations

While these recommendations are non-binding tertiary rules, international organizations also often limit themselves to drafting secondary rules in the form of conventions which, then, have to be ratified by states. These conventions are international treaties and differ from other international treaties only in the manner in which they are drafted. Usually, the term “convention” refers to international treaties, especially “multilateral treaties

42 Id.; See also M. Vierheilig, Die rechtliche Einordnung der von der Weltgesundheitsorganisation beschlossenen regulations (1984).
44 Id., 128-129.
45 Id.
48 This is meant in the sense of law-making treaties rather than contract-treaties. On the terminology see Malanczuk, supra note 10, 37.
49 Id., 52.
of a law-making character"\textsuperscript{50} and even if “the procedure leading top their adoption is different, the net result of this procedure often closely resembles”\textsuperscript{51} a treaty. In effect, “the organization drafts rules to which the members may adhere,”\textsuperscript{52} But the members do not have to adhere to these rules. While one problem of organization-drafted conventions is that they are rarely ratified by all member states,\textsuperscript{53} at the same time these conventions are not necessarily restricted to members of the international organization in question.\textsuperscript{54} The connection between the drafted convention and an international organization also can have a most welcome side effect, in that member states might be willing to adhere to the new rules prior to the convention officially coming into force. Crisis situations can make it necessary to take concerted action immediately. Art. 25 of the Vienna Convention on the Law of Treaties (VCLT)\textsuperscript{55} allows for the provisional application of an international treaty prior to its entry into force,\textsuperscript{56} regardless how the treaty was created. Art. 5 VCLT.\textsuperscript{57} Such an early compliance is, of course, more likely if there is already some kind of connection between the member states and the convention, in this case the membership in the drafting body.

While the creation of a multilateral convention is dominated by political negotiations, this approach allows for technically adequate solutions which are based on the technical expertise of the organization’s staff. Needless to say, this approach also allows for much faster drafting. Conventions created by international organizations are treaties, which give them the benefit of legal force.\textsuperscript{58} At the same time, they benefit from a greater degree of

\textsuperscript{50} Schermers & Blokker, supra note 3, 780.
\textsuperscript{51} Id.
\textsuperscript{52} Id., 780 - 781.
\textsuperscript{53} Id., 783.
\textsuperscript{54} Id., 800 – 801; For example, the Council of Europe’s (CoE) Cultural Convention (European Cultural Convention, 19 December 1954, 218 U.N.T.S. 139) and the Convention on the Equivalence of Diplomas leading to Admission to Universities (European Convention on the equivalence of diplomas leading into admission to universities, 11 December 1953, 218 U.N.T.S. 125) were ratified prior to Spain’s membership in the CoE. Australia and South Africa are parties to the CoE Patent Law Convention (European Convention on the International Classification of Patents for Invention, 25 March 1957, 298 U.N.T.S. 52).
\textsuperscript{56} Schermers & Blokker, supra note 3, 798; D. Vignes, ‘Une notion ambiguë: La mise en application provisoire des Traités’, 18 Annuaire française de droit international (1972), 181.
\textsuperscript{57} Schermers & Blokker, supra note 3, 785.
\textsuperscript{58} Id., 782.
flexibility which is hardly found in the traditional multilateral treaty-making process.

III. International Organizations as Law Makers

Apart from merely drafting new rules, international organizations can also set new rules, i.e. act as legislators. Therefore the final, and, as we will see, most promising, alternative for legal approaches to international crises are tertiary rules - that is, rules which are based on international treaties and are binding upon the member states of an international organization without further measures being required on the part of the member states.

1. The United Nations Security Council (UN SC)

The United Nations Security Council (UN SC) is rightfully considered one of the most powerful institutions in international law, but initially, it was seen as an institution that applies international law rather than creates it. But, as decisions by the UN SC have legal effect, it was inevitable that the UN SC would also be involved in law-making. “The hallmark of any international legislation is the general and abstract character of the obligations imposed”. It does not matter that the creation of new rules has been triggered by a specific event as long as the rules are neutrally phrased. In that sense, the UN SC made law in the context of fighting global terrorism. after 9/11, the UN SC has taken on more of a legislative role, most notably with UN SC Res. 1373 and 1540.

60 Boyle & Chinkin, supra note 43, 109.
61 Id., 110.
63 Id., 110.
Under Res. 1373, all UN member states are obliged to punish acts of terrorism and support of terrorists. The idea behind the resolution was to deny terrorists a safe haven. Under Art. 25 of the UN Charter, all UN member states have to carry out the resolutions of the Security Council, placing the responsibility for enforcement into the hands of states. When it came to fighting global terrorism, the UN SC actually tried to remedy this flaw inherent in Public International Law, creating the Counter-Terrorism-Committee (CTC), a new institution to enforce Resolution 1373, which has “far-reaching supervisory powers”. The idea of Security Council-created institutions for the enforcement of Security Council resolutions is anything but new, as UN SC Res. 1373 and 1540 do not stand alone. Instead they have to be seen in context with UN SC Res. 1267 (1999), which established the Taliban Sanctions Committee even before 9/11. After 9/11 it became clear that the 1267-regime “is no longer limited, time-limited nor restricted to the specific threat posed by the Taliban’s support for groups within Afghanistan”. The Security Council continued this trend in 2004 in the context of combating the proliferation of weapons of mass destruction with Resolution 1540. UN SC Res. 1540 “combines the Council’s declaratory, promotional, interpretative, and enforcement functions into a tidy tool of global law.” The preventive approach in Resolution 1540 and the UN GA’s 2005 Convention on the Suppression of Acts of Nuclear Terrorism already show the next

---


66 Boyle & Chinkin, supra note 43, 7. For an illustrative overview of law-making in response to global terrorism see also id., 3.

67 These were by no means the first instances in which the UN SC made law, albeit they were important steps in the development of the UN SC’s legislative role. Earlier, the UN SC had taken a legislative role, for example, with regard to South Africa’s occupation of Namibia and the 1991 cease-fire after Operation Desert Storm (UN SC Res. 687, 3 April 1991). Boyle & Chinkin, supra note 43, 110.


69 Boyle & Chinkin, supra note 43, 7.

70 Id.

71 J. E. Alvarez, International Organizations as Law-makers (2005), 198 [Alvarez, IOs as Law-makers].

72 Alvarez, IOs as Law-makers, supra note 70, 197.

73 UN GA Res. 59/290, 13 April 2005.
step in dealing with a global crisis.\textsuperscript{74} While UN SC Resolution 1373 was a reaction to the 9/11 attacks, UN SC Res. 1540 and the aforementioned Convention are preventive in nature. Together these resolutions show the existence of a “legislative agenda”\textsuperscript{75} on the part of the Security Council when it comes to fighting global terrorism.\textsuperscript{76}

While the UN SC has, at least partially, taken over the role of world legislature \textit{de facto}, the Council’s legitimacy to do so remains controversial. After all, neither Public International Law as a whole, nor the UN system in particular, know a universal “legislature [...] in the technical sense of the term”.\textsuperscript{77} If the term “legislation” is interpreted broadly, as is done here, the Council’s work is not short of legislation. The fact that the Council gets to act as \textit{de facto} legislator is owed to the permissiveness of states which have failed to restrict the Council to the tasks which were originally allocated to it in the UN Charter. The fall from grace came with Res. 1373, which created binding law applicable to all member states. In the debate leading up to Res. 1373, which included 37 representatives of states as well as the Palestinian observer\textsuperscript{78} “[n]o speaker expressed concerns that the Council was legislating in that resolution for the international community”.\textsuperscript{79} As the British representative reported, the issue for states was not so much the legal basis on which the Council was acting but rather the work of the CTC,\textsuperscript{80} the creation of which was simply accepted.

As Alvarez states it when referring to Higgins and Schachter: “States and their lawyers turn to the Council for guidance on these extraordinarily significant legal issues at the heart of state power[,] apparently because they assume (or hope?) that the Council acts in accordance with international law; because Council decisions that incorporate declarations of legality are legally binding; and because they have so few alternative sources for collec-

\textsuperscript{74} Boyle & Chinkin, \textit{supra} note 43, 8.
\textsuperscript{75} Alvarez, IOs as Law-makers, \textit{supra} note 70, 198.
\textsuperscript{76} S. Talmon, ‘The Security Council as World Legislature’, in 99 \textit{American Journal of International Law} (2005) 1, 175, 177-178; He also considers UN SC Res. 1422, 12 July 2002, and UN SC Res. 1478, 6 May 2003, to be legislative in nature. See also \textit{id.} fn. 33.
\textsuperscript{77} International Criminal Tribunal for the Former Yugoslavia, \textit{Prosecutor v. Dusko Tadić a/k/a “Dule”}, Decision on the Defence Motion for Interlocutory Appeal on Jurisdiction, IT-94-1-AR72 (Appeals Chamber), 2 October 1995, para. 43.
\textsuperscript{78} Talmon, \textit{supra} note 76, 177.
\textsuperscript{79} \textit{Id.}
\textsuperscript{80} See the quote of Sir Jeremy Greenstock, \textit{id.}, fn. 30.
tive legitimation.”

Therefore, “the Council’s actions enjoy a presumption that they adhere to general principles of law, including respect for treating like cases alike, [which gives states an] incentive to read Council enforcement actions as legal precedents. [The latter in turn apparently] tempts those with power on the Council to use it to establish general law.” This is what is happening in the UN SC because the Council’s new resolutions are general in nature (like laws), rather than situation-specific (like enforcement actions, which are supposedly the Council’s core business).

Although the UN SC remains selective, even after the end of the Cold War, it is still nourished by the expectation of states that the Council will act in accordance with the law, even when creating new law. It is only this expectation of states which provides a basis for the Council’s legislative work. This of course opens the door for abuse and should the Council’s new found power be abused, future lawyers might find it hard not to consider the states’ reliance on the Council as a naive dereliction of duty on the part of the member states of the UN. The states’ reliance on the Council might reflect a wish for guidance, or in terms of a domestic politics, for a strong leader. It is the states’ responsibility to control the authority they have thus created and to protect the UN’s institutional structure against abuse. In the case of the UN Human Rights Committee, abuse was not only not prevented, the anti-Semitic abuse of the Committee (a tendency which appears to resurface in the successor body, the UN Human Rights Council) led to its eventual demise. Given the Security Council’s central position of power and its far-reaching competencies which dwarf those of the Human Rights Committee, a “hegemonic capture of the Security Council” remains a source of worry.

Yet at the same time, the UN SC is significantly better equipped to deal with global crises than the G20. While there is a risk of the Security Council being abused, it has clear rules on how to create new rules which are also legally binding. Taking into account the aforementioned indicators of effectiveness, in particular fast law-making which results in binding rules, the UN SC’s experience fares better than what can be expected of the G20. The law-making process of the G20 is still too untransparent to allow for a final assessment of its effectiveness, but its legislative capabilities do

81 Alvarez, IOs as Law-makers, supra note 70, 188.
82 Id.
83 Talmon, supra note 76, 176-177.
84 Alvarez, IOs as Law-makers, supra note 70, 187.
85 Alvarez, Hegemonic International Law, supra note 64, 874.
not hold the promise of reaching the effectiveness of the UN SC’s law-making abilities. At the same time, it has to be kept in mind that the Council’s authority is lacking a solid foundation. In fact, unless the Council is acting under Chapter VII, the Council’s authority is based on the factual acceptance of states rather than a clear legal basis in the Charter. In the perception of states, though, the UN SC represents almost 200 states, while the G20 is, albeit no longer as exclusive a club as the G7, far less representative. In comparison, the UN SC is far more efficient, although its relative strength in this respect poses a risk of abuse, particularly in times of global crises.

2. The United Nations General Assembly (UN GA)

Also, the UN General Assembly (UN GA) made law, e.g. UN GA Res. 2131 (XX) of 1965, concerning the inadmissibility of intervention in the domestic affairs of states and the protection of their independence and sovereignty. But it has to be kept in mind that the UN GA’s resolutions are, unlike those of the Security Council, not binding. However, that does not mean that UN GA resolutions are without effect. Soft law rules are not necessarily intended to be legally binding—they are neither treaties nor indicative of an opinio juris for the purposes of creating customary international law. Soft law rules cannot be enforced but they nevertheless have an impact on the development of Public International Law as they can “later harden into custom, as has happened with the Universal Declaration of Human Rights or become the basis of a treaty”, like the 1975 UN GA Declaration on Torture, which provided the basis for the 1985 Convention against Torture (CAT).

3. The International Civil Aviation Organization (ICAO)

While the UN SC’s law-making agenda in recent years seems to center on fighting terrorism, this is just a small aspect of the legislative work of

86 Talmon, supra note 76, 179-180.
87 Chesterman et al., supra note 62, 117.
88 D. J. Harris, Cases and Materials on International Law, 6th ed. (2004), 64.
89 Id., 65; ICJ, Legality of the Threat of Use of Nuclear Weapons, Advisory Opinion, ICJ Reports 1996, 826, para. 70.
90 Harris, supra note 88, 65.
91 Id.
the International Civil Aviation Organization (ICAO). The work of the ICAO provides a particularly interesting case study on how to react to an unprecedented challenge that required a fast legislative response, involving not only many technical aspects but also had to apply globally.

“The ICAO adopts ‘International Standards’ and ‘Recommended Practices’ as ‘Annexes’ to its constitution. The Recommended Practices are recommendations, the International Standards bind only those states which do not give immediate notification to the ICAO of the differences between their own practice and that established by the international standard [...]. To some extent therefore, international standards resemble conventions.”92 But some ICAO standards have a wider geographical scope than conventions, in that they also apply to the high seas rather than only the territory of the member states.93

Originally, the ICAO aimed at improving air travel safety.94 Only later did the organization start to have to concern itself with terrorism, in particular in response to the hijackings in the late 1960s and the 1970s. Already around three weeks after the 9/11 terrorist attacks, the ICAO, in the Declaration on misuse of civil aircraft as weapons of destruction and other terrorist acts involving civil aviation,96 was able not just to present new rules, but actually to urge compliance with already existing rules (in this case, Annex 17 to the Convention on International Civil Aviation,97 the ICAO’s “consti-

96 International Civil Aviation Organization (ICAO); Declaration on Misuse of Civil Aircraft As Weapon of Destruction and Other Terrorist Acts Involving Civil Aviation, Assembly Declaration A 33-1, 41 ILM 2002, 5 October 2001, 501; see also Schäffer, Der Schutz, supra note 94, 18.
tion,” which is also known as the Chicago Convention, which had been created in response to the terrorist attacks against aircraft in the 1960s and 1970s.\(^{98}\) and to take additional security measures, strengthen cooperation in investigating aerial terrorism cases, and punish perpetrators,\(^{99}\) thereby pushing its mandate into the realm of criminal law. Today Annex 17 to Article 90 of the Chicago Convention contains a large number of rather detailed technical rules which oblige the member states to adapt their national legislations accordingly,\(^{100}\) including, for example, procedures regarding the screening of checked-in luggage\(^{101}\) and the creation of security-restricted areas which can only be entered after a security check.\(^{102}\)

In an age in which non-state actors play an important role in global crises, be it through irresponsible financial behavior, the spread of disease, terrorism or in other ways, more direct measures are necessary. Again, it is the ICAO which provides a glimpse at how this might be possible. Art. 86 of the Chicago Convention gives the ICAO Council “the power to decide whether a particular international airline is operating in conformity with the Convention on International Civil Aviation.”\(^{103}\) However, the ICAO Council’s finding works indirectly. For example, it may exert influence over the airline’s landing rights under the national laws of an ICAO member state (or

---


100 Schäffer, Der Schutz, supra note 94, 149.

101 Annex 17 to Article 90 of the Chicago Convention, Standard 4.4.1, supra note 97, see Schäffer, Der Schutz, supra note 94, 153.

102 Annex 17 to Article 90 of the Chicago Convention, Standards 4.7.1-4.7.3, supra note 97, see Schäffer, Der Schutz, supra note 94, 154.

103 Schermers & Blokker, supra note 3, 820.
under EC law). Even where the ICAO regulates the airspace over the high seas, the organization requires her member states to take truly effective action. It is the member states which will punish those who violate ICAO’s rules.\footnote{104}

The ICAO also is able to react quickly: Art. 48 (a), sentence 2 of the Chicago Convention allows for “extraordinary” sessions of the ICAO Assembly, the organization’s legislative body.\footnote{105} In being able to rapid action, the ICAO benefits from the inclusion of non-voting technical experts in the Assembly.\footnote{106} Under Art. 49 (g) of the Chicago Convention, the ICAO Assembly has transferred a lot of competencies to the ICAO Council, the ICAO’s executive branch. The Council, therefore, has become the true center of power of the organization. It is aided by a fifteen-member Air Navigation Commission, a technical body which wields a considerable degree of influence.\footnote{107} The Air Navigation Commission is what makes the ICAO truly effective, as it plays a key role in the creation of annexes to the Chicago Convention, and therefore in the creation of new rules. Although the Commission only makes recommendations to the Council, the Council will usually acknowledge the Committee’s technical expertise and follow these recommendations,\footnote{108} supported by other committees.\footnote{109} If there is a risk of too great a dependency on technocrats, it has not translated into serious problems for the ICAO. To the contrary, it provides the ICAO with the capability to take actions in a rapid manner. The Council’s power, and accordingly the committees’ practical influence, is highlighted when one takes into account that Articles 54(I) and 37 of the Chicago Convention gives the Council the power to create and update annexes to the convention in numerous areas, including air traffic rules,\footnote{110} rules on the airworthiness of air-

\begin{footnotes}
\footnote{104}{\textit{Id.}, 821.}
\footnote{105}{Schäffer, Der Schutz, supra note 94, 60.}
\footnote{107}{\textit{Id.}, 65-73.}
\footnote{109}{Schäffer, Der Schutz, supra note 94, 75; See also R. H. Mankiewicz, ‘The Legal Committee – Its Organisation and Working Method’, 33 Journal of Air Law and Commerce (1966), 94.}
\footnote{110}{Chicago Convention, supra note 97, Annex 2.}
\end{footnotes}
Effective Law-Making in Times of Global Crisis

At the center of the annexes are international standards and recommended practices.\textsuperscript{115} While the recommended practices contain exactly that - recommendations\textsuperscript{116} - the international standards are legally binding upon the member states. Although they do not yet cross the threshold from inter-to supra-national law, the international standards go far beyond the average power enjoyed by the executive body of an international organization. The Council’s power is only borrowed and in using it the Council relies on technocrats. But this executive technocratic approach allowed for a fast response to the challenge of terrorism, both in the late 1960s and after the 9/11 terrorist attacks. The existing doubts concerning the legitimacy of the ICAO Council’s approach can only be placated as long as this approach delivers the necessary results. The ICAO Council will have to continue to be up to date in order to combat new threats effectively, primarily by updating Annex 17 to Article 90 of the Chicago Convention.

This approach has its shortcomings from a democracy-theory perspective. But when it comes to providing fast legislative responses, existing specialized international organizations appear to provide an effective forum which should be used first, rather than looking for grand new political initiatives like the G20 which, after a decade of relative insignificance, has been activated only recently. Political initiatives will require time to build themselves and are better suited for agenda-setting rather than legislative purposes, in particular in times of crisis, which call for a fast response.

4. Coordination Between Different International Organizations

Although the financial crisis has a large impact around the world, it is accompanied by other crises, such as for example global warming and the fact that more than 1 billion people live in hunger,\textsuperscript{117} which is more than the

\textsuperscript{111} Chicago Convention, supra note 97, Annex 8.
\textsuperscript{112} Chicago Convention, supra note 97, Annex 14.
\textsuperscript{113} Chicago Convention, supra note 97, Annex 17.
\textsuperscript{114} Chicago Convention, supra note 97, Annex 18.
\textsuperscript{115} For a closer look at both, see Schäffer, Der Schutz, supra note 94, 89.
\textsuperscript{116} Id., 106.
combined population of the U.S., Canada and the European Union. Global crises will often require interdisciplinary solutions, as they are provided by the ACC. Should a topical approach prove to be too narrow to address problems which are not only global in scope but also interdisciplinary in nature, the UN can take a coordinating role, in particular when the international organizations in question are UN specialized agencies such as the ICAO or the WHO. In everyday practice the specialized agencies are already coordinating their work, which further reduces the need for additional new institutions. A long-term coordination could benefit from some institutionalized guidance, as already exists with the ACC for UN specialized agencies.

IV. A Role for International Organizations - Intermediate Conclusions

We can conclude that international organizations are uniquely equipped to deal with global crises to a degree not reached by either multilateral conferences or informal groups like the G20. International organizations can create subsidiary organs to focus subject matter expertise accordingly, as the ICAO has done to extremes. In terms of enforcing tertiary rules (primary rules being based on the international law of treaties, secondary rules being the rules included in the international organization’s constitutive treaty), international organizations have the advantage of potentially having enforcement options including in their respective constitutive documents, up to the exclusion of members in cases of non-compliance. Without this almost supra-national element, without any form of higher authority, it becomes much harder to enforce rules of Public International Law. Enforceability is a key ingredient of effective legislation. This is especially true when it comes to rules which can be very restrictive and therefore politically unpopular, increasing the risk of non-compliance. The international organizations’ additional enforcement possibilities add to making

---

119 But see also Schäffer, *Der Schutz*, supra note 94, 58.
120 *Id.*, 60.
121 Schermers & Blokker, supra note 3, 743.
122 *Id.*
123 This supra-national element extends to the international organization’s staff, buildings etc., which are often exempt from the national jurisdiction of the host state, *id.*, 744.
international organizations highly qualified for the creation of rules in times of crisis. Furthermore, the functional approach to international organizations can provide them with wide mandates which allow them to act. For example, Article 71 of the Chicago Convention, which essentially is the “Constitution of the ICAO[,] empowers it to provide, man, maintain and administer airports. [...] Whenever the organization acts under this provision, a great number of internal decisions on the administration of such airports are required. These internal decision[s] resemble national laws on the same matter.”

At least as far as new technical standards are required, the ICAO can certainly provide a template for a highly effective approach to global crises. One may ask whether ICAO’s approach is also adequate for cases which are more political than technical in nature. A crisis is characterized by the need for fast and effective action. If the situation requires a legislative approach, this will virtually always include new technical standards in the wider sense, regardless whether the standards in question deal with the threat of terrorism to international aviation or the question of if (and maybe how) to bail out banks which states deem to be too big to allow them to fail, to give just two recent examples. Should a crisis be purely or at least predominantly political in nature, the question is not so much whether the ICAO provides an adequate role model, but rather, whether law-making is the right approach in the first place.

Should the creation of new norms of international law be required, at least for the time being, tertiary law made by the specialized agencies of the UN remains the best available tool when it comes to creating rules effectively: firstly, in terms of creating them quickly; secondly, in terms of benefiting from the necessary technical expertise; and thirdly, in terms of reaching as many states as possible and in terms of being able to include the states which matter in solving crises. To realize this potential, a certain degree of permanence is necessary which cannot be provided by informal groups. The same applies to the required pool of human, intellectual and technical resources which makes specialized organizations, such as the ICAO or the WHO, better suited than less consolidated bodies such as G8 or the G20. The UN’s global reach furthermore benefits the creation of new rules as the membership in the UN is almost global, which benefits the UN specialized agencies, but even more so, the UN Security Council. The UN Security

124 Id.
Council therefore can be considered the most effective organization to create tertiary rules.

E. Conclusions

When compared to law-making under domestic law, Public International Law is not very effective in dealing with global crises. However, when measured independently against our effectiveness test based on the fast creation of binding rules, we have seen that Public International Law can indeed be utilized to address global crises. The most effective way to do so is through specialized international organizations, which can create binding law without the case-by-case consent of all states.

Specialized international organizations which can set tertiary rules without the express consent of all member states appear to provide the best approach to the fast and effective creation of new binding rules which are globally applicable and which aim to target a specific crisis situation. Decision-making by plenary organs such as the UN General Assembly, which meets once a year, is too slow and inefficient to provide a serious alternative for legislative reactions to global crises.\textsuperscript{125} The same is true of traditional multilateral treaty negotiations outside the context of international organizations. That is not to say that these ways of creating new treaty law are obsolete - not at all. But they lack the efficiency which is required to deal with global crises. Political compromises between states will not often yield the best results,\textsuperscript{126} which in turns makes it necessary to have some input by experts on the subject matter.\textsuperscript{127} International organizations tend to be bureaucratic,\textsuperscript{128} but it is this institutional character which gives them an edge over other actors,\textsuperscript{129} in particular informal and untransparent trans-governmental networks such as the G20.

\textsuperscript{125} Id., 286.
\textsuperscript{126} Id.
\textsuperscript{127} Id.
\textsuperscript{129} Id., ix.
The Snake and the Tail
Theory of Derivatives’ Regulation and the Asymmetry of the Global Financial Crisis

Mariusz J. Golecki

Table of Contents

Abstract ...................................................................................................... 294
A. Introduction ......................................................................................... 294
B. Three Models of Derivatives Regulation ............................................ 295
C. The American Credit Default Swaps Case ....................................... 301
D. The Polish Toxic Currency Options Case .......................................... 306
E. Conclusion ........................................................................................... 309

Ph.D., LL.M. Cantab., Assistant Professor at University of Łódź, Department of Legal Theory and Philosophy of Law and Post-doctoral KOLUMB Visiting Scholar 2008-2009, Faculty of Law, University of Cambridge. The article has been prepared within the framework of the KOLUMB research program sponsored by the Foundation for Polish Science.

doi: 10.3249/1868-1581-2-1-golecki
Abstract

The article concentrates on empirical verification of three competitive theories of the evolution of financial law, namely: the “origin of law” hypothesis, the “incompleteness of law” theory and the “normative uncertainty” hypothesis. It examines the adequacy of these regulatory approaches and their relative merits within the light of the asymmetry of the present financial crisis.

A. Introduction

The asymmetry claim will be based on the comparison of two different applications of derivative instruments under various regulatory regimes. The paramount role played by the credit default swaps (CDS) in the financial crisis in the US will thus be contrasted with the so-called “Polish toxic currency options crisis”. In both cases the rapid expansion of financial instruments (CDS in the US and vanilla currency put options in Poland) had been anticipated by regulatory failures. Nevertheless both the causes and the effects of the regulatory failures were extremely different. These facts beg the question whether or under what circumstances the internationally (G 20, Basle Committee) or regionally (EU) coordinated regulatory response could be both applicable and successful in terms of its influence upon diversified and fragmented financial markets. The second part of the paper will concentrate on the notion of evolution of law as a process induced by the change of economic theory within the light of policy recommendations concerning derivatives and in a broader sense the speculation as a kind of market activity.

