Global Financial Integration, Twin Crises, and the Enduring Search for Financial Stability

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List of Abbreviations

BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles
BIS	Bank for International Settlements
BRICS	Brazil, Russia, India, China (later also South Africa)
CACs	collective action clauses
CAR	capital adequacy requirement
CDOs	collateralized debt obligations
CRAs	credit rating agencies
ECB	European Central Bank
EFF	Extended Fund Facility (IMF)
EFSF	European Financial Stability Facility
EIB	European Investment Bank
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
FDI	foreign direct investment
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board (formerly Financial Stability Forum)
GDP	gross domestic product
IFIs	international financial institutions (IMF, World Bank, EIB, etc.)
IFRS	international financial reporting standards
IIF	Institute of International Finance
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (of the IMF)
IOSCO	International Organization of Securities Commissions
IRB	internal ratings based (Basel II)
NBFI	non-bank financial institutions
NPLs	non-performing loans

PIIGS	Portugal, Ireland, Italy, Greece, and Spain
PRGF	Poverty Reduction and Growth Facility (IMF)
PSI	private sector involvement
OECD	Organization for Economic Cooperation and Development
OTC	over-the-counter (derivatives)
ROSC	Reports on the Observance of Standards and Codes
SBA	stand-by arrangement (IMF)
SDDS	special data dissemination standard
SDRM	Sovereign Debt Restructuring Mechanism
SGP	Stability and Growth Pact (EU)
SIV	structured investment vehicle
SMEs	small and medium-sized enterprises
SPV	special purpose vehicle
VaR	value-at-risk (models)

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Preface

This report is contribution to a major EU-funded research programme entitled Politics, Economics and Global Governance: The European Dimensions (PEGGED). The project was coordinated by the Centre for Economic Policy Research (CEPR) and generously supported by the Seventh Framework Programme for Research and Technological Development (Contract No. SSH7-CT-2008-217559). This report contributes to Workpackage 1 (International Macroeconomic Governance) and yet more directly to Workpackage 2 (Globalisation and Financial Stability).

This report develops a policy-relevant analytical account of the current financial crisis in historical context. Drawing on an analysis of the political economy, economics, and policy studies literature and a range of interdisciplinary research findings developed during the project, the report distils out a series of concrete policy recommendations for the attention of the European Commission and other organs responsible for developing the international financial architecture. Given that the crisis is ongoing and new developments have emerged rapidly and often unexpectedly, it was a challenge to keep up with the pace of events. Given also that the reform process has been underway for some time, it was equally a challenge to provide timely policy recommendations. We are nonetheless confident that by adopting a longer-term perspective anchored in scholarly analysis we have succeeded in pointing to important new avenues for reform that for the most part go unrecognised in the current debate.

The chapters that follow thus constitute a synthesis of the research findings developed over the four years of PEGGED funding by the political economy research team based at the University of Amsterdam. The report develops our previously published work and combines it with new material so as to provide a broader analysis of the ongoing financial crisis. Attribution to earlier work and to contributors to earlier publications is made where appropriate. We are grateful to the DG Research at the Commission for their funding and patience in waiting for the final result, and likewise to CEPR for their logistical support on the project as a whole and their patience and encouragement in relation to this report in particular.

Executive Summary

This policy report provides recommendations on the provision of financial stability in the wider context of the global architecture for macroeconomic governance. The fallout of the original market crash has generated growing public and private debt problems, while global and intra-regional payments imbalances remain unresolved. Serious and persistent policy mistakes dressed up as reform have compounded the difficulties while economic growth remains subdued in the major western economies. Too many are now struggling with persistently high and growing unemployment. Meanwhile, the bottom line should be seen not as economic but in terms of political legitimacy. What kind of global economy do we want? What kind of financial system and macroeconomic governance? These broader questions have not been addressed in the reform process and this omission may prove highly significant. Political support for the current pattern of adjustment in both creditor and debtor countries is becoming increasingly fragile. The required degree of cross-border cooperation may prove unachievable in the future, leading to disorderly financial closure at great cost.

The global economy has been here before. The current reform process can learn much from earlier attempts at providing financial stability and facilitating macroeconomic adjustment (e.g. the interwar period; the Bretton Woods regime; crises of the 1990s), and how these regimes deteriorated under different pressures, domestic and international. A range of theoretical and empirical literature points to the potential for instability in the wake of financial liberalisation and integration. This literature not only offers insights into possible policy recommendations, but also leads us to argue that policymakers that consistently pushed for liberalisation cannot have been ignorant of the difficulties that were to be expected in terms of capital flowing ‹uphill› or financial crises. That begs the political economy question as to how the pre-crisis regime emerged, how policy was generated and whose interests were best served by the system that failed.

The examination of these issues is an important step towards assessing the actual functioning of the pre-crisis regime and its successes and failures, and therefore determining to what extent the current reforms may be on the right track. This report takes up policy issues such as the debt workout regime of the IMF and Eurozone, the Basel Capital Accords, and the functioning of financial and macroeconomic standards and conditionality. The assessment is a sombre one in light of the outbreak of the crisis, but the lessons are identified and carried forward to an examination of the various proposals for reform that have been developed in the aftermath of the crisis.

Many of the pre-crisis problems remain to be resolved as we experience a dangerous ‘twin-crisis’ phase of sovereign debt/bank insolvency and bailout once again. There has been little institutional innovation and the commitment to move towards macroprudential oversight lacks concrete policy manifestation and institutional embeddedness at the national, regional or global levels. This means that neither the historical lessons nor those of important contributions to economic theory have been yet well learned. Skewed idea-sets and private sector capture remain an ongoing danger and attention to generating real-economy growth has been limited since the initial co-ordinated stimulus policies. Policy learning under conditions of financial openness appears difficult and, despite the achievable benefits, the underlying legitimacy of global financial integration and the adjustment process has not been improved much.

To summarise:

1. The policy dilemmas and choices confronted by the contemporary system of global and European financial and monetary governance were long-standing and well-known, and there is a host of historical experience and concrete policy proposals to draw upon going forward.

2. The potential and more obvious flaws of the pre-crisis system of financial governance were, to a large extent, a function of the characteristics of the policymaking process dealing with financial regulation and supervision. Our analysis reveals that the core ideas upon which the post-crisis reforms have been built and the policymaking processes dealing with financial governance pay little attention to historical lessons and remain largely stuck in the pre-crisis mode. They are thus unlikely to achieve their goals. Worse, the Eurozone is descending into modes of crisis resolution that are known to be dysfunctional and destructive of successful economic growth and development.
3. Reform that is more likely to provide financial stability for the longer run requires a departure from the idea-set underpinning the contemporary market-based financial order, considerable institutional innovation, and institutionalised attention to the political legitimacy and long-run sustainability of financial openness globally and in the EU. To achieve this, the policy process should be reformed to include a wider range of stakeholders, to reduce financial sector influence, and to deepen the argument pool. The deliberative process and level of accountability for outcomes must also be improved.

The report provides recommendations addressing these three points, addressing first the ‘input side’ of global financial governance (strengthening policy processes), and then the ‘output side’ (improving the institutional framework and effectiveness of governance in a globally integrated financial system). The central point underscored above remains that these input and output side reforms should be taken *together* as an integrated conceptual and policy framework if enduring financial stability is to be attained.

Input side recommendations

Reform requires thinking about whose stakeholder interests are included in the policymaking process, whose interests *should* be primary to the functioning of the financial order, and about the asymmetrical effects of the functioning of the financial system upon them. This also includes reflecting on how a broad underlying consensus might be built, eventually establishing longer-term diffuse support for effective global financial governance. Even sound standards and policies may be unsuccessful if they are perceived as imposed by an unfair and exclusionary process. Thus, representation of, and input from, the diversity of interests with a stake the financial system must be a goal. Historically, the dominant voice in national policy processes, alongside the public agencies legally responsible for regulation and supervision, has been that of private financial institutions. G7 governments, in close consultation with the private financial sector, have dominated at the international level. Unless broader stakeholder and country input can be included, skewed and ineffective policy output with a strong whiff of capture will continue. Improving the range of inputs can lead to a more balanced view of the challenges and tradeoffs inherent to financial liberalisation and integration, and focus the financial system on serving real-economy development instead of the unrelenting growth of ever more obscure financial asset classes. At the regional and international level, the ‘voice’ of smaller countries should be better included without constraining effective decision-making. Across institutional layers, stakeholder interests beyond the financial sector itself should form a wider argument pool that would change the ideational underpinnings of the contemporary pattern of global financial governance. Concrete measures we propose are:

- Develop and formalise the role of the G24 as a developing country caucus feeding into the G20. This might be accompanied by a rebalancing of the G24 towards the poorest developing countries to attenuate the current overlap between G20 and G24 membership. More generally, a system of regional caucuses could be build to ensure regional representation in the different technical forums. This need not lead to a loss of decision-making efficiency if the number of EU seats at the table is reduced (see the next recommendation).
- Develop and strengthen single EU and/or Eurozone representation to various forums, while simultaneously improving internal coordination in the EU. With the

increasing institutionalisation of EU economic and financial governance, including the single currency and prospective banking union, prominent developing countries are arguably in more need of representation in international forums than the current range of European states.

- Increase the voice of the users of financial services in policymaking, from small and medium-sized enterprises (SMEs) and larger real-economy firms to pension funds and their labour-market constituency, to depositors and to savers. These currently have little say in the making of policy yet are *all significantly affected* by the decisions taken. An institutionalised system of 'corporatist' representation of stakeholders could bring the interests of these constituencies to bear on financial supervision and regulation. Technical forums should be required to actively solicit a prescribed range of stakeholder responses leading to real policy inputs. This would also imply that the technical forums should provide stakeholders with the necessary technical assistance to deliver this input.
- Public oversight of autonomous agencies should be enhanced and accountability and transparency in the policymaking process improved. This involves formalising two elements of an 'accountability phase' in the policy process: i) accountability for how the input side of the policy process has functioned and whose preferences constituted inputs into policy; and ii) accountability for actual outcomes achieved. The first involves full transparency on the involvement of lobbyists and social partners, allowing parliamentarians to judge whether an adequate balancing of stakeholder interests has taken place in technical forums. The second involves holding public sector agencies and private financial institutions accountable for outcomes achieved in terms of corporate governance, financial stability, and the balanced real-economy growth and development that the financial sector is meant to serve.
- The institutions of policymaking at national and international levels must properly 'join the dots' among interrelated policy domains that have so far been treated too separately: global imbalances and macroeconomic adjustment; monetary policy in

relation to asset markets; multilateral surveillance mechanisms; debt loads (public and private); financial system monitoring; firm-level risk management. The input side needs to consider data on these relationships and to reflect upon how the financial system should operate, and in whose interest and for what purpose in the broader real economy. This issue is taken up again below on the 'output side'.

Output side recommendations

The most promising development on the output side is the international commitment to 'macroprudential oversight', which rightly addresses the relationship of firm-level risk management and financial system stability to macroeconomic adjustment processes, monetary and exchange rate issues, and public and private debt loads in the economy. However, there is so far little indication as to the underlying substance or institutional form that the new approach requires. Successfully operationalising the concept requires institutional change and new policy approaches across national and international levels, both to 'join the dots' among policy domains currently treated as separate and to fill the remaining gaps in the global financial architecture. Supervisors and market agents still need to develop better tools to assess financial systems as a whole, including the dynamic relationships among risk management in individual banks, the procyclicality of credit, the nature of business cycles, and the links between individual risks, the monetary policy stance, and global imbalances. Concretely, this implies (moving from the technical to more general issues):

- The system of bank capital adequacy standards should be based on several intersecting gauges of risk that lead to a better linkage between firm-level risk management and emerging problems at the systemic level. Moreover, bank capital adequacy requirements should aim to err on the side of caution. Although this might lower bank profits in good times, more importantly it reduces the chance of taxpayer-funded bailouts in bad times, and may reduce the risk of financial-sector driven asset bubbles. On the firm level, several gauges of risk should be used in determining the capital requirement, for example balance sheet (a gearing ratio), the current risk-weighted liabilities, and income. The actual capital requirement should then be based on the highest absolute level of capital coming out of the different gauges. Basel III is a limited move in this direction, but these three 'anchors' should be established more firmly in the banking supervisory framework.

- Supervisory coordination needs to be strengthened and home-host responsibilities need to be clearly defined – also when it comes to the sharing of costs when things go wrong. The principle should be that whatever falls under the bank or holding company of the financial consortium – from structured investment vehicle (SIV) to derivatives affiliate to commercial bank or non-bank financial institution (NBFI), from London to Hong Kong to the Cayman Islands – should be subject to the rules of consolidated supervision and to the new minimum capital adequacy standards. Also, it should be defined how to impose losses in case of bailouts: on bank shareholders, but also on (senior) bondholders through haircuts or forced roll-overs and failed management through claw-back clauses. Basel III again goes only part way so far, while the EU 'Single Supervisory Mechanism' under the recently proposed banking union is a positive but still incompletely defined contribution in this direction.
- The international system of supervision must have the capacity to ensure that all countries apply this consolidated supervision with agreed consistency, and to intervene when shortcomings become evident. It is neither clear how discipline will be enforced, nor how inevitable excuses based on claims of sovereign autonomy will be confronted. If countries do not apply the consolidated supervisory standards, opportunities for regulatory arbitrage will continue and the system will break down. This applies especially to offshore financial centres. In short, global coordination as is now taking place in the Joint Forum and FSB is a necessary condition for a stable global financial system, but should be strengthened considerably and requires better institutional anchors. Again, the EU's 'banking union' proposals may well go some way in this direction, though the proposals are far from final and the political ground remains soft.

- The entire, so far only imagined edifice of 'macroprudential oversight' requires concrete manifestation. There is as yet no mechanism for linking financial supervisory measures to policy action to relieve global imbalances, exchange rate issues, cross-border capital flows, monetary policy issues and asset price inflation, debt loads or the multilateral surveillance and macroeconomic standards process. While a number of emerging market countries in Latin America and elsewhere have dynamic policy recipes that are generally recognised as embodiments of the macroprudential idea (the approach of the Central Reserve Bank of Peru comes to mind), at the global level the notion lacks both real substance and consistency.
- The IMF should be 'regionalised' by complementing it with regional funds similar to the World Bank-regional development bank structure. This should not dilute the IMF's capacity for global oversight, and would thus require a high degree of coordination. The European Stability Mechanism and Asian monetary cooperation are *de facto* developments along these lines, but with insufficient formal coordination mechanisms. The reforms should also be combined with formal recognition of the principles of Keynes' 'Clearing Union' proposal: imbalances are a joint problem to be resolved through *simultaneous and required* adjustment by both surplus and deficit countries. Debtor-state austerity alone is self-defeating – as even the IMF nowadays acknowledges.
- A comprehensive workout process to deal with sovereign debt restructurings should be established so as to limit the exposure of creditor and/or debtor states' taxpayers to problems that too often begin in the private sector. This could be a beefed-up version of the IMF's original proposal for a 'sovereign debt restructuring mechanism' (SDRM) and should include debt standstills, independent arbitrage, comparability of treatment, and private sector involvement (PSI) through haircuts and mandatory roll-overs. The EU should establish with urgency such a mechanism as one of the steps towards creating collective machinery for the tensions inherent in the single currency. This measure is crucial in relation to political legitimacy –

political support from both creditor and debtor nations for the current pattern of adjustment is wearing thin.

- A sustainable policy commitment to financial openness requires other forms of policy support, in particular public health provision and social welfare compensation to mitigate the risks to individuals of market dynamics. The global financial architecture needs formally to recognise the importance of providing the required 'policy space' to respond to domestic social and political imperatives by enhancing the 'room to move' for national governments, e.g. promoting judicious use of controls on short-term capital flows or, in the European context, enhancing the capacities of the EIB to come to the aid of states faced with austerity demands. This also involves rebalancing the obligations of debtors and creditors in a context of capital mobility: both the positive and the more negative results of capital mobility are collectively produced through market interaction, so they must be collectively owned and burdens must be shared by public and private debtors *and* creditors alike.

Why do these measures matter? The answer has to do with the long-run sustainability and legitimacy of financial openness and capital mobility and whether we wish to have continued access to the benefits it offers. Financial liberalisation is better sustained in economies that mitigate the risks of liberalisation through welfare and other forms of compensation for the vulnerable. Nurturing financial openness requires the very policy space that austerity is closing down. Electorates are rebelling against solutions that 'pool' sovereignty just as market integration and crisis makes national policy less effective. Failure to think systematically about the emerging legitimacy deficit is generating centrifugal populist political forces. This context potentially undermines the ability of states to cooperate so as to sustain liberal finance at all. In short, we need a global financial system and Eurozone that demonstrably places citizens above banks!

Introduction

This report provides policy recommendations on the provision of financial stability in the wider context of the global set-up for macroeconomic governance. At the time of writing, a vast and terrifying low-pressure weather system of financial crisis that originated in the banking system has collided and integrated with two other trans-oceanic atmospheric disturbances: debt (public and private), and global and intra-regional payments imbalances. The fallout of the original market crash has generated growing public and private debt problems, while global and intra-regional payments imbalances remain unresolved. Serious and persistent policy mistakes dressed up as reform have compounded the difficulties, and recession is once again spreading across the global economy. Meanwhile, the bottom line should be seen not as a technocratic economic problem but in terms of political legitimacy. Political support for the current pattern of reform and adjustment in both creditor and debtor countries is becoming increasingly fragile. Broad support for the distributional pay-off structure of a liberal financial system is rapidly declining, symbolised if perhaps exaggerated by the 'we are the 99%' slogan of the Occupy movement. The required degree of cross-border cooperation may prove unsustainable in the future, leading to financial closure at great cost.

The first of these colliding weather systems was related to the long run of economic growth and the emergence of a financial bubble, which were in turn accompanied by an unprecedented build-up of private consumer and corporate indebtedness in the US economy, a process mirrored in the UK. Savings rates were typically below zero, and the volume of debt traded in the financial system expanded significantly. Upon the bursting of the bubble, financial rescue packages meant that much of this private (often bad) debt was taken on or guaranteed by the public sector and, therefore, by citizens.

This socialisation of private losses combined with the second weather system, the festering current account deficits of the US, the UK, and some Eurozone countries. These imbalances are for example reflected in the large dollar reserve holdings of a range of otherwise fragile emerging market economies and in intra-Eurozone lending patterns. They are also linked to important exchange rate uncertainties and volatile patterns of global capital flows that were an integral part of the financial crisis itself.

The third weather system resulted from the growing problem of fiscal imbalances, as financial rescues accumulated public liabilities and enduring recession reduced government revenues and increased outlays via automatic stabilisers. While most of the countries in trouble began the crisis with minor deficits or positive fiscal balances and rather modest debt to GDP ratios, the accumulation of uncertainties associated with a persistent failure to deal with the problems of the Eurozone in particular has led to rising bond spreads and a sinister contagion that is self reinforcing.

The amalgamation of these three weather systems constitutes something akin to the perfect financial storm. Given the interlinkages, it is difficult to argue that particular states are uniquely responsible for their worsening lot. Collective responsibility not only implies cooperative solutions, but it is becoming clear that an approach to workout emphasising national adjustment in the stricken countries and nationally focused reforms in financial regulation is dysfunctional. It remains to be seen how long (western) citizens can withstand the austerity, the widening inequalities, and the stream of financial sector scandals before reminding their national authorities of their primary and necessarily domestic responsibilities towards them. Few incumbents have survived re-election since the onset of the crisis. Support for ‘mainstream’ political parties and candidates has become increasingly fragile. To this must be added the sense of unease generated by the delicate rebalancing of the global economy towards major emerging markets, often captured by the 'BRICS'.[1] Western governments and electorates in once dominant economies are hardly amused by the prospect of dwindling influence, much as they might welcome the opportunities represented by the ongoing growth in the emerging economies. Yet that growth is itself interdependent with western prosperity and thus remains fragile; successful development processes are anyway fraught with well-known risks.

The global economy has been here before. The current reform process can learn much from earlier attempts at providing financial stability and facilitating macroeconomic adjustment in the aftermath of a global crisis (e.g. the Bretton Woods regime following the interwar depression), and how this regime deteriorated under pressures domestic and international. A range of theoretical and empirical literature points to the potential for instability in the wake of financial liberalisation and integration. This literature not only offers insights into possible policy recommendations, but also leads us to argue that policymakers that consistently pushed for liberalisation cannot have been ignorant of the difficulties that were to be expected, such as greater financial volatility or capital flowing 'uphill.' Yet our understanding can be further enhanced by moving beyond the disciplinary boundaries of economics and finance to questions of political economy: How did the pre-crisis regime emerge? How was policy generated? Perhaps most revealingly: Whose interests were best served by the system that failed?

The examination of these questions is an important step towards assessing the actual functioning of the pre-crisis regime and its successes and failures, and therefore determining to what extent the current reforms may be on the right track. This report takes up policy issues such as the debt workout regime at the global level, centred on the IMF and more recently also debated at the level of the Eurozone; the Basel Capital Accords; and the functioning of financial and macroeconomic standards and conditionality. The assessment is a sombre one in light of the outbreak of the crisis, but the lessons are identified and carried forward to an examination of the various proposals

1 The BRICS originally referred to Brazil, Russia, India and China. More recently South Africa has been included as well.

for reform that have been developed in the aftermath of the crisis. The aim is not only to point out the extent to which the system has not changed fundamentally and why continuity with the pre-crisis period is an important feature of the reforms so far, but also to propose what can be done about it.

The analysis will reveal that many of the pre-crisis problems remain to be resolved as we enter a dangerous ‘twin-crisis’ phase of sovereign debt/bank insolvency and bail-out once again. There has been little institutional innovation and the move towards macroprudential oversight lacks concrete policies and institutional embeddedness at the national, regional or global levels. This means that neither the historical lessons nor those of economic theory have been yet well learned. Skewed idea-sets and private sector capture remain an ongoing danger. Since the initial coordinated stimulus policies of 2009-10, the focus has shifted to a self-defeating austerity regime with limited attention to generating sustainable, real-economy growth in the present. Policy learning under conditions of financial openness appears difficult, and despite the achievable benefits, the underlying legitimacy of global financial integration and the adjustment process has not been improved. We go on to offer remedies to address this failure in the concluding policy recommendations of this report.

Financial liberalisation, openness and the provision of stability

In this report it will be argued that in addressing the challenges presented by the current global financial crisis, three essential points should be kept in mind.

i. The policy dilemmas and choices confronted by the contemporary system of global and European financial and monetary governance were long-standing, well-known, and there is a host of historical experience and concrete policy proposals to draw upon going forward.

ii. The potential and more obvious flaws of the pre-crisis system of financial governance were to a large extent the consequence of the characteristics of the policymaking process dealing with financial regulation and supervision. Our analysis reveals that the ideas upon which the reforms have been built and the policymaking processes dealing with financial governance pay little attention to historical lessons and remain largely stuck in the pre-crisis mode. They are thus unlikely to achieve their goals. Worse, the Eurozone is descending into modes of crisis resolution that are known to be dysfunctional when it comes to economic growth and development.

iii. Reform that is more likely to provide financial stability for the longer run requires new ideational departures drawing on established historical experience, considerable institutional innovation, and systematic attention to the political legitimacy and long-run sustainability of financial openness globally and in the EU. To achieve this, the policy process should be reformed to include a wider range of stakeholders, to deepen the argument pool, and to improve the deliberative process and level of accountability for outcomes. The report will provide recommendations addressing these three points.

The fall of Bretton Woods in the early 70s ushered in a period of rapid financial liberalisation and cross-border/sectoral market integration (Helleiner 1994). Capital account opening and the removal of exchange controls essentially erased the distinction between 'national' and 'off-shore' financial markets. The current system is characterised by a high degree of market-led adjustment, product innovation, and capital mobility. This has vastly altered the financial and monetary rules of the game and has created a more challenging policy environment for governments and international institutions alike. The current crisis is so far the darkest manifestation of these challenges we face. When problems with US subprime mortgages emerged, these rapidly spread through the global financial system, from Wall Street via Iceland to Europe, leaving few corners of the world untouched. Moreover, the crisis has exposed the close links between the monetary/exchange rate and financial policy domains and between the banking and the public sectors. This linkage underscores why Kaminsky and Reinhart (1999) have labelled the sovereign and banking aspects of the problem 'the twin crises'.

That is not to say that financial liberalisation and market integration produce no benefits: they do indeed, but (often highly) asymmetric ones. However, theory (Minsky 1982, 1984) and historical experience (Bordo et al 2001; Reinhart and Rogoff 2009) told us financial markets also have a strong tendency towards instability and crisis. Financial globalisation was furthermore known to be particularly problematic for developing countries (Cassimon et al 2010; Ocampo and Griffith-Jones 2010). Institutional and economic weaknesses in the design of Economic and Monetary Union (EMU) were likewise well-known and exhaustively discussed in the literature (Underhill 2002, 2011). A long series of emerging market crises could and should have alerted public authorities in the dominant western states to these issues. Instead, a dominant 'blame the victim' discourse focused on country-level policy weakness as opposed to systemic failure. It remains to be seen whether the current crisis in the core of the system has driven home the message that a globally integrated and liberalised financial system will only prove politically and economically sustainable if based on governance that shapes outcomes in line with the public interest rather than responding to market mechanisms.

Avoiding persistent market failure or disorderly corrections of imbalances requires robust systems of governance at the institutional level appropriate to the extent of cross-border market integration. This implies regional and international institution-building. The basic dilemmas of such institutional design and the appropriate policy mix have been well-known since the 1920s (Germain 2010), and certainly since the Bretton Woods conference of 1944. The return of global financial integration after the collapse of Bretton Woods made it clear that financial regulation and monetary governance by national governments alone was increasingly ineffective; a market-based system strengthened by sound domestic regulation, better crisis prevention mechanisms, and better national macroeconomic policies and related international monitoring and coordination was billed as the solution. A pattern of what could be called 'governance-light' emerged, focusing on facilitating the free flow of capital across borders, preserving market-based characteristics, and enlisting the private sector as authorities responsible for the governance of markets.

However, this pattern of market-based governance-light was not solely focused on financial stability and certainly did not take the lessons of history to heart. For the past 30 years, the policymaking process on financial and monetary matters can be characterised as exclusionary and skewed. The theories and argument pools from which financial policies have been drawn became tilted towards particularistic interests as state officials and the private sector came to share interests and approaches to governance in a club-like setting (Tsingou 2012). The range of states represented in the crucial policymaking forums was limited. There was a serious policy rent-seeking and capture problem in the financial policy community: the input side of the policy process was flawed and idea-sets on stability of the market skewed as result (Baker 2010). The result was that policies were not only aimed at financial stability but also on providing material advantages to the large financial institutions that benefited most from financial liberalisation in the first place. Unfortunately, there are trade-offs between these two goals, if not to say that they might be mutually exclusive.

This pattern of ‘governance-light’ was thus fraught with flaws and conflicts of interests. The primary emphasis on global financial and macroecnomic standards and codes, aimed at strengthening the so-called ‘weak links’ in the chain of global finance, simultaneously stimulated a further expansion and integration of the global financial system itself. Emerging market economies were pressed to adjust such that internationally active financial institutions might be less concerned with due diligence and local variation. Naturally, this global level pressure from creditor countries frequently collided with domestic political imperatives at the national level. Despite a degree of demonstrable ‘mock compliance’ (see below), the direction of reform was clear.

More specifically, the system of sovereign debt crisis workout has long pointed the finger at debtors, while ignoring moral hazard on the creditor side. IMF programmes available to debtors seeking to avoid default to public and private creditors involved a combination of emergency loans and structural adjustment measures with substantial distributional costs for the domestic population, often the poor. There is substantial evidence that these programmes have too often failed to stimulate economic recovery and growth in particular (Vreeland 2003). The argument that IMF structural adjustment programmes lead to a ‘catalytic’ restoration of private investor confidence likewise does not hold (de Jong and van de Veer 2010). The limited governance mechanisms available to deal with debt restructurings of privately held sovereign debts – in the form of collective action clauses (CACs) in international bond debt and the Principles for Stable Capital Flows developed by the Institute of International Finance (IIF), a private interest association – put the creditors in a strong position to extract concessions at the cost of economic recovery.

The system of international banking supervision was equally flawed. From the promulgation of the Market Risk Amendment to Basel I passed in 1996 (BCBS 1996) through to the finalization of Basel II in 2004, a system of self-supervision for large banks that was based on internal risk assessment and controls was implemented. It was a micro approach to risk management based on market price signals, risk ratings and weightings, and a range of financial ‘governance’ standards. This market-based approach to the financial sector was amply criticised as procyclical and dangerous even before it was implemented (Persaud 2000; Ocampo and Griffith Jones 2010), and it neglected the macroprudential dimensions of systemic risk (Claessens and Underhill 2010). The system furthermore provided direct competitive advantages to the same large-bank constituency that had proposed the idea in the first place, and involved a substantial rise in the cost of capital for poor countries and their peoples who had no access to the decision-making forum (Claessens, Underhill and Zhang 2008).

So this was the state of affairs going into the financial crisis in 2007. It has been painfully exposed that ‘governance-light’ was singularly unsuccessful at providing either financial stability or satisfactory market outcomes in terms of efficiency. Bank capital levels fell significantly short and public rescues and sometimes nationalisations were necessary. Following serial bank rescues that transferred liabilities from the private to the public sector (all the while largely preserving the handsome severance pay and bonus packages of the failed executives and risk managers though saddling vulnerable taxpayers with the liabilities), lingering or double dip recession has affected too many economies these past five years. The lack of growth, company failures, and high unemployment levels have put upward pressure on social expenditures and downward pressure on most government revenues. Thus the attention of global financial markets has steadily turned toward government finances and bond market contagion set in.

Despite the evidence cited above that the structural adjustment approach to debt workout has at best a doubtful record in terms of success, the policy solutions to the twin crises have been taken directly off the pre-crisis shelf. Policy space was severely restricted as international institutions demanded austerity and fiscal consolidation. 'The markets' indicated their scepticism of the proposed workouts, all the while increasing the external adjustment pressures on national economies, by generating prohibitively high sovereign spreads. Private capital flows fell short of the level required for financing a successful recovery, especially in the Eurozone's periphery. The regional governance mechanisms to deal with this sovereign debt crisis centred on the Eurozone fell short, increasing uncertainty and prolonging and deepening the problems. At the same time, much regulatory reform of the financial sector has been either delayed or resisted by pointing to its potential interaction with the persistent 'twin crises' – the costs of reform born by financial institutions would lead to bank failures or a severe reduction in SME lending. The real economy has been held hostage to maintain the market-friendly pattern of 'governance-light.'

Reform so far: Of uncertain value

Even allowing for path-dependency and the role of vested interests, one would expect such a major episode of crisis to generate substantive change through the reform of the system, and indeed reform there has been. However, it is not yet clear whether the reforms have adequately understood and put to practical use either the knowledge developed and available during the pre-crisis financial architecture debates *or* the lessons of the crisis itself. While the rhetoric of change is considerable, the underlying approach to governance pursued in the reform process has changed little so far. A more fundamental rethink does not seem to be happening. The Eurozone crisis is being managed under the principle of outdated IMF structural adjustment on steroids. Policy space for domestic governments with difficult policy dilemmas and electorates in the streets is being dramatically diminished, instead of being enhanced through the pooling of reserves and risks and the promotion of growth. Despite proposed improvements in the level and quality of capital required of large banks, the underlying market-based approach to financial governance and supervision has changed little so far (Underhill and Blom 2012). The negative interaction between sovereign and bank debt, as noted already, also delays the actual implementation of more stringent financial regulation.

So the 30 years of global financial integration have lurched from crisis to skewed reform to crisis once again. What is to be done to break this cycle? Broadly speaking, we need simultaneously to improve the policy process *and* inject better ideas into it. The reform process has so far manifested a consistent bias towards precisely those measures that were conducive to the crisis, and this bias is a result of process design. New ideas are unlikely as long as there is no substantial shift in who is most able to influence authoritative decision-making. New voices and *interests* are required on the 'input' side of the policymaking process so as to inject better and more 'outside the box' policy ideas. The private financial sector has for too long been the primary and virtually exclusive interlocutor of the official sector, particularly the major financial conglomerates. A broader range of stakeholders (e.g. representing those whose pensions and futures are at such considerable risk) must become systematically involved in decision-making if policy output is to change. Such an institutional reordering of the policy process would also enhance insulation from the threat of policy capture. Public authorities must far more robustly defend the interests of those who ultimately underwrite financial bailouts, the citizen-taxpayer. Furthermore, the pattern of burden-sharing between debtors and creditors (public *and* private) in the adjustment process requires substantial rebalancing. This is most evident in the Eurozone: creditor states and their private banks enjoyed the lion's share of the benefits of both capital mobility and monetary union, while these same agents willingly purchased debt – both public and private – on the other side of the ledger, in the Eurozone's periphery.

There are still many reforms in the pipeline, but if they are to be enduring and successful new idea-sets must be developed and this is most likely if new interests come to bear on the policy process. The most innovative turn in the reform proposals is towards a macroprudential approach aimed at better management of the systemic dimensions of risk (Baker 2012). Successfully operationalising macroprudential oversight requires institutional innovations across national and international levels to 'join the dots' among policy domains that were until now treated all too separately: global imbalances and macroeconomic adjustment, monetary policy in relation to asset markets, multilateral surveillance mechanisms, public and private debt loads (including a much-needed debt workout regime in either the Eurozone or the global financial system), financial system monitoring, and firm-level risk management. This requires a more integrated institutional setting for policymaking and implementation than has so far been proposed, which confirms that reforming the policymaking process and reforming its outcomes are two sides of the same coin.

Why does this matter so much? The answer has to do with the long-run sustainability and legitimacy of financial openness and capital mobility and whether we wish to have continued access to the benefits it offers. The issue requires institutionalised attention in a reformed policy process. Research has shown that financial liberalisation is better sustained in economies that mitigate the risks of liberalisation through welfare and other forms of compensation for the vulnerable (Burgoon et al 2012). Meanwhile, electorates are rebelling against solutions that 'pool' sovereignty just as market integration makes national policy less effective. The risk is that failure to think systematically about the emerging legitimacy deficit could lead to a rapid political radicalisation. Centrifugal populist political forces have already been generated by the process, sometimes deliberately by politicians but more often by the nature of the solutions developed. This context will continue to aggravate the difficulties of reaching workable solutions to governing EMU or global finance and may call into question the institutional and ideational plumbing of the system: the benefits of openness, the autonomy of regulatory of agencies and central banks, and eventually the ability of states to cooperate to reform financial governance.