The brief look at the American deregulatory reform (Commodities Futures Modernization Act 2000) justifies some scepticism towards any theory of linear legal evolution, especially in a form of the “incomplete law theory”. Additionally, the dynamic growth of financial innovation does not facilitate the regulatory task. The question remains how to combine innovation with security under the conditions of uncertainty (the normative uncertainty hypothesis). In this respect the recent financial law legislation in the UK (2000), the EU (2006), Germany (2007), Poland (2008) and France (2009) will finally be contrasted with the alleged purposes of the future US regulation of the OTC derivatives. It seems that under the “normative uncertainty” any valuable theory of derivatives’ regulation should promote “dynamic efficiency” and flexibility rather than fixed regulatory approach, con-
centrated on one particular purpose. Thus the future regulatory frameworks will have to be responsive and multi-purposive.

B. Three Models of Derivatives Regulation

According to the ‘legal origin’ theory, legal institutions developed within the common law legal systems create better conditions for the protection of shareholder’s interests in comparison with the civil law systems. Concurringly, companies in the common law systems could have developed much faster, having better access to financial resources. Sometimes the legal origin hypothesis is being elaborated further, to contain two substantial claims: the “law matters” claim and the “legal origins” claim. According to the “law matters” claim, legal rules create the institutional framework for market economy, establishing property rights and enforcing contracts. Legal rules and their enforcement by the state could thus indirectly influence the economic output attracting investors by safeguarding their potential returns.

Therefore the quality of regulation plays an important economic role, even if transaction costs are relatively low. Additionally, the “legal origins” claim states that the quality of laws varies depending on whether that legal

---

system belongs to the common law or to the civil law legal family. Common law is said to establish legal rules which would be superior in terms of shareholders protection and thus creating better conditions for rapid growth of firms. The reason for that contention is not clear, although it is generally claimed that common law as judge-made law is more flexible and can be adapted to changing circumstances. It is also claimed that judicial independence creates a very good safeguard against the anomalies of political process that often penetrate the statutory law-making process. The anomalies of the law-making process are supposed to influence civil law systems, leading to wasteful legislative results due to the influence of interest groups. Additionally, civil law is said to be more ‘rigid’. The question remains whether the same could be said about the differences between civil law and common law regulatory regimes on derivatives.

It can only be said that a brief sketch of the evolution of anti-speculative laws proves the opposite, the main vehicle of change being statutory law and the common law often being even an obstacle towards liberalization. Moreover, there is no evidence that the civil law jurisdictions adopted significantly different attitudes towards derivatives. The difference lies rather in the style of regulation and the institutional regime. In Germany the general legislation was enforced for a long time directly by the courts. The same could be said about France and the UK in the nineteenth and the first half of twentieth century. Moreover, there was virtually no difference of the scope of regulation. All anti-speculative laws established in the second half of the nineteenth century were essentially similar, reflecting the same attitude towards speculation: the general enforceability of contracts for differences was balanced with exemption clauses concerning organized stock exchanges. Thus the presently called over-the-counter (OTC) derivatives became unenforceable.

---


In this context one may examine the question: either the liberalization of the derivative market is inefficient from the economic standpoint or judge-made law falls short in terms of flexibility and production of economically efficient rules. Assuming that the evolution of derivative market is efficient and that the financial innovations meet important economic needs such as the increase of fluidity, spread of information and dispersing risk, it seems that the law’s origin hypothesis does not work in the context of derivative regulation. Moreover, the differences between the American and British approaches and regulatory techniques create a source of puzzlement for the potential adherents of the law’s origin hypothesis. It is not clear to what extent the law’s origin matters since both systems finally arrive at very different conclusions, adopting strikingly different regulatory regimes. Moreover, the discrepancy between the American and English regulatory approach is additionally paired with the significant similarity between the English, French and German regulations. In all of these European jurisdictions the regulatory framework seems to be at least analogical, if not the same.

Nevertheless, it may be beneficial to assume that this evidence is not conclusive and that the American approach finally favored the most efficient regulatory regime. This could be possible under the assumption that the economic theory regards derivatives as instruments with the power of putting the market in jeopardy. Therefore, even though it had been true, the restrictive regulatory approach should be flexible enough to react to the evolution of the economic theory pertaining to the economic function of derivatives. Meanwhile, it should be stressed that the basic framework of the American derivative regulation remained virtually untouched for almost one hundred years. It seems however that the difference between American-style and European-style regulation is conceptually too broad to be useful. Still, the regulatory regime seems to respond to the economic proviso at least to some extent.

The major weaknesses of the origin of law theory such as its institutional asymmetry and its strong dependence upon the overstated differences

---

between civil law and common law could possibly be overcome. This seems to be the case of the incomplete law hypothesis. The incomplete law theory does not build on the strict distinction between the legal families, concentrating rather on the type of institutional arrangements, and therefore it seems to be a much more promising candidate for the positive theory of the regulation of derivatives. The fundamental assumption purported by K. Pistor and Ch. Xu is that firstly, law in general inherently incomplete and secondly, that the incomplete system cannot be effectively enforced. The power to interpret existing law, to adapt it to changing circumstances and to extend its application to new cases could thus be called ‘residual law-making power’. According to the “incompleteness of law” theory, residual law-making powers may be conferred to the legislature, courts, or regulators. Hence, depending on the identity of the residual law-maker, the regulatory regime could be legislator-oriented, judicially-oriented or administrative-oriented.

While analyzing the development of financial law between the nineteenth and twentieth century, the authors come to the conclusion that the legal evolution leads from the judicially- or legislator-oriented regulatory frameworks to the more developed forms in which the administrative agencies have the last say. This hypothesis is illustrated by the parallel development of the English, American and German financial law, leading in all jurisdictions towards the paramount influence of specialized administrative agencies, playing the crucial dual role of residual law-makers and ultimate enforcing agencies at the same time. Both common law systems with the paramount role of judge-made law and civil law countries, where the statu-

---


14 *Id.*, 934.

15 *Id.*, 963.

16 *Id.*, 1010-1013.
tory enactments responded to the problem of incomplete law, tend to develop the specialized agencies.

It has been suggested that the regulatory powers of either private or public regulatory agents developed faster in common law jurisdictions such as the US and the UK than in Germany. This could be an effect of both faster development of financial markets and relatively greater incompleteness of law in those countries. It seems that even if the incompleteness of law theory applies to the financial regulations concerning stock market and shareholder capital, for various reasons it is not necessarily an adequate instrument to be used within the development of derivatives. Firstly, it does not capture the fundamental difference between the stock exchange traded derivatives and the OTC derivatives. Secondly, the smooth evolution from judge-made or statutory rules to the sophisticated regulatory frameworks administered by specialized regulatory agencies is questionable. There are two reasons for this criticism: firstly, there is no integrated regulatory regime for all derivative instruments in the majority of jurisdictions, the regulation being based on a patchwork of security regulators, stock exchange supervision, and judicial enforcement in case of the OTC contracts; the existence of one integrated regulator and supervisor being nothing more than a political and regulatory challenge or mere wishful thinking. This line of reasoning is albeit not conclusive. It surely undermines the positive claim while leaving the normative claim untouched. Analytically, it could be possible that the derivative market as a whole has not yet reached the stage already attained by the regulation on financial securities.

Thus the question remains as to how to combine innovation with security under the conditions of uncertainty. This fundamental regulatory consideration is reflected by the normative uncertainty theory. Therefore, the normative theory of regulation would favor the capability to adapt the regulation to changing circumstances rather than a fixed regulatory approach, concentrated on one particular purpose. Such an approach is very often

19 M. J. Golecki, ‘Titanic, albo wstęp do neokapitalizmu’ (‘Titanic or the Introduction to Neocapitalism’), 1 Praktyka Polityczna (The Political Practice) (2004), 106-118.
called reflexive regulation. Not intending to define reflexive regulation or a wider concept of reflexive governance, it is still important that it is oriented on the maximization of dynamic efficiency, as juxtaposed with mere static allocative efficiency. The reflexive regulation could also be associated with the I. Ayres’ and J. Braithwaite’s theory of responsive regulation and the so-called Australian theory of regulation. The main point is that the reflexive or responsive regulation should be based on a flexible regulatory framework, which means inter alia that it should be based on principles rather than on rules.

The difference between rules and principles could be expressed in various ways. Within the context of the theory of regulation perhaps the most significant difference concerns much higher degree of flexibility and openness of principles in comparison with the relatively well entrenched and precise rules. Thus the major features of reflexive regulation are the predominance of the purpose-oriented rules and principles, a vast scope of discretionary powers, the hierarchy of legal remedies in a form of the so-called pyramid of sanctions and the dialogical-discursive approach, as the regulator collects data and transforms private information revealed within the process of regulation into the public one.

The last feature of the responsive regulation, namely the discursive process of adaptation and dialogical character of the regulator-agent interactions, is sometimes described in terms of a bargain taking place between the regulatory agency and the operating business enterprise. This contractual aspect of the relation plays an important role in regulatory endeavor, since the regulator, due to the constant monitoring and dialogue with the regulated subjects, could obtain the relevant private information possessed by the business entities. The information centered strategy reflects the fact that the access to the relevant private information on derivative strategies, tech-

---

niques, methods and relevant practices is otherwise difficult to collect and prohibitively costly. The communication between the regulator and entrepreneurs plays an important if not crucial role, according to the contemporary network-oriented theories of regulation.

Nevertheless, the acceptance of the responsive regulation in a style proposed by I. Ayres and J. Braithwaite raises some well-known problems. One of the most serious issues is the fact that it is not clear how the regulator could sustain the cooperation with the agents whose activities are being regulated, thus being the subject of constraints. Certainly, the principle-based regulation is always affected by the limited scope of accountability of regulatory bodies. Sometimes it is even suggested that the responsive regulation contradicts basic constitutional principles, such as proportionality principle, leading to the illegitimate interference of public bodies with the potential economic actions of private agents, who are unable to predict the potential strategy, purposes and actions of regulators. These observations even if valuable, seem to be far-fetched, given the fact that the actions of regulators are not deprived of substantial control of legality. The judicial control of administrative actions seems to be the best way of combining the regulatory efficiency with the requirement of the rule of law and constitutional accountability. Additionally, the division of power and tasks between the regulators and the courts seem to be a constant point of reference for any feasible and realistic theory of regulation.

C. The American Credit Default Swaps Case

The very short story of the US derivatives regulatory framework reads as follows: In the beginning was the word, or concept, called “unrestricted freedom of contract”. This lasted until the middle twenties of the XX century. Later on the massive regulation made the world better off, for the financial world has been dramatically tortured by the glooms of great depression.

---

24 For the characteristics of the institutional theories of regulation, in both, information based and network oriented forms cf. B. Morgan & K. Yeung (eds), An Introduction to Law and Regulation (2007), 53-79.
26 Id., 167-170.
The whole structure of federal agencies has been established as the offspring of the New Deal policy. The regulatory powers over derivatives have been divided between the Stock Exchange Commission and the Commodity Future Commission. Those agencies regulated, supervised and enforced restrictive anti-speculative laws; then the trend to liberalization came in the 1970’s, derivatives still being generally regulated by the Commodities Exchange Act (CEA) with the growing list of exemptions issued by the Commodity Futures Trading Commission (CFTC). In general, all ‘contracts for future delivery’ were either exchange-traded or void. Thus the OTC market existed only within the scope of the CFTC exemptions, concerning basic OTC transactions.

Such a regulatory framework lasted until the year 2000, when the US congress passed the Commodity Futures Modernization Act 2000 (CFMA) deregulating OTC derivatives by virtue of exemption from the application of CEA and the regulatory power of the CFTC. According to Section 2(d)(1) of the CFMA 2000, parties who are “eligible contract participants” (ECP) to any individually negotiated derivative contract on any commodity are excluded from the application of the CEA. Moreover, Section 2(d)(2) stipulates that the CEA is generally not applicable at all to those transactions. The only exception to that rule is the set of provisions concerning fraud and manipulation of market price, which means that the scope of regulation is limited to fraud and price manipulation. Thus the statutory law provided for deregulation, and ousted the jurisdiction of existing agencies. At the same time such a deregulated approach created some doubts concerning the existence of any regulatory framework for the OTC derivatives.

The underlying assumption might have been that the very statutes of the “eligible contract participants” would create a sufficient regulatory safeguard, since the requirement for ECP’s would have selected only the sophisticated professional market participants (US financial institutions, non-US regulated insurance companies and banks and their US branches and agencies, participants acting as brokers, agents, investment advisers or fiduciaries) and natural persons with more than USD 5,000,000 in assets who enter into the related transactions for risk management purposes. In effect, the CFMA acted as a double sword: it either excluded some market participants from any supervisory regime as in case of eligible natural persons or shifted

---

that task to other agencies, already supervising some categories of financial institutions.

The move to fragmentation and decentralization of supervision may be regarded as a striking phenomenon if compared to the British FSMA 2000, which adopted the opposite approach, creating a single integrating supervising agency, i.e. FSA. This alteration of the regulatory structure has provided with an excellent opportunity for the regulatory failure. The lack of any control on the so-called over the counter derivatives led to the rise of systemic risk and finally resulted with a spectacular threat to the whole banking and financial system.

Within this context of particular interest are credit default swaps. Those instruments were contracts concluded by the parties on unregulated market. A CDS contract is typically privately regulated according to the confirmation published by the International Swaps and Derivatives Association (ISDA), which concerns the credit derivatives definitions and basic terms of typical credit derivatives contracts. According to some judicial decisions swap based derivatives are to be treated as contracts and not as securities, as it had been stated in Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996). Moreover, the judgment in Caiola v. Citibank, 137 F. Supp. 2d 362, 364-65 (S.D.N.Y. Apr. 2, 2001) had impact on the evaluation of the legal status of the so-called soft law regulations issued by International Swap and Derivatives Association for the OTC derivative transactions. The court held that certain provisions of the ISDA Master Agreement could have prevailed over the statutory provisions of the Securities Exchange Act 1933 (SEA).

Against this background it seems that courts in fact acted as residual law-makers, creating a basic legal framework for CDS. The question remains whether that framework was an adequate legislative tool. In order to evaluate the deregulation and heavy dependence on the ISDA style soft law, a closer look at the dynamic of the market for the OTC credit derivatives is needed. Firstly, the financial mechanism and the economic purpose of the CDS should be identified. Accordingly a credit default swap (CDS) can be described as a credit derivative based on a relatively simple mechanism. One party makes periodic payments to the other, and in return he or she receives a payoff in case of default concerning the so-called underlying instrument. If the later party actually owns a debt, the CDS can constitute a kind of insurance against the risk of default. This especially concerned a secured debt, very often somehow related with the market for immovables. Generally such a situation is regarded as hedging. However the party may enter into the CDS contract without owning any debt for reason of clear
speculation. Such a “buyer” of the CDS simply bets against the solvency of the debtor in a gamble to make money if it fails.

If the relevant debtor defaults, there are two possible solutions. Firstly, the party which holds a debt delivers a defaulted asset to the counterparty for a payment of amount of money, which is usually called physical settlement. Secondly, the counterparty pays the difference between the par value and the market price of a specified debt obligation, which is termed cash settlement. Since 2003 CDSs started to be used rather by the speculating parties than by banks willing to insure against default. Thus the CDS has been transformed from the hedging based instrument into the highly speculative contract for differences, which in fact constituted a kind of bet for or against the likelihood that a particular company would suffer financial difficulties and default to pay debt.

The above situation cumulated both systemic risk and liquidity risk. Consequently, the market for CDS grew, and in 2007 it reached the peak notional value of USD 45 billion\(^{30}\). In 2008 the CDS market collapsed after a number of spectacular events such as the collapse of Bear Stearns and its taking over by JP Morgan in March 2008 and the bankruptcy of Lehman Brothers. The latter meant that approximately USD 7 billion eventually had to be paid to the buyers of CDS protection issued against the default undertaken by that bank. Additionally in September 2008 American International Group (AIG) required a federal subsidizing because it had been excessively selling CDS protection without hedging against the possibility of default. Those events eventually threatened the stability of the whole banking and financial system leading directly to the global financial crisis.

The reasons of the American financial crisis of 2008 are certainly complex. However it is obvious that some sophisticated derivative instruments significantly contributed to the systemic nature of the failure of the whole financial system. Two major considerations loom large on the horizon. Firstly, the adopted deregulatory policy deprived the system of any monitoring system. This is particularly evident in case of the unexpected risk exposure and inability to control it. Additionally, the system has been significantly weakened by the introduction of a patchwork of fragmented private clearing houses, which were unable to minimize the legal risk of non performance. This finally led to cumulated bankruptcies and further eroded the system as a whole. According to the sec. 2 d 1 of the CFMA 2000, CDS

\(^{30}\) According to the ISDA Market Survey, Year-End 2008.
have become exempted from regulation by the SEC and the CFTC, as any other OTC derivatives, provided they had been issued by the ECP.

In case of the over the counter CDS market this led to the unexpected increase in both legal and systemic risks. The legal risk stem from the fact that the CDSs were not standardized. The ISDA documentation requirements played an important albeit primarily procedural role. The substantial elements would concern method of calculating the relevant payout. The increasing complexity of the methods of calculation empowered by the gradual departure from the underlying instruments rationale brought about a considerable level of uncertainty leading to the increase of the other party risk and finally to the risk of default. This especially pertains to the so-called ‘vanilla CDS’, where the underlying protection is sold as a broad category of "Bond or Loan" instead of being sold on the reference entity which is the underlying debt.

The main outlines of the presently proposed regulatory reform concentrate on the potential harmonization and standardization of the CDS contracts. This certainly leads to the question whether the stock exchange would not be the best institutionalized safeguard of that standardization. Additionally, a stock exchange secures not only standardization but also volatility and enforcement by the clearing house. A clearing house operates as a kind of buyer to any potential seller and as a seller to every buyer. This mechanism significantly reduces the risk of a counterparty’s breach of derivative contract, whereas in case of the OTC market, participants are exposed to each other’s default risk, which usually is referred to as to the counterparty’s risk.

The lack of centralized enforcement system in a form of clearing house became the major cause for the increase of systemic risk. The problem has at least partially been initiated by the defragmentation and privatization resulting from the CFMA 2000. The Act has led to the creation of ineffective network of private clearing houses which has not been up to the task in crucial moments. As has been announced by the US Secretary of the Treasury, Timothy F. Geithner, the awaited American regulation of derivatives should fulfill the following expectations and purposes: “(1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that
OTC derivatives are not marketed inappropriately to unsophisticated parties.”

D. The Polish Toxic Currency Options Case

The lack of standardization of derivative contracts and centralized clearing house systems should not be treated as an exclusive problem of the OTC derivative market. During the 2008-2009 financial crisis different markets have been affected by various types of market failures. In the US the deregulatory policy on OTC derivatives has resulted in over-exposure towards risk and created very good conditions for excessive speculation with credit derivatives (especially credit default swaps-CDS), leading to fluidity problems and gradually affecting the whole banking and financial market. Additionally, the crisis had an immense impact on other markets, where the toxic financial instruments such as the CDS-styled derivatives and collateralized debt obligations (CDOs) have not even been traded.

Against that background the case of the Polish currency toxic options could be presented. Since 2008 over 10,000 Polish companies engaged in contracts designed to protect them from a stronger Polish currency złoty. The main economic reason for this strategy was the fact that the value of the euros they earned from selling goods and services in Europe had continuously been decreasing for last consecutive 5 years. However, the unexpected collapse of the Polish currency has had very serious financial and economic consequences leading to many prospective bankruptcies. The Polish Financial Supervision Authority (PFSA) estimated that at least 99 Warsaw Stock Exchange-listed companies concluded option deals in 2008.

Many relatively small private firms have been exposed as well. The currency has lost nearly 30% of its value against the euro between October 2008 and March 2009. About 1500 firms may go bankrupt in case of performance of the option currency contracts. The aggregated loss of Polish exporters amounted to 18 billion PLN (approximately €5 billion).

32 Komunikat KNF z dnia 17 grudnia 2008 r. w sprawie wpływu walutowych instrumentów pochodnych na banki i spółki publiczne, (The Announcement of the Polish Financial Supervision Authority of the 17 of December 2008, On the impact of derivatives on banks and public limited companies (2009), 1-4.
33 Based on The Announcement of the Polish Financial Supervision Authority of the 11 of March 2009, Note on exposure of Polish companies to FX derivatives: “Banks’
Both macro and micro effects are discernible. On the macro level the rise of unemployment and bankruptcy of so many enterprises, massive loss of the bigger, including the biggest, stock exchange listed companies, will have a considerable impact on the whole national economy. On the micro level the prospects of relationship between banks and investors are not clear since many banks had allegedly acted as financial advisors, thus breaching their fiduciary duties and inciting small firms to conclude the toxic derivative transactions, especially toxic currency options, where the banks in fact hedged against the decline of the Polish currency\(^ {34} \). The information on risk exposure had not been properly disclosed. Moreover, many contracts notoriously contained some hidden provisions or suffered other serious formal defects. Dissatisfied firms claimed not only misrepresentation, but also more serious defects such as deceit and fraud accompanied by breach of fiduciary duties by banks’ representatives.

Under those conditions two issues should be addressed. Firstly, the question arises whether the case of Polish toxic currency options is a market or government failure. Secondly, under the assumption that there was a real market failure, how should the government and the judiciary respond to the potentially disastrous economic consequences of those contracts for a group of business entities? As to the first question, there seems to be no unanimously accepted answer. Thus, each contract should be scrutinized on an individual basis. This requires control performed by the courts. In fact, the majority of loss-suffering disappointed companies have brought claims against banks, submitting for resolution or invalidation of those option contracts. One of the possible solutions is to adopt the position, that those contracts as bets or contracts for differences were valid but not enforceable. There is no straightforward solution on the level of national contract law, regulated by the Polish Civil Code\(^ {35} \).

The other option may still be contemplated, namely the general legislation rendering the majority if not all option contracts void or voidable,
depending on the version of the bill. Three bill proposals have been prepared so far but there is no political consensus as to which one of them should be implemented.

This is not however, the complete milieu of the case, as the European Union’s normative influence should also be taken into account. Poland is a member of the EU since May 2004. In 2006 the European Council adopted the EU’s Markets in Financial Instruments Directive (MiFID), stipulating minimum requirements for the protection of individual unsophisticated investors. The implementation of the directive would have solved the problem of toxic options provided the contracts where fraudulent or unbalanced. In other terms, if the option contracts had constituted a typical case of market failure, the problem would have been solved by the implementation of the directive. The Polish government failed to adopt the directive however, thus acting in breach of the EC law.

As a summary it could be stated that the Polish toxic options case resulted from lack of consumer protection and in the existence of the political bias which prevented the implementation of the EU MiFID 2006 directive. Thus, the relatively cheap protection in a form of the already enacted EU directive has not been deployed. It could be said that the Polish government eventually failed both to prevent the spread of the toxic derivatives and to regulate the market ex post. In fact the government and the legislature decided to shift the burden of regulatory task to the court. It seems however obvious that the implementation of the MiFID was in fact a much better option than conferring the role of the interstitial legislator to the ordinary courts. The solution which finally has been adopted seems both exuberant in term of costs and unsatisfactory, since the MiFID directive has still to be implemented by the Polish government. Thus the Polish toxic options case seems to be a good example of inefficient deployment of courts as residual law-makers

Meanwhile the differences between the US and Polish derivative crises are striking. Both the Polish and the US financial crisis stemmed from the lack of regulation, but the nature of the process was different. In case of the US market for CDS’s the fragmentation and deregulation led on the one hand to the financial crisis, on the other hand to the serious development of financial instruments. It is true that the regulator not only did not emerge, but the already existing CFTC has been incapacitated by the expensive legislative intervention. However this incapacitation resulted at least in the unexpected growth of derivative market for CDS. In Poland, the costs of the regulatory failure are not balanced by any serious development in deriva-
The financial instruments such as vanilla currency options have been widely applied for at least ten years.

The significant difference lies in the fact that the American OTC market for CDSs cannot be based on the judicial enforcement, for that would result with major break down of the financial liquidity. Courts are simply not fast enough at that stage of the financial market development. If this is true, then the development of the financial market should lead to the prospective centralization. The growth of the quasi stock exchanges in derivatives and finally the diminishment of the role of OTC markets would become possible albeit unintended result of the financial crisis. In other terms the present financial crisis seems to be just nothing more than a price or cost which would inevitably accompany such a regulatory and institutional shift.

E. Conclusion

Three different models of regulation are discernible as a regulatory and evolutionary response to the potential risks related to financial innovation, namely transaction-oriented, institution-oriented and market-oriented model. It seems that the market-oriented model of regulation has not accidentally been adopted by many jurisdictions. Taking the unusual and diversified evolution of derivatives market into account, two lessons should be remembered. Firstly, the financial crisis proved that regulation is necessary and good regulation requires a sound normative theory of both derivatives and investors’ behavior. Additionally, it seems that the judicial regulatory capacity could still play an important albeit limited role among the regulatory instruments and institutional arrangements. Thus the judicial governance remains a significant alternative to market and political processes, whereas in majority of cases the regulatory framework seems to depend primarily on the quality of regulators, especially public agencies. At the same time the output of the flexible regulatory process should remain under the control of judges so that the principle of rule of law is safeguarded. Thus the quality of regulation will in the future depend on the division of labor between courts and regulators. There is however no universally applicable regulatory strategy, since the heterogeneity of financial markets and the diversity of regulatory approaches remain untouched.
Regional Power Shifts and Climate Knowledge Systems in (Global) Climate Governance

Babette Never*

Table of Contents

Abstract .......................................................................................................................... 313
A. Introduction ................................................................................................................. 313
B. Regional Powers and Regional Power Shifts in the International Climate Negotiations ............................................................................................................. 314
   I. Definition and Concept of Regional Powers ................................................. 314
   II. Power Shifts in Global Climate Governance ............................................. 317
       1. Country Profiles .............................................................................................. 318
       2. Role of the Regional Powers in the International Climate Negotiations .......................................................... 319
       3. Activities by State and Non-state Climate Governance Actors ...................... 321
   III. Implications for the International System ................................................ 322
C. Communities of Practice and Climate Knowledge Systems ................ 324
   I. The Role of Knowledge, Norms and Practice for Solving Global Crises .......................................................... 324

* The author is a research associate at the Hamburg International School for the Study of Regional Powers, University of Hamburg/GIGA (German Institute of Global and Area Studies). She is writing her PhD on climate governance in India and South Africa. Contact: never@giga-hamburg.de.

doi: 10.3249/1868-1581-2-1-never
II. Emanuel Adler’s Theory of Cognitive Evolution and Communities of Practice ......................................................... 327

III. Climate Knowledge Systems ........................................................................ 329

D. Conclusion ........................................................................................................... 332
Abstract

In the International System, there has been a power shift towards regional powers that is supported by recent developments in climate governance. I argue that some of the regional powers are also climate powers which benefit from an issue-specific power shift. The behaviour and strategies of regional powers concerning climate change are central for global climate governance. To analyze their strategies, a multi-level approach is required that captures the link between domestic climate governance and climate foreign policy. I develop such a concept of climate knowledge systems. It is based on Emanuel Adler’s theory of cognitive evolution and communities of practice. A pragmatist philosophy that allows for mixed methods research is most suitable for analyzing the proposed connection between knowledge, practices and change. It also presents the key to an extended regional powers framework, leaving behind the somewhat artificial boundaries of International Relations in climate governance.