As mentioned above, the world economy has been here before, underscoring the danger of the tendency towards centrifugal political forces among economies in the global system. Ignoring the societal and democratic underpinnings of a globally integrated financial system puts the system itself in peril. Nobody would like a rerun of the 1930s, and therefore it is crucial that financial policymakers realise that both the policy ideas underpinning financial liberalisation and the democratic legitimacy of the process should be addressed simultaneously. Better financial governance can only be effective if it is perceived as legitimate. Effectiveness and legitimacy should not be seen as two separate issues, but rather as two sides of the same coin when it comes to the stability of the global financial system. The arguments laid out above will be elaborated and supported by research findings in the remainder of this policy report. The logic of the analysis will lead to a number of concrete policy recommendations in the final chapter.

In the first chapter we will discuss the emergence of financial globalisation and the idea-sets that came to underpin its governance. The chapter demonstrates that global financial integration was the result of conscious public policy decisions taken in close consultation with the private sector actors most likely to benefit from the trend. The chapter goes on to look at the systems of governance that began to emerge to deal with the resulting pressures and challenges. The most prominent of these was the G7 Ministers of Finance and Central Bank Governors, which served as the coordinating forum amongst the major powers. The G7 initiated and coordinated an agenda of enhancing 'market transparency' through a range of technical forums that include, among others, the IMF and the 'Basel process' based at the Bank for International Settlements (BIS). The resulting macroeconomic and financial standards and codes were supposed to improve the functioning of the financial system by strengthening the market disciplining of the supposed weak links – the emerging markets – in the system. The chapter demonstrates how there is a close and reciprocal relationship between the emergence of a cross-border financial system and the policy processes dealing with their management.

The second chapter analyses the inherent challenges of financial liberalisation and integration: the increase in financial and monetary volatility; the interaction between the acceleration of capital mobility, the floating exchange rate system and the (non-) management of imbalances; and in particular the persistent under- and overshooting of market equilibrium and 'fundamentals' through those abrupt corrections known as financial crises. The chapter discusses the literature on financial liberalisation and integration, critically exposing those tensions and risks that were known in advance and which it was also known required deliberate policies and institutions of governance targeted at their mitigation. Much of the literature discussed focuses on developing countries and emerging markets – they proved the most consistently vulnerable to financial instability. However, the current crisis has demonstrated that the problem is the inadequate governance of liberalised and integrated markets themselves, and is not in an inherent feature of emerging markets themselves. While each crisis manifested its own unique dynamics, they had in common a vicious circle of misunderstood risks of systemic dimensions: overenthusiastic cross-border private lending to private and public sectors alike in current account deficit zones; the bursting of the bubble and reversal of capital flows induced costly emergency public sector support for a financial sector moving rapidly from illiquidity to insolvency; deteriorating sovereign finances leading to an international rescue involving skewed burden-sharing between debtors and creditors. Spillover and contagion ensured that the crises rapidly spread regionally or globally. Thus the simultaneous governance of bank capital adequacy and of sovereign debt workout has proven persistently central to the search for financial stability in a globally integrated system.

The third chapter devotes critical attention to the 'input side' or policy processes that produced the system of governance that failed so spectacularly during the crisis. Why were 'sophisticated' banks allowed to determine their own capital requirements, based on flawed risk assessments and risk management models? Why was no adequate sovereign debt crisis resolution mechanism ever developed? The chapter will address the governance failures in each of the 'twin crises'. Hence, the first case discussed in this chapter concerns the policy process on banking supervision and the Basel Capital Accords. The second case concerns the 'international financial architecture', focusing on sovereign debt workout. The analysis will look at the actors involved in the policy process, the policymaking institutions in which authoritative governance decisions are taken, and the ideas underpinning the substantive positions. As will be argued, the exclusionary 'club-like' nature of these processes is an important ingredient of the ineffectual pattern of governance that emerged.

The fourth chapter will shift the analysis to the post-crisis period. How has the underlying 'idea-set' been affected by the drama of the crisis? Has the range of actors with authoritative influence on decision-making widened? What changes have taken place in the institutional framework? How likely are the current reforms to ensure the financial stability at which they aim? What still needs to be done? The chapter will argue that although a lot of important measures are being introduced and more fundamental policy reforms are being discussed, across the input, idea-set and institutional dimensions there is still too much continuity with pre-crisis financial governance. Most ominously, persistent inattention to the political legitimacy dimension and to the requisite democratic underpinnings of financial governance may be rapidly undermining the capacity of public authorities to cooperate sufficiently in the ongoing rescue and reform process. The same ordinary citizens whose financial guarantee was the last resort for the banks are being asked to accept an increasing burden of adjustment for little apparent evidence of recovery, while contagion continues to implicate yet more victims. The dynamics of financial sector rescue and debt workout may yet prove incompatible with the increasingly centrifugal imperatives of national democratic politics.

The fifth and final chapter will respond to this challenge by summarising the analysis and offering concrete policy recommendations. These policy recommendations address first the 'input side' of global financial governance (strengthening policy processes) and then the 'output side' (improving the institutional framework and effectiveness of governance in a globally integrated financial system). The central point – also underscored above – remains that input and output side reforms should be taken together in an integrated policy framework if enduring financial stability is to be attained.

1. Financial liberalisation and integration: From whence it came

This chapter deals with the origins of the liberal and globally integrated financial system which currently suffers from serial implosions, from Wall Street to Iceland to the Eurozone. In order to draw the right policy conclusions from the current crisis, we should understand how attempts at providing financial stability and facilitating macroeconomic adjustment worked in the post-1945 regime, how this was a response to the experience of the Great Depression, and why this Bretton Woods regime deteriorated under a range of pressures. This chapter will thus discuss the re-emergence of financial globalisation and the idea-set underpinning its governance.

The chapter first analyses the lessons of the Great Depression that so informed the Bretton Woods regime, as well as earlier legislation such as the Glass-Steagall Act. It subsequently discusses how Bretton Woods only partially functioned as originally conceived, and over time came under the increasing strain of the emergence of the Eurodollar markets as well as the macroeconomic imbalances between the US and its main trading partners. The third section describes the period of the 1970s and 1980s, when the collapse of Bretton Woods unleashed global finance and led to rapid liberalisation and cross-border integration driven by a series of crucial policy (non-) decisions. The fourth section examines the response of policymakers to the new risks of financial globalisation through new forms of governance, most prominently the establishment of the G7 Ministers of Finance and Central Bank Presidents (accompanied by the establishment of the Basel Committee on Banking Supervision and a re-invention of the IMF's role in the sovereign aspects of 'twin crises') and the development of global standards and codes dealing with macroeconomic and financial market policy.

The chapter takes care to demonstrate the close and reciprocal relationship between financial market developments and the policy processes through which global financial governance develops. This sets the stage for a more detailed discussion of the challenges posed by the globally integrated markets (Chapter Two) relative to the policy responses they generated in specific policy domains (Chapter Three).

Taming global finance: The response to Great Depression[2]

The impact of war and depression, not to mention the danger that the aftermath of the crash of 1929 had posed to stable democratic government, led to a number of conclusions that were implemented in one way or another in the 1944 Bretton Woods Accord.[3] A first lesson was that unregulated financial markets were inherently unstable, and required robust institutions built on public authority to shape both the financial system and macroeconomic policy (see also Germain 2010). The impact of a major financial crash on the broader political economy was such that a repeat of the experience had above all to be avoided. Confronting the potential cost of financial repression and tight regulation was seen as a beneficial trade-off. An example was the 1933 enactment of the US Glass-Steagall Act in the US that most famously separated commercial and investment banking activities and established a federal deposit insurance scheme. It was also an important step towards strengthened sectoral oversight of financial markets, an innovation at the time (Germain 2010: 31).

A second lesson was that laissez-faire as a general economic policy, either nationally or globally, was no longer an option. It tore societies apart and undermined the conditions for stable democratic development. The Depression had worsened domestic and international political tensions and led directly to war. Above all, full employment had to be achieved, and workers, the poor, and the dispossessed reintegrated into society

2 This and the next section build on Underhill (2013).
3 A classic account of the Bretton Woods Accord is by Gardner (1981).

and its political institutions. This meant that the financial system had to be placed at the service of the real economy and of national economic development goals.

A third lesson was that financial system stability and the international monetary system were irretrievably interconnected. The banking system and balance of payments are intricately connected, leading to ‘twin crises’. Financial crisis in a context of international macroeconomic imbalances and unstable sovereign lending patterns (the cycle of German reparation requirements, allied war debt repayment, and US international lending in the recovery period of the 1920s) could rapidly translate into exchange rate and macroeconomic instability. This endangered international trade and growth, generating centrifugal global dynamics rooted in ‘beggar-thy-neighbour’ domestic policy reactions that precluded effective international cooperation and rendered the problems all the worse.

The response to these lessons was to build a system that would ease the inevitable tension between international market pressures for adjustment and national socio-economic development aspirations – and therefore to provide the required policy space for the macroeconomic policies that were essential to fulfilling these aspirations. This was done in three ways:

i. The establishment of a fixed-but-adjustable exchange rate regime of fully convertible currencies tied to a gold-dollar peg, to be supervised and eventual imbalances monitored by a new multilateral institution, what became the IMF. This established mutual and symmetrical obligations and disciplines in terms of adjustment as well as exchange rate stability to promote trade.

ii. Through the availability of short-term balance-of-payments adjustment finance from the IMF and of long-term development finance from what became the World Bank group.

iii. Through national-level financial repression and regulation combined with selective capital account and exchange controls constraining especially short-term cross-border capital flow volatility – trade was to be open but finance relatively closed beyond currency convertibility. In other words, national policy space was enlarged and multilateral institutions of governance were developed to facilitate the patterns of cooperation required to maintain systemic stability and ensure smooth adjustment to imbalances. The plan was furthermore a clear assertion of public authority over the form and effects of private capital markets/flows so as to render the adjustment pressures of an open economy politically sustainable and more compatible with national (especially full employment) policies. The expansion of international trade was seen as integral to resolving the problem of employment. Finally, the plan aimed to establish a symmetrical system wherein global liquidity provision and exchange rate adjustment would have essentially national roots but where the national impulses of large and small economies alike were checked by mutual obligations and the multilateral agency that was the IMF.

The strains within: The re-emergence of financial globalisation

The new Bretton Woods system of governance was implemented only partially, and even this was with difficulty. The demands of European and Japanese post-war reconstruction precluded an early return to currency convertibility, even for the UK, so the convertibility obligation and the exchange rate regime remained in abeyance. In the period immediately following the conclusion of the Bretton Woods Accord, the US apparently possessed a structural payments surplus and competitive lead in international trade, corresponding to a dismal situation for the war-weary rest. The IMF struggled to find a role until conditions improved. Both the World Bank and the IMF were anyway chronically under-resourced relative to the size of the world economy, and thus proved an inadequate source of global liquidity for the reconstruction process. This underfunding was the result of US domestic politics; the strong American current account position and industrial competitiveness meant that the US was likely to be the only initial contributor to the system. It was anyway difficult enough to persuade an instinctually isolationist and fiscally conservative Republican congressional majority to participate in and fund a new set of multilateral organisations that might impose constraints on US policy autonomy. *The system that emerged when convertibility and the exchange rate peg was finally introduced in 1959 was quite different from what had been planned at Bretton Woods*; it had become an *asymmetrical* reserve currency system wherein the liquidity required for international trade and growth was supplied unilaterally by US monetary authorities, instead of individual national currencies via the IMF as had been planned. The gold-dollar relationship thereby became the fulcrum of confidence in the system, and national currencies and the international trading system organised themselves in relation to the dollar.

Moreover, already in the late 1950s global financial markets began to re-emerge in the form of the off-shore Eurocurrency markets. Contrary to expectations, the US began to develop a trade and eventually chronic current account deficit financed by the international use of the dollar as a reserve asset. Private US firms also went multinational, their investments and bankers adding to the growing pool of offshore dollars. US financial repression led American banks to seek more liberal conditions than post-depression regulation permitted, but the route to domestic de/re-regulation was seriously blocked in Congress. The UK authorities and City of London were happy to provide an off-shore home for the emergence of dollar-based international financial markets, and US authorities looked the other way as bankers escaped national regulatory reach. These developments, especially the credit multiplier machine of the rapidly growing off-shore Eurocurrency markets, all combined to disturb confidence in the gold-dollar peg and system of parities.

Although Bretton Woods had been conceived of to put an end to volatility, short-term capital flows born of the Euromarkets began to overwhelm the capacity and/or willingness of governments to maintain the system of parities. Strange (1976: ch. 6) claims credibly that these markets, more than any other factor, destabilised the system of fixed exchange rates. But there were always two sides to the story – the US government showed little willingness to properly control capital outflows, to contain its overseas military expenditure or domestic inflation, or to adjust to imbalances.

The US was making use of its reserve currency status to avoid adjustment and duck its obligations to the others in the system (summarised in the famous statement from the Nixon administration's Treasury Secretary John Connelly to a group of European ministers of finance - "the dollar is our currency but your problem"). Firms and markets in almost all countries had anyway become dependent on dollar invoicing for international trade. The US unilaterally pulled the plug in 1971, freeing itself from the constraints of maintaining the gold-dollar peg, and the world moved to a 'non-system' of floating exchange rates.

At the end of the period, institutional developments may be summarised as follows. The exchange rate regime had collapsed due to the re-emergence of short-term capital mobility and the deliberate pursuit of monetary lassitude by the US, and (frequently managed) floating had taken its place. National preferences were clearly predominant in the new era, and part of the highly optimistic argument in favour of floating was that market forces would smoothly adjust imbalances and currencies automatically. One thing is for sure: the exchange rate uncertainty generated by floating forced firms involved in cross-border trade and investment into the arms of bankers who devised hedging strategies and helped firms adjust to the new volatility. Second, states likewise confronted volatile swings in exchange rates. The non-system had led not to automatic adjustment but serious overshooting and, especially for the weaker economies, to new balance-of-payments financing demands. The private market became the preferred source of this funding, relatively free of IMF discipline. This was an effective 'privatisation' of balance-of-payments lending and it was not long before the bulk of balance-of-payments financing came from private, not official sources. The theory was that the capital markets would discipline state and private behaviour alike, but for the more credit-worthy sovereigns access to global markets in the absence of conditionality actually released them from the shackles of official policy while expanding their sources of finance (Cohen 1982), providing *less*, not more, discipline.

A final reason for the growth of international finance was that official policy began to release the financial sector from the shackles of regulation. New York became the first of many financial centres to implement measures stimulating cross-border liberalisation and, over time, the desegmentation of the securities, banking, and insurance markets. Competition between global financial centres led to the unleashing of global finance through the Thatcher 'Big Bang' in 1986 (Plender 1987) and the French 'little big bang' (Cerny 1989), abolishing many restrictions on desegmentation and internationalisation of financial markets. These responses by states and firms to the fall of Bretton Woods led to a rapid expansion of financial markets.

Global finance unleashed: The 1970s and 1980s

The combination of cross-border financial market integration and the liberalisation of formerly repressed national financial systems which accelerated after the collapse of the Bretton Woods regime in 1971 has been one of the fundamental transformations of our time (Helleiner 1994). It is particularly important not to underestimate the role played by state policies in generating the changes that took place, and the direct interest of states in promoting the new departure. As noted above, the collapse of Bretton Woods was to a large extent the result of domestic imperatives of the US. The wave of liberalisation was enthusiastically endorsed and facilitated by states with a desire to promote their domestic financial system as well as to enjoy the benefits of capital market access the better to finance official debt free of the constaints of pegged exchange rates . The rapid spread of information technology coupled with policies to break down the barriers among market segments and national financial systems has greatly altered market structures. The widespread securitisation of transactions and the resulting desegmentation of financial institutions have created complex and dynamic linkages between banking and public and private securities markets, including the rapidly growing derivatives segment. Capital account opening and the removal of exchange controls following the collapse of Bretton Woods essentially erased the distinction between 'national' and 'off-shore' financial markets. The new system was characterised by a high degree of market-led adjustment, product innovation, and capital mobility. These developments have vastly altered the financial and monetary rules of the game and have created a more challenging policy environment for governments and international institutions alike. The difficulties for developing and emerging market economies have been particularly marked.

If the interest of highly competitive large financial institutions in expanding their access to international markets seems intuitively obvious, what was in it for states? States emerged from the 1970s and 1980s economic downturns after the fall of Bretton Woods with large fiscal deficits. These had to be financed, and once Paul Volcker at the Federal Reserve ruled out inflation as a solution to debts, an adventure with financial internationalisation seemed a good bet. OPEC oil surpluses provided international markets with a massive increase in capital just as recession had dampened private appetites for investment and increased public need. The public sector could conveniently absorb this supply (Cohen 1982: 471) as state treasuries and central banks (the latter increasingly independent from the 1990s) discovered the delights of access to international capital markets. The major international banks were hardly averse to such a strategy. Governments and private sector actors gained enhanced access to international capital while large financial institutions facing market saturation at home gained access to new public and private markets. Cross-border coalitions formed to press their own and foreign governments to engage in cross-border financial liberalisation (Underhill 1993) and this proved an enduring alliance for the promotion of cross-sectoral and cross-border financial market integration.

This financial market integration coincided with an explosion in volume. As Table 1 shows, the net size of the Eurocurrency market increased tenfold from 1970 to 1980. Moreover, when we look at the OECD banking market, between 1970 and 1981 foreign assets rose from 12.1% to 23.7% and foreign liabilities from 11.3% to 23.4% of respectively total assets and total liabilities (Pecchioli 1983: Table I.3, p 19).

Table 1 Growth of the Euromarkets, 1966–1980 (billion US$)

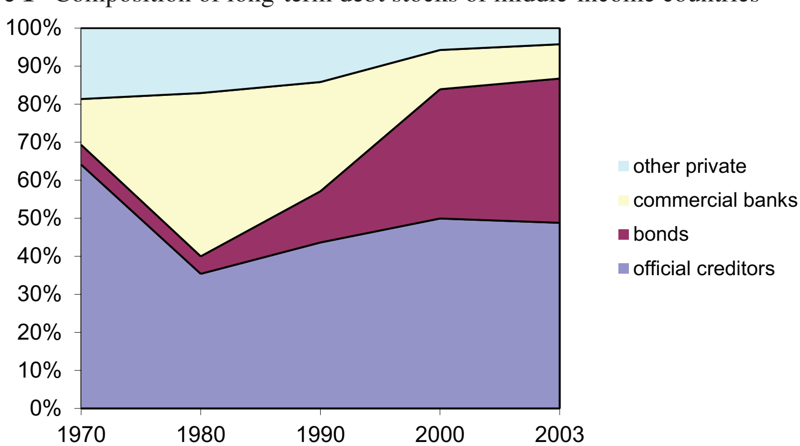
	Gross 'international' liabilities*	Eurocurrency market (net size)
1965	55	11
1970	200	57
1975	650	205
1980	2270	575

Note: * these suffer from double counting of interbank transactions, estimated to account for about two thirds to three quarters of the total (p. 29)

Source: Pecchioli 1983: table I, p. 17.

As indicated above, this increase in market size was driven at least in part by the increasing provision of sovereign finance by private creditors and a structural shift from bond financing (common pre-1970s) to bank-based finance (Llewellyn 1985: 208). This phenomenon was not limited to the more credit-worthy G10 economies. Confronted with a simultaneous deterioration of current account and fiscal balances as a result of the oil crisis of the 1970s, many middle-income countries also postponed domestic adjustment by borrowing on the international financial markets. 'Market discipline' of national economies in need of adjustment did not occur due to the supply-side push for new lending opportunities that was result of petrodollars recycling by financial institutions. As Figure 1 shows, the proportion of commercial bank borrowing in emerging market debt stocks grew rapidly.

Figure 1 Composition of long-term debt stocks of middle-income countries



Source: Blom 2011: figure 3.1, p. 86.

However, these significant structural shifts in financial markets presuppose governance – a legal and macroeconomic order in which market and inflationary expectations and adjustment mechanisms among national currencies obey relatively consistent and predictable rules and norms. Most market agents seek calculable risk as opposed to uncertainty, a climate which is partially delivered by a regulatory and policy environment which allows them to form expectations for the medium and longer term. The assumption behind the emerging market-based system was that market processes would prove self-regulating and, in combination with flexible exchange rates, would generate more stability than the policy mistakes of the 1970s.

This ‘governance-light’ came to mean the pursuit of stable and market-friendly macroeconomic policies by governments, providing a positive investment climate as well as market and regulatory transparency at the national level, and leaving private financial institutions and markets largely to themselves. Market discipline would apply to state behaviour and fiscal and monetary policies, too. For this last mechanism to work, once-separate national financial systems had to converge sufficiently in terms of regulatory policy and business practice (and therefore market expectations) so as to constitute a more or less contiguous market in the eyes of investors.

The roots of the financial standards and codes agenda as it emerged after the 1997-98 East Asian crisis can be traced to this logic. Yet the degree of convergence in national policies and financial systems required for such a system to function never fully materialised, and is arguably unlikely to do so in the near future. The global ‘system’ that greeted the early to mid-1990s was in fact a series of complex linkages facilitating high degrees of capital mobility among dissimilar national financial systems characterised by contrasting legal traditions and national policy styles (see, for example, Richardson 1982 and Allen and Gale 2000). There were considerable differences in levels of national financial development, openness or repression, regulatory and legal traditions, and national monetary and exchange rate policy imperatives.

The combination of these differences yielded high levels of 'dissonance' as capital moved rapidly across borders, responding to a bewildering array of signals under conditions of imperfect information. A host of collective action problems emerged as governments facing adjustment pressures followed policies that made sense for them but not for the system as a whole. National institutional capacities to deal with these problems diverged widely, often worsening the situation in times of crisis. National financial reforms revealed themselves to be less than rational processes replete with unintended consequences. In fact, they were often highly political affairs in which special interests could write the rules for themselves in narrow and effectively closed policy communities (Moran 1991; Underhill 1995; Coleman 1996; Zhang 2003).

The dissonance between cross-border capital flows and national financial-economic developments already highlights the importance of the governance of this system of liberal markets that was rapidly integrating across borders and market segments, to which we turn in the following section. Policymakers had to manage the new challenges and pressures coming from the market developments on a very aggregate level, as markets became ever more integrated and their geographical reach grew as well. Global-level coordination was necessary through an 'apex policy forum' (see below and Baker 2010)

The emergence of global policymaking processes: The Group of Seven

Historically speaking, and certainly in the aftermath of Bretton Woods, financial policymaking typically took place in relatively closed policy communities in which central banks, finance ministries, regulatory agencies, and their private sector interlocutors interacted to determine the scope of the market, the terms of competition, and the costs of supervision and regulation.4 While the decisions taken affect a broad range of interests in society, the preferences that underpin policy outcomes

4 See e.g. case research by Baker et al. 2005; Baker 2006; Cohen 2003; Claessens, Underhill and Zhang 2008; Mügge 2006.

are the product of a close alliance of private actors and autonomous state agencies. Accountability in terms of either outcomes or process remains limited. The public choice literature warns us that such arrangements run a persistent risk of policy capture.

The cross-border market integration and growth of market complexity that has accelerated since the 1970s has exacerbated the problem, as will be elaborated below. The policies of developed countries have tended to facilitate further cross-border integration accompanied by 'governance-light' with little of the regulatory framework normally associated with functioning domestic financial markets. The growing technical complexity of global markets has rendered public agencies dependent on the preferences of private agents and has contributed to the emergence of closed and transnational policy decision-making clubs. International-level decision-making is yet further removed from traditional lines of democratic accountability; decisions at the international level have become dominated by these policy communities. This is manifested in the strong policy preference for a market-oriented financial architecture.

The crucial manifestation of this dynamic was the emergence of the Group of Seven Ministers of Finance and Central Bank Governors following the collapse of Bretton Woods, accompanied by an annual G7 economic 'summit'. The G7 was not only a response to increasing economic interdependence – especially prevalent in the financial and monetary domain – but also to the US desire for less Eurocentric forums.5 The origin of the G7 lay with the invitation of US Secretary of the Treasury George Schultz to his counterparts from France, Germany and the UK to an informal meeting in the spring of 1973. By 1976 these meetings developed a heads of government/state summit element including Japan, Italy, and Canada that eventually became a sort of self-proclaimed executive committee for global economic governance. The finance ministers club also evolved to include a central bankers component (the latter including the Managing Director of the IMF). The G7 functions as a highly informal and personal club, with no permanent secretariat, no minute-taking and little bureaucratic support.

5 This brief history of the G7 is drawn from Baker 2006 (especially chapter 2) and Baker 2010.

There are no formal decision-making procedures or 'votes'. During the first decade of its existence, the G7 was mostly preoccupied with the consequences of the collapse of Bretton Woods and the international macroeconomic and monetary coordination of its aftermath. However, despite this seeming informality, over the course of the 1980s and 1990s the G7 has emerged as the 'apex policy forum' in global financial governance, i.e. the policymaking institution that coordinates and steers actions by other international bodies and states, and therefore plays a crucial role in contemporary global financial governance.

Apex policy forums are informal gatherings of senior national officials from finance ministries and central banks from self-selecting groups of economies of 'systemic' importance in the global financial order. An ongoing process of deliberation aims to develop international consensus on issues relevant to financial governance – setting strategic priorities, agendas and normative parameters (Germain 2004; Baker 2009). Most participants are professional economists trained in the neo-classical tradition (Baker 2010: 63 note 3). Through these ongoing deliberations, they get to know one another over time. The consultations produce communiqués aimed at markets, national authorities, and international bodies that together constitute the international financial architecture. They seek to convey a sense of consensus on the priorities to be addressed and on the broad policy orientation that should be followed (see below).

From the onset of the emerging market financial crises of the mid-1990s, the G7 became less concerned with macroeconomic and exchange rate matters and focused more on crafting a normative consensus on the form the global financial system and its governance should take and how it should function (Best 2003). This process is portrayed as technical, but has political significance because it defines the terms on which global financial governance is conducted and, most crucially, who has a legitimate right to participate in key debates. The G7 has thus established the parameters within which multilateral institutions operate, and provided the political support underpinning their authority without which little in global financial governance can happen. Proposals that cannot generate support or are opposed by (important) G7 members are effectively sidelined, abandoned, or rejected.

A consensus in favour of the further liberalisation of financial markets accompanied by market-based governance-light has been forged which has become deeply and instinctually rooted in the dynamics of current policymaking processes. The institutional embeddedness of this consensus results in the exclusion of alternative perspectives and arguments from deliberation and the development of a self-referential debate. This was quite apparent during the financial architecture reform debate following the Asian crisis: more interventionist measures to restrict the speed and volume of speculative financial flows proposed by what Armijo called the 'financial stabilisation' camp were largely overlooked (Armijo 2002). A 1999 report produced by the UN recommending capital controls as permanent safeguards rather than instruments to be abolished was all but ignored in the G7 (Culpepper 2003). The rejection of the IMF's Sovereign Debt Restructuring Mechanism provides further evidence of this 'ideational screening'. The G7 opted instead for a more market-friendly approach involving voluntary Collective Action Clauses (CACs) in sovereign bond contracts (G7 2003). These two examples corroborate other evidence of skewed 'limited argument pools' that create powerful incentives conformist dynamics (Sunstein 2002).

Bad faith or deliberate bias is not the problem. Finance ministry and central bank officials regard themselves as technicians searching for the correct answers. Yet the pattern of G7 consultations means that although they attempt to take decisions without reference to outside interests, they are most likely to interact with large-scale internationally active banks and private interest associations such as the IIF. They share with the private sector a common intellectual orientation, also exemplified by the many movements of high-level employees through the 'revolving door' between the official and the private sector. Crucially, however, the apex forum provides only guidance. The actual implementation is delegated to follow-up processes and other (autonomous or sometimes self-regulatory) bodies such as the BCBS, the International Organisation of Securities Commissions (IOSCO), or the Financial Stability Forum (FSF, nowadays

Financial Stability Board, FSB), wherein private actors waste little time in seeking to minimise and dilute the more objectionable aspects of the package. The G7 has thus typically defended and indeed promoted the broad Anglo-American consensus of the last 20 to 30 years, and major banks and financial institutions have found this consensus favourable to their activities. Leading private financial interests and public policymakers have therefore forged a complex and mutually supportive relationship. It remains the case that highly specialised finance ministry and central bank officials involved in the governance of an increasingly complex financial system became more receptive to the ideas promoted by financial sector interests than from other societal actors. How this ideational consensus worked in practice will be elaborated on a more general level in the next section by analysing the market transparency agenda.

Technical policymaking forums and the 'market transparency' agenda6

While the G7 establishes the general policy framework, the task of more detailed elaboration is mandated to several 'technical' forums devoted to more specific aspects of the global financial system. Prime examples dealt with here are the BCBS and the IMF (when it comes to monetary issues). Such bodies often work by promulgating internationally agreed standards and codes, such as the Basel Core Principles (BCP) that attempt to come to terms with the problem of 'uncertainty.' If uncertainty in the global financial system has an apparent edge over calculable risk, price signals become difficult or impossible to read. This can impair market adjustment processes and result in crises – with potentially systemic implications. Following the surprise outbreak of the 1994-95 peso crisis in a Mexico that had undergone considerable adaptation to the new market-based order, the G7 countries initiated reform of what became known as the 'global financial architecture' (Eichengreen 1999). These efforts were redoubled after the 1997-98 Asian crisis with the professed (but contested) aim of strengthening

6 This section is drawn from research summarised in Walter 2010; see also Walter 2008.

the weakest developing country and emerging market links in the system. Regulatory reform and convergence was encouraged through the promulgation of macroeconomic and financial standards and codes. This focused on strengthening the market-based nature of the system, based on the counterfactual notion that if markets would only be better facilitated, market failures would not arise.

Led by the US and UK, the aim was to promote financial regulation in emerging economies that attained the 'best practice' regulatory standards prevailing in the major Anglo-American financial systems. These standards were designed to induce convergence across national financial systems so that capital markets could function better. While the international 'standards and codes' that resulted were legally non-binding, considerable effort went into their establishment and implementation to strengthen the weakest links in the global financial markets. In turn, the developing and emerging economies had little input into the development of these standards.

Walter (2010) argues that the quality of financial regulation in some emerging market countries has improved considerably since the 1990s. However, systematic convergence on western regulatory standards has *not* occurred. As occurred with exchange rate policy, where official policies and actual behaviour often diverge (Reinhart and Rogoff 2002), regulatory convergence has in practice been gradual, limited, and varied across countries and regulatory domains. It is often what Walter (2008) calls superficial or 'mock compliance' because substantive compliance can be costly, thus encouraging local actors to resist cross-border standardisation. Regulatory convergence has therefore proven considerably weaker than assumed by the G7 or the international financial institutions (IFIs) that officially monitor the process.[7] Zhang (2010) argues that as far as institutional and regulatory adaptation to global financial markets has indeed taken place, it has often been as reflective of national imperatives as of the demands for international convergence emanating from the G7. *Global reform processes need to*

7 For official claims about the role of both official and market incentives, see FSF 2000. For academic claims of this kind, see Ho 2002; Simmons 2001; Soederberg 2003.

become much more sensitive to these domestic constraints if global financial governance is to be effective in achieving financial stability.

Table 2 measures formal compliance across different groups of countries with international financial reporting standards (IFRS), special data dissemination standards (SDDS), and with one key aspect of the Basel Core Principles (the Basel I Capital Accord).

Table 2 Formal compliance with SDDS, IFRS, and Basel I standards (% compliant)

	SDDS	IFRS	Basel I **
IMF members *	36%	43%	99%
OECD members	97%	80%	100%
Emerging market countries (IMF definition) ***	81%	35%	96%
Thirteen major crisis-hit countries (since 1990) ****	92%	0%	100%

Notes: *The figure for the 'IMF' group for Basel I compliance is for those 143 countries on the Barth et al (2006) database, which probably overestimates compliance in this category. **Basel I figures generally are as of end 2007 ***The IMF lists 26 emerging market countries. ****The thirteen major crisis-hit countries are Argentina, Brazil, Hungary, India, Indonesia, Japan, Korea, Malaysia, Mexico, Russia, Thailand, Turkey and Venezuela (non-compliant).

Source: Adapted from Walter, 2010

The data analysed by Walter highlights three things: i) there are fairly high levels of formal compliance to these standards across OECD countries; ii) the pattern for SDDS and IFRS is variable, but formal Basel I compliance is almost universal; iii) among emerging markets (for which the SDDS was primarily intended), formal compliance is high for SDDS and Basel I, but low for IFRS.

Compliance is of course a continuous, not a binary variable. Formal indicators therefore do not fully capture the reality of either legislation or regulatory and private sector practice. Though emerging market adoption of IFRS is patchy, some (e.g. South Korea and Thailand) claim that their domestic accounting standards are 'largely' though not completely based on them. Mock compliance occurs when regulators, banks, companies, and internal and external auditors formally signal their adoption of specific international rules or standards but behave inconsistently with their public commitment (see Raustiala and Slaughter 2002: 539; Shelton 2003: 5). This thus includes a continuum between the extremes of formal non-compliance and substantive (behavioural) compliance. Mock compliance also occurs for a range of potentially overlapping reasons: deliberate regulatory forbearance by the government or its agencies; low bureaucratic enforcement capacity or corruption; or unwillingness by private sector actors to behave in ways consistent with the rules.

At best, one may be reasonably sure that the level of compliance with SDDS is relatively high because the macroeconomic data posted on the IMF's bulletin board are based upon publicly available national statistics and must be internally consistent, and the IMF publicly declares whether or not a country meets the SDDS requirements. But in other areas, such as the IMF-World Bank Financial Sector Action Programme, reports often omit (at member countries' request) very critical and quantitative judgements on compliance,[8] and a quarter of all reports are never published. Many systemically important countries (including the US up to the crisis) simply refused to participate in the FSAP. For all these reasons, published FSAP reports offer a poor guide to patterns of compliance, so we do not know if these standards achieve their goals or not.