A. Introduction

The 4th Assessment Report of the Intergovernmental Panel on Climate Change (IPCC) and the Bali conference in 2007 have once again brought climate change to the attention of policymakers. Two years later – and despite the financial crisis – climate change is still high on the agenda. Some authors argue that the next economic crisis is looming unless the transition to low carbon-energy systems is undertaken now. For a true green new deal that effectively addresses climate change, regional powers such as China, India or South Africa have to firmly support it as well. Regional powers’ current and prospective share of global greenhouse gas (GHG) emissions is considerable. Simultaneously, some of them will be among those worst hit from the impacts of climate change. The role of

---

* The author is a research associate at the Hamburg International School for the Study of Regional Powers, University of Hamburg/GIGA (German Institute of Global and Area Studies). She is writing her PhD on climate governance in India and South Africa. Contact: never@giga-hamburg.de.

regional powers both in their respective regions and the International System underline their importance for solving global crises. In the international climate negotiations leading up to the Copenhagen Conference in December 2009, a shift in power relations is discernible.

In this article, I focus on three points. First, I elaborate on the content and implications of the power shift taking place. Second, I argue that existing analytical frameworks need to be extended to take into account multi-level influences in climate governance, particularly concerning knowledge and norms. The analytical separation of global and domestic climate governance is obsolete – and therefore, to a certain extent, the boundaries between International Relations and Comparative Politics. Third, I contend that new ideas, attitudes and practices begin to evolve in reaction to climate change. Building on this, I develop a theoretical concept suited to regional powers and the multi-level character of climate governance. It is based on Emanuel Adler’s theory of cognitive evolution and communities of practice, but refines his ideas to a concept of climate knowledge systems.

The article is divided into two parts. In the first part, I give some essential definitions: regional powers, power and leadership. I discuss the power shift in global climate governance and its possible implications for the international system. In the second part, I explain the multi-level quality of climate governance with respect to the role of knowledge and norms, particularly concerning regional powers’ strategies. I develop my concept of climate knowledge systems and show how it connects to the analytical framework of regional powers. Finally, I demonstrate the advantages of taking a pragmatist stance that focuses more on practices.

B. Regional Powers and Regional Power Shifts in the International Climate Negotiations

I. Definition and Concept of Regional Powers

The terminology for the group of states that possess growing economic and political weight varies in the literature. There is neither a consensus as to which states constitute regional powers, nor a common set of analytical criteria. I do not intend to enter the debate about the advantages or disadvantages of each of the underlying concepts. That is not the purpose of this article. I employ the definition and understanding of regional powers used by the German Institute of Global and Area Studies (GIGA). It is one of the more complex concepts available that still gives sufficient room to include issue-specific dynamics. Moreover, it provides a starting point for
an extension beyond the analytic arena of International Relations, which is essential for the analysis of climate governance.

Generally, regional powers possess a certain economic stability, a relative military power and a regional power base. Based on this, Daniel Flemes identifies four basic defining criteria: Regional powers have to (1) be part of a geographically delimited region, (2) be ready to assume leadership, (3) possess material and ideational capabilities for regional power projection, and (4) be highly influential in regional affairs. Four more criteria serve to classify regional powers: (a) economic, political and cultural interconnectedness of the regional power within its region, (b) the provision of collective goods for the region, (c) the existence of an ideational leadership project, and (d) the acceptance of the leadership by potential followers. The countries that meet these criteria and can therefore be defined as regional powers are Brazil, China, India, South Africa and Russia, although Russia differs from the others because of its lack of ideational capabilities.

The definition of regional powers is closely related to the terms ‘power’ and ‘leadership’. The GIGA approach understands leadership as a process rather than a static qualification. Following Michael Barnett and Raymond Duvall, power is seen as both resource- and process-based. This appears to be the most suitable definition of power for the analysis of regional powers, because it allows for differentiated analyses. Thus, power has four dimensions: compulsory power, institutional power, structural power and productive power. Compulsory power entails the direct control over others via material or symbolic resources. Institutional power refers to indirect control through rules, processes and institutions. Structural power
concerns the structures and constitutive relations (e.g. inter- and transnational) that define actors’ self-understanding, social capacities and interests. Finally, productive power, also termed discursive or ideological power, is “the constitution of all social subjects with various social powers through systems of knowledge and discursive practices of broad and general scope”.

Nolte adds the differentiation between direct and indirect applications of power as well as three states of activity: active, passive or reactive power.

The original GIGA concept of 2006 was criticized for its overemphasis on materialist factors as well as the insufficient integration of socialisation effects and the possibility of policy linkage strategies. This criticism has been met by the recent conceptual developments outlined here. The advantage of understanding and analysing regional powers in the way presented is the inherent multilevel approach that looks at different actor relations, interests and issues on global and regional levels from various analytical angles. Regional powers’ strategies may differ depending on the issue, so that some present a stronger regional power or power projection than others. To understand these choices and dynamics, I argue that the domestic, local and transnational levels of governance need to be more explicitly integrated with respect to both state and non-state initiatives.

While there is some danger to the complexity of the GIGA concept, it should serve as an overall framework inside which more specific approaches can be developed. These may lead to different results. Yet as long as the connection to the framework is made explicit, those results could actually be closer to actual practices – which is what all political scientists, even the most radical interpretivists, try to explain. The theoretical approach outlined in the second section of this paper shows one possible way of doing this. First, however, I explain the kind of power shift that has taken place in the climate governance field, in which regional powers are involved, and what implications this might have for the development of the overall International System.

---

8 Id., 20.
9 Nolte, supra note 2, 16.
II. Power Shifts in Global Climate Governance

The change in the International System toward a multi-polar world has been extensively discussed for two decades. Various contributions have analysed and projected changes in the power distributions towards regional powers, especially concerning China and India. I argue that these power shifts are supported by the recent developments in climate governance, qualifying some of the regional powers as climate powers. A shift in power implies (a) a change in actor relations on a general level in the International System, (b) a change in at least one of the dimensions of power mentioned above, and/or (c) a certain gain in leverage beyond the concrete issue or governance field (issue linkages).

The power shift in climate governance is linked to the new urgency of dealing with climate change. Despite the fact that climate change is not new to the international agenda, extended scientific knowledge about the speed of climate change today draws a specific, quickly closing policy window. Implicitly, the new scientific findings invoke an air of crisis. This could present the sort of trigger that generates a change in attitudes and ideas – a “cognitive punch”\(^\text{11}\) that induces processes of cognitive evolution (see section C).

The increase in power in climate governance does not concern all regional powers as per the GIGA definition, but primarily the heavyweights – China and India, as well as Brazil and South Africa. Russia maintains a low profile in international climate negotiations; parts of its climate strategy appear even to contradict other of its interests.\(^\text{12}\) Also, large parts of Russia are expected to benefit rather than suffer from the impacts of climate change, setting it apart from the other four regional powers. Therefore, so far Russia has not benefited from the power shift in the climate field and cannot be termed a (potential) climate power.

The power shift in global climate governance can be ascribed to three main points: (1) the regional powers’ country profile with respect to both emissions of greenhouse gases and the expected impacts of climate change (mitigation and adaptation\(^\text{13}\)), (2) their role assumed in the international

---

11 E. Adler, *Communitarian International Relations. The Epistemic Foundations of International Relations* (2005), 75.
13 “Mitigation” refers to an anthropogenic intervention to reduce the anthropogenic forcing of the climate system; it includes strategies to reduce greenhouse gas sources
climate negotiations, and (3) climate governance activities, both by state and non-state actors.

1. Country Profiles

In terms of their climate country profiles, China, India, Brazil and South Africa all belong to the top 20 of the global GHG emitting countries. In 2009, China surpassed the United States and now emits the most GHG per year in cumulative terms. Projections for India, for instance, range from 4 billion tons to 7.3 billion tons of GHG emitted in 2030. These figures underline that it is imperative to include the regional powers in a new climate deal. Due to its large amount of rain forest, Brazil has a special role for both mitigation and adaptation. The forests function as a carbon sink, explaining why the instrument Reducing Emissions from Deforestation and forest Degradation (REDD) is central to the negotiations. REDD is also linked to adaptation because of the livelihoods that depend on the forests as a source of income. The IPCC 4th Assessment report and the UNDP Adaptation Country Profiles project severe impacts of climate change in several sectors and issue areas for all four regional powers, for example disaster risk, water or food supply.

Given their level of economic and human development, regional powers are in a better initial position than other developing countries to face climate change impacts. They can help to foster adaptation in their region. Despite the fact that some of the science has been known for a decade, the actual scope of the climate change problem as well as more concrete data on emissions and adaptation needs have only become available in the past 2-3 years. This strengthens the basic power position of the four regional powers, particularly in the dimensions of institutional and structural power. With

and emissions and enhancing greenhouse gas sinks. “Adaptation” can be defined as adjustment in natural or human systems in response to actual or expected climatic stimuli or their effects, which moderates harm or exploits beneficial opportunities (IPCC, Appendix I: Glossary, 869, 878, available at http://www.ipcc.ch/pdf/glossary/ar4-wg2.pdf (last visited 18 February 2010)).

14 Netherlands Environmental Agency, Which are the top-20 CO2 or GHG emitting countries?, available at http://www.pbl.nl/en/dossiers/Climatechange/FAQs/index.html?vraag=10&title=Which%20are%20the%20top-20%20CO2%20or%20GHG%20emitting%20countries%3F#10 (last visited 18 February 2010).
15 Id.
respect to the international negotiations leading up to the Copenhagen conference, they are simply too important for governing and protecting the global commons ‘climate’.

2. Role of the Regional Powers in the International Climate Negotiations

The high degree of difficulty in reaching agreement on any of the four big negotiating blocks – mitigation, adaptation, technology transfer and finance – is a clear sign of the power shift. If a coalition of states were able to dominate the negotiations and use its power to push for a specific solution, there would be fewer controversies than there currently are.\(^\text{17}\) The four regional powers function as issue leaders of the G77, especially China. Additionally, South Africa acts as a speaker for the Africa group. All four regional powers try to keep a united position around three major principles: (1) the polluter pays principle – emphasising the historical responsibility of industrialised countries for GHG emissions and therefore their responsibility to take the lead, (2) the principle of common but differentiated responsibility as laid down in Article 3 of the UNFCCC – strengthening the argument that industrialised countries need to financially support developing countries’ adaptation to the impact of climate change, and (3) a right to (economic) development – often interpreted as a certain right to emissions.

The negotiations in the past few years have been characterised by the deadlock between the two biggest emitters, China and the United States. Both governments blamed the other for the stalemate; each refused to act as long as the other country did not do so first. Yet with the change of administration in the US, the pressure on the Chinese government has increased. The declaration of the G8+5 at the Major Economies Forum (MEF) in July 2009 can be attributed to the new dynamics in the international climate negotiations. Even the Indian Prime Minister Singh agreed to the 2°C goal, i.e. that the global average temperature should not increase more than 2°C compared to pre-industrial levels. The MEF declaration indicates that political high-level events are necessary to boost the negotiations leading up to Copenhagen. The final extent of what we

\(^{17}\) Note that at the time of writing (September 2009) the negotiating text for the Copenhagen conference still included around 7000 brackets, indicating disagreement on the passage.
have termed the “Obama effect” on the regional powers elsewhere\textsuperscript{18} could not be determined before the outcome of Copenhagen, but its capacity seemed to have diminished. Now let us turn to each of the four countries individually.

The Chinese delegation counts as progressive in the international negotiations. Despite its refusal of binding emission targets, the government accepts its leadership position. In September 2009, the Chinese President stated the country would cut its emissions per GDP “by a notable margin by 2020”.\textsuperscript{19} Yet China was not always a progressive force in climate governance. When the new IPCC report was published at the beginning of 2007, China tried to downplay its relevance in order to decrease its own responsibility.\textsuperscript{20} Today, domestic climate governance efforts are comparatively ambitious; clear efforts are being undertaken to prepare for the change to a low-carbon economy. The active pursuit of its issue leadership position has increased China’s institutional power. Using Nolte’s terminology, China has shifted from a rather reactive power position to an active power position. The first mover advantage could benefit China.

The second heavyweight, India, has assumed a reactive, blocking position since climate change first hit the international agenda in the early 1990s. The government continues to point to India’s low per-capita emissions. Only in September 2009, as a reaction to China, did environment minister Jairam Ramesh state that India needs to take on more aggressive, voluntary mitigation measures, learning from China.\textsuperscript{21} Since the 1970s, socio-economic development and protection of the environment are understood as contradictory. Due to its relevance for the economy, technology transfer is the only issue area in which India tries to constructively help achieve a solution. Outside international negotiations, India has signed several bilateral agreements on technology cooperation, for


\textsuperscript{21} See The Times of India, *supra* note 19.
example with the US. Given its important function for overall climate governance, India benefits from a direct power shift even though its power currently manifests itself in a blocking attitude.

In the negotiations leading to the Kyoto Protocol, Brazil was very active and progressive. Its delegation still counts as rather progressive, but has lost some influence in the past years. Activities centre primarily on REDD, where the Brazilian voice exerts considerable power. If the principle of common but differentiated responsibility were respected, Brazil would consider accepting mandatory emission reduction targets.\(^{22}\) This demeanour is similar to South Africa’s position. In general, South Africa does not oppose emission reduction commitments anymore. The South African delegation had shifted to an active, progressive position under the now former environmental minister Marthinus Van Schalkwyk. In 2005, despite a domestic move towards a proactive position, the government still felt bound by the reactive position of all other developing countries – so the South African position remained reactionary as well.\(^{23}\) The change implies a gain in institutional power and potential leverage beyond the climate issue. As a speaker of the Africa group, South Africa advocates actively for financial support of adaptation for all developing countries. The EU seems to recognize South Africa’s potential, calling on the government to take a progressive lead function within the group of regional powers. The power South Africa exerts in the international climate negotiations can therefore be termed active and direct.

3. Activities by State and Non-state Climate Governance Actors

Finally, the activities both by state and non-state actors in Brazil, China, India and South Africa strengthen the respective governments’ position in global governance questions. Increasing domestic activities show the countries’ willingness to assume their share of responsibility. The deadlock between China and the United States softens. For instance,


Chinese provinces have been active in climate governance since 2007. Given the size of the country and the difficulties of integrating developmental and environmental concerns, the Chinese national climate policy counts as comparably progressive. In South Africa, a long-term mitigation strategy that envisions emissions peaking by 2020/2025, plateauing for a few years, and then declining, was approved by Cabinet in 2008. A roadmap with concrete steps for both adaptation and mitigation was discussed and agreed on at a National Climate Summit with stakeholders in March 2009.

The projects conducted under the Clean Development Mechanism (CDM) are part of the Kyoto Protocol. They are public-private partnerships or fully private projects, with the first project registered in 2004. China currently has the biggest share of roughly 35% of the 1815 projects currently registered at the UNFCCC, India comes second with 25% and Brazil hosts 9% of all CDM projects. This underlines their economic attractiveness and importance as trading partners for the developed countries. Even though it is not clear yet what form the future emission trading system will take, it can be assumed that the structural power gain in this area will not be lost again. In addition, both Brazil and India posses some structural power in terms of competitive advantages in the renewable energy sector. Brazil is the world’s biggest producer of biofuels. In terms of installed wind power plants, India is ranked fifth globally. The Indian company Suzlon is one of the world’s leading wind turbine manufacturers. Moreover, the potential for innovations in green technology is deemed particularly high in China and India.

Overall, China, India, Brazil and South Africa exert some qualities of climate powers and have a high potential to fully assume their role. A definite classification is subject to in-depth, multi-level empirical studies.

III. Implications for the International System

Given the impacts of climate change on key sectors such as the economy, and its simultaneous catalyzing effects on many already existing problems, the developments in power relations in climate governance are crucial for the International System. Spill-over effects on other issue areas

---

24 See Korppo et al., supra note 12.
appear possible. I contend that climate governance has the potential to become – if it is not already – one of the most important governance fields of this century. It cannot be put into the low politics box the way environmental policy issues normally are. The challenge it presents to two of the state’s core functions – welfare and security – is likely to transform the management of climate change into a domestic performance test for governments. In the international system, assuming a leadership function in climate governance is likely to strengthen both regional leadership and global recognition. China could benefit from a demonstration of global leadership ambitions via climate governance, confirming its ability to address global problems. Therefore, its power position in relation to the US is reinforced. If India changed its current negotiation position somewhat to lobby for a specific type of emission trading, it could become the winner in a new climate deal. Due to its low per-capita emissions and already attractive location for CDM projects, India could significantly strengthen its economic attractiveness – and therefore its power position.

The direct leap from low levels of development to a low-carbon society could improve the economic situation for all regional powers through the creation of green jobs, markets and attraction of investors seeking innovative but affordable technology. A distinct competitive advantage in green technology seems possible because all companies worldwide are, or start out at, nearly the same level in this area now. Since the beginning of the G8+5 summits in 2005, it has become evident that the voice of the five Outreach countries must be heard in global questions. The G8 summits in Heiligendamm and L’Aquila (and the MEF meeting) exemplify that this matters for dealing with climate change. Here, climate governance could induce a sustainable change in the G8+5 meetings, reorganizing the group into a true G11. In this sense, the G11 would be grouped according to their economic weight and explicitly in terms of their political importance for global challenges. This would be a further step towards a multi-polar world in which the regional powers occupy a central position.

26 According to Duan Chengwu (analyst of IHS Global Insight Auto), this situation combined with the firm backing of its most dominant power source, the communist government, creates a great business opportunity for China; see H. Iveson, ‘China builds a green dream machine’, The Guardian online, 26 February 2009, available at http://www.guardian.co.uk/technology/2009/feb/26/green-technology-motoring (last visited 18 February 2010).
C. Communities of Practice and Climate Knowledge Systems

I. The Role of Knowledge, Norms and Practice for Solving Global Crises

Knowledge and norms play an important role for climate governance. There is reason to believe that actors in the climate regime choose options that conform to a dominant knowledge system or discourse.\textsuperscript{27} A lack of understanding of climate change, and knowledge about technological options to adapt and mitigate, count as inhibiting factors to climate governance in different areas of the world. Evidence of this exists for the Swedish forest sector\textsuperscript{28} and local climate governance in Durban, South Africa.\textsuperscript{29} Knowledge relates to socialisation processes. The social construction of climate change has been discussed differently by three branches of research: epistemic communities, norm and discourse-oriented scholars. Yet it is not entirely clear yet what role knowledge plays in inducing change in climate governance mechanisms. The connection between science, knowledge and policy is still not sufficiently conceptualized\textsuperscript{30} – especially for the non-OECD world, to which the regional powers all belong.

Epistemic communities, e.g. the IPCC, are transnational scientific networks that help overcome policymakers’ uncertainty by providing policy-relevant knowledge. It is widely acknowledged that scientific knowledge matters for shaping climate governance processes and outcomes. Therefore, it also exerts a certain power. Discourse-oriented scholars criticise the epistemic community research for its dichotomous view of interests and knowledge versus power. They do not treat ideas or knowledge

\begin{itemize}
\item \textsuperscript{27} H. Breitmeier \textit{et al.}, ‘The International Regimes Database: Architecture, Key Findings, and Implications for the Study of Environmental Regimes’, \textit{Politische Vierteljahresschrift Sonderheft 39 Politik und Umwelt} (2007), 41, 55.
\item \textsuperscript{28} K. Blennow & J. Persson, ‘Climate Change: Motivations for Taking Motivations to Adapt’, \textit{Global 19 Environmental Change} (2009) 1, 100.
\item \textsuperscript{29} D. Roberts, ‘Thinking Globally, Acting Locally; Institutionalizing Climate Change at the Local Level in Durban, South Africa’, \textit{20 Environment & Urbanization} (2008) 2, 521.
\end{itemize}
as given, but argue that effective governance requires the constant translation between global and local knowledge-power formations. Norm research indicates an increasing transnationalization in climate governance. For instance, transnational advocacy networks play an important role in diffusing climate protection norms in China. Other transnational initiatives include community and city cooperation, business partnerships that lobby for climate protection (e.g. 3-C Combat Climate Change) and multilateral cooperations beyond the UNFCC regime. The technology cooperation Asia-Pacific Partnership on Clean Development and Climate is a well-known example for such a multilateral network. In all these initiatives and therefore across country boundaries – and governance levels – ideas, knowledge and practices are exchanged. Acknowledging the norm-building function of these transnational networks has impacts on global governance and the global order: first steps towards the development of a world civil society may be taken.

But how does this body of research relate to regional powers’ behaviour and strategies in climate governance? What role do norms, ideas and knowledge play for advancing climate governance? Two points are relevant. The first concerns the multi-level quality of climate governance; the second relates to change and practices in climate governance.

First, since climate governance simultaneously takes place top-down, bottom-up and across levels, climate governance is indeed multi-level governance. The linkages between the domestic and international sphere as well as different actor groups are acknowledged in the literature. Due to these different types of activities on different levels, the climate governance architecture is increasingly fragmented. The production of knowledge, ideas and norms as well as their diffusion takes place across levels. In Brazil, there is a considerable lack of trust between national scientists and

---

34 This has been underlined by various authors, see e.g. A. Brunnengräber, Multi-Level Governance: Klima-, Umwelt- und Sozialpolitik in einer interdependenter Welt (2007).
Policymakers additionally perceive the IPCC to be dominated by the North and deduce a political disadvantage from this. Science in this view becomes “situated knowledge and a potential vector for hegemonic power”. The Indian government, in contrast, relies a lot more on national scientific advisory institutions than on IPCC reports. Hence, analyzing the behaviour of regional powers in global climate governance and their possible ideational projects remains incomplete without taking knowledge, ideas and norm into account in a more comprehensive way. Those actors who craft and exert the regional powers’ foreign policy do not act in a vacuum or in isolation from the developments in their countries – nor do they act apart from the activities of transnational actors groups. Socialisation effects do not recognise or stop at governance levels. All global climate governance is local, and all local or domestic climate governance is global.

Second, constructivist research has established that knowledge, ideas, attitudes and norms have some influence on how actors behave and what they actually do. They inform practices at least to some extent, and practices inform change. Under what conditions and to what extent knowledge, ideas and norms shape regional powers’ climate governance, and how change is induced through practices, is not yet sufficiently clear. My theoretical approach outlined below presents a step towards this. Furthermore, because the solutions for dealing with climate change in terms of concrete adaptation steps or techniques and mitigation technologies are currently under development in many different parts of the world, the exchange of knowledge and best practices is essential. Technology transfer therefore presents a highly contested issue. The exchange of local adaptation practices are supported by various initiatives, ranging from regional workshops to internet platforms. Regional powers could play an important role here because of their higher level of development, availability of resources and leadership role in other issue areas. If and to what extent some of the regional powers already consciously or unconsciously pursue these strategies through state and non-state governance actors has not been

35 See Lahsen, supra note 30, 182-187.
36 Id., 186.
38 See E. Adler & V. Pouliot, The Practice Turn in International Relations, Manuscript (2009).
sufficiently investigated. Given the importance of climate governance for the economy, for instance, these links between knowledge and climate governance may prove to enhance or diminish ideological leadership and projections of “region”-ness.

II. Emanuel Adler’s Theory of Cognitive Evolution and Communities of Practice

The theory of cognitive evolution and communities of practice builds an appropriate starting point for an analysis of change in climate governance. It has been developed by Emanuel Adler as a process-based communitarian approach to explain change in international relations. While international relations is the major field for analysing regional powers, in climate governance, as stated, processes on other levels need to be integrated to fully understand regional powers’ strategies. Adler himself proposes its application to the environmental field on international, transnational and national levels. In the following, I outline the essentials of his theory.

The theory concentrates on collective learning and knowledge evolution. Communities of practice are informal, dynamic social structures that cut across levels of society and may transcend countries’ boundaries as well. They consist of like-minded people who learn from each other and share practices that embody the knowledge the community develops, shares and maintains. In contrast to social networks, members also develop an identity and have a “sense of joint enterprise”. This way, the members are connected without ever necessarily meeting each other: they are bound by exchanging knowledge, ideas and practices. Communities of practice can take different forms such as security communities, epistemic communities or trans-boundary advocacy networks – because they “encompass the social space where structure and agency overlap, and where knowledge power and community intersect”. The concept can serve as an umbrella concept.

41 Adler, Communitarian International Relations, supra note 11, 15.
42 Adler, Security Communities, supra note 39, 199.
Cognitive evolution is Adler’s term for a collective learning process. It explains

“how communities of practice establish themselves, how their background knowledge diffuses and becomes institutionalized, how their members’ expectations and dispositions become preferentially selected, and how social structure spreads. Cognitive-evolution theory helps reveal why certain ideas become practices and how practices evolve.”

In his understanding, knowledge is more than the individual information held by a person, but also the “intersubjective, background or context of expectations, dispositions, and language that gives meaning to material reality“. He differentiates between four dimensions of knowledge: scientific, technological, ideological and normative, and connects these to institutional and productive power. Processes of cognitive evolution change these background dispositions or the intersubjective, collective social structures that Adler also calls “epistemes”. An episteme is “the sum of collective understanding and discourse about material capabilities, knowledge […], legitimacy […] and fairness […].” Cognitive evolution and therefore a change of epistemes through the activities of communities of practice means institutionalising new conceptual categories that people draw on. This process follows the stages of creation, selection, diffusion and institutionalisation. Events that take the form of or are perceived as a crisis may jump-start processes of cognitive evolution.

The notion of epistemes has a certain degree of fuzziness to it; in terms of the research process the problem of measurement immediately comes to mind. Therefore, I do not employ this complex conceptualization, but focus on knowledge. In his more recent texts, Adler advocates for a practice turn which means that he shifts practices as a conceptual term to the centre of his theory. Practices, understood as socially meaningful routine

43 Adler, Security Communities, supra note 39, 202.
44 Adler, Communitarian International Relations, supra note 11, 4.
46 See Adler, supra note 11.
47 Adler & Bernstein, supra note 45, 300, italics in the original.
48 Adler 2005, supra note 11, 75.
practices or that what people actually do, present the core that sits between structure and agency.\textsuperscript{49} Practices therefore have the potential to connect the different “isms” present in international relations.\textsuperscript{50} Hence, Adler tries to synthesize constructivist and rationalist approaches. He still builds on constructivism, but moves somewhat closer to pragmatism. In his own words: “my approach offers a pragmatist reading of rationality that takes strategic construction into account”.\textsuperscript{51} In the next section, I explain how a concept of knowledge systems that sets out from Adler’s theory can provide the necessary extension for the analysis of regional powers in climate governance. I also indicate the advantages of a pragmatist philosophy for the analysis of climate governance. Hence, I advance the theory of communities of practice and cognitive evolution towards pragmatism, both philosophically and methodologically.

III. Climate Knowledge Systems

The previous sections have shown that there is reason to believe in a connection between knowledge and climate governance mechanisms. Climate governance can be defined as “all the purposeful mechanisms and measures aimed at steering social systems toward preventing, mitigating, or adapting to the risks posed by climate change”.\textsuperscript{52} This definition becomes less general when climate governance mechanisms are understood as purposeful practices that are actually performed to achieve mitigation or adaptation: clear efforts towards implementation are required, even if effectiveness cannot be measured. Knowledge, more specifically knowledge systems, could present one of the key factors shaping the climate governance strategies that evolve in China, Brazil, India and South Africa. I hypothesise that the existence and characteristics of climate knowledge systems are a necessary but not sufficient condition for the emergence of climate governance. In an empirical test, climate knowledge systems would be the independent variable and climate governance mechanisms the dependent variable. If evidence for this is found, a subsequent hypothesis concerning regional powers’ foreign policy could be: The characteristics of

\textsuperscript{49} See Adler & Poulito, supra note 38.
\textsuperscript{50} Id.
\textsuperscript{51} Adler, supra note 39, Security Communities, 222.
climate knowledge systems decisively impact regional powers’ behaviour in global climate governance.

I draw on Adler’s definition of knowledge with the four dimensions scientific, technological, ideological and normative knowledge. Applied to climate governance, scientific knowledge refers to the consensual understanding of climate change: models and projections, impacts and explanations climatologists provide about climate change. Technological knowledge includes the available tools and options for adaptive and mitigating measures. Here, a relation to innovation or research and development exists. Ideological knowledge refers to a set of beliefs about the relation between humans and nature or economic development v. the environment – a basic “green” or “non-green” attitude. Normative knowledge then means the assessment of climate change-related issues as good or bad, e.g. that reducing GHG emissions is good and should be promoted.

Climate knowledge systems are an advancement of the theory of communities of practice and cognitive evolution. I define climate knowledge systems as such:

1. Individual and intersubjective knowledge (normative, ideological, scientific, technological) that influences actors’ behaviour and is shaped by
2. Different communities of practice which split into
   a) the source or producers of knowledge, i.e. epistemic communities, national scientific advisory institutions, and businesses (the latter to a certain extent, primarily in technology)
   b) different carriers: in the climate field these are central business actors (national and transnational), state representatives at different levels of government, and environmental civil society organizations – so possibly a lot of the governance actors themselves
3. Category a) influences primarily through productive power, as defined above, and category b) through institutional power – in the case of business actors these may overlap.

While the outcomes of specific models or projections may be somewhat contested between climatologists, the overall existence and dynamics of climate change are not contested anymore.
(4) A (dominant) climate change discourse that is knowledge-related is part of the knowledge system. It helps selection and diffusion of new conceptual categories.

(5) There are no strict boundaries of the knowledge system as different communities of practice influence processes of selection and diffusion. In the ideal process, wide-spread new conceptual categories and practices come about so that the climate knowledge system has a certain dynamic character.

Bridges to studies that could focus more explicitly on discourses or climate norms form a part of my concept. The definition of knowledge I employ has a normative component to it. In the theory of cognitive evolution, ideas, attitudes, knowledge and discourse are not isolated from each other. However, to keep the concept of climate knowledge systems manageable, discourses need to be treated as existent and somewhat independent. In an empirical application, I would only look at how the knowledge component feeds into the climate discourse in the form of a discursive snapshot or alternatively by a content analysis. The question is what effects the discourse has on climate governance and on actors’ decision-making, rather than tracing its development in detail – this would be a good starting part for an additional discourse-analytical study. The state of development of regional powers, i.e. as developing countries even though advanced, requires the integration of economic incentives or the economic strategy in any empirical study treating climate governance. Moreover, it is possible that other building blocks impact climate governance. This has to be empirically tested.

By allowing for economic incentives (or hindrances, if the necessary financial resources do not exist) and possibly other influencing factors as a second independent variable, I take a pragmatic position that truly starts from the research question. I do not negate any explanation a priori for ontological or epistemological reasons. Finding an explanation or interpretation to cope with a specific problem takes precedence over abstract analytic principles. In terms of epistemology and ontology, pragmatism means that meta-theoretical debates such as the question of structure and agency are somewhat avoided. There are different strands of pragmatism in political science, and none of them support an “anything goes” approach. I understand pragmatism in the form of analytical eclecticism, as proposed by Peter Katzenstein and Rudra Sil. For them, it means expanding the range of available concepts, assumptions, methods and empirical data. The aim is not to build a genuine synthetic, unified theory. Instead, analytical eclecticism
focussed “on a given problem and assumes the continued existence of, and growing engagement between, competing research traditions”.

In terms of methodology, pragmatism allows for multiple methods of both the qualitative and quantitative kind. Mixed methods approaches are often undertaken for the purpose of significance enhancement. This is relevant for analysing complex, hard-to-measure problems. Therefore, many mixed methods researchers defend pragmatism as their philosophical stance. Indeed, what I propose for testing my concept of climate knowledge systems as well as for enhancing the analytical framework for regional powers is an explicit mixed methods approach. Looking at complex multi-level influences as in climate governance and discerning their relevance for the foreign policy standing of regional powers becomes easier to handle if the research question can be investigated with all (promising) data collection methods. Moreover, if practices come more into focus, the problems of too few cases and designation of variables may be attenuated somewhat. Concrete practices in specific issue areas could become cases with communities of practice presenting the hinge between governance levels or domestic and international policy/governance strategies. Additionally, concentrating on practices and communities of practice (e.g. in the concept of knowledge systems) enables the extension of a regional powers framework beyond the state. Communities of practice in a specific governance field function either as dependent or independent variables, depending on the focus of the prospective study. The reintegration of (empirical) results into the overall network of regional powers could take place via an encompassing explanation of change that looks for explanatory factors beyond international relations.

D. Conclusion

The power shift towards the regional powers, China, India, South Africa and Brazil, has a decisive impact on global climate governance. Their reactions and strategies in the face of climate change are central to the quality and effectiveness of the global response. I have argued that these four countries are (potential) climate powers – a final classification depends on in-depth empirical studies on the climate governance activities taking place, both domestically and concerning their respective regions. To

undertake these empirical studies the analytical framework for regional powers as used by GIGA needs to be extended. It has to account for the multi-level dynamics in climate governance. The concept of climate knowledge systems and communities of practice presents a point of departure for this. The production and diffusion of knowledge takes place across governance levels. It is closely connected to ideas, norms and attitudes that together account for socialisation processes of governance actors and inform practices. Climate knowledge systems and communities of practice could play an important role in inducing change – a change that may start crosscutting national, local or transnational levels before it impacts the climate foreign policy of the regional power as such. Thus, communities of practice may fulfil the function of an interlink or hinge.

A stronger focus on practices and pragmatism that avoids the paradigm wars and connects research schools to some extent appears viable. Methodologically, pragmatism if understood as analytical eclecticism opens up ways of understanding complex phenomena such as climate governance without *a priori* ruling out the explanatory power of some factors due to abstract philosophical reasons. This is essential for the development of an encompassing, dynamic framework for the analysis of regional powers beyond international relations. For the analysis of regional powers’ behaviour in (global) climate governance, taking practices into account in a more pragmatic way could help to solve the methodological problems of identifying variables and cases to compare. Empirical work will show the strengths and weaknesses of the theoretical approach presented here.
Beyond the Financial Crisis: Addressing Risk Challenges in a Changing Financial Environment

Marianne Ojo*

Table of Contents

Abstract ........................................................................................................................................... 337
A. Introduction ................................................................................................................................. 338
B. The Significance of Risk in Regulation.................................................................................... 341
C. Explanations as to Why Risk Has Become so Important ....................................................... 342
   I. Risk as an Organising Principle ............................................................................................. 342
   II. The Embedded-ness of Risk in Regulation .......................................................................... 343
D. Risk Theories ............................................................................................................................. 344
   I. Risk Society ............................................................................................................................ 344
   II. Cultural Theory ......................................................................................................................... 345
   III. Governmentality Approach to Risk ....................................................................................... 346
   IV. Theory of Risk Colonisation ................................................................................................. 346
   V. Criticisms of Risk Theories ................................................................................................... 347
E. Quantification of Risks ............................................................................................................... 347
F. Traditional Regulation ................................................................................................................. 351
   I. Advantages of Traditional Regulation ..................................................................................... 351

* Research Fellow, Center for European Law and Politics (ZERP), University of Bremen.

doi: 10.3249/1868-1581-2-1-ojo
II. Addressing the Deficiencies of Traditional Regulation........... 351
G. Responsive Regulation v Risk Based Regulation .................... 352
H. Meta Regulation .................................................................. 353
   I. Why Meta Regulation Could Be the Most Responsive
      Form of Regulation........................................................... 353
I. The Centrality of Capital Adequacy to Risk Measurements and
   Persisting Problems of Basel II............................................. 356
J. Conclusion............................................................................ 358
   I. What Proportion of Risks are actually provided for by
      Basel II? ........................................................................... 359
      1. Hedge Funds............................................................... 359
      2. Non-Banking Financial Institutions............................... 361
II. Procyclical Nature of Risk.................................................... 361
III. Risk Management within the EU.......................................... 363
IV. The Potential of Meta Risk Regulation................................. 364
Abstract

The Financial Crisis has not only highlighted the importance of addressing issues such as liquidity risk – it has also brought to the fore the need to focus on unregulated instruments, such as hedge funds, which are of systemic importance to the financial industry. Risk is an area, which, owing to its increasing significance, requires greater focus. A move to risk based strategies is evidenced by the growing popularity of risk based regulation and meta regulatory strategies. However, given the presence of an unregulated hedge fund industry such attempts are not sufficient on their own. Further, the systemic nature of risk exacerbates the problem of such unregulated institutions.

This paper aims to address the complexities and challenges faced by regulators in identifying and assessing risk, problems arising from different perceptions of risk, and solutions aimed at countering problems of risk regulation. These issues will be approached through an assessment of explanations put forward to justify the growing importance of risks and well-known risk theories such as the cultural theory, the risk society theory and the governmentality theory. These theories will be considered against the background of themes such as dynamism, evolutionism, developments in science and industry, cultural attitudes to risk and the need to be responsive and reflexive to changes, which, have arisen in modern society.

Theoretical models and hybrids of a responsive model of regulation such as enforced self regulation and meta regulation, which have the potential to address the problems relating to risk, will be addressed. By virtue of the procyclical nature of risk, the inability of Basel II to address risk cycles was revealed by the Northern Rock Crisis. Other flaws and deficiencies inherent in Basel II, a form of meta regulation, will be highlighted. The relevance of internal control systems to an efficient system of regulation, the reasons for which meta regulation is not only considered to be the most responsive form of regulation, but also one which assigns a central role to internal control systems will be discussed.

The contested nature of risk and the difficulties attributed to its quantification, raise questions about its ability to function effectively as a regulatory tool. If risks could be eliminated in their entirety, however, then
regulation would serve no purpose. Therefore, this paper aims generally to
direct attention to those areas which could be addressed, namely
institutional risks and measures whereby such risks, even though impossible
to eliminate, could be minimized.

A. Introduction

Factors such as the growth of financial conglomerates and the
derivatives markets, which have been facilitated by the impact of
information technology and increased competition within the financial
services industry, have instigated a change in the way financial regulation is
carried out around the world. A realisation by countries and their financial
institutions that they were at a competitive disadvantage as globalisation
gained momentum, led to ultimate liberalisation in these countries.\(^1\)

As a result of the above-mentioned global changes and developments,
the benefits of financial regulation have not been realised to full potential
since financial regulation also needs to evolve with changes such as the
growth of financial conglomerates apart from social and economic changes.
This has resulted in some arguments being put forth that regulation could
also be detrimental.\(^2\) The reasons for differences in opinions between those
who are in favour of regulation and supervision in finance and those who
are against, focus around four key issues, namely:\(^3\) i) How financial
institutions and markets work and operate in practice: This would require
consideration of the domestic and global financial environment, ii) The
incentive structures faced by financial firms,
iii) The extent of market
imperfections and failures in the financial system and the power of
regulation and supervision to address these, iv) the extent to which financial
products and contracts are substantially different from goods and services
which are not regulated to the same degree as financial institutions.

The summer of 2007 signalled the start of events, which culminated in
the subsequent nationalisation of Northern Rock in the UK and the demise
of Merill Lynch\(^4\) and Lehman Brothers. The unfolding of the mortgage

\(^2\) D. Llewellyn, ‘The Economic Rationale For Financial Regulation’, Financial Services
\(^3\) Id., 5.
\(^4\) Merill Lynch was taken over by the Bank of America.
crisis was revealed during this period and the crises deepened in 2007 and 2008 – resulting in turmoil for the global financial markets.

The Financial Crisis, with particular reference to IKB and Hypo Real Estate in Germany, also revealed a declining market confidence in banks’ stability.\(^5\) This was illustrated in cases where companies assured the public that they were unlikely to be affected by the Financial Crises, whilst in reality there was a high probability that within the near future, they could be exposed – owing to their status as “liquidity providers for securities arbitrage conduits or as investors in complex re-securitisations”.\(^6\) Even though the Capital Requirements Directive, through its inclusion of a section on public disclosure requirements – aimed at strengthening “market’s understanding of banks' risks and capital positions”,\(^7\) provided for such a situation. However, such disclosure requirements entered into force at a period, which unfortunately, was rather late to contribute in any meaningful manner in reducing the problems generated by the Financial Crisis.

The central theme of this paper revolves around problems encountered through the implementation of risk as a regulatory tool. In highlighting the susceptibility of a globalised world to a globalised crisis, this paper will commence with a discussion which demonstrates the impact of risk and particularly, in the regulation of systemic risk. The next section of the paper will then consider explanations which have been put forward to justify why risk has become so important – particularly in regulatory and governmental circles. These explanations are attributed to: Risk as an organising principle and, the increasing embeddedness of risk in regulation – whereby the increased connection between risk and regulation is becoming more apparent. Modes whereby risks are incorporated are then considered, namely, the transformation of internal controls to risk management, a

---


\(^6\) Id.

\(^7\) Id.
quantitative process whereby societal risks are utilised and, a “qualitative shift towards the management of institutional risks”.8

This will then set the scene for a discussion on various risk theories such as risk society theory, cultural theory, governmentality approach to risk, and the theory of risk colonisation. One of the difficulties associated with risk, as a regulatory tool, is attributed to its contested nature and the uncertainty, which is associated with it. In order to address myths surrounding the quantification and control of risks, “risks must be made auditable and governable”.9 A means of quantifying risks, whereby institutional risks constitute the focus, as regards those risks, which are being quantified, is discussed. Whilst the audit risk model has its merits, its disadvantages are also considered.

The advantages of traditional regulation and means whereby its deficiencies can be addressed, are then considered in the subsequent section. Meta regulation, the regulation of self regulation,10 a form of regulation whose “collaborative approach to rule generation” is considered to be the most evolved approach, and reasons why it could be the most responsive form of regulation, will then constitute the topic of discussion. Basel II, an example of meta regulation, will be introduced with particular focus on capital adequacy. The vital role assumed by capital in “containing risk in a banking firm, protecting deposits and equalising competition among banks”,11 and capital adequacy which is considered to be fundamental to prudential supervision as its constitutes one of its foundations are all taken into account. Its significance to risk management and the persisting problems which Basel II presents, will be considered with reference to the recent crisis, and particularly to the pro cyclical nature of risk. Having considered all these crucial topics, a conclusion, which comprises efforts which have been undertaken as a means of addressing regulatory flaws which were highlighted during the recent crises and further proposals which need to be effected, will then be drawn.

B. The Significance of Risk in Regulation

The rationale for financial regulation is an embodiment of two issues, namely:\(^{12}\)

- The problem of systemic risk\(^{13}\)
- The problem of asymmetric information whereby certain information is known to some people but not to others.\(^{14}\)

Systemic risk is referred to as the risk that the failure of one firm may affect others, resulting in the collapse of the financial system.\(^{15}\) Consequences emanating from the systemic impact of the financial sector on the real economy were, once again, brought to light during the recent financial crisis, as evidenced by its impact on economic recovery.\(^{16}\) Measures aimed at combating systemic risks and rejuvenating market confidence have been classified into two, namely:\(^{17}\) “A first line of defence against ‘systemic liquidity risk’”\(^{18}\) and “a second line of defence against [...] ‘systemic solvency risk’”.\(^{19}\)


\(^{13}\) Regulation for systemic reasons is required when the social costs of the failure of financial institutions (particularly banks) exceed private costs and such potential social costs are not provided for in the decision making of the firm. Social costs could arise from systemic situations triggered by a bank run (withdrawal of deposits by depositors) which may have contagious effects on other banks. Llewellyn, supra note 2, 13.

\(^{14}\) Market failures include “information problems, externalities, conflict of interests”. Id., 21.

\(^{15}\) P. Cartwright, Bankers, Consumers and Regulation (2004), 192.


\(^{17}\) Id.

\(^{18}\) Instruments, which fall under the first line of defence, include an increase in “the size and frequency of liquidity operations, extending the list of eligible collateral, significantly expanding [...] balance sheets and implementing unprecedented interest rate cuts.” Id.

\(^{19}\) This includes re capitalisation, guarantees and asset support schemes. Id.
Apart from the reasons attributed to the rationale for financial regulation, other explanations which have been put forward to explain why risk has become central across regulatory and governmental circles are partly influenced by different approaches as to what risk is. Further explanations, mainly from socio-cultural disciplines, suggest that the importance of risk is derived from issues related to control, accountability, responsibility and blame in late modern society.

Two well-known theoretical perspectives addressing these questions are termed as the “risk society” theory and the “governmentality” theory.

C. Explanations as to Why Risk Has Become so Important

I. Risk as an Organising Principle

In considering the features that make risk such a vital regulatory tool, Rothstein et al. conclude that “[…] risk provides an organizing concept for societal decision-making under uncertainty and is a key characteristic of modernity. […] Regulatory systems attempt to control events that have formerly been beyond control, the process of decision-making transforms those events into risks as a way of rationally managing the limits of regulation.”

Apart from being considered as a means of describing what constitutes the subjects of regulation and related institutional threats, risk is increasingly being perceived as a procedure for the organisation of regulatory activities.

---

22 Rothstein et al., supra note 8, 99.
23 Id., 97.
II. The Embedded-ness of Risk in Regulation

The increasing connection between risk and regulation is apparent. This fact is collaborated by the transformation of internal controls to risk management. It is maintained that the transformation of risk into internal controls is required for the operation of risk-based regulation, which in turn would facilitate the functioning of the risk management state. According to Rothstein et al., the incorporation of risks in regulatory processes has taken place in two ways, namely: Through a quantitative process whereby risk analysis and risk management methods are increasingly being utilised in the regulation of “traditional and novel” risks, such risks being referred to as “societal risks”.

The second mode of incorporation involves the “qualitative shift towards the management of institutional risks”. There has been an increased focus on the risks of risk management. Such consequence of risk management has been referred to as the “duality of risk”. However, the ever-increasing connection between risk and regulation does not mean that both perfectly correspond to one another. This in turn has resulted in compliance related issues for organisations.

Corporate governance tools are considered to be risk management strategies for the distinctive risk of failure by senior management to prevent the growth and development of risk. Modern risk management strategies

24 Power, supra note 9, 50-58.
25 Id., 24.
26 Id.
27 Rothstein et al., supra note 8, 92 (emphasis omitted).
28 Institutional risks are implied to include risks encountered by institutions, which are responsible for managing and regulating societal risks and/or legitimacy risks (to their rules and practices) - regardless of whether these institutions are state or non state institutions. Id., (emphasis omitted).
29 Id. Power, supra note 9, 50-58, in which Power argues that reliance on internal controls may increase risk if it leads to an undermining of the knowledge of risk in other areas; despite the benefits of risk management, concerns are generated due to the fact that secondary risk management has become an accepted “organisational common sense” - reflecting the society’s loss in faith “in its professions and public organisations” id., 57.
have arisen from new institutions involved in the collection and statistical analysis of data required for activities like the census.\textsuperscript{33}

In his speech to the Institute of Chartered Secretaries and Administrators (ICSA) EU Corporate Governance Summit, Charles McCreevy, European Commissioner for Internal Market and Services, highlighted the fact that it was apparent that:

“poor, indeed, sometimes disastrous, risk management by financial institutions was partly to blame for the current financial turmoil. [...] Risk management should be part of the strategy of the firm, and indeed the culture of the organisation. It is the duty of senior management in financial institutions to address this and it is the role of the board to oversee it. In their respective roles, both senior management and the board need to ensure a holistic approach to firm-wide – and group-wide – risk management.”\textsuperscript{34}

D. Risk Theories

I. Risk Society

The theme of evolutionism is common to various theories of ‘simple’ modernisation.\textsuperscript{35} However, a different perspective is offered by Ulrich Beck who views risks and unpredictability as the consequences of developments of science and industry.\textsuperscript{36} Furthermore, he argues that no one can be considered responsible for unpredictable events in the “risk society”.\textsuperscript{37} In addition, the ability of regulators to act successfully depends on the level of efficiency and coherence of “institutionally complex regulatory regimes”.

\textsuperscript{33} Id., 12.
\textsuperscript{35} Such theories range from those of Habermas to Marx to Parsonian sociology. Beck, \textit{supra} note 9, 2.
\textsuperscript{36} Id., 2.
\textsuperscript{37} Id. In contrast to societal risks, Rothstein et al. maintain that it is much easier to account for institutional risks through the transformation of behaviours and outcomes that could not be recorded previously or were considered to be acceptable. Rothstein \textit{et al.}, \textit{supra} note 8, 96.
Beyond the Financial Crisis: Addressing Risk Challenges

hence even regulators have a limited ability to control societal risks. In Beck’s view, modernization must become reflexive and such modernization not only involves structural change, but also a dynamic relationship between social structures and social agents. Beck, among many others, argues that risks of late modernity differ in type and magnitude from those which previously existed. They maintain that, in the ‘risk society’ in which we now live, risks are no longer imposed from external sources but are ‘manufactured’ as “products of mankind’s decisions, options, science, politics, industries, markets and capital.”

II. Cultural Theory

Cultural theorists on the other hand, argue that attitudes to risk differ according to cultural preferences. However, it is argued that it is highly unlikely that the cultural theory would be able to predict risk perceptions in particular situations. Cultural theory proceeds with the assumption that a culture consists of persons, which hold one another mutually accountable. There is an attempt by such persons to live, at a level of being held accountable, which is identical to a level at which such a person would want to hold others accountable. From this perspective, culture is an embodiment of political implications of mutual accountability. Rather than the perception that an isolated individual would check every piece of information in such a manner devoid of prejudice or moral commitment, the person is perceived to investigate possible information “through a collectively constructed censor set to a given standard of accountability.”

Since assimilated knowledge or the rejection of “mere noise” is based on a criterion which considers whether the new conception or fact will

38 Id., 95.
39 Beck, supra note 9, 2.
40 H. Rothstein et al., supra note 8, 94.
41 R. Baldwin & M. Cave, Understanding Regulation: Theory, Strategy and Practice (1999), 141.
42 Id., 142.
44 Id., supra note 21, 31.
45 Id.
46 Id.
47 Id., 31.
consolidate the subject’s preferred political scheme, in Douglas’ opinion, it would be fruitless to undertake a study of risk perception without a systematic consideration of cultural preferences.48

III. Governmentality Approach to Risk

The “governmentality” theory is related to the work of Michael Foucault.49 According to his approach, risk is generally considered to be a concept, which is socially produced in its entirety.50 Furthermore, no external environment compels society to respond to risk.51 A broader view of government, which the notion of governmentality embraces, can be found in Mitchell Dean’s definition of government:

“Government is any more or less calculated and rational activity, undertaken by a multiplicity of authorities and agencies, employing a variety of techniques and forms of knowledge, that seeks to shape conduct by working through our desires, aspirations, interests and beliefs, for definite but shifting ends and with a diverse set of relatively unpredictable consequences, effects and outcomes”.52

IV. Theory of Risk Colonisation

This theory is founded on the dynamic linkage between societal and institutional risks - thereby paving the way for a new explanatory model of “contemporary regulatory development” 53 which recommends a research schedule for the study of the separate fields of risk and regulation. It is also an attempt to explain what is considered to be some of the “conceptual consequences”54 of efforts aimed at regulating risk.

48 Id., 31 and 32.
49 Foucault, supra note 22, 87-104. Bratich et al., supra note 20.
51 Id.
52 Bennett, supra note 20, 47. Dean, supra note 20, 11.
53 Rothstein et al., supra note 8, 107.
54 Id., 108.
V. Criticisms of Risk Theories

Criticism which, revolves around Beck’s concept of risk, is that, risk is too restricted in accounting for the complexities involving governmental risk strategies and rationalities or socio-cultural perceptions and responses to risk. A wider approach, which is in line with the concept of reflexive modernization, commences with uncertainty instead of risk. The distinction between risk and uncertainty is as follows: Risk is traditionally associated with probability calculation and this suggests that an event can be predicted and controlled. Uncertainty, however, is not capable of measurement and deals with possibilities, which are incapable of calculation and are based on guesswork and judgment. It is also stated that uncertainty has to be defined acknowledging the possibility of unpredictable outcomes rather than adopting an approach, which aims to transform uncertainty into certainty.