Anecdotal evidence nevertheless suggests that formal non-compliance is considerable in some areas and that mock compliance is even more significant. An example is the case of South Korea, probably the most avid adherent of the international standards project in Asia. Regulatory officials there claimed that the country had met or exceeded most international standards by 2002 (FSS 2002: foreword). But the 2003 FSAP review team claimed the new Korean financial regulator was sufficiently independent from neither government nor industry, as required by the first Basel Core Principle. Furthermore, banks willing to lend in line with government industrial restructuring objectives, often to large chaebol conglomerates in distress, were subject to regulatory forbearance. An example are the loans to the Hyundai group by state controlled financial institutions. Half of the new loans went to Hyundai's semiconducted affiliate, Hynix,

8 For the Reports on the Observance of Standards and Codes (ROSCs), see the IMF website..

considered uncreditworthy at the time (US ITA 2003: 18). Yet through to late 2001, the new financial regulator allowed banks to classify their Hynix loans as 'normal' or 'precautionary', (Fitch Ratings 2002: 2-3). Even foreign-controlled Korean banks complained of government pressure to roll over loans to Hyundai. The scale of the problem was revealed by September 2004 when, Hynix's prospects having improved, both the auditors and senior management were indicted for producing fraudulent accounts for the whole period 1996-2003.

Similarly, Singapore's Monetary Authority (MAS) consistently required Singapore-based parent banks with Thai subsidiaries to re-estimate their reported Thai non-performing loans (NPLs) and set aside additional provisions in lieu, so little did it think of Thai reporting standards. The differences were considerable: Singapore estimated that from 2001-2003 there were up to five times as many Thai NPLs than reported by Thai figures.[9] The consequences of lax NPL classification is serious, artificially inflating net income, retained earnings, shareholder's equity, and hence also capital adequacy requirements under the Basel Capital Accords. Thai Danu Bank was technically insolvent by Singapore's standards, but had positive net assets according to Thai 'generally accepted accounting principles'.[10]

Other Asian countries, such as China, Indonesia, Japan, Korea and Thailand, also manifest evidence of regulatory forbearance (Walter 2006, 2008). Additional costly public bailouts would have been inevitable had most East Asian governments properly applied to their banks the regulatory regimes of the US or UK – often viewed as international best practice by apex policymakers – or indeed the Singaporean regulatory regime in the post-Asian crisis period up to 2003-04. Given the widespread perception that weak or discretionary regulation caused the Asian crisis, forbearance became the sin that dare not speak its name. The compliance of many Asian banks during this period with the core Basel I minimum capital adequacy requirement (CAR) of 8%

9 The affected banks were DBS, which controlled Thai Danu Bank, and UOB, which controlled Radhanasin Bank.
10 See DBS Group, 2002 (p. 126) and DBS Group 2003 (p. 80). MAS' relatively strict regulatory treatment probably contributed to DBS' decision to sell its stake in Thai Danu Bank in 2004.

was formal at best. Even though cross-country comparisons of CARs and NPL levels are often made, these are clearly unreliable if the standards applied are not the same. The underlying reason for these disparities and lax reporting standards was simple: there were huge political and economic constraints on further bailouts coming out of the crisis. Even if arguably justified on various public policy grounds, regulatory forbearance in Asia tended to remain hidden because of the perceived need to appear to conform to key international regulatory standards after the crisis. It may be small wonder that Asian governments turned a blind eye to low NPL recognition and provisioning in such difficult times, but doubt is cast on the effectiveness of the global standards effort as an underpinning of market-based governance-light.

Evidence concerning the implementation of corporate governance and accounting standards reveals similar outcomes. The reform of corporate governance was also aimed at increasing corporate transparency and enhancing legal and other incentives towards providing proper information to the market while avoiding the protection of insider privileges that often shroud corrupt practices. This was to be achieved by adopting western-style rules regarding independent directors on the boards of publicly listed companies and various protections against the exploitation of minority shareholders. These reforms were promulgated despite evidence from a range of studies that ‘independent’ directors seldom successfully constrain incumbent management or major shareholders in practice – and that minority shareholders can still suffer systematic abuses in spite of new rules; in Asia the situation is further complicated because managers are still mostly families and governments. One of the most systematic cross-country surveys of public and private sector behaviour in Asia concluded in 2005:

> A few years ago regulators were praised for tightening up on rules and regulations; today it is apparent that many of these rules have only a limited effect on corporate behaviour. Where implemented, they are often not carried out effectively (CLSA Emerging Markets 2005: 3).

Other cross-country surveys also show that the quality of financial reporting practice in most Asian countries lags behind the major developed countries despite the claimed adoption of IFRS-consistent domestic financial reporting standards.[11] While mock compliance also exists in the US or the UK, these surveys suggest that the quality of corporate compliance in countries like China, Indonesia, Korea and Thailand lags far behind that in the US, UK or regional champions such as Singapore (CLSA 2005; Standard and Poor's 2004).

In short, convergence upon a range of international standards was seen as integral to making markets work better by correcting the failures of domestic financial regulation prior to the crisis of the late 1990s. On the face of it, Asian countries have complied with this trend towards convergence, but Walter demonstrates that there lies a more complex pattern underneath the formal claims. The average level of substantive compliance in Asia is much higher for SDDS than for banking supervision, financial reporting, or corporate governance. In the crucial domain of banking supervision, mock compliance with core standards such as the Basel I Capital Accord has been extensive in some countries. The variety in levels of genuine compliance also remains considerable across countries, from China, Indonesia and Thailand towards the bottom to countries like Singapore and Hong Kong at the top end. Even greater variations in the degree of corporate compliance with international and domestic standards lie underneath these country averages.

The 1990s crises in the emerging markets certainly favoured the formal adoption of international financial standards, strengthening both the external political pressures from the G7 as well as domestic groups favouring regulatory reform. But formal adoption was only part of the battle. Once formal acceptance has been achieved, much depends on the interaction between the domestic private sector costs of substantive compliance with particular standards and the difficulty that outsiders encounter in

11 See World Bank (2004: 11); World Economic Forum (2003: 610), and later issues.

monitoring the quality of compliance.12 The room for variation across economies and sectors is therefore great, although the long-term goal is clear: a more market-friendly financial system.

Walter's explanation for divergent cross-country compliance with standards is that public and private sector actors are likely to prefer mock compliance when visible non-compliance *and* substantive compliance are both costly. The costs of compliance for private sector agents are dependent upon the content of the standards, including their scope and degree of specificity. For example, strict compliance with the Basel Capital Accords is costly for weak banks or borrowers – and also for governments that are confronted with SME demands for cheap credit or that might be required to bail out banks if their low capital adequacy ratios were rendered public. Other more general principles are only potentially onerous, especially if broad principles and lax definitions mean that apparent or formal compliance with standards can be relatively easy in practice. Substantive compliance is most likely to involve costs concentrated on particular vested interests in financially distressed economies, or where entrenched insiders will lose from greater transparency and more stringent regulation. Concentrated insider resistance is likely to overwhelm the diffuse political support for compliance that derives from its relatively uncertain and more broadly distributed benefits (such as gains for minority shareholders or the promise of future FDI and economic growth). When the costs of compliance are also high across the economy in general, politicians may exert pressure for the exercise of regulatory forbearance. By contrast, when private sector compliance costs are low, resistance to substantive compliance is likely also to be low.

Other factors affect the degree of pressure on the government and on the private sector to comply. Among these is external monitoring by the standard-setting bodies. This third party monitoring is often difficult and costly. The difficulties of monitoring and of imposing third party sanctions vary from one set of standards to another. Monitoring

12 Outsiders include the IFIs as well as most market actors. For elaboration, see Walter 2008: ch. 2.

the true level of compliance with financial regulation, corporate governance, and accounting standards can be effectively impossible (Hegarty et al. 2004: 9). Third party monitoring requires not just detailed knowledge of particular jurisdictions but also inside information concerning public and private sector behaviour. Even the IFIs, as membership organisations, have difficulty obtaining inside information about compliance and have no effective means of detecting or sanctioning non-observance within the private sector. Formal non-compliance would of course signal deep problems in a particular economy, and it is anyway easily detectable by outsiders. This means it is often easier for private or public sector opponents of substantive compliance to pursue mock compliance strategies. Such a context casts serious doubt on the effectiveness of the centrepiece of the reforms to the international financial architecture and reflects the lack of policy 'ownership' in countries on which the market-transparency agenda is imposed without being seriously involved in the policymaking process establishing this path of reform.

In sum

Whereas the post-Second World War Bretton Woods regime was established as a direct response to the economic lessons of the Great Depression and hence sought to restrict global finance, these lessons were slowly forgotten, sometimes enthusiastically, over the decades. As a result, policymakers turned a blind eye or even promoted the hollowing out of the system of national control and financial repression that had been erected, and thus provided the political underpinnings for the re-emergence of global finance. The introduction of floating exchange rates under the pressures of growing capital mobility and chronic payments imbalances was both a cause and a consequence of the changes taking place. Once conscious regulatory change encouraged the financial sector to integrate across borders and across distinct market segments, a period of rapid financial sector expansion followed. The huge financial conglomerates that now lie dangerously crippled by the crisis came to dominate global financial markets. Their origins often enough lay in regulatory arbitrage and state promotion of national financial 'champions' that would compete on Wall Street and in London. The bonds of interest and shared idea-sets between financial sectors and sovereigns that drove the emergence of global finance became ever closer.

Although the reflex to fear the dangers of instability inherent in financial liberalisation may have faded with the lessons of the 1930s, the knowledge was hardly lost. The Latin American debt crisis of the 1980s and the serial emerging market crises of the 1990s anyway provided ample reminders and demonstrated the dangers of large payment imbalances in a world of ample – if temporary – private financing. The market-oriented reforms promulgated by the G7 that aimed to correct these failures were not only ill-conceived, but the standards and codes to strengthen the weakest links in the market chain turned out to function poorly on their own terms.

The process of both liberalisation and the reform of the financial architecture were facilitated by the emergence of an intellectual consensus among key policymakers in the G7 that market processes would lead to both stability and economic development. This conviction was clearly reflected in the standards and codes reform initiatives following the East Asian crisis. These reforms focused on improving the functioning of markets and the adjustment of emerging markets and their financial institutions to global standards and thus to market pressures. These standards and codes were formulated in technical forums like the BCBS and IMF, and endorsed and promoted by G7 policymakers. Although implementation of these standards has been uneven, this reform initiative clearly reflects the G7 consensus in favour of market-based ‘governance-light’.

The standards and codes agenda unfortunately ignores not only the inherent instability of financial markets, but also and crucially the tensions between global structures and national policy imperatives (Underhill and Zhang 2003; Zhang 2003). While the standards and codes emphasised the adaptation of emerging market financial systems and firms to developed country norms – with important consequences for their long-run development prospects and plans – evidence accumulated that this approach was unlikely to achieve its objectives (Eichengreen and Hausmann 2005). The technical bodies responsible for crisis prevention and management experienced difficulties designing policies perceived as fair, applicable across national contexts, and balanced in distributional terms. Many emerging markets took refuge in mock compliance, and there was little sense that these reforms were perceived as legitimate by a developing world that often paid the price of financial instability in a system it could only influence with difficulty.

The bottom line of this still-prevalent consensus is that private actors, in particular large internationally active financial institutions, have more influence on financial architecture reform than prominent emerging market economies or domestic non-financial constituencies. This influence emanates from their intellectual alignment with the G7 agenda as well as their influence on the technical forums (discussed in Chapter Four). Those most successful at influencing decisions on the input side tend to derive the most benefit from them, calling into question the legitimacy of the policy process.

These exclusionary policy processes also yield legitimacy problems on the output side. The frustration of many non-core countries with what they experience as ossified governance structures unresponsive to their needs and views (cf. Mahbubani 2008) has led them to seek alternatives for addressing policy problems, both unilaterally and in smaller or larger groupings. The major Asian members of the IMF have built virtually impregnable reserve fortresses against future crises – with the unintended consequence of contributing to global imbalances – and question a range of IFI policies. Several Latin American countries had similarly taken evasive action. They built their reserves and a number implemented dynamic and flexible systems of inward capital controls to counter the worst effects of capital mobility on their economies, exchange rates, and monetary policies. National or regional solutions to crises may be the future preference to avoid intrusive and inappropriate IMF and other IFI policy advice and conditionality perceived as unwanted and unlikely to provide financial stability. Meanwhile, there is apparently less learning in the developed world: creditor members of the Eurozone have brought the IMF closer in attempts to resolve the Eurozone crisis, implementing adjustment policies on steroids.

There are thus serious questions to be asked about the pre-crisis institutional framework of global monetary and financial governance, the relationship between national and other levels of governance, the norms which underpin policy and its implementation, and the interests which governance processes can and should represent. How might one enhance the legitimacy of the institutions of global governance, adjusting the policies of international institutions so as to enhance the capacity of national governments to achieve their aims and satisfy their key political constituencies? Who should be represented in the process and how? How and through what sorts of institutions, with what sorts of authority relative to national instances, should the tasks of global monetary and financial governance be achieved? What sorts of normative and political underpinnings are appropriate for a system that must cater to developing, emerging market, and developed countries alike? Who benefits from the unfettered growth of the financial system, and who bears the costs of increased financial instability?

These issues would be less pertinent if the global financial system had delivered more equal benefits to all. However, it does not. The input side questions will be addressed further in Chapter Three. Meanwhile, Chapter Two will present some important stylised facts emerging from the literature about the impact of global finance on national economies. This analysis points to the challenges and trade-offs of facilitating liberal and globalised finance while providing sufficient stability and distributional benefits to ensure popular support for further integration.

2. Challenges and risks of financial integration and liberalisation

This chapter examines the challenges posed by financial liberalisation and integration. Financial liberalisation increases the range of financial products on offer and the range of actors which are allowed to invest in them. Financial integration intensifies capital mobility and therefore accelerates the way and velocity with which money can circulate in the global economy. Both lead to a growth of the financial sector and tie together the money of consumers, governments, international trade, and financial institutions. This means that the capital mobility born of cross-border financial integration and market desegmentation within the financial sector is more than a financial market phenomenon per se and its potential impact goes far beyond financial institutions (e.g. banks) alone.

The apparently simple deregulation of financial markets naturally implied the removal of capital controls and the panoply of post-war macroeconomic management inherited from war and the Depression. Capital mobility changes the way national economies relate to each other, and therefore simultaneously alters the policy space available to governments and the competitive playing field for firms in the real and financial economy alike. On the one hand it presents new opportunities: firms, governments, and consumers gain access to new and less costly sources of finance. This can assist economic growth and facilitate developing countries access to much needed capital and technology to invest and develop their economies. Finance granted access to the housing market for millions. On the other hand, capital mobility generates a more complex world. It affects the macroeconomic adjustment process and the functioning of exchange rates, possibly exacerbating imbalances if not well managed. This new complexity affects the environment in which real economy firms must produce and trade as they face new forms of competition and opportunities, not to mention new forms of risk at the national and international level. The new environment also affects government policy options and may impair their functionality, certainly in relation to monetary and exchange rate policy, and it potentially affects the behaviour of asset prices relative to the real economy. National efforts to monitor and supervise financial firms and the financial system become more difficult as financial conglomerates emerge and their operations internationalise. Better access to finance means new temptations in terms of private and public debt loads, and debt management becomes more complex. Perhaps most importantly, capital mobility and the growth of finance involves a rise in volatility: the under- and overshooting of market price adjustments is too often concentrated in abrupt correction episodes known as financial crises.

Those taking the decisions that unleashed capital mobility in the 1980s did not always fully understand these broader implications. Those who did fully understand often embraced the trend with enthusiasm: the rise of market pressures for adjustment would at a stroke force adjustment on inefficient and often subsidised producers, and would put pressure on labour – especially of the low-skilled kind. The new environment would also end the government policies that could be blamed for the stagnation and inflation of the 1970s. The new market discipline would be good for the public and private sectors alike. Those who claimed not to have known found out soon enough about the challenges and trade-offs of the emerging new order.

But ignorance as a plea was an unnecessary and ultimately unaffordable vanity: there had long been a rich and varied theoretical and historical literature on the costs and benefits of financial integration and liberalisation, not least dating from the interwar period. Since the 1980s, contemporary scholarship and policy experience has added considerably to the accounts available, from critical warnings of financial Armageddon to ongoing enthusiasm for the Efficient Markets Hypothesis – now exposed as a fanciful complacency.

This chapter will address three important lessons from this burgeoning literature: (i) financial markets are inherently procyclical and unstable, and this instability is ubiquitous; (ii) financial liberalisation and integration typically reduces the policy space of national economies to address instability and deal with the distributional consequences of capital mobility; (iii) when private capital falls short in a crisis (either in the form of inadequate bank capital or lack of private sovereign financing), it is the taxpayer who takes the ultimate hit. This latter lesson highlights the crucial importance of keeping that notional 'median taxpayer' on board in terms of policy legitimacy.