The functionalist view on risk, namely works which are related to those of Douglas and Wildavsky, are principally criticised for their oversimplified interpretation of the significantly complicated and ever changing process of how risk is approached. The ‘socio-cultural’ approach and ‘risk culture’ try to address the functionalist view on risk by targeting more complex and changing processes, which involve risk in every day life. One advantage of these approaches is namely, that responses to risk are generated.

E. Quantification of Risks

The focus placed on the quantification of risks in various jurisdictions, varies according to two factors. First, the degree to which the decision making processes are subject to legal challenge and review and second,
whether there has been in existence a tradition of independent regulatory agencies or not.\textsuperscript{63}

In order to overcome the myths surrounding the quantification and control of risks, “risks must be made auditable and governable”.\textsuperscript{64} In the attempt to make risk auditable, the role assumed by risk management has been transformed to a level, which is synonymous with that of an appropriately managed organisation, which is internally and externally in control of the way it “handles” uncertainty.\textsuperscript{65}

Since societal risks are difficult to quantify, it could be argued that focus should be placed on preventing, detecting and rectifying the effects of institutional risks. Moreover, societal risks (excluding those risks attributed to “force majeure”), it can be argued, are consequential of the systemic effects of institutional risks. Hence the control of the source (that is, institutional risks) would be an effective way of containing the uncontrollable effects of societal risks.\textsuperscript{66} Risk management of institutional risks, even though this generates risks (which are the consequence of an omission of other significant risks), can be undertaken using the audit risk model – especially since the assessment of risks, based on differences in perceptions\textsuperscript{67}, is so subjective.

Successful management of institutional risks is dependent on many factors, namely, accuracy – inaccurate assessments of societal risks may further exacerbate the difficulty in managing institutional risks.\textsuperscript{68} Furthermore, methodological challenges and the degree to which other decision shaping factors are aligned to the success of risk management, also

\textsuperscript{63} Rothstein \textit{et al.}, supra note 8, 101.

\textsuperscript{64} Power, supra note 9, 10. Beck, supra note 9.

\textsuperscript{65} Power, supra note 9, 40.

\textsuperscript{66} Whilst Power has argued that societal and institutional risk management are closely related, Rothstein \textit{et al} contend that institutional risk management is stimulated by the ‘residual failures of societal risk management’ and that a focus on institutional risk management could also define the perception and management of societal risks. In other words, they emphasize the importance of concentrating not only on the management of societal risks, but also on the management of institutional risks. Rothstein \textit{et al.}, supra note 8, 103.

\textsuperscript{67} Attitudes to risk vary with individuals and may be different at different levels of an organization. “Risk attitudes or appetites may also vary across different aspects of the same risk, may in reality not correspond to any stated appetite and may change with new or better information.” Power, supra note 9, 19 and 20. B. Hutter, \textit{Risk and Regulation} (2000).

\textsuperscript{68} Rothstein \textit{et al.}, supra note 8, 101.
Beyond the Financial Crisis: Addressing Risk Challenges

Contribute to the effectiveness of the management of institutional risks.\(^69\) Even in situations where institutional risks, which emanate from the government and the judiciary, are successfully managed through risk based procedures, there may still be exposure to institutional risks from external sources.\(^70\)

The audit risk model not only requires the auditor to have an understanding of the client’s business and industry, systems used in processing transactions, qualifications of personnel engaged in accounting procedures, policies related to preparation of client’s financial statements but also requires that auditors have knowledge of the company’s internal controls.\(^71\)

Traditional auditing techniques involve auditors performing tests to find out the level of risks, which may exist in an entity. These risks consist of three components namely: inherent risks, control risks and detection risks and they all contribute to the audit risk.\(^72\) The audit risk model is denoted by the following equation:

\[
AR = IR \times CR \times DR
\]

Where AR represents audit risk, IR represents inherent risk, CR represents control risk and DR represents detection risk.

Inherent risks\(^73\) are those risks, which emanate as a result of the nature of the business entity, control risks\(^74\) are those risks resulting from reliance on the internal controls functioning within the business, whilst detection risk

\(^{69}\) Id.

\(^{70}\) Id., 102.


\(^{72}\) This is defined as the probability that an auditor may unknowingly fail to adjust an opinion, which is materially misstated in the financial statements. U.S. Gen. Accounting Office, Report on Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges (October 2002), 8, available at http://www.gao.gov/new.items/d03138.pdf (last visited 2 December 2009).

\(^{73}\) Inherent risk can also be defined as the susceptibility of an account balance to material error. American Institute of Certified Public Accountants, *supra* note 71, 1567.

\(^{74}\) Risk that error could occur and not be prevented or detected by internal controls. Id.
is the risk that the auditor would not be able to detect material misstatements during procedures aimed at detecting such.

Inherent and control risks are outside the control of auditors, the consequence is that the higher the assessed level of inherent and control risk, the lower the detection risk must be, if the desired overall level of audit risk is to be achieved. The level of detection risk can be varied by auditors through the increase of a substantive procedure, namely statistical sampling. Substantive procedures are usually costly and auditors who place reliance on the internal controls in order to support the reduced use of substantive procedures need to show that the assessed level of control risk is low. This is done through the performance of tests of controls. Where internal control weaknesses are discovered, this does not necessarily mean that more tests of control should be performed. Where performance of such tests of control would not be potentially cost-effective, the use of predominantly substantive procedures is recommended straightaway. A preliminary determination of the control risk is required where there is potential for cost effectiveness. If this pre determined risk is high, then a predominantly substantive approach is recommended. If the control risk is low, then the tests of internal controls are to be performed to confirm the preliminary assessment of control risk. Following the confirmation of a low pre determined level of control risk, a reduced level of substantive procedures can then accordingly be carried out.

Materiality is provided for in the audit risk model, as auditors are not required to account for every misstatement within a financial statement – only material misstatements need to be accounted for. Furthermore, the nature, timing and extent of audit procedures are vital to the model. Auditors are also required to ascertain “fraud risks” which take into consideration qualities of both inherent and control risk.

Whilst according to some, the audit risk model has been relatively successful, its focus on internal use has been said to contribute to the

---

76 Id.
77 Id.
78 Id.
79 Id.
80 Public Oversight Board, supra note 71, 177.
81 Id.
existence of inherent problems in external procedures. This was soon highlighted in a study on expectations gap, following its introduction.

F. Traditional Regulation

I. Advantages of Traditional Regulation

Although command and control regulation has been criticized for its rigidity, such rigidity having contributed to economic inefficiency, Latin suggests that this approach has its advantages. Further, these advantages extend beyond those advantages identified with more tailored and flexible instruments.

II. Addressing the Deficiencies of Traditional Regulation

“Responsive regulation is distinguished (from other strategies of market governance) both in what triggers a regulatory response and what the regulatory response will be”. Ayres and Braithwaite also propose regulation to be responsive to industry structure – since different structures will be conducive to different degrees and forms of regulation. According to Baldwin and Black, in order to be “really responsive”, regulators are required to be responsive - not only to the level of compliance of the regulatee, but also to the frameworks within the firms – both operating and cognitive, to the environment which encompasses the regulatory regime, which is broader and institutional, to the different ways whereby regulatory tools and strategies operate, to the performance of the regime and

---

83 Id., 96.
84 N. Gunningham & P. Grabosky, Smart Regulation: Designing Environmental Policy (1998), 42.
87 Id.
ultimately, to changes which exist within each of the mentioned elements. Regulation, it is argued, is responsive when it knows its regulatees and its environments, when it is capable of coherently organizing different and new regulatory modes of reasoning, when it is sensitive to performance and when it recognizes what its changing challenges are.\(^8^9\) Baldwin and Black’s opinion of what is really responsive would have to take into consideration the growing impact of risk.\(^9^0\)

G. Responsive Regulation v Risk Based Regulation

Theoretically, regulatory regimes can become more responsive to the self-organisation of regulatees regardless of whether such regulatees are banks or local government service providers.\(^9^1\) Risk based regulation, in Power’s view, is considered to be “a blueprint for the risk management state”.\(^9^2\)

In comparison to responsive regulation, risk based regulation is relatively new.\(^9^3\) It has been adopted by several regulatory agencies as a means of organising resource allocation, managing limited resources and concentrating those resources where they are needed most - for example, in cases involving banks with weak internal controls.\(^9^4\) Such an approach is “strategic and goal-oriented”\(^9^5\) at the same time. The link between risk and strategy is vital in advertising new regulatory approaches and risk management and would also result in an improvement in the communication between the regulator and the regulated.\(^9^6\)

Responsive regulation is distinguished from risk based regulation since the latter focuses on analysis and targeting rather than a “process of responsive escalation”.\(^9^7\) Whilst the framework of risk based approaches not only enables regulators to link enforcement-related activities to the achievement of objectives, but also allows for the targeting of resources in

\(^8^9\) Id., 4.
\(^9^1\) Power, supra note 9, 21.
\(^9^2\) Id.
\(^9^3\) Rothstein et al., supra note 8, 96.
\(^9^4\) Power, supra note 9, 21.
\(^9^5\) Id.
\(^9^6\) Id.
\(^9^7\) Baldwin & Black, supra note 88, 12.
such a way which prioritises the highest risks, the main controversial issue surrounding risk based regulation relates to inspection.

Further, risk based regulation is an embodiment of the idea that regulatory failures are possible – in contrast with the concept of “zero-tolerance”. Whilst some events can be classified as being of a “zero-tolerance” nature, such an event as that of the fall of Equitable Life, which could be considered as ‘tolerable’ from the perspective of a systemic financial risk, in fact, generated life-changing catastrophic consequences for many.

Other problems which relate to risk based regulation derive from the fact that “drivers of action” are short term random and irrational considerations, focus is not necessarily given to the most important risks. There is a likelihood that risk based systems will tend to neglect lower levels of risk, which may aggregate to risks of immense and dangerous proportions.

H. Meta Regulation

I. Why Meta Regulation Could Be the Most Responsive Form of Regulation

Regulation may be regarded as a response to risk and the control of risks can be considered to be the main concern of regulation. “The regulatory state is becoming a risk management state”. Ulrich Beck argues that whilst the standard way of risk regulation in modern societies was well suited for such societies, it is not responsive enough to our “post modern” societies. Risk is, as a result, inefficiently controlled at costs,
which are unnecessarily high.\textsuperscript{105} Recent years have witnessed growing acceptance of the fact that the efficiency of regulation will be enhanced where collaboration with private control systems exists.\textsuperscript{106} By utilising activities which relate to private internal control systems for purposes which are of public regulatory nature, regulators are not only able to relieve themselves of the cumbersome work which derives from rule making, but are also able to concentrate on the oversight of the functioning and design of local systems.\textsuperscript{107} ‘Enforced self regulation’, ‘regulated self-regulation’ and ‘meta regulation’ are various forms, which a responsive model may assume and such a model assigns a central role to internal control systems.\textsuperscript{108} Basel II bank regulation reforms constitute an example of meta regulation.\textsuperscript{109}

Meta regulation is referred to as the regulation of self regulation\textsuperscript{110} whilst meta risk management implies the risk management of risk management. Traditionally risk management, to a large extent, has focused on complying with current rules.\textsuperscript{111} It has great potential especially in situations where risks are volatile and where the regulator is not in a position to comprehend such risks.\textsuperscript{112} However maximum realisation of such potential can only occur when such risks are within the control of an enterprise where the regulator holds an influential position.\textsuperscript{113}

As mentioned in the previous paragraph, there has been a trend over the years, towards greater regulation of business management processes and strategies of regulated firms through regulatory tools, which address the role

\textsuperscript{105}It can be observed from daily occurrence that more attention should be devoted to recent evolution toward risk based regulation, examples of which can be found in recent European and partly Western-rule setting as illustrated by the Basel II agreement on the regulation of risks in banking and the European Commission White Paper on how to regulate risk in the chemical industry. For more information on this, see Lassagne & Munier, supra note 104.

\textsuperscript{106}Power, supra note 9, 21.

\textsuperscript{107}Id.

\textsuperscript{108}Id.


\textsuperscript{110}Parker, supra note 10, 245-291.

\textsuperscript{111}Lassagne & Munier, supra note 104.


\textsuperscript{113}Id.
of senior managements of firms and directly regulate individuals within firms.\textsuperscript{114} According to Fiona Haynes\textsuperscript{115}, meta regulation “with its collaborative approach to rule generation”, could controversially be considered to be the approach with the greatest evolvement when considered in relation to other approaches such as co-regulation, enforced self regulation and process or management-based regulation. Meta regulation is a method, which is capable of managing “self regulatory capacity” within those sites being regulated whilst exercising governmental discretion in stipulating the goals and levels of risk reduction to be achieved in regulation.\textsuperscript{116} Processes and procedures for risk management are developed, not only by key stakeholders, but also by personnel within these organisations.\textsuperscript{117} This takes place whilst ensuring that “pro-compliance motivational postures” are generated within the site being regulated such that the goal of the regulator, that is, risk reduction, is achieved.\textsuperscript{118} The success of the implementation of meta regulation is based on the regulator and regulated organisation’s understanding of risk priorities in the same manner.\textsuperscript{119} Meta regulation is advantageous particularly where there are complex causes of harm, which also require constant monitoring.\textsuperscript{120} The disadvantages of meta regulation are not only attributed to its use of mathematical models, but also attempts to leverage off firms’ own systems and expertise, as a means of limiting risks to the regulator’s objectives – rather than a direct imposition of requirements on firms.\textsuperscript{121}

The increasing popularity of internal control systems has been an express feature of risk management.\textsuperscript{122} Primary or real risks\textsuperscript{123} are translated by internal control systems “into systems risks such as early warning mechanisms and compliance violation alerts”.\textsuperscript{124} As a result, many risks are capable of being and are being “operationalised as organisational processes

\textsuperscript{114} Gray & Hamilton, supra note 20, 2.
\textsuperscript{116} Id., 32.
\textsuperscript{117} Id., 33. Parker, supra note 1.
\textsuperscript{118} Id.
\textsuperscript{119} Haines, supra note 122, 33.
\textsuperscript{120} Id., 47.
\textsuperscript{121} For further information on this: Gray & Hamilton, supra note 20, 38 and 216.
\textsuperscript{122} Power, supra note 9, 24.
\textsuperscript{123} Primary risks, for example financial loss, are distinguished from secondary risk (reputational risk). Id., 32.
\textsuperscript{124} Id., 24.
of control”. Such transformation is a pre requisite for the feasibility of risk based regulation.

I. The Centrality of Capital Adequacy to Risk Measurements and Persisting Problems of Basel II.

In response to the deficiency of Basel I, and given the fact that the measurement of minimum capital requirements is based on a general assessment of risk dispersion in the banking sector, which does not correspond in every case to the specific circumstances of individual institutions, credit institutions will be required to retain more capital than that which is stipulated for by the minimum capital requirements, if their individual risk situation so demands.

A consequence of one of the primary objectives of the framework of Basel II, which was directed at making capital requirements more risk sensitive, is that the capital requirements became more cyclical periodically, than under Basel I. Such increased pro cyclicality had been anticipated and hence, the Capital Requirements Directive already provides for situations involving increased pro cyclicality through the inclusion of measures aimed at reducing such effects. Such measures include “the use of downturn Loss Given Default (LGD) estimates”, adjustments which can be made technically to the risk weight function, “stress testing requirements, and Pillar 2 the supervisory review process.”

---

125 Id.
126 Id.
127 Id.
129 Id.
130 Id.
131 Id.
Pillar Two, namely, supervisory review, consists of four principles. Principle 1 states that banks should have a means of determining their overall capital adequacy in relation to their risk profile and also a plan for sustaining their capital levels. Principle 2 states that supervisors should review and evaluate banks' internal capital adequacy determinants and plans and also their ability to monitor and ensure compliance with regulatory capital ratios. Supervisors should also take necessary supervisory action if they are not satisfied with the outcome of this process. Pillar Two could also include the combination of on-site examinations or inspections; off-site review; discussions with bank management and review of external auditors' work (as long as it sufficiently focuses on necessary capital matters) and periodic reporting. Principle 3 states that supervisors should require banks to operate above the minimum regulatory capital ratio. It also requires that banks hold capital in excess of the minimum. Principle 4 states that supervisors should act at an early stage to prevent capital from falling below stipulated minimum levels.

During periods when risks are considered to be lower, namely, during economic booms, the tendency of banks to indulge in greater levels of risk taking activities tends to augment. Owing to tighter lending criteria during economic downswings, “feedback effects” may be generated for the real economy. Pro cyclical problems were revealed following the collapse of Northern Rock wherein it was highlighted that it was complying with the Basel capital requirements and had excess capital on the eve of its crash. Another problem identified with Northern Rock was that it had high leverage – relying heavily on debt to finance its assets.

134 EU, supra note 128, 44.
135 Northern Rock had obtained approval from the Financial Services Authority to switch to Basel II advanced approach in order to calculate risk weights for its assets using the bank’s internal models. In December 2006, its capital ration was 11.6 under Basel I calculations but this jumped to 17.5 under Basel II. In June 2007, this had risen to 18.2%; for further information on this see S. Cociuba, ‘Seeking Stability: What’s Next for Banking Regulation?’, 4 Economic Letter: Insights from the Federal Reserve Bank of Dallas (2009) 3, 5-6.
136 Leverage is pro cyclical – being high during booms and low during downturns. Whilst some other institutions adjusted their balance sheets by raising new equity or selling assets to repay some debt, Northern rock did not reduce its debt. Idd, 6.
Other criticisms directed towards Basel II include supervisory discretion – that this could result to regulatory capture, that it is excessively risk sensitive, that its capital formula is too prescriptive and complex and that it is not well-suited for 90% of the world’s population. Further, even though Basel II, which is embodied in EU legislation, sets out what should be considered under Pillars 2 and 3, it does not provide directions to authorities of member states regarding what steps are to be taken in the cases involving non compliance. Such matters are to be decided at the national level.

J. Conclusion

Some lessons from the Financial Crisis of 2007/08 indicated flaws in the following areas:

- Market discipline: This was “ineffective in constraining risk taking outside the banking sector.”
- An underestimation of the systemic importance of some non-banking institutions.
- That regulators (and supervisors) failed to take adequate account of the systemic risks presented by the interaction between regulated and unregulated institutions activities (such as hedge funds), and markets.

According to Brunnermeier et al., failures such as Northern Rock, Lehman Brothers and Bear Stearns were triggered not only by their inability to transfer their liabilities (funding illiquidity), but also by their inability to sell mortgage products at “non-fire sale-prices” (market illiquidity). The extent to which the maturity of funding determines the risk of an asset is an

137 Alexander. supra note 141.
138 Through the Capital Requirements Directive.
140 Id., 18.
142 Id.
important lesson from the Crash of 2007/2008. A reason, which was attributed to Northern Rock’s vulnerability, was its excessive reliance on wholesale funds. “Wholesale funds are obtained from nonfinancial corporations, money market mutual funds, foreign entities and other financial institutions. Typically, the funds are raised on a short-term basis through instruments such as certificates of deposit, commercial paper, repurchase agreements and federal funds.”

I. What Proportion of Risks is actually provided for by Basel II?

1. Hedge Funds

The main purpose of Basel I and Basel II focuses around the management and control of risks. As a starting point, it needs to be stated that risks cannot be eliminated – they can only be minimised. If risks were eliminated, then regulation would cease to serve any purpose. Concerns remain over hedge funds, as this is an area where regulators have limited jurisdiction. Many regulators do not authorise such funds and most of the administrators of these hedge funds are located offshore. In March 2008, 

---

144 Id., viii.
145 Cociuba, supra note 135, Chart 3, 6.
146 Id., 8.
147 The risks identified by the Financial Services Authority (FSA) in relation to hedge funds can be summarised as follows: “Serious market disruption and erosion of confidence as a result of the failure or significant distress of a large and highly exposed hedge fund or, with greater probability, a cluster of medium sized hedge funds with significant and concentrated exposures; Liquidity disruption leading to disorderly markets as hedge funds make increasingly illiquid investments in particular markets and instruments whilst offering their investors the ability to withdraw their money more quickly. This could result in a significant liquidity mismatch and require hedge fund managers to dispose of assets very quickly, causing volatile and potentially disorderly markets. Insufficient reliable and comparable data is available to regulators, which limits [...] their ability to make informed decisions about risk and take proportionate regulatory action to mitigate [...] such risk. Control issues arise as the trading (rather than management) background of many hedge fund managers, and their typical ownership structures, means that some managers do not have the right skills or incentives to create an effective control infrastructure.” Financial Services Authority, Hedge funds: A discussion of risk and regulatory engagement (23 June 2005) available at http://www.fsa.gov.uk/pages/about/media/notes/bn008.shtml (last visited 2 December 2009).
the Financial Stability Forum (FSF) during its 19th meeting, considered efforts by the hedge fund industry to review and improve sound practices – particularly those of the UK-based Hedge Fund Working Group and the US-based Asset Managers’ Committee and Investors’ Committee with the aim of increasing transparency and providing better risk management practices.\textsuperscript{148}

Up till now, regulatory focus has been directed towards ensuring that bankruptcy relating to hedge funds, does not trigger further systemic crisis in other parts of the financial sector.\textsuperscript{149} From the responses obtained from the European Commission’s Consultation Document on Hedge Funds, a significant percentage of these were of the opinion that adequate bank capitalization structures were in place to contain consequences of a hedge fund crisis.\textsuperscript{150} Furthermore, the results not only revealed that prime brokers were equipped with risk management tools which would shield them from counter party risks, but that respondents also considered the prudential requirements to which prime brokers were subject, to be stringent.\textsuperscript{151} The European Commission’s Consultation Document on Hedge Funds\textsuperscript{152} should contribute to a consideration of the appropriateness of existing approaches to regulation and supervision of the hedge funds sector.\textsuperscript{153}


\textsuperscript{150} Id.

\textsuperscript{151} Id. Many respondents also thought that banks’ risk assessment systems were robust enough to address counter party risks – even though such responses were based on preliminary assessments. Due to the fact that credit, counter party and market risks could speedily materialize, some respondents considered further consolidation of prime broker management of hedge fund related risk as essential in limiting the possibilities of a systemic impact being triggered.

\textsuperscript{152} Whose period of consultation was between 18 December 2008 and 31 January 2009.

2. Non-Banking Financial Institutions

Even though banks are unique in the sense of the extent of systemic risk they generate, such risks could also be triggered by a non-banking financial institution. This could be illustrated by the effects of Enron’s collapse on the financial markets. It could then be argued that the disclosure of risk to market participants under Pillar 3 is not on its own sufficient, and that there is need for greater efforts to incorporate those risks attributed to non-bank institutions.

According to Baldwin and Cave, the first regulatory challenge faced by regulators consists in the identification of risks that need to be reduced – not only on the basis of priority, but also in a way, which would be approved by the public. Second, regulators are confronted with the challenge of managing and regulating risks in a manner, which is both, effective and acceptable. Furthermore, the design of institutions and techniques for managing risk, the choice of the appropriate regulatory technique, issues relating to whether risk management or regulation should be “blame oriented” and the contentious topic of reliance by risk managers on qualitative risk evaluations in contrast to more quantitative methods of assessments constitute additional challenges.

II. Procyclical Nature of Risk

Proposals, which have been put forward by the Financial Stability Forum in a bid to address pro-cyclicality and alleviate factors which exacerbate it, extend to three areas. These are as follows:

i) A consolidation of the regulatory capital framework: Aimed at improving the quality and levels of capital in the banking system during periods of economic boom, such that when the economy experiences a period of downturn and financial pressure, stored up capital could be utilised.

154 Baldwin & Cave, supra note 41, 142-143.
155 Id., 143.
156 Id., 144.
157 These are “bank capital framework”, “bank loan loss provisions” and “leverage and valuation issues”. EU Commission, supra note 5, 45-46.
158 Id.
ii) A revision of the Basel II framework for market risk: Aimed at reducing a dependency on “cyclical VAR-based capital estimates”.159

iii) Bolstering risk based capital requirements with a measurement base, which is neither risk based nor complex. This is aimed at facilitating the management of leverage within the banking system.

iv) The imposition of a requirement that supervisors adopt the Basel Committee’s stress testing practices.

v) Monitoring the effect of Basel II and implementing relevant adjustments to ease “excessive cyclicality of the minimum capital requirements”160 which relate to the “risk coverage of the capital framework”.161

In response to Basel II’s shortcomings and since the capital regulation contributes to the degree of economic downturns,162 a complement of the rules on bank capital with rules on liquidity and leverage is proposed by Cociuba as a means of addressing the inadequacy of risk based capital measures in promoting the stability of the financial system.163

Counter cyclical regulatory mechanisms have also been proposed to address pro cyclical problems, which have not been addressed by Basel II.164 Recent amendments to the Basel II framework and Pillar 2 (supervisory review process) in particular, are aimed at addressing weaknesses that have been highlighted in bank risk management processes during the recent crises.165 Areas which have been addressed include “firm-wide governance and risk management”,166 the capture of risks emanating from “off-balance sheet exposures and securitisation activities”,167 the

159 Id., 46.
160 Id.
161 Id.
162 Since banks choose to reduce lending when capital is scarce.
164 Brunnermeier et al., supra note 143, 29-35.
166 Id.
167 Id.
management of risk concentrations, the provision of incentives to banks in order to facilitate better management of risks and returns on a long term basis, and sound management practices.  

III. Risk Management within the EU

In view of all that has been considered in this paper, namely, increased globalisation, conglomeration and the impact of systemic risks across national boundaries, the need for risk management at level of the European Union would appear almost inevitable. Basel II has come a long way since its inception and although it has encountered its fair share of regulatory challenges, it is constantly evolving and adapting to the changes resulting from a dynamic and more complex financial environment. The adoption of the Capital Requirements Directive has resulted in more comprehensive capital requirements that are particularly geared towards accounting for “operational risk.” In addition, the rules have become more risk sensitive – hence providing for institutions to implement approaches designed to select regulatory capital, which corresponds with their situation.

While further work is required in adopting measures aimed at improving bad incentive structures - which contribute not only to high levels of risk taking, but also to increased pro cyclicality, this becomes complicated due to the fact that there is a need for clear legal rules at the level of the European Union. These must be aimed at providing clear explicit requirements, which stipulate that “remuneration policies of financial institutions should be subject to supervisory oversight”.

---

168 Id.

169 “The risk of systems breaking down” is used to denote the definition of operational risk. To elaborate on this using the EU document’s own words, the adoption of the Capital Requirements Directive has resulted in more comprehensive capital requirements that are particularly geared towards accounting for “operational risk”. One of Basel II’s primary objectives was geared towards increased sensitivity to risks (which include credit risk, market risk and operational risk). EU Commission, supra note 5, 7.

170 The Internal Rating Based Approach for example, enables institutions to decide on capital requirements for credit risk through an incorporation of their own “risk inputs”. Id.

171 Id., 18.
IV. The Potential of Meta Risk Regulation

The ability of responsive regulation to address such a complex factor as risk, its flexibility and responsiveness to regulatees and its environment, among other advantages, make it an increasingly desirable regulatory tool as compared to traditional regulation or risk based regulation. Whilst direct monitoring by the State would be required, the involvement of third parties such as non-governmental organisations would also be crucial towards ensuring that a situation, whereby the State could be captured, is avoided. Further, the possibilities available in achieving the right “regulatory mix” make it a promising regulatory tool. Even though the contested nature of risk contributes to the difficulty of relying on risk as a regulatory tool, its presence and ever growing significance cannot be ignored – hence the need for a form of regulation which is able to manage risk more effectively and which would best suit an evolving regulatory environment.

172 According to Baldwin and Cave, risk regulators encounter problems with the search for legitimation as a result of differences between the lay and experts’ perceptions of risk. For additional information on what could be done to improve the effect of legitimating arguments and solutions advanced to counter problems of risk regulation, see Baldwin & Cave, supra note 41, 145-149. For problems with defining and assessing risk, id., 138.
The Productive Semantics of the Crisis

Florian Süssenguth*

Table of Contents

Abstract ...................................................................................................... 366
A. A Sociological View on Global Crises................................................ 366
B. The Concept of Crisis as a Valid Scientific Category? ....................... 367
C. Globality in a Functionally Differentiated Society ............................. 369
D. The Semantics of the Crisis and Productive Uncertainty................. 373
E. Crisis Communication as Impetus for Evolutionary
   Adaption .............................................................................................. 383

* Florian Süssenguth is a research associate at the department of sociology at the
  Ludwigs-Maximilians-Universität of Munich. Research interests include system the-
  ory and discourse analysis, theories of media and media criticism, qualitative research
  and theories of society and differentiation.

doi: 10.3249/1868-1581-2-1-suessenguth
Abstract

Within sociological discourse the scientific category of the crisis is often criticised for being arbitrary and as a consequence deemed devoid of meaning in modern society in general. Observing crisis communication as an empirical phenomenon puts this mindset into perspective. Using examples from scientific and political semantics reveals the productive aspects of communication taking the form of a crisis. Within the scientific system a crisis simultaneously serves as guiding line for the decisions on which topics and issues the limited resources for research and publication are to be devoted, and as a point of reference for the revaluation of theories and methods. In the political system crisis communication forces decisions on policy and compels parties to develop stances and solution strategies by which they are able to delineate themselves from each other. Crisis communication therefore follows the various rationalities of the systems in which it occurs without adding up to an overarching rationality encompassing society as a whole and shaping its reaction. Crisis communication in this sense serves to increase variety within social systems and can be understood as a societal adaptation mechanism operating in the mode of evolution.

A. A Sociological View on Global Crises

We live in a time of global crises. This appears to be self-evident. Beyond that the debate begins, though. Which one is more important? Global warming or globalisation? Terrorism or the financial crisis? A completely different crisis we have not even noticed, maybe? There are more questions asked: who is to blame and who is able to solve the issues at hand? The aim of this contribution is not to decide on these issues but to observe them as a form of communication. Of interest here is to question this self-explaining evidence of crisis communication.

How does conceptualising an issue as a crisis reflect on the forms of communication and social practice surrounding it? Niklas Luhmann’s work on ecological communication\(^1\) will be generalised into a framework for the sociological observation of crises. Instead of claiming for sociology to be the better economical, juridical or political science or even political tool for the solving of crises, the focus of this sociological investigation is on the

---

meaningful but divergent observations of a crisis and thus the unique contributions to society these different perspectives bring forth.

Building on a short overview of the sociological approach to crises (B) I want to propose a shift from using crisis as theoretical concept towards an empirical study of crisis communication in societal practices. The notion of the global character of crises is used to introduce a theory of observing society built on the idea of differentiation (C). A society encompassing a multitude of presences operating under their own rules and logics reacts to crises according to the limits and opportunities of its mode of differentiation. Using scientific and political semantics of the current financial crisis as empirical examples (D) it becomes apparent that they do not solve crises in the sense of instrumental and causal rationality. They do so by enabling evolutionary and uncoordinated processes of societal adaption instead (E).

B. The Concept of Crisis as a Valid Scientific Category?

Sociology itself was born of crises. Auguste Comte – its founding father – saw the need for a new discipline as an answer to the crises of his time. It was to give answers to the problems generated by a society entering its last and final phase, one ruled by science and positivism. He conceptualised crises simultaneously as a normal part of social progress and as events threatening the teleology of history. This conception offered a possibility for comparison between the deficient actual situation and a future utopia. Sociological experts would be those offering solutions to the problems preventing the promised progress to the last stage.

A similar tight coupling between the idea of social progress and a loss of traditional orientation is at the core of Reinhart Koselleck’s work on the semantics of the crisis. As the temporal focus on the past inherent in traditional forms of life became increasingly inadequate to make sense of a modernity oriented towards the future, the semantics of the crisis arose as a new way to verbalise the fears and hopes of an uncertain future. The crisis can be seen as the “structural signature of the modern age.” As the remnants of

---

2 For a detailed reconstruction of Comte’s concepts see R. Repplinger, Auguste Comte und die Entstehung der Soziologie aus dem Geist der Krise (1999).

3 See R. Koselleck, Krise, in O. Brunner et al. (eds), Geschichtliche Grundbegriffe. Historisches Lexikon zur politisch-sozialen Sprache in Deutschland, Volume III (1982).

4 Id., 627. Translated by the author.
traditional forms of life disappear the concept of the crisis itself becomes increasingly obsolete. For Koselleck it has lost its specific historical meaning and devolved into an increasingly ambiguous descriptor for arbitrary phenomena.\footnote{Id., 649.}

Armin Steil attempts to amend Koselleck’s diagnosis by studying the connections between social structure and the semantics of the crisis in deeper detail. He identifies three core aspects of the historical use of the concept. An internalised conception of social problems as pathologies calls for social solutions and action since the older mode of externalising problems by projecting them onto a sinful outside force became unavailable.\footnote{A. Steil, Krisensemantik – Wissenssoziologische Untersuchungen zu einem Topos moderner Zeiterfahrung (1993), 244.} The second aspect of crisis semantics is their twofold conception of temporality. Pathologies as specific modalities of contemporary time only become visible by contrasting them with a utopian idea of future society. The future therefore simultaneously offers a frame of reference and the promise of a solution.\footnote{Id., 245.} In a third aspect the diagnosis of pathology and the call for its removal is not a simple statement of fact but rather the medium through which intellectuals are able to address collectives and to actually create community.\footnote{Id., 245.} In the end Steil shares Koselleck’s view on crises having devolved into a vague metaphor unsuited to be a scientific category.\footnote{Id., 265.}

I want to contend that these sombre assessments have difficulties to account for the continuing popularity of the semantics of the crisis. A reason for this might be found in their conception of society which does not clearly differentiate between scientific discourse and others. It is in the works of Niklas Luhmann where a first lead towards an explanation for the relationship between these spheres of society and the role of crisis communication within and between them can be found: “Crisis is an alarming notion, alarming because it is used in science and in everyday life as well. The word is taken as a shoot from so-called theory to so-called praxis. The word may be used to establish the thing, it may be used as ‘self-fulfilling prophecy.’”\footnote{N. Luhmann, ‘The Self-Description of Society: Crisis Fashion and Sociological Theory’, 25 International Journal of Comparative Sociology (1984) 1, 59.} Luhmann himself responded in Ecological Communication\footnote{Luhmann, Ecological Communication, supra note 2.} to the public
perception of a critical state of the environment, highlighting the structural
degrees of freedom available to society for intervention.

Drawing on this theoretical outline the observation of a historical shift
in the semantics of crisis towards universal applicability is not disputed here
but rather taken as an invitation to observe their contemporary function.
This paper presents an attempt to describe the link between specific forms
of modern crisis communication and the degrees of freedom society can
utilise to react to it, conscious of the limitations to its potential for reson-
ance:

“Even without real influence and without a real chance to apply
its analytical potential sociological theory could use the theory
of self-referential systems to analyze the conditions of its own
contribution. It may reflect about withdrawing the notion of ‘cri-
ses’ and substituting something else – maybe self-reference. Or
it may try to offer package deals: if crises, then as explained by
functional differentiation. For in the end, we cannot be sure on a
priori grounds that theories of adequate complexity will turn out
to be unsalable.”

Luhmann’s work on ecological problems is thereby generalised into a
framework for the observation of global crises and their semantics in a func-
tionally differentiated society.

C. Globality in a Functionally Differentiated Society

The dialogue on global crises in itself already suggests an approach
using differentiation. How else could we explain the heterogeneous array of
indicators used to assert a global dimension of a crisis? We normally do not
refer to a spatial extension measured in square kilometres or the percentage
of the earth’s surface affected. We talk about the number of people, nation
states, markets, legal systems etc. affected instead. The varied use of the
qualifier global thus reveals an experience of differentiation where it be-
comes meaningful to discern between a political, an economic and other
spheres of social practice.

12 Luhmann, Self-Description of Society, supra note 10, 68.
This holds true for society in general. With the beginning of modernity, we can observe a shift in the primary mode of social order from the principle of a universal hierarchy of social rank towards heterogeneous areas of practice without a single ranking mechanism of participants true to all of them.\textsuperscript{13} This does not imply that social inequalities do not exist anymore but rather that they have become secondary to a differentiation by functional modes of communication.\textsuperscript{14}

For example monetary or social status cannot and may not decide who is right and who is wrong in court anymore. If it does a scandal is born and becomes a subject of further legal scrutiny to rectify this deviation from established practice. Scientific truths, as countless scientists have to experience, cannot force political decisions even if all their data points to their effectiveness and urgency. Gone too are the days where salvation was up for sale.

In short: these different spheres are based on unique forms of relevances and guiding principles that cannot be simply transferred between them. At the same time they are not neatly separated areas of society but rather perspectives observing the whole world in regard to their purview. System theory calls these different guiding principles the fundamental code which forms the basis for their self-referential operations.\textsuperscript{15}

In the case of the political system this basic code is one of power/no power, taking the form of government/opposition within democracies. The economic system is concerned with the question of payment/non-payment. The scientific system focuses on producing results that are true and on refuting untruth, even if those truths are not favourable to those in power or in accordance with religious revelations.\textsuperscript{16} It is important to note that no side of these distinctions is automatically better or worse than the other. Proving something as untrue can be equally important as proving truth and democracy is dependent on politicians losing power in elections.

\textsuperscript{13} Id., 64.
\textsuperscript{14} System theory treats communication as the basic element of social reproduction, not actions or individuals. This serves to emphasise the concept of social systems as self-organising processes that are not reducible to the persons involved. This does not imply that communication does happen without human input but emphasises that this input follows structures determined by the system itself. Anyone who ever desperately wanted to say something in a conversation but failed to do so because no opportunity presented itself can attest to this fact. For a general outline of this theory of social systems see N. Luhmann, Social Systems (1995).
\textsuperscript{15} Luhmann, Ecological Communication, supra note 2, 36-43.
\textsuperscript{16} Id., 36.
This focus on a tightly coupled pair of opposing terms allows them to be able to observe and conceptualise everything imaginable in the world according to their own relevancies. The system of law is able to observe payments and markets in regard to their legality; scientific observers can evaluate policies in regard to their effectiveness. In doing so the environment observed does not determine the systems' conclusions, nothing external can dictate if something is legal or not, it is decided within the legal system and only there. The scientific system and only the scientific system can decide whether something is false or true.

These decisions are not arbitrary though. They follow programs that condition and guide them. From the perspective of systems theory the code of law fulfils the same function as a program as do the criteria that decide which fund to invest in for maximum ROI or the methods employed to verify or falsify scientific theories. These programs are not immutable; they evolve and change over time. Normally multiple programs can and do exist for a system at the same time, increasing flexibility. This possibility of temporal and factual variation will be of importance when the effects of crisis communication on the function systems are later discussed.

This variety of programs leads to the next important aspect. The different functional systems of society are not to be understood as substantial entities or even monolithic organisations but rather as forms of communication that connect to those of their own kind that came before and form the basis for future instances. As much as it is not possible to talk to the society, it is impossible get an answer from the economy, the legal system or any other, as their identity is one of function, not of substance. A multitude of speakers and situations utilise these functions without being reducible to a single position or identity. The focus on the creation and change of organisations especially during crises can be read as an attempt to generate social addresses for responsibility and intervention within society.

Functional logics are properly characterised as resources that allow for the of ignoring a large amount of otherwise equally possible options and considerations to concentrate on those left, providing frames of reference for

---

17 Id., 44-46.
18 This can be best seen in the modern form of individuality. Inclusion in society is not organised as inclusion into a specific stratum anymore but follows functional specifications that only selectively address persons, e.g. as consumers, clients or government officials. For an elaborate discussion of modern forms of inclusion see A. Nassehi, The Person as an Effect of Communication, in S. Maasen & B. Sutter (eds), On Willing Selves. Neoliberal Politics and the Challenge of Neuroscience (2007), 100-120.
practices and action. Metaphorically this can be seen as an almost total deafness that allows concentration in a world full of noise. Were it not for a medical system we would think twice before undressing in front of a person in a white coat or handing over to give another example: handing over valuable goods for pieces of coloured paper. Without the stability of expectations provided by these logics the actions mentioned would be seen as a sign of profound madness.

Armin Nassehi therefore speaks of a society of presences to emphasise this perspective that function systems are not something alien and detached from everyday life but a play integral part in establishing what we take for granted. Innumerable presences operate by their own rules and generate their own structures of communication by drawing on functional logics as one resource without having to take to most other presences into account.\(^{19}\)

The thesis of a functionally differentiated society does not imply an autarky of the functional systems. On the contrary, they are dependent on the continuing functioning of their peers. Only by way of salaries and funding of scientific instruments can science concentrate on performing experiments and theoretical research, only by legislation can most political decisions be realised. These stable forms of mutual observation and offering input for another are described as structural couplings between functional systems.\(^{20}\)

This too produces risks. If differentiation was just segmented no single segment would be negatively affected by the disappearance of others, as each one is self-sufficient. In a system characterised by functional differences no system is able to replace the other or generate all the resources necessary to its reproduction. There is no redundancy when it comes to functional systems.\(^{21}\) Political decisions can try to create incentives for economic growth and prosperity, but government cannot simply replace the economy by resolving that no one is starving. Therefore it is the system most prone to malfunction that gets the most attention, with crisis communication as a prominent form. An operational model of multiple incommensurable perspectives replaces the idea of a neatly ordered and objectively measurable world. Each system is able to look at the whole through the lens of its code

\(^{19}\) A. Nassehi, *Der soziologische Diskurs der Moderne* (2006), 448-450.


\(^{21}\) *Id.*, 48.
and all it sees is framed in its terms.\textsuperscript{22} It is reminded of its perspectivity
when it encounters alien descriptions formulating the same claim.

This has a profound influence on a sociological conception of global
crises. In agreement with Armin Steil and Reinhart Koselleck there are no
external objective criteria defining crises. A crisis is nothing less and nothing
more than the result of observations and attributions made within social
presences. If the approach favoured here is brought to its conclusion it be-
comes apparent that the meaning, status and importance of a crisis cannot be
determined for the whole of society. An empirical approach has to reflect on
the various presences it observes and understand divergent conclusions and
perspectives within them not as a flaw of observation or social practice but
as pointers to the differentiated condition of modern society. This is not to
be confused with an argument that crises are somehow less real because
they are the product of contextual communication. Those involved with
markets, national borders or the law can attest to the reality of prices, travel
restrictions and laws even as they are products of social practice.\textsuperscript{23}

D. The Semantics of the Crisis and Productive Uncer-
tainty

To exemplify the approach suggested here two examples of crisis
communication are investigated more closely. To illustrate the resonance
within the scientific system the contributions made in this issue of the Goet-
tingen Journal of International Law (GoJIL) are understood as products of
the semantics of the crisis. The political form of the crisis is observed in
Barack Obama’s speech on 14 September 2009, given on the first anniver-
sary of the collapse of Lehman Brothers\textsuperscript{24} and the German leaders’ debate

\textsuperscript{22} This becomes particularly evident in the reflection theories of specific function logics,
for example economics, political sciences and legal sciences. Rational choice theory
as conceptualised by Gary S. Becker is a prime example for this. This perspective is
even able to describe drug addiction in terms of the economic decision calculus of a
rational actor maximising his utility. See G. Becker & K. Murphy, ‘A Theory of Ra-

\textsuperscript{23} Rephrased in a more abstract way, the fact that something is the product of observa-
tion is no qualifier of reality for a deontological and constructivist theory such as sys-
tem theory. It rather points out that all observation is based on distinctions that could
have been drawn a different way.

\textsuperscript{24} B. Obama, Remarks by the President on Financial Rescue and Reform. Transcript of
the speech given in the Federal Hall, New York on 14 September 2009 available at
between Angela Merkel and Frank-Walter Steinmeier during the 2009 parliamentary election campaign.  

The scientific system is probably the one most familiar to the audience of this journal. Even if open to any and all readers it is aimed at experts and articles are selected according to scientific criteria instead of others such as entertainment value or how pleasing they are to government officials.  

The social effects of communicating a topic as a crisis can be observed on two levels in this issue of the GoJIL. The performative level does not become evident in the specific content of the contributions but rather by observing what is published and what could have been published instead. It is the function of journals and publishers to make a selection within a wide range of topics and submitted papers as to which ones are deemed of high enough quality and importance to merit being published.  

This paper is published among others on the same topic in a special issue of the Goettingen Journal of International Law. Here a choice was made to dedicate an issue to a specific topic while at the same time this decision excludes other possible topics and contributions. The present financial crisis and especially the inevitability of future crises provide a plausible justification for the topic chosen. The future is observed as uncertain and risky; therefore action in the present is needed to prepare for all eventualities. This is further supported by the assessment that a time of crisis offers increased chances of scientific thought influencing national and global policy.  

26 Dangers are outside of the control of those potentially affected, while risks are taken, including a decision on the part of those potentially affected. The same thing can be a risk for one person and a danger for another. Letting a dog off a leash is a danger to other people in the park while for owner is taking the risk of potential legal consequences if the dog bites someone. With technological and social progress e.g. insurance or derivative financial instruments more and more dangers are transformed into risks. For an elaborate discussion see N. Luhmann, Risiko und Gefahr, in N. Luhmann, Soziologische Aufklärung 5 Konstruktivistische Perspektiven (2005), 126-162.  
28 For a rather fierce justification of the need for scientific contributions to the financial crisis see B. Blatschek et al. (eds), Crash statt Cash. Warum wir die globalen Finanz-
The semantics of the crisis are able to provide acceptable reasons for the decisions on which topic is most relevant for publication. 

There the implicit and sometimes often explicit promise is that only the dedicated study of the crisis will be able to generate solutions and in a more abstract sense a true perspective on the crisis. In this sense the semantics of the crisis are as difficult to escape as a heated argument. Just as insisting that one is not pointing out flaws to aggravate the other but just stating facts will not end a dispute but be interpreted as new insult, the semantics of the crisis have a similar effect of subsuming all communication under their umbrella. This is evident in the debate on global warming insisting that there is no global warming is not a statement outside of crisis communication but right at its heart.

The result of this is paradoxical. While the semantics of the crisis indeed enable research and discourse on their issue, in lieu of a definite answer a multitude of conflicting proposals is produced. So while each scientific contribution to the analysis of a crisis presents its findings as true and certain and offers starting points to its solution or even whole programmes, taken together the results have the opposite effect. Conflicting findings and disagreements on adequate theories and methods increase uncertainty within the scientific system in a highly specific and productive way. It serves as an ideal starting point for the justification of further research.

We have seen that crisis communication directs the attention of the scientific system and increases the probability of research and publications towards its issue at the expense of other topics. On the second level, the level of the content of the realised scientific communication of the crisis serves as an opportunity to revaluate theories, methods and findings.

This dynamic can be studied by looking at the content of this issue of the GoJIL. Instead of a unified perspective on the financial crisis, each paper observes the crisis from a different point of vantage. Depending on the approach chosen the causes of the crisis are attributed to different groups, systems and dynamics. All papers present compelling arguments as to their construction of causality and the consequences that are to be drawn from them.

For political science the crisis is one of governance and sovereignty. For example the speed of government intervention necessary to solve a crisis is seen as potentially creating a crisis of legitimacy as deliberative 

mäßte bündigen müssen (2008). Even without an explicit explanation a focus on the finance crisis at the expense of other topics can be observed in 37 Leviathan (2009) 2. Four contributions deal with the crisis at hand.
processes are in danger of being circumvented. In the factual dimension of meaning issues are commonly framed as information deficit; in the social dimension as principal-agent problem.

The changing parameters of policy making are interpreted as a need for a revaluation of existent theories and the development of new models. The perceived threat of a loss of the capability of the political system to lead society is countered by producing models as to how it can be re-established. Here political science and politics itself are quite similar in their reactions, as will be shown in the analyses of Obama’s speech and the German leaders’ debate. At the centre of the suggestions the reform of the segmented internal differentiation of the political system in form of the nation state features heavily. The function of evoking collectives described by Armin Steil can be respecified as a function of crisis communication specific to political contexts.

Scholars of law approach crises from a different point of view while the dynamics are similar. Here it is the failure of existing laws to affect or properly condition financial exchanges that are seen as the cause of the problem and its solution at the same time. Again the speed of economic transactions compared to the limited capacity of the law system to change its programs quickly is identified as core problem.

A change in the environment in which law operates is observed, as is a failure of existent legal provisions to prevent the financial crisis. For legal scholars the crisis therefore is interpreted as an imperative to bring existent models up to date, develop new ones and to re-establish legal stability. The perceived state of crisis allows a wider range of demands and suggestions to be made, offering new impulses for the discussion or maybe even preparing a paradigm shift. 

---

29 See J. Becker et al., ‘The National Environmental Premium in Germany: A Rapid Reaction to the Financial Crisis at the Expense of Democracy?’, 2 Goettingen Journal of International Law (2010) 1, 43-62. While the national environmental premium appears to be legitimate according to the criteria applied by Becker, a similar inquiry into the bank bailouts might produce a different result. Of sociological interest is how the condition of societal differentiation is reconstructed as a problem of legitimacy immanent to politics here, exemplifying the universal and at the same time perspective access to the world employed by functional logics.


31 The proposal of a contextual and reflexive law can be read as a reaction to the experience of a crisis within the legal system. See A. Mascareno, ‘Ethic of contingency beyond the praxis of reflexive law’, 12 Soziale Systeme (2006) 2, 274-294.
What has been said about the other disciplines is equally applicable to sociology. Here the financial crisis is seen as a chance to challenge the dominance of economics in the humanities. This is accompanied by a renewed interest in alternative forms of economic and social organisation. At the same time crises are seen as chances to study modern society and return sociology to a prominent position within public discourse. This paper itself is an example for an attempt to contribute to a scientific account of the crisis, and simultaneously to position a theoretical perspective as more rewarding than its alternatives.

This heterogeneity of approaches and conceptualisations is further exacerbated by the seductive call of interdisciplinary research that resonates even louder than normal in the halls of academia during times of crisis. Here the promise of better and holistic results is put into obvious contrast to the results that usually are all but univocal. If we accept this description to be accurate does this imply that the semantics of the crisis have a negative impact on science and are nothing but hollow promises if not outright deception by those that use them? A conclusion stating this would fall short in multiple aspects.

Insinuating that scholars interested in a crisis are just using it as a vehicle to increase their prestige ignores Bourdieu’s observation that capital within the academic field can only be won through good scientific performance. At the same time a critique of the inability to provide a definite answer to a crisis ignores the functionality of the sub-differentiation of the scientific system into subjects and disciplines. It is the focus on selected aspects of a topic while deliberately ignoring others that allows in depth analyses. Calling for sociology, economics, political science and legal science to come to identical models and conclusions would imply a loss of analytical capabilities that might be worse than the crisis itself.

Scientific practices depend on new results that can be considered true and new methods to be able to generate them. Whether the new truth consists in refuting old findings by proving them wrong or by adding new aspects to a topic is secondary to this operational imperative. A crisis is uti-
lised within the scientific system to generate new results and to test hypotheses and implications. The *pressure of time* during crises often prevents empirical results from a current crisis to be generated within a frame of time where they could be used to counter its effect. It is the *pre-existence* of conflicting theories, methods and findings that guarantees instead that at least some of them are immediately applicable to the problem at hand. Different positions and findings that at the time of publication both seemed valid are reinterpreted in the face of a crisis and form the basis for further research.

If the events and dynamics of a crisis fit a theory or model developed *before* the crisis began, science observes this as a *confirmation* of these approaches. Their methods and frameworks are considered to be usable and useful to solve the crisis at hand, giving them an upper hand compared to conflicting theories. However, those other theories do not disappear, instead the crisis is copied into those theories invalidated by the new developments. The theories and methods diverging from the actual events are seen as experiencing a crisis themselves that either motivates a *reformulation* and modified approaches to incorporate the new reality of the crisis, or attempts to prove the new criticism unfounded some other way. The financial crisis at hand provides new fuel for the old feud between neoclassical and Keynesian approaches to economy, while at the same time no decisive victory for one side or the other seems close.

The *scientific system* in this way does not offer a single true explanation for a crisis but its resonance to the problematic events rather *supplies society with a multitude of models and technologies* that can be applied. The scientific system is only able to react to a crisis by diverting its attention to the problem and thus generating new truths by presenting new approaches or even fields of study. Old and problematic models are adjusted if possible, or otherwise discarded.

This creates an array of new perspectives and technologies from which to choose. At the same time science is not able to provide certainty or a holistic point of view despite its self-declared claim of striving to do so.

More often than not it is not the scientists who decide about the *implementation* of the developed technologies or who determine which model creates resonance outside the scientific community. Scientists discover this

---


36 A recent example for the continuation of this discussion can be found in the contributions of 33 *Cambridge Journal of Economics* (2009) 4.
fact when they try to influence politics and have to realise that policies are not determined by scientific truth but political feasibility. They inadvertently find themselves in the position of a political actor facing opposition. Even worse, to each expert supporting a specific position on an issue another expert can be found who is equally convincing at arguing for an opposite course of action. Science therefore cannot relieve politics from the need to decide and to find a way to generate enough support to do so.