These three lessons will be elaborated in four sections by drawing on PEGGED research findings supplemented by other scholarship. The first section discusses the literature on financial instability. The second section deals with the impact of financial liberalisation and integration on the policy space of national economies. The third and fourth sections deal more specifically with the flaws in the regimes for bank capital adequacy and sovereign crisis resolution – flaws which were again exposed in the current financial crisis. These flaws are what makes the resolution of the current crisis so difficult, but also beg the question why the known problems have yet to be fully addressed by policymakers – a question we will take up in the following chapter.

Global finance means global instability and crisis[13]

We know and have long known that liberal financial markets are potentially unstable. The case for adequate governance in the form of supervision and regulation was well-understood and entrenched in the fabric of post-Depression economic systems, as discussed in Chapter One. However, after the collapse of Bretton Woods and the re-emergence of global finance some analysts argued that market forces would automatically induce policy and financial system convergence over time (Smith and Walter 2003). Proponents of the Efficient Market Hypothesis in any case believed on

13 This section elaborates on Underhill 2010.

theoretical grounds that only very limited governance was needed; markets would self-correct. Others (e.g. Eichengreen 1999; Bryant 2003) argued that the conditions for operating global markets could be consciously developed, but attention to stability and convergence of national policies was necessary. Of course there were also those who argued, on the basis of historical evidence, that financial markets and monetary systems are inherently unstable in the first place (Kindleberger 1982, 1989; Galbraith 1993, 1995; Strange 1998) so that they required the consistent attention of and should be restrained by political authorities. The persistent pattern of crises, exchange rate volatility and payments imbalances which accompanied the emergence of the market-based system seemed to give the latter group the better part of the argument. A brief examination of some 20 years of research findings and scholarly analysis should allow one to review the record of our prior understanding of financial stability.[14]

When it comes to the challenges of global finance, there is historical evidence aplenty that a liberal or market-based order of cross-border and cross-sectoral financial integration underpinned by a high degree of capital mobility constitutes an inherently unstable system. This instability is not only a stylised fact: there are also adequate theoretical explanations of the phenomenon. Famously, Minsky (1982, 1984) demonstrated how financial booms generate excessive risk-taking by market agents, which eventually leads economies into crises (the financial instability hypothesis). In a similar vein, Galbraith (1993) focused on the psychology of speculation, showing how it generates debt-fuelled asset bubbles which eventually burst. More recently, White (2006) argued that low interest rate environment resulting from the successful pursuit of low inflation by central banks since the 1970s led to a 'search for yield' generating financial and other imbalances through excessive credit creation, carry trade and leverage. So instability was arguably inherent in the way financial markets work, and episodes thereof should be expected though not welcomed.

14 See the analysis of the origins of the crisis in Schwarz 2009: 27-38.

With respect to these consequences of global financial integration, among the most consistently prescient of political economists was Susan Strange. The rise of offshore and deregulated financial markets outside national systems of governance had largely been responsible for the breakdown of the international monetary system during the 1970s (Strange 1976: ch. 6). In *Casino Capitalism* (1986) she argued persuasively that the increasing liberalisation of capital markets and their cross-border integration was transforming and risked disrupting the system of states and the global economy. Despite the increasing prevalence of arguments concerning the importance of financial market discipline on government finances and macroeconomic policy, the increasing availability of private finance postponed or allowed states to avoid altogether the required adjustment to international imbalances (see also Cohen 1982: 471-5). Arguably, the same effect occurred more recently in the Eurozone. Thus the system led to the *avoidance* of the very disciplines some of its proponents held to be its greatest virtue.

The distortionary growth of the financial sector was skewing incentives in western societies, destabilising the international monetary system, and was an inherently unstable enterprise. This *Retreat of the State* (Strange 1996) in favour of markets not only increased the risk of major financial crisis, but by enhancing private power it correspondingly disarmed crucial instruments of public policy which risked delegitimising government over time. Her last book was appropriately entitled *Mad Money* (1998) and was published at her death and just in time to welcome the DotCom bubble and crash, in retrospect a forerunner of the crisis of 2007-10.

A range of IPE scholars followed Strange's lead (e.g. Cerny 1993; Moran 1991) to focus on this 'phoenix risen' (Cohen 1996) of global finance and the domestic dimensions of policy change (Moran 1984; Pauly 1988; Rosenbluth 1989; Coleman 1996). There were also prominent economists who also pointed to the instability of global financial markets and the challenges to effective government it posed well before the current crisis (see e.g. Bhagwati 1998; Rodrik 1998; Stiglitz 2000, 2002). Many of the works emerging at this time focused on the causes of this major shift in global order, while others debated the balance of economic costs and benefits of financial openness (King and Levine 1993; Demetriades and Hussain 1996) and/or possible systems of regulation and supervision (Steil 1994; Barth et al 2006). Often enough cautionary messages in the literature emerged that should have served as ample warning that global financial market integration was potentially problematic.

The instability of a liberalised and integrated financial system shows up not only in acute form as financial crises, but also in the more subtle form of procyclicality – which also hampers the conduct of macroeconomic policy. One would expect financial supervision, regulation, and macroeconomic policy to counteract these dynamics to reduce the upside and downside aspects of boom and bust – taking away the proverbial punch bowl before the party gets going. This is what 'governance-light' was allegedly designed to do. However, the analysis above shows that for those who wished to hear, it was understood that market-based governance-light would on the contrary *accentuate* these cyclical dynamics, which meant the results might be and eventually were disastrous. Research findings that underscore this point are worth examining further.

Ocampo and Griffith-Jones (2010) demonstrate that before the current crisis, the procyclicality problem was especially prevalent in those developing countries that were highly integrated into global financial markets. Over a period of some three decades, these countries suffered highly procyclical volatility in their external financing, damaging domestic economic activity and other macroeconomic variables through direct and negative effects on both their balance of payments and domestic financial markets. This capital flow volatility also markedly constrained developing economy 'policy space' to adopt autonomous counter-cyclical macroeconomic policies – especially monetary and exchange rate policies. A vicious circle emerged involving procyclical financing, underdeveloped financial markets and institutions, and external constraints on macroeconomic policy autonomy. This produced far more frequent and regular 'twin' external debt and domestic financial crises than prior to the breakdown of the Bretton Woods regime (Bordo et al 2001).

Ocampo and Griffith-Jones go on to argue that since the 1970s, business cycles in developing countries have been dominated by *capital* account fluctuations, particularly in the case of those economies that are more integrated into world financial markets. Boom-bust cycles in capital flows reflect investor herding and associated patterns of contagion, and this enhanced volatility is apparently associated with significant changes in risk evaluation. Market sentiment alternates between periods of ‘appetite for risk’ in a ‘search for yield’ (more precisely, underestimation of risks) followed by a sudden ‘flight to quality’ (risk aversion). This herding phenomenon is exacerbated by managers’ evaluation of competitor performance as well as by the market-sensitive risk management practices associated with the G7 ‘governance-light’ prescription (Persaud 2000). Information asymmetries tend to lead to the pooling of different sorts of assets into risk categories that come to be viewed by market agents as strongly correlated. Such apparent correlations turn into self-fulfilling volatility prophecies. The events in the US of 2007-08 revealed this problem most dramatically: the search for yield had pushed a wide range of financial institutions to take on the heavily correlated risks of mortgage-backed securities.

In developing countries, fluctuations in capital markets have been reflected in the procyclical pattern of bond market interest rate spreads, variations in the availability of financing (absence or presence of credit rationing), and in maturities. This involves intense short-term upward movements of spreads and periods of financial drought during crises. More importantly still, procyclical dynamics involve *medium-term* cycles wherein different types of capital flows show different volatility patterns. Reliance on short-term capital flows with their higher volatility is highly risky (Rodrik and Velasco 2000), while more reliance on less volatile FDI is considered a source of strength. However, ‘financial engineering’ employing the use of derivatives-based risk management techniques may be rendering FDI as volatile as traditional financial flows at critical moments, again enhancing market procyclicality. Firms employing a ‘dynamic hedging strategy’ may increase pressure on the national currency exactly when that pressure is already there (Dodd et al 2007).

Escape from these dynamics remains difficult. Developing countries viewed by markets as 'success' stories are almost inevitably drawn into a capital account boom, producing risky balance sheets and private-sector debt (French-Davis 2001; Marfán 2005). During the boom, even countries with weak 'fundamentals' may be drawn in (see, for example, Calvo et al 1993). In turn all countries, largely independent of their 'fundamentals', will be drawn into 'sudden stops' (Calvo and Talvi 2005). As the boom implodes, rising risk premiums and the onset of financial drought may eliminate room for counter-cyclical monetary and fiscal policies to combat the recession. On the contrary they may be forced to adopt procyclical macroeconomic policies – i.e. high interest rates and fiscal austerity. In this way, developing countries may be forced to adopt procyclical macroeconomic policies that reinforce rather than counteract the movements of financial markets. The conditionality of IFI lending may reinforce these depressing dynamics. Their industrial country counterparts are much less subject to capital flow volatility and therefore can smooth procyclical effects of credit and asset prices through counter-cyclical macroeconomic policies (as occurred in the initial phase of the current global crisis).

Ocampo and Griffith-Jones also point to widespread evidence that procyclical macroeconomic policies during booms may be encouraged by ample private sector financial flows. In short, the instability of external financing distorts incentives faced *throughout* the business cycle by both private agents and public authorities, producing procyclical behaviour of market agents *and* policymakers setting macroeconomic policy (Kaminsky et al 2004). As Stiglitz (2003) claimed, increased exposure to financial market risks has replaced Keynesian automatic stabilisers with automatic *de*stabilisers. Dependence on financial swings has encouraged the adoption of procyclical monetary and fiscal policies, in sharp contrast to the argument of proponents of financial liberalisation that financial markets would discipline the behaviour of private and public agents alike.

Although these cyclical dynamics are inherent to financial markets, domestic financial and capital account liberalisation have accentuated the procyclicality problem. Failure to develop adequate supervision in a timely fashion further increases these risks, while the costs of such financial volatility in terms of economic growth are high: the combination of procyclical financial markets and macroeconomic policies have not encouraged growth in the developing world (Prasad et al 2003), while the advertised efficiency gains from financial market integration are swamped by the negative effects of increased growth volatility. According to estimates by Dobson and Hufbauer (2001), the twin crises have reduced developing country income by about 25% over the past 25 years.

There were meanwhile new sources of instability and procyclicality emerging. One source is the explosive worldwide growth of derivatives products in recent years. Derivative contracts are part of risk hedging strategies, but for international hedge funds and investment banks they also represent speculative activity such as the ‘carry trade’. Derivative markets remain largely unregulated (especially the offshore and/or over-the-counter (OTC) markets), even though they can (and did) substantially contribute to the build-up of systemic risk. Secondly, the accumulation of vast global imbalances that may unravel in a disorderly fashion have also increased potential uncertainties. Paradoxically, the huge emerging markets ‘self-insurance’ measures taken to cope with financial instability and enlarge policy space (large current account surpluses, increased international reserves and reduced indebtedness) are part of global imbalances. What appears to be a new source of strength for individual developing countries is a major element of vulnerability for the global financial system as a whole. A global cooperative approach to the provision of ‘collective insurance’ and the management of global imbalances would thus be a more desirable solution (Griffith-Jones and Ocampo 2008).

The troubles of the Eurozone provide ample evidence that the boom-bust pattern of capital flows is no longer limited to developing countries. The establishment of the common currency in the EU led to an initial period of strong interest rate convergence towards the lower end of the scale. Peripheral Eurozone countries could take advantage of this by lending cheaply and thus experiencing a boom in capital flows. However, when the crisis hit, and private debts were transferred into sovereign liabilities (with

Ireland as the most prominent example), the waves of capital retreated back to the AAA core countries (most notably Germany) in a display of typical overshooting. Supposedly save havens in the Eurozone even pay negative interest rates, while the peripheral countries pay dearly. This procyclicality has greatly exacerbated the crisis now confronting the European Economic and Monetary Union (EMU).

Given the known propensity for financial instability, one might wonder what the benefits of global finance could be. Here it might be noted that in particular for developing countries – those most in need of economic growth, and also those most likely to be pressed by the G7 into adopting market-friendly policies – the benefits of financial liberalisation had always been in serious dispute. Despite the predictions of 'standard' economic theory, empirical research revealed that net capital flows to developing countries over time mostly flowed 'uphill' from poor to developed economies, with (fortunately) foreign direct investment as a major exception (Prasad, Rajan and Subramanian 2007). If one adds to this 'Lucas paradox' (Lucas 1990) the frequency of crises in emerging market economies, then it seems highly likely that capital market integration would develop as an erratic system, potentially destabilising for exchange rates and other macroeconomic variables, and often costly for economic development.

There is in any event no real-time historical case of successful economic development under conditions of financial openness. On the contrary, successful development strategies in 19th and 20th Europe and from the US to Japan to the Asian tigers to contemporary China rather demonstrate that economic development is accompanied by a range of strategic state intervention measures: capital account and/or exchange controls, selective protectionism, and measures to attract and shape foreign direct investment flows to national advantage.[15] The clear conclusion was that financial openness would most likely turn out badly if insufficient attention were to be paid to governance and if there were to emerge an over-reliance on the market as the core mechanism of the system.

15 See Schwartz 2010 on late industrialisation.

While there might be identifiable longer-run benefits to financial openness, these might require considerable and successful institutional development and governance in developing countries if the benefits were to be realised properly (Kose et al 2006). Research conducted in the context of the PEGGED programme (Cassimon et al 2010) demonstrates the existence of a 'financial globalisation trap': despite major efforts to increase capital account openness, poorer countries with weak institutions might get stuck in a self-perpetuating cycle of low actual financial integration, low financial development, and lack of economic development. The analysis suggests that the positive effects of financial openness are dependent on the quality of institutions. The authors conducted empirical tests for the existence of multiple equilibria: a positive one where good institutions ensure that financial integration leads to growth, and a negative one where countries with bad institutions are stuck at the edges of the global financial system (see also Cassimon and Van Campenhout 2012). Their results indeed show that a model allowing for two stable equilibria better describes the empirical measures of financial globalisation than a simple linear model. More importantly, the multiple equilibria disappear when controlled for the quality of institutions (indicating that it is indeed institutional quality which determines the existence of the financial globalisation trap). In other words, unfettered capital account liberalisation will not lead to economic or financial development for countries with bad institutions. Instead they will become trapped without access to either external capital or the capacity to develop domestic institutions that would allow them to benefit from the external capital should it begin to flow.

Global financial integration constrains policy space

This brings us to the second cautionary tale of the literature: if liberal finance is to function so as to reap its benefits while reducing its instability, the institutional fabric of financial governance and of the appropriate policy mix must be consciously developed. Any institutional fabric that can cope with cross-border market integration will also require substantial levels of international co-operation if national policy goals are to be achieved. This was one of the main policy lessons drawn from the Great Depression, as discussed in Chapter One above. Financial market integration and the resulting capital mobility render national policies less effective where the provision of financial stability is concerned and in the domain of macroeconomic adjustment. This ultimately involves pooling sovereignty and some compromise of individual country preferences so as to maintain sufficient policy space for all. This logic has historically best been followed in the European Union, though the crisis in the Eurozone has seen a remarkable reversal of what was once termed 'European solidarity'.

A crucial element of these institutional underpinnings of global finance concerns the macroeconomic policy framework, particularly in the domain of monetary policy, exchange rate policy, and public debt. A high degree of capital mobility renders more difficult the autonomous use of national policy instruments to shape the macroeconomic environment, especially in the domain of monetary and exchange rate policy. The classic dilemma is what Cohen has called the problem of the 'Unholy Trinity' (Cohen 1993, 1996: 90-4) based on the long-standing work of Mundell and Flemming. While capital mobility may increase the access of (erstwhile creditworthy) governments to international deficit finance, this can prove a dangerous game. An economic downturn or rapid reversal of capital flows can suddenly increase constraints on the fiscal options available to governments, and force a procyclical deleveraging. This in turns constrains the redistributional and social welfare policy choices crucial to domestic political legitimacy and thus places governments between often-incompatible global market pressures and national political imperatives (Underhill and Zhang 2003; Rodrik 2007). Managing these trade-offs is far more difficult for poor and emerging market economies than for the developed world and often challenges their historical economic development models (Underhill 1999), but the pressure is felt by all. Yet far too often regulatory change leading to financial liberalisation and integration was implemented without due consideration for the macroeconomic consequences thereof, and capital market regulation and macroeconomic considerations involved quite different policy communities and processes wherein the gains of the financial sector were not measured against potential losses for others (Underhill 1996).

As an interesting example, we might return to the reform of the international financial architecture, undertaken in the shadow of the serial emerging market crises from 1994-2002. What is interesting is the way in which the tension between national policy space and global finance was addressed and why. The approach at Bretton Woods in 1944 had been to render the international monetary and financial order compatible with creating for national governments the policy space required to make, in their own way and according to their internal politics, the difficult choices involved in adjustment to international imbalances. The achievement of growth and particularly full employment was seen as essential in the shadow of the Depression. Fixed but adjustable exchange rates provided a series of mutual (and originally symmetrical) obligations among members of the system. In other words, the aim was to make the global system compatible with the political vagaries and legitimacy requirements of national democracy.