The specific way a crisis gains traction within the political system and generates resonance can be made visible by studying Barack Obama’s speech on the first anniversary of the collapse of Lehman Brothers and the German leaders’ debate during the parliamentary election campaign of 2009.

The political system functions by making collectively binding decisions. The collective so addressed has to be continually reproduced in doing so; it cannot be expected to just exist. To do so Obama draws on the collective “we” to create the collective he represents:

“We could not separate what was happening in the corridors of our financial institutions from what was happening on the factory floors and around the kitchen tables [...]. So the only way to address successfully any of these challenges was to address them together. And this administration, under the outstanding leadership of Tim Geithner and Christy Romer and Larry Summers and others, moved quickly on all fronts, initializing a financial -- a financial stability plan to rescue the system from the crisis and restart lending for all those affected by the crisis. By opening and examining the books of large financial firms, we helped restore the availability of two things that had been in short supply: capital and confidence.”

In these few sentences, the whole mode of political resonance to crises becomes evident. The crisis is construed as a threat not caused by those in power but still within their responsibility. Only by communicating a crisis in terms of necessary political decisions can it generate resonance within the political system. At the same time a critical issue can circumvent many of

---

37 For an elaborated system theoretical concept of politics applied here see A. Nassehi, Der Begriff des Politischen und die doppelte Normativität der „soziologischen“ Moderne, in A. Nassehi & M. Schroer (eds), Der Begriff des Politischen (2003), 133-169.

38 Obama, supra note 24.
the usual political routines, such as lengthy debates or even formal requirements for decision, potentially leading to the threats to democratic legitimacy discussed before.

So while scientists may disagree and claim that a crisis cannot be solved because it might have progressed too far or is inherent in the dynamic of the system affected this is no option for politics. The existence of an opposition guarantees that at least one party will put the crisis on its agenda and use it to call for action or to criticise the inaction of the ruling party. This dynamic guarantees that a crisis has to become a topic for all parties without any decision on their part.

Apparent here is the form of attribution within politics. The ruling party attributes successful measures and positive developments in the crisis to its actions and reads them as confirmation for the effectiveness of future actions:

“While full recovery of the financial system will take a great deal more time and work, the growing stability resulting from these interventions means we're beginning to return to normalcy. But here's what I want to emphasize today: Normalcy cannot lead to complacency.”

The risky future has to be managed by the right factual choices in the present. These decisions are only possible by evoking a consensus in the social dimension of meaning. The attribution of the opposition is a mirror image to the ruling party. Successes are attributed to environmental dynamics, while negative trends are communicated as a result of the choices made by the government. In doing so a crisis allows parties to delineate themselves from the others by offering alternative definitions of the crisis and programmes to combat it. At the same time the underlying assumption that the crisis is indeed manageable by political means is not challenged.

What is at stake is the decision on the best way to confront the critical future. In crisis communication each party describes itself as being best suited to guide the nation safely out of danger, while the choice of another party is connected to negative outcomes. This can be observed in Frank-Walter Steinmeier’s comment on possible coalitions without SPD involvement:

39 Obama, supra note 24.
“One direction is black-yellow: black-yellow means that those who count among the originators of the crisis will not be held accountable for the consequential costs. Black-yellow means that the divide between the poor and the rich will deepen. Yellow-black means a return of nuclear power.”

Elections enable a periodic shift in the programme of the political system. The structure of time within the political system reflects on this cycle and the parties aim their actions at a maximum chance at (re)election at these moments. As elections happen every few years, policies are favoured that produce visible and therefore presentable successes within a short time. This can lead to clashes between strategies that have moderately positive short-term effects and long-term strategies that might be more effective in the long run but take a long time to result in visible changes.

So far the presentation of the resonance global crises can cause within the political system has been rather bleak. Making visible that crises have to be translated into the political language of collectively binding decisions first does not imply a total impotence of politics. If this translation is possible a wide array of tools is available to policy makers. The ability to pass new laws and ordinances is the most important among these. In the case of the financial crisis the state combined this ability to set generally binding frameworks with fiscal policies.

The state cannot order market stability or economic growth, but it can set incentives to influence market movements and introduce regulatory bodies to observe them:

“This is in part because there is no single agency charged with making sure that doesn’t happen. That’s what we intend to change. The Consumer Financial Protection Agency will have the power to make certain that consumers get information that is clear and concise, and to prevent the worst kinds of abuses. Consumers shouldn’t have to worry about loan contracts designed to be unintelligible, hidden fees attached to their mortgage, and financial penalties – whether through a credit card or a debit card – that appear without warning on their statements. And responsible lenders, including community banks, doing the

40 Merkel & Steinmeier, supra note 25. Translated by the author.
41 Luhmann, Ecological Communication, supra note 2, 92.
right thing shouldn't have to worry about ruinous competition from unregulated competitors.”

The political system here is being able to observe the economic system and its tendency to maximise profit by exploiting any possible loophole. Instead of going against this core principle of capitalist economic activity the proposed policies aim at designing the framework for economic activities in a way that makes the desired behaviour the most profitable. At the same time this cannot guarantee that the new regulations themselves do not open up new loopholes.

Political response to global crises is operating under another restraint inherent to the system. The segmented sub-differentiation in the form of nation states necessitates the coordination between many political entities but simultaneously offers the participant governments another chance at describing themselves as being proactive in combating the crisis and external scapegoats in the case of failing policies:

“The United States is leading a coordinated response to promote recovery and to restore prosperity among both the world’s largest economies and the world’s fastest growing economies. […] And this work will continue next week in Pittsburgh when I convene the G20, which has proven to be an effective forum for coordinating policies among key developed and emerging economies and one that I see taking on an important role in the future.”

It is this capacity for self-transformation of the political system that is an important effect of the semantics of the crisis. It has to be noted that possible developments are not limited to democratic outcomes; a crisis can result in non-democratic forms of government too. In the current crisis an attempt to move toward increased international coordination and supranational structures can be observed but it remains to be seen if lasting chances will be achieved.

A perceived crisis therefore forces the political actors to adjust their programs and decision routines to be able to offer solutions. A crisis is not always a political issue from the start, but it has to be translated into a go-

42 Obama, supra note 24.
43 Id.
vernable form in the first place for the political system to be able to react to it. There, programmes and proposed courses of action are formulated as alternatives the voting public can decide on and the actions taken to combat the crisis become the measure by which success is to be determined. The semantics of the crisis at the same time lead to a focus on the problematic topic and force a decision to deal with it while generating alternative courses of action that can be substituted.

E. Crisis Communication as Impetus for Evolutionary Adaption

Looking back at the two exemplary functional systems studied in regards to their resonance to global crises, a few conclusions can be drawn. Instead of a central perspective on global crises society is characterised by a fractured approach to solving them. For the scientific system the reaction to a crisis consists in the production of a multitude of conflicting descriptions of the crisis, its causalities, actors and consequences. This follows the system rationality of science, the attempt to formulate true statements about the crisis and to falsify others.

The political system processes a crisis differently, according to its own incongruent logic. Here not a scientific true definition of the crisis is of the essence, but a conceptualisation of the crisis that allows for solution strategies using the tools of legislation and finance available to the political bodies. While the solutions indeed can be and often are effective, they have to conform to the form political programmes in democracies are decided, namely elections and the generation of majorities. While observers of the political system such as scientists often lament this fact they find themselves forced to act under the same logic of campaigning for majorities to have a chance at implementing their solution strategies, becoming political speakers in the process.

In both cases crisis communication directs attention to the issue at hand. The most important effect of this has been shown to be an increase of perspectives, positions and approaches instead of singular and unambiguous plans of action. No unified rationality emerges from interdisciplinary scientific discourse on the crisis; political differences do not disappear in a flash of sudden enlightened unity. On the contrary: in light of the crisis the differences between parties become more pronounced. Not reason but political majorities guarantee that decisions are made to counter the effects of crises.
Niklas Luhmann spoke of too much and too little resonance at once when looking at the social responses to ecological communication.\textsuperscript{44} Too much resonance within functional systems whose reactions to the ecological dangers could prove to be destabilising to themselves and other systems, while society as a whole might not be able to exhibit enough resonance to address the problem in a way guaranteeing its survival. This diagnosis can be generalised to global crises in general. Crisis communication is able to incite function systems to focus their attention on an issue but \textit{there is no guarantee the results of this attention add up to an effective solution} or that the solution is a desirable one.

Crisis communication does not allow for an overarching rational and coordinated effort by society as a whole. Calls for intervention and solution based on this premise are doomed to failure. If implemented they are surprised by \textit{unintended reactions and side effects} that their contributions cause in other areas of society, often lessening or inverting the intended consequences.

Crisis communication has another function. It serves as catalyst within functional systems by \textit{reintroducing contingency} to their operations, thereby \textit{encouraging a variation of forms} and approaches while making theories and political programmes unviable that prove unable to adapt to the new societal environment. This does not ensure optimal outcomes or a higher level of reason. The systems provide themselves with the ability to adapt to a changing environment by replacing failing programmes with a variation that is more suited to the changes. This is no teleological progress but rather operating under the \textit{principle of social evolution} instead.\textsuperscript{45}

The concept of the crisis in its ambiguity and universal applicability might be unsuitable to be a scientific category, to deny its importance because of this means closing our eyes to society. It is exactly the ambiguous nature that enables crisis communication to function as \textit{a way for society to observe itself} and to spur its evolution. A scientific contribution to solving global crises therefore is not an illusory idea but it has to be able to reflect

\textsuperscript{44} Luhmann, \textit{Ecological Communication}, supra note 2, 116.

\textsuperscript{45} Organisations have been left outside the scope of this contribution but a similar function of crisis communication enabling organisational change and reorientation seems likely. For a theory of organisation focusing on the idea of differentiation and a model of evolution instead of a rational control of change processes see N. Thygesen & N. Aakerstroem Andersen, ‘The Polyphonic Effects of Technological Changes in Public Sector Organisations: A System Theoretical Approach’, \textit{7 Ephemera: Theory & Politics in Organisation} (2007) 2, 326-345.
on the society it is formulated within to maximise its chances at generating meaningful societal resonance.
Lending and Sovereign Insolvency: A Fair and Efficient Criterion to Distribute Losses among Creditors

Juan Pablo Bohoslavsky*

Table of Contents

Abstract .................................................................................................................................................. 389
A. Introduction ....................................................................................................................................... 389
B. Distributing the Financial Losses of Sovereign Insolvency Among Creditors ................................................. 390
   I. Credit Ranking in Sovereign Insolvency: An Insufficient Rule, Difficult to Enforce ................................. 390
   II. General System of Priorities, Realpolitik and Disorder ................. 392

* European Ph.D., director of the LL.M. in Global Administrative Law, Universidad Nacional de Rio Negro, Patagonia, Argentina. This paper was produced during the postdoctoral fellowship at the New York University School of Law during 2008-2009. The author wishes to extend his gratitude to the Hauser program’s academic and administrative staff for their phenomenal support. Special thanks also go to New York University Professors Lee Buchheit, Richard Hulbert, Andreas Lowenfeld, Harvey Miller, and Gerald Rosenfeld for their helpful suggestions and insights, particularly in reshaping early drafts of this paper. I also want to thank all the participants at the 1 April 2009 Hauser forum at NYU where the first version of this paper was presented and discussed. Finally, thanks to Johannes Jürging and the team of editors of GoJIL who made invaluable edits and contributions to this piece. The views and conclusions reflected in this paper are solely mine and are in no way intended to reflect the views of the aforementioned people. A longer version of this paper, developing a comparative analysis of eight private domestic laws on liability for granting abusive loans will be published in the Spanish Yearbook of International Law, 2008 (forthcoming 2008).

doi: 10.3249/1868-1581-2-1-bohoslavsky
III. A Sound Guide for Distributing Losses Among Creditors: Looking at the Lender’s Behavior and Its Consequences........................................................................................................... 396

C. Applying the Principle of Responsibility for Granting Abusive Loans to the Realm of Sovereign Insolvency ........................................ 398

I. Abusive Loans in Sovereign Finances .................................................. 398

II. The Application of the Legal Principle and Some Practical Problems ........................................................................................................... 402

III. The First-In-Time Rule, Abusive Loan Liability and Their Economic Rationale .............................................................................................. 405

IV. The Legal Principle Already Exists: Now It Must Be Applied......................................................................................................................... 407

D. Final Considerations ............................................................................. 410
Abstract

This article argues that there are legal and economic justifications for extending the principle of responsibility for granting abusive loans from private law to a general principle of international law and, as such, that it can and should be applied to matters of sovereign insolvency. Employing this rationale, the article develops concrete legal and economic reasons and mechanisms by which the financial losses that any sovereign insolvency imposes on creditors should be distributed among them.

In particular, the article takes the position that loans, which are granted to states without following the most elementary prudential guidelines with regard to the analysis of credit risk and which are granted with the intention of taking unfair advantage at the expense of other creditors, should be totally or partially subordinated to those not classified as abusive in the case of sovereign bankruptcy. While the effects of this principle mostly coincide, in practice, with those of the first–in-time rule, it is argued that insolvent sovereigns and creditors must respect this criterion when proposing, negotiating and agreeing on a restructuring.

A. Introduction

This paper examines some legal aspects of sovereign insolvency, focusing on the stage at which the financial losses (reduction of the debt) of sovereign bankruptcy have to be distributed among creditors. It argues that a general principle widely accepted in private law – the so-called responsibility for granting abusive loans – should have an influence on the credit ranking system of sovereign insolvencies, and thus on the amount of money that each class of creditors collects in these collective procedures.

This paper describes the poor and insufficient legal rules that govern the ranking of credit priorities that apply to creditors when trying to collect their credits from an insolvent state and how this situation leads to inefficiencies and abuses from creditors and debtors. The first section also explains how these legal deficits have negatively impacted on particular creditors, allowing, on the one hand, sovereign debtors to impose excessively painful haircuts and, on the other hand, allowing abusive creditors to take advantage of this at the expense of the bona fide ones. The paper introduces a basis of responsibility for granting abusive loans –
emphasizing the way in which the credit risk was assessed and the dishonesty of the lender – as a new principle to promote efficient and fair allocation of financial losses in the sovereign insolvency realm.

The second section applies this general principle to the sovereign insolvency field. Abusive loans are visible as a representation of a collective action problem that comes with the insolvency of the borrower when lenders grant excessive loans to the already insolvent sovereign trying to get unfair benefits at the expense of aggravating the borrower’s situation and diluting the other creditors. Departing from the analysis of the practical difficulties inherent to the implementation of this idea, the paper then proposes a feasible way to introduce the new principle into real sovereign insolvency procedures. It also holds the so-called first-in-time rule next to the legal principle presented in this paper, in order to articulate the economic rationale of both legal rules in an interactive manner.

B. Distributing the Financial Losses of Sovereign Insolvency Among Creditors

I. Credit Ranking in Sovereign Insolvency: An Insufficient Rule, Difficult to Enforce

In international law there is one general guideline that relates to the distribution of financial losses derived from sovereign insolvencies, and it does not tackle the collective action problem that this article is concerned with. This deficit within the legal framework of sovereign insolvency also produces a notable gap that market forces, sovereign interests, and experts try to fill.

The main rule that governs this field is the principle of parity of treatment of creditors in relation to comparable debts. This is a rule that comes from the very basis of most domestic bankruptcy laws. Because of the practical borrowers’ discretion when applying this principle – basically allowing them to decide how to use their assets to pay their debts – creditors


2 For more on this principle in European law see W. McBryde & A. Flessner, ‘Principles of European Insolvency Law and General Commentary’, in W. McBryde et al. (eds), Principles of European Insolvency Law (2003), 9, 81-82.
try to enforce this rule through specific clauses such as the negative pledge, *pari passu* and sharing clauses, which minimize (but do not suppress) *ex ante* the impact of the state’s power. Reflecting this idea of parity, we can find some informal rules related to credit ranking if we look at the Paris Club’s practice, which works on the ground of equitable burden sharing as follows: each sovereign creditor has to extend debt relief in proportion to its exposure to the debtor country and the debtor is expected to seek comparable relief from the private sector.

The enforcement of this basic legal guideline, which rules the ranking of payments that an insolvent sovereign should follow, is limited mainly by two factual circumstances. First, given that sovereigns cannot be subjected to norms like chapter 7 (“liquidation”) of the US bankruptcy code and that they usually do not have assets abroad, they enjoy wide discretion in paying their creditors, often violating informal or customary rules. Second, even these informal criteria applied by insolvent states are neither clear nor unanimously accepted by all the creditors, as they evolve and are constantly challenged. For example, if the traditionally excluded (from restructurings) creditors form part of a large portion of the debt stock, it should be expected that these preferred categories will be subject to questioning.

---

4 Under the same rationale, on the old clauses establishing the right of the lender to invoke and utilize in case of need the diplomatic intervention of its own government, see C. C. Hyde, ‘The Negotiation of External Loans with Foreign Governments’, 16 *American Journal of International Law* (1922) 4, 523, 539-540.
6 When Ecuador defaulted its debt in 1999, it was logical to assume that the collateralized Brady bonds were going to have priority over uncollateralized bonds. However, Ecuador opened the restructuring negotiations with the Brady bondholders first, apparently because these bonds gave the country a thirty-day grace period for not being in default, see B. Eichengreen & C. Ruehl, ‘The Bail-In Problem: Systematic Goals, Ad Hoc Means’, *National Bureau of Economic Research Working Paper*, No. W7653 (2000), 15-19.
The parity of treatment is altered in practice by the use of preferred treatment, given, for example, to international financial institutions’ (IFIs) credits, secured debts, trade debts, new credits, collateralized loans, and inter-bank deposit debts, among others. Each of them is grounded in political and economic reasons that would suggest the recognition of its seniority. Given the nature of these reasons, this ranking evolves continuously and without paying much attention to legal principles, as we will see below.

II. General System of Priorities, Realpolitik and Disorder

Under a general framework lacking an effective sovereign bankruptcy regime, apart from the weak parity treatment rule we just examined, there are no formal and fixed rules regulating the credit preference ranking in cases of sovereign insolvency. Going back in history, if we observe the debt settlements reached during the thirties, there was no uniformity there either. In most of those cases the agreements were not grounded in legal principles but in practical solutions to meet immediate necessities. The same phenomenon can be observed in the debt settlements reached in the last two decades.

Insolvent sovereigns do a cost-benefit analysis when deciding which debts to exclude from the restructuring. The main reason why, for example, sovereigns try to care about short-term trade is that they are playing with the country’s capacity to participate in the international market. The same reasoning explains why some countries, in particular instances (like Mexico in 1982), decide to exclude capital market instruments from restructuring, because supposedly these markets have very long memories.

We already saw that the main principle governing the priorities system is the equal treatment of creditors. Thus, the discrimination of creditors would not only be incompatible with international financial tradition and justice, but also with the so-called pars conditio creditorum rule distilled

---

11 Buchheit, 1991, supra note 8, 12.
from most domestic bankruptcy laws, and even from bilateral investment treaties.\footnote{For the fair and equitable treatment in foreign investment law see A. F. Lowenfeld, 	extit{International Economic Law}, 2nd ed. (2008), 556-558; P. Muchlinski, 	extit{Multinational Enterprises & The Law}, 2nd ed. (2007), 635-647. This field of law is nowadays particularly important in sovereign debt restructuring since thousands of financial creditors of Argentina sued the state through the ICSID in order to collect their bonds. The cases are 	extit{Giovanni Alemanni and others v. Argentine Republic}, ICSID Case No. ARB/07/08 (claiming 14.3 Euro) and 	extit{Giovanna A. Beccara and others v. Argentine Republic}, ICSID Case No. ARB/07/05 (170.000 bondholders claiming US$ 3.5 billion). Analyzing whether it is legally possible to use the BIT’s frame to invoke financial credits, see M. Waibel, ‘Opening Pandora’s Box: Sovereign Bonds in International Arbitration’, 101 	extit{American Journal of International Law} (2007) 4, 711-759.}

In spite of the deficient manner in which this principle has been treated by the IMF in its institutional proposal for a Sovereign Debt Restructuring Mechanism (SDRM), even this institution appears to recognize the importance of this rule. The SDRM has explicitly prohibited \textit{unjustified discrimination} of creditor groups when the insolvent sovereign presents the classification of debts in order to negotiate and approve a restructuring.\footnote{IMF, The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations (2002), 10, 53, available at http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf (last visited 9 December 2009).}

The restructuring process involves the allocation of payments over a long period rather than the liquidation and distribution of the present assets of the debtor. This is why prioritization (and discrimination) can emerge in form of at least three different kinds of acts: by paying a certain creditor or creditors first; by reducing their principal and interests less than that of others; and by applying an amortization schedule providing for complete liquidation before others.\footnote{Feilchenfeld \textit{et al.}, supra note 9, 1144.}

These kinds of decisions are taken at the early stages of restructuring procedures when the debtor decides, for example, which debts are going to be restructured and which are not.\footnote{W. Bratton, ‘\textit{Pari passu} and a Distressed Sovereign’s Rational Choices’, 53 	extit{Emory Law Journal} (2004) Special Edition, 823, 843-844; Buchheit, 1991, supra note 8, 12.} This dynamic is not a fixed practice, since creditors included in restructuring will try to ensure that even those categories of debts that are formally excluded be subjected to informal roll-over agreements.\footnote{Buchheit, 1991, supra note 8, 12.} In any case, after deciding which credits are restructured,
the debtor, negotiating\textsuperscript{17} with its creditors, determines the terms of the haircut.

Historically, most restructuring procedures have not entailed overly painful haircuts for creditors, while the Brady plan, multilateral bail-outs, and restructuring plans still significantly reduced the extent of the negative effects of the sovereign’s defaults. It is thus understandable that the criteria, according to which losses are shared, did not receive much attention among creditors.

This inertia was challenged by the Argentinean case of 2001-2005, when a haircut that exceeded 75\% of the face value of the bonds had been accepted by more than 76\% of its creditors. Although the Argentinean haircut was the toughest, the most recent defaults (Russia, Ukraine, Pakistan, and Ecuador) led to restructuring agreements that implied haircuts clustered in the range of between 25\% and 60\%.\textsuperscript{18} If the current sovereign insolvency framework allowed a debtor to implement such radical haircuts,\textsuperscript{19} then it is possible that other debtors might consider taking similar steps.

The Argentine case very clearly demonstrates several things: that the impact of the haircut among creditors can be a zero sum game;\textsuperscript{20} that there is not a stable and predictable priority credit ranking; that creditors do not enjoy an institutional framework within which to have an orderly discussion about how to allocate financial losses among themselves, an issue which delays and complicates the restructuring process;\textsuperscript{21} and, that if the borrower

\textsuperscript{17} To read about the aggressive style of the Argentinean government in negotiating the terms of its last default, see A. Porzecanski, 'From Rogue Creditors to Rogue Debtors: Implications of Argentina’s Default', \textit{6 Chicago Journal of International Law} (2005) 1, 311-332.


\textsuperscript{19} The pending judicial and arbitral claims against Argentina are related to holdout creditors, not to the majority of creditors that in fact accepted the restructuring agreement.

\textsuperscript{20} Buchheit, 2002, \textit{supra} note 4, 74.

feels that it has enough space within which to expand its discretionary (and arbitrary) power, it will do so.\textsuperscript{22}

Looking at different financial crises that have occurred over the last fifteen years, we can easily confirm that many sovereign borrowers have used their discretion to discriminate against creditors or groups of creditors when dealing with the problem of inter-creditor equity.\textsuperscript{23} The last sovereign defaults show that, within the same restructuring the extent of the haircut varied greatly among different classes of creditors, without following any legal guide when doing so.\textsuperscript{24}

In the current legal and institutional framework sovereigns enjoy wide discretionary faculties to negotiate, agree with their creditors, or just decide the terms of the restructuring and how it affects each of them in terms of their place in the credit priority ranking. This prerogative is usually associated with not only the legal disorder in preference terms but also the idea of sovereignty itself.

Even respecting the very core of the notion of sovereignty, it is desirable for every party to develop a minimum set of rules to govern the credit ranking in a sovereign insolvency. There are several negative consequences of not having a clear and enforceable priority system.\textsuperscript{25} First, some creditors can gamble on subordinating other creditors. Lenders may attempt to obtain \textit{de facto} priorities by issuing debts that involve a very high credit risk through short maturities and dispersed bondholders, provoking higher costs for the borrower, higher risk of default, and higher transaction costs in case of restructuring. Second, because creditors do not know whether they are going to be involuntarily subordinated, they can charge this risk on the price of the loans. Third, the borrower itself, trying to delay the default, may be tempted to take excessive new debts and dilute earlier

\textsuperscript{22} Since 1987, the coerciveness of the average sovereign borrower has increased, due (primarily) to the change in creditor composition and the international legal environment, see H. Enderlein \textit{et al.}, Debt Disputes. Measuring Government Coerciveness in Sovereign Debt Crises (2008), 22, available at http://www.sfb-governance.de/teilprojekte/projektbereich_d/d4/Debt_Disputes.pdf (last visited 9 December 2009).
\textsuperscript{23} Gelpern, \textit{supra} note 8, 1116.
\textsuperscript{24} Sturzenegger & Zettelmeyer, \textit{supra} note 20, 780-805.
creditors. Fourth, a creditor may try to lend, but only backed by collateral. Fifth, because the priorities and even the collaterals are difficult to enforce, creditors can try to shelter themselves with faster repayment schedules, provoking a roll-over crisis. Sixth, once the financial distress emerges, creditors will compete to catch the cash flows of the debtor, complicating and delaying the restructuring and, thus, the recovery of the borrower. Finally, it has been pointed out that violating the absolute priority in bankruptcy increases the bias of equity holders and managers in favor of riskier investments, because they know they will receive the benefits while creditors will bear the negative outcomes of this business.26

III. A Sound Guide for Distributing Losses Among Creditors: Looking at the Lender’s Behavior and Its Consequences

When we turn to the problem of how we should distribute financial losses of insolvency among a sovereign’s creditors, we must pay closer attention to domestic bankruptcy laws. Although equal treatment of creditors is the main rule, it is limited from two sides: priority credit ranking and the subordination of certain credits. We will focus on one specific category of this last type of credits.

Most domestic legal systems establish that if creditor A engages in some kind of fraudulent lending practice and grants excessive loans, it does not deserve the same treatment as creditor B which hasn’t violated the *pars conditio creditorum*, carefully evaluated its credit risk, and acted according to the economic situation of the debtor. This rule has a clear economic rationality: it provides incentives for creditors to be prudent and diligent in assessing risk, encourages the efficient allocation of financial resources, helps creditors to act in good faith, prevents collective action problems in insolvency contexts, and helps to avoid the aggravation of the debtor’s situation and, thus, also of the creditors as a group. This rationale is sensitized in the so-called responsibility for granting abusive loans.27

Even when this responsibility is broader in domestic legal systems, from an international perspective – and with the aim of identifying a general principle – reckless conduct alone is not enough to create liability and subsequently lead to being subordinated in a sovereign bankruptcy procedure. This general principle requires the establishment of fraudulent intent, which differentiates this rule from the so-called deepening insolvency doctrine.

When a lender tries to obtain extra (unfair) advantages at the expense of other creditors in the context of insolvency, it can do so by attempting to grant loans which assume an excessive risk that can only be understood if we integrate those extra advantages to the cost-benefit analysis conducted by the lender. It is in this way that excessive risk assumed by an abusive lender and unfair advantage can go hand in hand.

Regarding the factual consequences of abusive loans, it is important to mention, firstly, that they can impede the debtor’s asymptomatic insolvency from revealing itself, precisely because the new credits keep the debtor afloat and functioning in the market for a longer time, concealing the real (insolvent) situation of the debtor.28

Secondly, during this “extra time” in the borrower’s commercial life, its debt usually increases considerably due, on the one hand, to the moral hazard problems that appear in the administrators’ and shareholders’ behaviour during the final period of the company and, on the other hand, to the gradually worsening conditions in which the company is dealing with other economic players. The assets of the debtor are also dramatically reduced during this period because of the same moral hazard problems and the claims that other creditors are starting to make against the debtor, that erode his wealth.

Finally, the dissimulation of the debtor’s situation can inhibit creditors from using their contractual and legal self-protection tools in order to collect their credits and defend the borrower’s wealth.

All those patrimonial deteriorations affect the guarantee of the creditors: they will receive less than they could have collected if the debtor had filed a restructuring procedure earlier. Since the debtor’s economic situation that leads a loan to be qualified as abusive is characterized by its irreversible distress (no rational financial aid would avoid the collapse), this kind of loan does not eliminate the insolvency, but rather hides it and

---

28 Di Marzio, supra note 27, 39, 170-171, 186-189, 220.
possibly aggravates it, prolonging the interval between the asymptomatic and symptomatic insolvency.

For all the reasons just mentioned, domestic bankruptcy laws have tried to discourage abusive loans by making these creditors collect less money in insolvency procedures than those who did not act abusively. This role is carried out by the responsibility for granting abusive loans.

C. Applying the Principle of Responsibility for Granting Abusive Loans to the Realm of Sovereign Insolvency

I. Abusive Loans in Sovereign Finances

A lender may realize the economic situation of a borrower who faces an unavoidable default. The outlook is such that resorting to a moratorium or insolvency procedure is the only way to reduce the debt to a sustainable level. At this point, the lender might speculate about the possibility of gaining an unfair advantage or reducing his losses at the expense of other creditors, violating the pars conditio creditorum.

This can occur when a creditor speculates with increasing interest rates, as this will create more liabilities for the common debtor. A creditor can also seek to obtain or improve securities or pledges. In this case, it is clear that these assets are subtracted from the general economic guarantee of the debtor to benefit only this creditor. Granting larger loans or postponing the moratorium can also be an instrument to accelerate terms to collect credit, which implies fewer assets for the other creditors and aggravates the situation.

Another type of advantage or benefit can be identified in the case of multilateral lenders whose credits enjoy a de facto preference status,29 which means that they also benefit objectively from more loans without assuming the same major risks. By increasing the volumes of their loans they

---

strengthen their bureaucratic structures and their political leverage, no matter what the country’s economic repayment capacity.  

It is perfectly legal and understandable that a creditor will try to contain and minimize its financial losses. However, when the insolvency is the only possible fate for the common debtor, this creditor cannot protect itself by harming other creditors through the violation of the equal treatment principle. This is precisely one of the collective action problems that bankruptcy laws try, or should try, to prevent. These legal norms seek to protect and maximize the value of the debtor’s goods, in the interest of all creditors and the debtor itself.

If we translate the damages from the private abusive credit realm to the sovereign insolvency phenomenon, it should be noted that the loans that only postpone the agony of the country will also aggravate its situation, as experienced by Belize in 2005 to 2006. In these contexts, debts will increase dramatically, as usually happens in the last stage before a default, because of the high interest rates these lenders usually require. Also, the sovereign tends to ruinously consume its hard currency reserves during this time, while also increasing rates to avoid suspending debt payments. The effects – capital flights and the weakening of the banking system – are costs that increase during, after, but also before the default.

Moreover, sometimes countries issue excessive amounts of short-term debt while trying to avoid defaulting on their existing debt, provoking liquidity problems and forcing higher costs of adjustment which the debtor will have to implement. All of these problems are aggravated by one of the main reasons: namely that sovereign governments are reluctant to accept

---

30 For details about the economic relationship between the IMF and Argentina during the 1990s and its default, see Lowenfeld, supra note 12, 719-733.
34 J. Bulow, First World Governments and The World Debt, draft version (2002), 16.

From the “insolvency game” perspective, when one lends money to an over-indebted sovereign, some creditors can gamble on diluting and subordinating other creditors.\footnote{Gelpern, supra note 8, 1117, 1140-1141.} In that case, when the country has already reached its repayment capacity, the new loans are not aimed at paying the old ones, but rather for paying the new debt: the old creditors are thus diluted in their claims, having to share the debtor’s lower repayment capacity with new creditors.\footnote{Id., 1140-1141.} This involuntary subordination can also contribute to harming the old creditors since the borrower, desperate for new funds, promises new creditors they will be the first to collect on the loans in times of trouble.

If we look closer, we might say that non-abusive creditors could indeed benefit from abusive loans. If these loans postpone the default and the reduction of the debt during this borrower’s extra life period, the creditors will continue receiving interest payments in a regular way, putting off the application of the fatal restructuring. However, this postponement will also provoke a more painful haircut, precisely because the situation of the country is worse than before this deferring process.

From a practical perspective, it can be difficult to demonstrate in formal procedural terms that a lender had the intention of damaging or obtaining an unfair advantage, but some indirect evidence can help in approaching the facts. Among the indicators that the lender knew (or must have known) about the situation of the borrower – factors which the loan could only aggravate, causing distress and therefore harming others by trying to take an unfair advantage – are the following: the date on which the transaction was made; the execution date of the contract; the interest rate of the loan; the public availability of the information related to the debtor’s situation; the human and material resources that the lender enjoyed in order to evaluate the risk; the economic volume of the loan; the legal nature of the contract; the request and constitution of strong collaterals; and, the acceleration of payments requested to the borrower, among others.

The rule proposed here suggests that those creditors who behaved with \emph{bona fide} (which implies the fulfillment of minimum due diligence standards when negotiating and signing contracts) regarding the debtor and
the other creditors, should receive different (read better) economic and legal treatment during the restructuring process than those creditors who did not follow this standard of conduct and violated the equal treatment principle, as described in the last few paragraphs. 39 These abusive credits should be totally or partially subordinated to the constructive ones.

The peculiarities of each class of creditor and each type of transaction will determine the prerequisites for the definition of responsible lending with regard to each concrete insolvent debtor. Those creditors with the greatest human and material resources to assess the credit risks of the loans, and those which have the largest volume of financing availability, are more likely to be subjected to stricter due diligence duties (and are probably more regulated). The responsibility of lenders has to be proportional to the power and resources that they actually enjoy. 40

We must employ the same task of individualizing the duties of lenders when looking at the nature and goal of each. Banks and other private financial investors must be presumed to be economically rational: they prioritize their profit, which means that they have to conveniently evaluate the risks of their transactions, 41 and cannot allege extra economic motivations for their decisions. Bondholders are less homogenous than banks, and correlative their due diligence obligations differ as well. On the one hand, non-institutional investors have more freedom to take risks; on the other hand, institutional ones are more regulated and controlled because of their characteristics, goals, structures and roles in the economy. 42 The regulation of what they can do (pension funds, insurance companies, sovereign funds, etc.) tends to match with those characteristics.

Regarding bilateral loans 43 other factors enter into consideration because of the possibility of political gain. The main problem here is that

39 “In an insolvency procedure respecting existing legal principles, private bona fide creditors would recover more than under present public creditor domination. Disregarding the Rule of Law, official creditors presently cause substantial negative effects for bona fide creditors”, Raffer, supra note 31, 17.
40 Principle broadly applied in the banking activity, see J. Vézian, La responsabilité du banquier en droit privé français (1983), 138.
42 For an overview of the different types of institutional investors, see IBD, supra note 34, 151-152.
these loans do not usually make these political motivations explicit. If the loan does not say anything about these political considerations it is possible to presume that the lender tried to make money with this loan, which means its acceptance of a minimum due diligence when assessing the credit risk.44

Finally, although the ultimate institutional goal of IFIs is not to make money from their lending activities, indeed they make profit. Their respective charters require them to ensure that the loans granted to member countries will be repaid, which presumes a proper evaluation of the sovereign state’s capacity to repay. In fact, IFIs usually count with sophisticated manuals of risk assessment. Specifically, international development banks must do a serious and reasoned analysis about the viability of their projects.45 In any case, IFIs also have a broader room for discretion since they fulfill, at least theoretically, counter cyclical functions.

II. The Application of the Legal Principle and Some Practical Problems

While different countries have different domestic bankruptcy laws, it is clear that all of them postulate that some decisions must be taken by neutral authorities (judges). Creditors can negotiate the restructuring plan with the debtor, but they cannot decide, for example, about the validity of the credits – and neither can the debtor. Nor can they modify certain rules around credit seniority. It is up to a judge rather than the creditors or the debtor to decide when a credit must be subordinated because its holder granted abusive loans.

The neutral judge principle is well accepted at the domestic legal level, as well as in international arbitration and the municipality insolvency law of the US (chapter 9, US bankruptcy code). Therefore it is not a surprise that many scholars have also pointed out the importance of a neutral


authority for settling disputes in sovereign insolvency issues. However, bargaining power and a failure to coordinate the parties involved in the sovereign insolvency problem have evidently not yet permitted the implementation of this basic principle. Even so, it seems that private financial creditors are starting to realize that impartial arbitration could be beneficial for them. At the same time it is difficult to predict whether or not this tendency will continue and what the position of IFIs and the US will be regarding this trend toward a third-impartial-authority. To make the issue even more complex, due to social movements and NGOs concerned with the debt problem of many developing countries, the idea of a neutral authority settling financial creditor-debtor disputes is slowly gaining acceptance at the international political level.

Regarding collective action clauses, at least in the form in which they have been already implemented, they do not seem to allow the creditors as a group to efficiently and fairly distribute among themselves the burden of a haircut. Why would a creditor vote against its own benefit, accepting that it did not grant a loan in a prudent way? Since there is a capitalist base in the political system to decide what to do with the sovereign debt, and being a pareto optimum (the creditors would discuss how to distribute the reduction of the debt previously agreed with the debtor), it is not easy to imagine how creditors themselves could find and implement a sound criterion for sharing the losses. In other words, in the absence of incentives from a legal or contractual framework, this collective action problem could not be solved spontaneously by its protagonists. This collective action limitation is tested, to some extent, when bondholders are asked to subordinate their credits in order to grant priority to the new lending.

Theoretically, there are other possibilities we can explore before simply accepting that we are in a stalemate where some players are too strong to accept a neutral authority to assure a fair insolvency procedure.

and where the US administration is too convinced that the statutory approach is not consistent with its vision about how international financial markets should work.

One option would be to incorporate some basic guidelines into the bonds’ collective action clauses. They could come into force once the insolvency erupted. They would establish a gradual system enacting that certain creditors – or categories of creditors – should assume more financial losses than others (subordination of the debt) if they lent money under undue circumstances. They would be defined by the announcement of the most well known credit ranking agencies and IFIs, informing that the country credit risk grade was too high.

One of the problems of this proposal would be its partial approach. Even if bond holders voluntarily accepted instruments with such clauses, IFIs, banks, other sovereigns, and both trade and domestic creditors would not be considered by this seniority ranking scheme. Most importantly, why would creditors buy a bond that already says that it is going to be subordinated? The price of this bond would be very low.

Recently it has been said that the recognition of a broad ex ante priority hierarchy would be politically hard to envision, and that for this reason it would be advisable for each sovereign borrower to unilaterally decide its own priority policy. In this scenario, the only requirement would be that the debtor has to disclose the ranking at the time of borrowing. This proposal falls short in that it does neither explain what guarantees would be in effect in case of financial distress, nor if the sovereign would respect the priority policy announced in tranquil times. In this way, it would likely lack enforceability.

Finally, the first-in-time-priority rule has been suggested as a criterion complementing the SDRM. The priority is based on the time that the loan was extended, with the debt of any given year taking priority over loans granted in subsequent years. This rule would tackle the problem of debt dilution through over-borrowing because, in case of a crisis, the sovereign could not turn to new lenders because they would be junior and their indebtedness would thus be limited. To some extent, this rule is already

---

49 See Gelpern, supra note 8, 1143-1150. In 1992, California implemented a system of disclosure like this, see details in id., 1152.

50 Bolton & Skeel, 2004, supra note 25, 799. These authors propose a two-step voting process. In the first one, creditors have to assess the haircut proposal sent by the insolvent borrower. If they accept it, the following step is to discuss the restructuring plan, 796-797.
applied by the Paris Club when agreements work under the *pre-cut-off debt* principle, meaning that the loans granted before an agreed date are incorporated in the restructuring, facilitating a situation in which new lending enjoys priority.

III. The *First-In-Time* Rule, Abusive Loan Liability and Their Economic Rationale

Behind the first-in-time-priority rule there is a presumption that the closer the loan was to the moment of the final default, the less constructive and more speculative it was. Connecting this idea to the abusive loan theory, both must depart from the fact that the situation of the borrower – at the moment the loan is granted – cannot be fixed by adjustments and therefore needs to carry out a debt restructuring to pay off its debts. In this context, any adjustment would either worsen the situation or improve it to an insufficient extent, striving to raise enough hard currency to pay the debts or violating the minimum standard of life that should be assured to any debtor.  

This criterion allows differentiating the *hero* that trusted the country in tough times and helped it to avoid the crash from those that just speculated and tried to dilute other creditors. If the default was clearly unavoidable and the lender tried to unfairly take advantage of the rest, the conditions required by the abusive loans theory could be encountered. On the other hand, if the country could have reasonably implemented adjustments or changes in order to avoid the disaster and new loans could have helped in this direction – beyond what eventually happened to the borrower’s economy – this lender would have behaved constructively. The possibility of recovering presented by the borrower’s situation in this case suppresses the idea of fraud on the lender’s side.

Some criticism against the first-in-time rule has been voiced regarding the proposal of Bolton & Skeel, which departs (and modifies) the

---

51 Vital interests of the contractual debtor according to the terminology used by L. Diez-

52 Gelpen, *supra* note 8, 1145-1146.
model of SDRM. This criticism also applies to the principle proposed in this paper and this is why it is worth analyzing here.

First, implementing this rule could provoke pro-cyclical effects, accelerating toward the day in which the insolvency is recognized. Lenders would perceive the possibility of default and would likely shorten maturities and raise interest rates in order to compensate for their junior status.

If the over-indebted state does not have more remedy than facing a restructuring procedure, its postponement can only provoke the harms that the abusive loan theory describes. Thus, it does not seem particularly wrong to force the sovereign to openly recognize and deal with its problem and implement the bankruptcy remedies necessary for overcoming the difficulties and minimizing the creditors’ damages.

However, a country could be traversing liquidity problems and new loans would genuinely help the debtor to avoid the painful consequences that are brought by any default. The first-in-time rule could then discourage refinancing which could have been useful for solving liquidity troubles. This is precisely why the first-in-time priority rule should distinguish between the insolvency and liquidity problems of the debtor – which is not an easy task.

Here, again, we should pay attention to the technical development that bankruptcy law exhibits in this field. When it regulates the goal of promoting prudent credit risk assessment by punishing, in some way, financial recklessness, it opts for adopting a retrospective-prospective approach.

Whoever judges such a case has to isolate the actual possibilities for recovery that the debtor presented when the loan was granted. This analysis requires a distinction between liquidity problems (which allows one to think that with new loans there are hopes of solving the situation) from solvency ones (which need, because they lack a way out, a haircut and/or debt restructuring). The key is to determine whether, when the loan was granted, real possibilities for recuperation existed. If so, they were probably

53 “In the absence of enforceable priorities, when a debtor country approaches financial distress any new debt it issues is partly at the expense of existing creditors who face a greater risk of default and will have to accept a greater ‘haircut’ (or debt reduction) in the event of default, since the total resources the debtor can muster towards repayment of its stock of debt will have to be divided pro rata among its creditors, old and new”, P. Bolton & D. Skeel, ‘Redesigning the International Lender of Last Resort’, 6 Chicago Journal of International Law (2005-2006) 1, 177, 185.

54 V. C. A. Lyon, Revue de la Banque (1983), 1198.
encouraged by the new set of loans,\textsuperscript{55} which is why whoever analyzes the situation has to perform an economic evaluation that is at the same time retrospective and prospective.\textsuperscript{56} This analyst must ponder whether, at a certain moment in the past, it was easy to forecast that the debtor was not going to be capable of avoiding the default.

Beyond the important nuances and limitations that the first-in-time rule can engender, it is necessary to remember again that it was proposed in the context of an improved version of the SDRM. This means that it required an amendment in the IMF’s statutes, which implies an enormous political energy\textsuperscript{57} towards enforcing this system. Suggestions of using section VIII (2b)\textsuperscript{58} of the IMF’s agreement in order to implement some of the new institutional ideas seem to strain the text and spirit of this section too much, which could provoke political troubles among the member states.

IV. The Legal Principle Already Exists: Now It Must Be Applied

The principle proposed in this paper must be added to the priority ranking system, which does not require any statutory change as it is a lege lata rule. This idea – that the treatment of abusive and non-abusive lenders must be different in terms of bearing the financial consequences of the haircut – already exists and is strongly evident in the similarities among domestic laws of different countries which embody this general legal principle.\textsuperscript{59} This principle applies to a problem which is not directly tackled by any other legal source.

\textsuperscript{56} Likillimba, supra note 27, 134.
Regarding the practical features of this proposal, since the state’s goods are mostly in its territory, it cannot be ignored that sovereign power is at the very core of the sovereign insolvency priority system. The state will try to do what is the best for its interests (even trespassing contractual and legal limits); therefore, trying to force the sovereign to renounce *ex ante* the use of its discretion, especially in tough times, seems an infertile effort that, in any case, would require costly statutory changes. Hence, the control should be *ex post*, which once applied would exemplarily work *ex ante* as well.

When a creditor challenges the restructuring agreement that an insolvent sovereign reached with the majority of its creditors, it can argue different reasons. For example, if it is a rogue creditor, having done a very high risk bet buying the instruments at their lowest price and then claiming to collect the full face value, it could attempt merely to argue that the majority cannot modify the monetary terms of its contract. Depending on the political climate and the global effects that the threat of the frustration of sovereign debt restructuring can reach, a court will decide whether this holds out credit or if the agreement is legally superior. Sometimes the sanctity of contracts is really sacred, sometimes it is not.

This points to a different, specific problem, which is conceptually subsequent to the haircut: when the distribution of the financial losses (reduction of the debt) among creditors is legally unfair. Of course, arbitrary discrimination implies the violation of the *pars conditio creditorum*. However, sometimes it is also unfair to treat all creditors in the same way. For example, it is legally and economically difficult to argue in favor of forcing those creditors that bought ten-year-instruments nine years before the default to bear the same financial losses as those that bought them only a few months before the moratorium with a huge interest rate, at a very low price, and reaching some collateral.

There is a viable manner for applying this *responsibility for granting an abusive loan* rule to the current institutional and legal sovereign

---


insolvency framework. When a creditor challenges the legal effects, which it had on it by a sovereign debt restructuring, the court has to analyze whether the agreement fulfills basic legal rules, such as the principle that nurtures the responsibility for granting abusive loans. This is a concrete way to enforce seniority, bringing into play the possible effects that this implies in terms of efficiency when negotiating haircuts.62

The court does not have the authority to decide how much money the agreement has to assign to each creditor, but deciding in a particular case that the sovereign – even when ratified by a majority of creditors – engaged in arbitrary discrimination of some creditors and/or in violation of the rationale underlying the rule proposed here, the borrower (and the creditors who could have ratified it) would absorb this judicial decision and consequently react. If both sovereigns and creditors want to legally shield restructurings, they should fulfill the principle studied in this paper.

As empirical studies have recently shown,63 the correlation between creditor losses and government coerciveness is rather weak. That is why it is also necessary to pay attention to the cases in which creditors’ majorities voluntarily accompany large haircuts (like the Russian case64), which can also implement a discriminatory distribution of losses. The will of the majority cannot punish non-abusive creditors by making them bear more loss than what the credit ranking system establishes for them – including the criterion emanating from the new rule proposed here. It bears repeating here the logic previously argued in explaining why the rationale of “$1=1 vote” behind the Collective Actions Clauses cannot be the exclusive rule to decide how to distribute the financial losses among creditors: as a group they do not efficiently and fairly distribute among themselves the burden of a haircut.

In fact, creditors that feel they were victims of abusive treatment from the debtor or other creditors – and who are not receiving the financial consideration they deserve in the restructuring – will simply not accept this agreement. This is precisely how some small creditors reacted in Argentina, when they felt that the IMF and the big investment banks should have borne heavier losses according to their behavior toward the common debtor.

63 Enderlein et al., supra note 22.
64 The international promissory notes (Prins/Ians) presented a moderate degree of coerciveness but a haircut of over 50%.
The logical effect would be that sovereigns financially treat creditors respecting the equal treatment principle not in an automatic or egalitarian way, but by focusing on the creditor's behavior itself. And by the same token, creditors would be constrained to respect this rule when agreeing the terms of the restructuring.

When implementing the right credit ranking system in a concrete case, different treatments must be given to different categories of credits which are previously proposed by the sovereign under objective and well-founded criteria that must reflect the rationale of the abusive loan theory according to the parameters sketched out in this paper. In this case, the restructuring must partially or totally subordinate, specifically, the abusive credits and, correlatively, benefit other creditor categories. And beyond the freedom that they have to decide concerning the extent of the haircut by freely negotiating with the debtor, creditors have to take lawful decisions when allocating the financial losses amongst themselves.

Finally, regarding the IFIs' credits: their immutable preference disconnects the quality of these loans from the losses caused by the borrower's insolvency. While the anti-cyclical functions of these institutions deserve to some extent a different (read better) treatment than that which private creditors receive, IFIs should be incorporated into the general scheme of sharing some losses and promoting efficient and prudent loans. This idea could be translated in practice into a partial preference, which would recognize the public interest element of the functions of these institutions and, at the same time, force them to act diligently, demonstrating that even development banks have to assess the viability of their projects and some losses with the private sector.

D. Final Considerations

The theory of abusive credit, in both private and sovereign spheres, is based on a failure of the market. Abusive credit is a manifestation of imperfect and asymmetrical information, generating a negative externality for other market participants. This phenomenon exacerbates the collective action problems that usually come into play when insolvency is approaching. Assigning legal responsibility for the abusive granting of credit, and thus protecting confidence as an ethical and legal principle, is a corrective remedy for this market failure. This is the point where the

---

65 Rigo Sureda, supra note 43, 87-88, 106.
persuasive and reparatory mechanism of responsibility for abusive credit intercedes, promoting a constructive attitude amongst all creditors.

In the context of the unavoidable bankruptcy of a sovereign, some lenders try to unfairly benefit at the expense of other creditors, facilitating the aggravation of the debtor’s situation and diluting other creditors. This explains why they grant loans under circumstances where the financial deontology would usually suggest otherwise. This conduct must have some financial impact at the moment of conceiving, agreeing on, and implementing the credit ranking in the sovereign restructuring. Applying the general principle on abusive loans, this rationale is translated into a subordination mechanism, which gives total or partial priority to the good faith creditors while correlatively subordinating those that are abusive. This principle is complementary to the main pillar of bankruptcy law – the equal treatment of creditors – since it applies except for when a fair and justified differentiation must be made among creditors.

This system not only protects bona fide creditors from abusive creditors, but also from the arbitrariness of the sovereign debtor. The sovereign debtor can be tempted to treat different groups of creditors only according to its own convenience, unfairly discriminating against them and/or rewarding abusive behaviors. This can happen even when some creditors ratify this illegal discrimination by approving restructuring agreements that confirm this treatment to some of them.

Since the proposed principle demands greater rigorousness from market agents in obtaining, processing, and transmitting information, and discourages non-cooperative behavior among creditors, it would presumably impose higher standards of good practice on the participating parties – both public and private – in international finance, and would therefore enhance a more efficient functioning of market economies.

The responsibility for granting abusive loans is not a revolutionary act; it is about applying sound rules of risk management that presume the need to be informed about the client and its situation. Critics of this responsibility principle warn that this theory could dampen, and maybe preclude, efforts to restructure distressed entities, precipitating potentially premature bankruptcy cases. Beyond this warning, however, there is no empirical data that confirms this premonition. Because this responsibility

66 Likillimba, supra note 27, 144.
67 In 2005, when the French National Assembly was discussing the reform of article L. 650 code de commerce – reducing significantly the scope of this type of bank responsibility – representative Arnaud said (without being contradicted) that the new
only applies when all other financial efforts are in vain, and the loans can only deepen the insolvency and facilitate the dissipation of assets, the extent of the responsibility proposed here only discourages abusive loans, not those that can be dramatically helpful in situations of distress.

It is in this manner that constructive risk and diligence are promoted among lenders and the distressed entities are forced to turn to formal relief before there is a dissipation of assets and the ability to reorganize. It is true that a form of flexible borrowing can be a way to face cataclysmic events and economic crisis and to avoid the intrinsic costs that any default implies. In that case, the criteria for assessing whether a loan was abusive must be adjusted to this environment of extreme and overall financial need. Regardless, bad faith of lenders is not justifiable – or to be rewarded – in any context.

...act would protect the banking industry from a ghost, since in 2004 the damnatory sentences for abusive loans had only reach the sum of 14 million Euro.