The financial architects of the 1990s saw the problem the other way around: the focus was on adapting and strengthening the 'weakest links' in the global chain, the developing and emerging market economies, to the pressures of a market-based and integrated global financial system. There was no overt monetary order or provision for macroeconomic stability; on the contrary, the monetary system and system of international adjustment was a de facto derivative of the market-based financial order. Volatile capital flows were seen as constituting useful pressure to develop sensible norms and standards to underpin macroeconomic policy compatible with the global system. Because national financial regulation and monetary governance was increasingly ineffective, a market-based system strengthened by 'sound' domestic regulation, crisis prevention mechanisms, and 'better' national macroeconomic policies and related international monitoring and coordination was billed as the solution. There was indeed emergency lending from the IMF in a crisis, but under intrusive terms of conditionality.

In this way the 'new' international financial architecture focused on facilitating the free flow of capital across borders, preserving the same market-based characteristics that emerged in the 1980s and 1990s while aiming to render national economic policy and policy space more compatible with the demands and pressures of financial integration and resulting market sentiment. If the rules were right and properly applied, the market would function in a stable manner. The conclusion was that politicians should be 'strapped to the mast'[16] to prevent them exercising the discretion that might destabilise the workings of the market. As Baker (2010: 66) argued, this reflected the G7 consensus that the recurrence of financial crises was not rooted in the nature of financial markets but in policy errors and a lack of transparency. Improving the provision and quality of information about national economic policies is therefore the foundation stone of the solution. 'The markets' will employ the increased availability of data on the structure and state of economies to rationally evaluate where to invest so as to maximise returns; reckless national policies would thus be disciplined by investors withdrawing their money. Transparency is thus favoured over policy space and attention to national context. However, as demonstrated in the previous section, it seems very uncertain that the underlying assumption that improved transparency leads to market stability holds true. Moreover, because the countries in question rightly perceived their limited 'ownership' of the policy framework, implementation of the standards and codes became a farce (as discussed earlier). This throws into question the whole rules, standards and codes agenda as a route to financial stability.

It is unlikely that a rules-based approach restricting policy space will work any better than the Gold Standard disciplines that so disastrously served the world in the interwar period. Yet once again historical lessons readily available in the literature have been and continue to be ignored, and this is nowhere better illustrated than in the approach taken towards EMU in the EU (from which the 'strapped to the mast' metaphor was

16 The allusion is to Odysseus strapped to the mast so he could not follow the song of the sirens, tied there by his crew that meanwhile blocked their ears against the same; this was used in title of an article on EMU to describe the constraints on policy space promulgated by the Maastricht treaty and the subsequent 'Stability and Growth Pact' (Dyson and Featherstone 1995) and wherein EMU took the rules-based approach to new heights.

drawn, see note 17). EMU was ostensibly about the pooling of sovereignty to create a European island of exchange rate and monetary stability in a complex world of capital mobility that sapped the policy autonomy of national governments. Yet creating a single currency would clearly reinforce the integration of financial markets in Europe and would accelerate capital mobility; because it remained heavily integrated into the global financial system, the new currency zone was unlikely to prove entirely immune to financial instability beyond its borders (Underhill 2002). There were also important questions raised about the wisdom of tying a relatively diverse set of economies together despite the prevalence of regional imbalances and a history of adjustment challenges. Setting one monetary policy for so diverse a mix of developed and developing economies would also be a challenge, though this challenge was familiar to large federations with substantial internal regional imbalances such as Canada or the US, and was certainly familiar to Federal Germany after reunification with the much poorer Eastern provinces. So monetary union was supposed to bring a range of benefits (eliminating exchange rate risks, facilitating trade and cross-border transactions, creating a larger and deeper financial system in the EU to provide capital for investment and growth), without eliminating the need for the adjustment of 'internal' Eurozone imbalances.

Once again, the policy approach adopted was to promote structural and policy convergence: the adjustment of national political economies to the requirements of the monetary order and the single financial market. Market pressure emanating from an integrated Eurozone financial system would enforce adjustment. A rules-based approach committing governments to sound macroeconomic disciplines come what may (the Stability and Growth Pact, SGP) also prevented the new European Central Bank from fulfilling the role typically played by a national central bank in times of stress: the ECB was permitted to provide unlimited liquidity to financial institutions, but there was no provision for pooled, collective support for the public finances that ultimately backed the financial system and the banks. The rules in fact specified a 'no bailout' clause for governments. Governments in times of stress would by virtue of the single currency have forfeited any capacity to monetise debt in a crisis, but there was no replacement ‘federal’ solution either. Governments in debt would have to resolve the problem themselves devoid of the typical policy space and instruments available to contemporary treasuries and central banks.

The restriction of policy space required by the SGP was already controversial enough, though in good times these were hardly serious constraints. The peripheral countries such as Greece or Spain performed well enough in the lead-up to union and even better afterwards (even allowing for the rather lax Greek reporting standards). With the benefit of hindsight, we might conclude that capital markets underestimated risks in the periphery, and are once again overshooting in their flight to quality. A rescue package has been assembled involving the IMF and new Eurozone funds which trade off access to this emergency lending for conditionality and fiscal adjustment on steroids. So far this debt workout approach enforced by creditor economies in the single currency zone appears only to succeed in exacerbating the crisis, driving up borrowing costs and inducing contagion and spillover from one economy to the other.

The institutional and policy deficiencies of EMU were well debated and understood prior to the decisions being taken. The often painful historical experiences of the asymmetries of monetary union in older federations were available for anyone to observe. EMU provided no mechanism for dealing with structural payments imbalances or the need for occasional or regular fiscal transfers to ease competitiveness and other asymmetries. There was no prior agreement on burden sharing in crisis situations and no institution to deal with a crisis in the first place (though in rescuing the financial system, the ECB did admirably in the breach when it came). The ‘no bailout’ clause was a masterpiece of both economic and political fantasy devised to keep a particular surplus country happy enough to embrace the union in the first place. It focused on debtor moral hazard, while allowing private creditors to act as hazardously as they saw fit. Market discipline, ‘no bail-out’ and the SGP were the supposed oil of the system, keeping it primed and in equilibrium, whereas historical experience informs us that this cosy equilibrium was unlikely to be achieved.

EMU was bound to work asymmetrically as capital flows and the absence of exchange rate risk allowed economies to escape their current account constraints (Jones 2003), at least temporarily as capital flows filled the gap. Adjustment could therefore proceed lethargically, and corrective structural funds and/or fiscal transfers were insufficient or absent. Capital looking for better returns flowed from surplus to deficit countries and to faster growing peripheral members, and imbalances emerged along with inflation differentials and competitiveness problems (Jones 2010). Asset bubbles appeared where there was nothing done to prevent it – and there was little national policy space to do so. When the financial crisis rocked the system, financial rescue meant that private liabilities were transferred to government and central bank balance sheets and the sovereign debt problems began to emerge into an effective policy vacuum where the policy space of member states was restricted by the common market for financial services and the 'no bail-out' clause. Meanwhile the ongoing twin crises in the Eurozone once again expose the central flaws in the crisis resolution mechanism of market-based governance-light: bank capitalisation, sovereign debt workout, and the policy space and instruments to deal with either. These issues will be discussed in the following two sections.

Inadequate capital reserves and procyclicality: the supervisory dimension[17]

The Basel Capital Accords promulgated by the Basel Committee on Banking Supervision (BCBS) are a particular centrepiece of global financial governance aimed at preventing banking crisis. The accords aim to establish minimum standards across major banking markets so as to ensure that banks hold enough capital to deal with adverse scenarios. Given that the level of capital requirements can affect the competitiveness of banks on international markets, establishing minimum standards is also aimed at preventing competition in laxity among national supervisory jurisdictions and therefore levels the competitive playing field. Going into the crisis, the negotiations on the second Basel

17 This section draws on Claessens and Underhill 2010.

Capital Accord (Basel II) had just been concluded and implementation was on its way in the major economies – indeed already anticipated by the most important global banks.

Basel II established a new approach to and set new global norms for the capital adequacy requirements of internationally active banks in a context of increased cross-border banking activities, building on its predecessor, the first Basel Capital Accord (Basel I). The development of Basel II should be seen in the broad context of the overall G7 approach to international financial architecture reform focused on market transparency and standards and codes. Amongst these standards and codes, the new Basel II market-based approach to banking supervision has a uniquely important place.[18] This section will assess Basel II in the light of drawbacks that were known before the crisis hit, and were discussed but disregarded in the policymaking process. Many of these drawbacks can be directly related to the eventual outbreak of crisis and therefore served to *amplify* taxpayer rescue packages and the difficulty of crisis resolution instead of providing the financial stability they intended.

The three starting points of Basel II were to measure risk exposures better, to promulgate better internal controls and risk management by banks, and to increase the role of market discipline. In Basel II this led to three 'pillars' consisting of 1) minimum capital requirements; 2) supervisory review of capital adequacy; and 3) public disclosure and market discipline (BCBS 2004). Under the three pillar system, bank supervisors would no longer be exclusively responsible for specifying and monitoring levels of capital adequacy; bank risk managers, supervisors, and market forces are expected to combine to jointly oversee and to discipline banks. This built directly on the framework already

18 Although Basel II notionally concerns specifically internationally-active *banks*, it's sectoral and country coverage impact is much broader. Its principles embodied in the Basel Core Principles for banking supervision and the 'Basel Concordat,' Basel II covers de facto all international banking activities as well as many insurance and capital markets activities of financial conglomerates. This involves in particular the Concordat's principle of home-host supervisory responsibility for cross-border supervision, combined with the principle of consolidated supervision, requiring coverage of financial conglomerates as an integrated whole, i.e., including the securities trading and investment fund activities of commercial banks and their subsidiaries and affiliates. While capital market *regulation* falls under other (international) organisations (such as the International Organisation of Securities Commissions or IOSCO, see Underhill and Zhang 2008), much of banks' activities in capital markets is covered by Basel II.

adopted for determining the CARs of the 'trading book' activities of banks that was contained in the 1996 'market risk amendment' to Basel I (BCBS 1996).

Pillar one introduced important changes in the way aspects of risks and resulting capital adequacy requirements were to be calculated. It also expanded the range of risks covered – to include, for example, operational risk. Three different options for measuring required capital are available under Basel II. The first option is the 'Standard approach' which is aimed at 'less sophisticated' institutions. This approach is based on Basel I but enhances risk sensitivity, with differential 'risk weightings' for sovereign and corporate exposures based on external credit assessments, such as by commercial ratings agencies (Standard and Poor's, Moody's, Fitch, etc). The second option is the 'foundation internal ratings based (IRB) approach' to risk management. This option allows for (limited) use by banks of internal value-at-risk (VaR) models. Under the Foundation IRB approach, only the probability of default is calculated by the bank, and all other ratios determining capital required are specified by the supervisor. The third option is the 'Advanced IRB approach' for the largest and most 'sophisticated' financial institutions.[19] Under the Advanced IRB approach, all aspects of credit risk are estimated by the bank itself once the VaR model has been approved by the supervisor.

The second pillar provides for ongoing dialogue between supervisors and banks in order to deal with the idiosyncrasies of individual banks and situations. Under this pillar, banks must qualify for the Advanced IRB approach and supervisors must regularly 'stress test' and assess the appropriateness of banks' (use of) risk management models. The third pillar enhances bank transparency in the form of public disclosure of, among others, bank risk profiles and capitalisation. This applies the idea of exposing banks to 'market discipline' and is seen as a *complement* to the first two pillars. This pillar is based on claims, mainly by the industry itself, that market discipline is the best guarantor of sound risk management, and that supervisory oversight is essentially

19 Which are also the most systemically significant.

redundant in a soundly functioning system of market discipline.[20] Yet, after successfully achieving an approach based on market discipline in the Basel II Accord, the same industry fretted that the disclosures might not enable the markets to compare risk profiles between banks, and that an additional, self-regulatory framework for pillar three was necessary.[21]

A number of interrelated criticisms of the emerging Basel II Accord were voiced in the policymaking process. The crisis has shown that its implementation (many large banks applied the accord well in advance of the deadline) did not ensure adequate levels of bank capital under stress – apparently validating the criticisms. Hence a rapid renegotiation of the accord has taken place (discussed in Chapter Four). For our discussion, it is especially important to note (i) the negative impact Basel II might have had on financial stability; and (ii) the reductions in capital levels held by the largest, systemically most important banks relative to Basel I and which might have augmented the shortages of capital in the crisis. Next to that, there were also criticisms of the high implementation costs of Basel II and related doubts about its suitability as a global standard.

First, the market-based approach of Basel II arguably enhanced the inherent procyclicality of financial markets (see discussion above), thus implying that the accord most likely had a negative impact on global financial stability. There are multiple reasons why this may indeed be the case. First, Basel II relies more than Basel I on market signals (prices and ratings). This could be beneficial if it avoids relying on the (more) subjective judgements of individual financial institutions, but it is not clear that good risk management practices in individual institutions leads to stability at the systemic level. If a wide range of banks employing similar risk management models respond simultaneously and in similar ways to (perceived) risks and opportunities – as

20 While market discipline may assist in sound risk management, it is less clear that it makes supervisory oversight redundant. Even in well-functioning systems with a long history of market discipline, corporate (governance) scandals and bank failures in light of the subprime crisis, cast some serious doubts on the adequacy of public disclosure for proper (risk) management.
21 Confidential interview statement, corroborated by Tarullo 2008: 111.

reflected in prices and ratings in the market – downturns and upturns may be reinforced as banks downgrade or upgrade clients and adjust prices on a large scale. This kind of herd behaviour is what happened in the subprime crisis and many earlier boom and bust periods in advanced markets. This issue may be of even greater concern to crisis-prone emerging markets whose asset prices and ratings are already very volatile. Of course, if systemic risk is to be reduced and asset bubbles and their consequences avoided, then by nature prudential regulation ought to be *counter*-cyclical, a principal which Basel II appears to violate. This issue was acknowledged by the policymakers involved in developing Basel II and received some attention in public debate. Most famously, Avinash Persaud (then the managing director of State Street global markets analysis and research department) argued the point in a prize-winning essay:

> The problem is that in a world of "herding," tighter market-sensitive risk management regulations and improved transparency can, perversely, turn events from bad to worse, creating volatility, reducing diversification, and triggering contagion (Persaud 2000: 3-4).

However, the BCBS never took the matter very seriously because it claimed any bank capital adequacy standard would be procyclical in some form or the other.[22]

A second way in which Basel II might have detracted from financial stability is through its encouragement of financial innovation. Under the Advanced IRB approach the new accord arguably favoured the very sort of financial innovation and risk management practices which led to the current financial crisis, such as attempts to offload risks from the balance sheet. In the crisis, it became clear that these risks might have vanished from the books, but had in no way vanished from the banks' risk profile. It should be noted, in this respect, that many banks were already shifting their business models in anticipation of the implementation of the new accord. At the same time, Basel II

22 Blom 2011: 127.

discounted the potential benefits in terms of risk of 'relationship banking' as practised by small-scale lenders.

A third way in which Basel II might have added to financial instability is through its risk management practices, for example the reliance on rating agencies (see also the discussion in the next chapter). This not only created biases against small and medium enterprises but also ignored the well-understood risk reduction effects of portfolio diversification. Better internal risk management within systemically important financial institutions may not aggregate into effective reduction of systemic risk, especially if the accord enhances the procyclicality and volatility of financial markets. Arguably the accord rewards insufficiently the benefits and lower risk correlations of portfolio diversification when bank portfolios include smaller, perhaps individually riskier, but systemically less significant borrowers, including those from developing countries. The general underemphasis on the risk reduction effects of portfolio diversification could lead to a higher concentration of lending in less individually risky, but more correlated segments of the world economy, leading to higher systemic risks. This appears to be precisely what happened in the case of the subprime crisis, as banks engaged in creating similar highly-rated securitised off-balance sheet assets attracting relatively modest capital charges and which proved quite correlated during financial turmoil. At the least, it does not appear that the Basel II process gave proper consideration to this portfolio diversification issue.

The reliance of Basel II on credit ratings agencies (CRAs) in the 'standard' and 'Foundation IRB' approaches was also problematic. A high degree of informational objectivity would be required if the agencies were successfully to provide the information necessary to the functioning of market-based risk assessments. Yet the CRAs face perverse incentives in their relationships with the clients they rate and the financial intermediaries they serve (see Sinclair 2005). CRAs are remunerated by the very firms the risks or products of which they are supposed independently to assess. Since higher ratings mean lower capital costs for financial institutions and their clients, there is at least a notional conflict of interest. While one might expect that consistent mistakes by the agencies would over time reduce their client base and their credibility, the duopolistic dominance of Moody's and Standard & Poor's in the sector (with Fitch somewhat less influential) mitigates against this. More specifically, the track record of CRAs in foreseeing the most important systemic events is rather disappointing. The ratings agencies did not foresee many of the 1990s emerging market crises. Rating agencies not only failed to anticipate the Asian crisis, but were also relatively slow to adjust to its outbreak and then did so overly dramatically thus reinforcing procyclicality and instability (IMF 1999: Annex V; Tarullo 2008: 98-9). Nor did they anticipate well the emergence of the subprime crisis: while some downgrades began in the summer of 2007, many collateralized debt obligations (CDOs) remained AAA-rated well into 2008, even though these and other bundled asset problems were already clear and prices had declined (Morris 2008: 160). Questions can thus be raised concerning the capacity of CRAs to produce information that can help prevent systemic risks and whether due to their apparent reinforcement of procyclicality they can make a positive contribution to financial stability.

Basel II has exacerbated the problem with CRAs. For one, the conflicts of interest involve not only existing clients. Unrated banks and firms which believe they might enhance their competitive position by obtaining an advantageous rating share an incentive with the CRAs to seek each other out, vastly increasing the potential client base of the agencies. Furthermore, there are many newly designed financial instruments for which the financial intermediaries that issue them also seek low ratings. Not surprisingly, in pecuniary terms the agencies did well in recent years (Morris 2008: 77). Furthermore, under Basel I, all of this remained more of a private issue: mistakes would be costly for their clients, but not necessarily affect systemic risk. Yet today the agencies have implicitly been assigned new public responsibilities and their ratings can affect systemic stability. This indeed happened during the subprime crisis when, as ratings were adjusted downwards (having downgraded late in any event), systemic stress rose. This questions the Basel II practice of giving such a major role to CRAs in the management of risk.

A final way in which Basel II might have contributed to financial instability concerns the dangers of using a model-based approach to risk assessment in the first place. There has been a comprehensive – and scathing – critique of the models: the standard relationships on which these are based break down in periods of financial crisis (as the current financial crisis once again demonstrates). This danger of the model-based approach was well-known, and the 1997 Asian crisis had already provided empirical backing of the main criticism on the models.[23] Jón Daníelsson of the LSE also brought this to the fore in a response to the BCBS second Consultative Paper on Basel II.[24] Alas, these and other crucial interventions seem to have been to no avail but their prominence underscores the crucial point: the new bank capital adequacy regime would likely underestimate capital requirements prior to and during crisis periods, would also reinforce market procyclicality, and in practice the regime did indeed do so.

It was thus well known that Basel II for a large number of reasons could contribute to financial instability. To make things worse, it appears to have contributed to a reduction in capital levels *particularly in systemically important institutions* because of the different approaches offered to these 'sophisticated' banks running internal models. This effectively meant providing competitive benefits for the large and internationalised 'sophisticated' banks under the advanced approach, but translated into lack of capital during the current crisis. While Basel II was ostensibly, in part at least, about creating a more level playing field among internationally active banks, it was in fact far from neutral in terms of its impact on the terms of competition among different types of banks. The systemically most important banks arguably expected to benefit the most from the new regime, in terms of the levels of regulatory capital and the treatment of collateral.[25]

23 Daníelsson 2002, 2008; Persaud 2000.
24 Daníelsson 31 May 2001.
25 A 2006 survey by Ernst and Young underscores this point: three-quarters of banks believed Basel II would alter the banking sector's competitive landscape, as large groups with the most sophisticated risk models would benefit at the expense of those who have been slower to adopt these systems.

In addition to the financial stability concerns raised about Basel II, supervisors responsible for applying the system were also raising operational questions. They questioned the utility of the accord as a global or even national standard as a consequence of the high costs of implementation – in part because of its complexity. Indeed EU and US supervisors were already applying it quite differently within their respective jurisdictions, so the playing field was not being properly levelled. The hallmark of Basel I was its simplicity, at the cost of some insensitivity in terms of credit risk. Dealing with the complexity that was the hallmark of Basel II raised relative compliance costs more for smaller and less sophisticated banks, erecting barriers to entry and hindering competition. In the US, therefore, a Basel II derogation for smaller banks was announced, casting doubt on the accord as true 'standard' even in the core markets. Another, more subtle effect of Basel II's complexity is that it could generate a false sense of security irrespective of real market conditions. Banks and supervisors could hide behind technical complexity. Furthermore, it could facilitate regulatory capture as supervisors became overwhelmed by bank-based information during their discussions under pillar two. Complexity may also encourage the 'mock compliance' discussed in Chapter One. And finally, it remains unclear to what extent market pressures will enhance risk management systems since the greater disclosure and transparency required under pillar three (for example, of portfolio diversity) has been less forthcoming.[26]

We can thus conclude that while the BCBS claimed at the time that Basel II would contribute to the general efficiency and stability of global financial markets, scholars and practitioners had demonstrated that its effects might prove skewed, and that what may be efficient for international banks involved costs for developing countries as well as some (SME) social constituencies in developed economies. Whether Basel II would enhance the safety and soundness of the financial system it was supposed to protect was clearly in doubt. It would enhance the procyclicality of lending. It encouraged the very sorts of financial innovations that proved fatal to the system in the crisis. It relies

26 Initial indications were disappointing according to a confidential interim report by the EU Committee of European Banking Supervisors on Pillar 3 disclosure.

on asset prices and ratings that prove unreliable signals upon which to base a system of banking supervision. If a wide range of banks were to respond simultaneously and in the same way to perceived market trends – as reflected in prices and ratings in the market – then once again the inherent procyclicality of financial markets would only be reinforced, not countered.

Good risk management by a range of individual banks might not add up to a sound financial system, and the inbuilt market incentives might mean that supervisory practice could accentuate financial cycles and indeed herd behaviour in the market. “Market prices should never be employed as a solution to the problem of market failure,” warned Avinash Persaud (2000). Instead, any system of prudential supervision should be counter-cyclical, ‘leaning against the wind’ (Goodhart and Persaud 2008) of the market trends that might constitute a ‘Minsky moment’ and stemming the tide of panic in a downturn. Finally, there was the issue of the undue complexity and unevenness in the implementation of the accord across national jurisdictions. All these problems came at the additional price of delivering competitive advantages in the form of lower capital charges to the same major banks that presented the greatest danger to the system. Warnings there were, but the proposals had remained largely intact at the point of implementation. The crisis tells us that the system either did not or perhaps could not work.

Sovereign debt restructuring: Debtors, creditors, and the distributional equation[27]

In case of sovereign debt problems – often resulting from external imbalances – there are three elements to a resolution once national central bank or treasury resources have been exhausted in a crisis: i) official refinancing through for example the IMF; ii) domestic economic adjustment and/or reforms increasing the capacity to repay;

27 The discussion on the catalytic approach is drawn from de Jong and van der Veer 2010.

and iii) the restructuring of (private) creditor debts or private refinancing.[28] Domestic adjustment and reform takes time to bear fruit and is often most painful to those who are already poor. Official financing puts at risk pooled taxpayer funds from other, usually creditor countries, and needs to be paid back as a priority.

At the heart of the flaws in the (one could say lack of, or rather, ad hoc nature of) current governance of sovereign debt crises is an ideational bias that discounts the fact that there are always two sides to a lending transaction: those private or public agents who sought or were offered credit in the first place, and those (usually private) agents either wise or foolish enough to have taken the risk to lend. Historical practice and national law usually gives the edge to the creditor when it comes to repayment: instinctually institutions side with those who want their money back (with profit), except where blatantly exploitative lending practices have put perhaps helpless debtors at a disadvantage. Yet the outcome is always generated by both sides in the transaction and the risks are shared. Neither party can ever be fully informed about the future while each needs the other to fulfil their goals. If debtors and creditors are irretrievably linked in this way, it is sometimes surprising just who the parties to the transaction might be. The rapacious bondholders might at first appear to be major banks or vulture capitalists, but behind these agents will be citizen depositors or the pension funds of the working population in both creditor and debtor economies. The debtors might range from ambitious (or foolish) governments providing much needed services to their citizens to private banks supporting crooked property developers to venture capitalists rolling out the latest environment-saving technologies. Most economic agents are simultaneously debtors and creditors, or at least in *net* terms one and then the other over time. Given this opacity, a consistent normative bias towards creditors is unjustified.

A common issue in relation to sovereign and other debtors is ‘moral hazard’. This refers to the fear that (prior knowledge or expectation of) bailouts reward excessive borrowing and may also greatly reduce the incentives to adjust and enact painful domestic

28 Roubini and Setzer 2004.

adjustment and reform. Yet this problem has its mirror image in *creditor* moral hazard: official bailouts hamper a proper risk assessment by creditors and reward excessive lending (Haldane and Scheibe 2004). One might wonder why so many pension funds and banks continued lending willingly to Greece after it was abundantly clear that its economy was in a deep-seated structural debt crisis. A more balanced view on sovereign debt crisis resolution might take as its starting point that behind all these agents on the debtor and creditor side stand the final guarantors of the monetary system. These are best characterised as the median taxpayer, who is far from rich. All will collectively suffer the shock of a debt crisis, but the costs are unlikely to be evenly distributed.

The issue of burden sharing among the three parties (the population of the debtor nation through economic adjustment and reform, the 'private' creditors through restructuring, or the official sector through refinancing) and the trade-offs among the actors involved makes the resolution to sovereign debt crisis highly politically charged. It is clear that the official sector and the citizens of the debtor economy are going to bear a significant element of the risk and the pain of adjustment. The challenge is to ensure 'private sector involvement' (PSI) in the crisis resolution. After the defeat of the SDRM proposal (see the discussion in Chapter Four below), there are two principal mechanisms for dealing with the problem: IMF programmes providing official refinancing accompanied by reforms, and collective action clauses (CACs) in external bond contracts based on model-clauses developed by the G10. The private sector itself has developed 'principles for stable capital flows and fair debt restructuring' (IIF 2005) in cooperation with some leading emerging markets, but these have increasingly focused on crisis prevention instead of debt crisis resolution.

Official international creditors have limited resources granted by member governments on behalf of their citizens. With the emergence of crises born of capital mobility, it became increasingly clear that the International Monetary Fund – or creditor states in general – lacked sufficient resources to fully meet the refinancing needs of major crisis-hit countries, especially if contagion occurs on a global scale. Beyond this problem of resources lies a legitimacy issue. If the adjustment measures are going to be accepted by the general public, it may prove crucial for the implementation of IMF programmes by the authorities of the debtor country that the IMF succeeds in creating a sense of equal burden-sharing between public and private agents. In turn, successful programme implementation should notionally increase the chance of renewed private capital inflows as economic prospects improve. In other words, the legitimacy of IMF policy may depend to a considerable extent on its output-side effectiveness in involving private creditors, and vice versa.

In principle, PSI may be generated in two ways. First, the 'catalytic approach' involves the voluntary participation of private creditors triggered by the success of official intervention. Second, the use of debt standstills or (partial) default combined with the application of CACs for debt restructuring may compel private agents to share more of the burden. On the whole, the rules of the international monetary system have tended to rule out even partial default or standstills, except in exceptional circumstances. This section first addresses the effectiveness of the catalytic approach. The challenges and tradeoffs of CACs are subsequently discussed. It may be noted at this point that the perceived flaws in CACs were one of the main reasons why the SDRM was put forward by the IMF as an improvement over the current system. The analysis demonstrates once again that weaknesses with the current pattern of governance have been both longstanding and known to the relevant financial policymakers.

The 'catalytic approach' has long been an underpinning of IMF lending programmes. A country's financing need (or 'gross financing requirement' as it is called by the IMF) usually exceeds the projected inflow of private capital during a crisis. The gap between financing need and the finance available may be reduced by the adjustment measures adopted by the country's government, and also by loans provided by official and private creditors, but the capital available may still be insufficient over time. The catalytic approach rests on the understanding that IMF intervention sufficiently improves market confidence such that it triggers private capital inflows, and therefore is it an assumption that private creditors will be involved in solving a country's balance of payments difficulties. The catalytic effect can be said to arise if private sector inflows adequately supplement official lending to fulfil the gross financing requirement. This has sometimes proved to be the case, for example Mexico in 1994 and the South Korean case in 1998. In other crises, official emergency lending was not accompanied by an inflow of private capital, for example Thailand and Indonesia in 1997, and Argentina in 2000. To assess the effectiveness of the catalytic effect as a mechanism of governance, de Jong and van der Veer (2010) have undertaken an analysis of IMF programmes in past decades. The results are illuminating and cast doubt on yet another mainstay of market-based governance-light of the global financial system.

There are two ways in which official creditors such as the IMF may trigger private capital inflows: i) the *lending* channel, providing liquidity through new loans; ii) the *policy* channel, by the assessment of and influence of creditors on a country's policies. Emergency lending to relieve the situation may give private creditors an incentive to roll over their existing loans and to supply new loans (Bordo et al 2004: 11). Official financial assistance may also help the debtor country undertake an otherwise (politically) unworkable adjustment programme (Morris and Shin 2006), thereby inducing creditors to roll over their loans. The act of signing an agreement is a confidence signal from official creditors that a country follows sensible policies and has sound financial institutions. This 'stamp of approval' (Rodrik 1995) or 'good housekeeping seal of approval' (Bordo et al 2004) supposes that official creditors have an informational advantage compared to the private sector. The IMF then serves as a 'delegated monitor' for private creditors (Tirole 2002) as the restructuring programme develops and the several 'tranches' of lending are advanced if the agreed lending conditions are met.

De Jong and van der Veer's analysis is based on annual data covering the years 1988-2004 for 65 developing and emerging market economies (see also van der Veer and de Jong 2007). The data for all years includes both countries with and without an IMF programme. Out of the total of 722 observations, 251 refer to country-year combinations in which an IMF-programme was in effect, and for which data is available from the IMF's MONA database. Drawing on this data, de Jong and van der Veer estimated the total financing need of these countries, and found that in 25% of the observations, official financing exceeded the country's financing need (Table 3). In these cases, 'catalytic' private financing is unlikely to have played any role because public financing was sufficient to facilitate debt workout and exit from the adjustment programme. It should be noted that over-lending was not limited to countries with a high level of external debt.

Table 3 Official lending in countries with an IMF programme

Number of observations	External debt /GDP < 40	External debt /GDP 40 – 60	External debt /GDP > 60	Total
< 100% of financing need	30 (65%)	56 (82%)	103 (75%)	189 (75%)
> 100% of financing need	16 (35%)	12 (18%)	34 (25%)	62 (25%)
Total	46	68	137	251

Source: De Jong and van der Veer 2010: 141.

To determine whether IMF programmes led to additional private capital inflows, de Jong and van der Veer develop an equation with private capital inflows (in which the explanatory variables are a set of control variables explaining capital inflows under normal conditions), and a dummy variable which is 1 if the country has signed an IMF programme. The control variables include three groups of indicators representing: (1) long-term potential growth and market size; (2) the country's capacity to pay or reimburse investments; and (3) macroeconomic performance and stability.29 They use a two-step Heckman selection procedure to control for sample selection, and run the equation for each of three separate types of IMF programmes: stand-by arrangements (SBAs), extended fund facilities (EFFs) and poverty reduction and growth facilities (PRGFs). SBAs aim to solve short-term balance-of-payments problems; EFFs are geared to alleviate protracted balance-of-payments problems; and PRGFs are concessional loans to low-income countries. SBAs and EFFs are mostly used by middle-income countries.

29 See Table A-3 in van der Veer and de Jong (2007) for the list of variables used.

The different sorts of programmes are listed in the first column of Table 4. The results for the full sample run counter to the IMF expectation of a catalytic effect. They suggest that SBAs facilitate the exit of private investors, whereas no effect on private capital flows is found for the other two programmes. One should be reminded that a catalytic effect can only materialise if official finance falls short of the amount needed. Distinguishing between observations where official finance is larger or smaller than the country's financing need indeed reveals that over-lending negatively affects private capital flows in countries with a SBA (Table 4, last two columns). In these cases the private sector is effectively bailed out. For PRGFs a marginally significant positive (negative) effect was found for cases where total official financing was smaller (larger) than the financing need. These results suggest that if any catalytic effect is to be expected at all, it is for PRGFs.

De Jong and van der Veer's overall conclusion is that the catalytic effect remains elusive: official creditors thus cannot rely on private investors to voluntarily provide finance to crisis-hit countries. Their findings may be added to the equally pessimistic research into the broader effects of IMF approach to crisis countries undertaken by Vreeland (2003): over 20 years, IMF interventions failed to contribute positively to growth or economic recovery, and exacerbated inequalities in the process.

Table 4 Official financing and the catalytic effect of IMF programmes

Sample	Full sample	< 100% of financing need	> 100% of financing need
Stand-By Arrangement	-1.375 (-2.00)**	-1.061 (-0.82)	-1.444 (-2.07)**
Extended Fund Facility	-1.288 (-1.25)	-1.900 (-1.04)	-1.038 (-1.33)
Poverty Reduction and Growth Facility	0.096 (0.12)	2.558 (1.64)*	-1.519 (-1.76)*
Observations	722	248	474
F-test	0.00	0.00	0.00

Note: Significance level: *** = 1%, ** = 5%, * = 10%. Regressors not reported: export growth, external debt as per cent of gross domestic product (GDP), GDP per capita, inflation rate, interest rate, investment rate, reserves in months of imports, real GDP growth, short-term debt to reserves, short-term debt to total external debt, total debt service as per cent of exports, lagged dummy for IMF programme

Source: De Jong and van der Veer 2010: 142.

These disappointing results underpin the case for employing more coercive instruments to achieve PSI in crisis resolution. These more coercive instruments currently consist of standstills and ad-hoc debt renegotiations – increasingly aided by CACs in outstanding bonds. CACs facilitate collective decision-making in case of restructuring of the bond contract, for example by instituting majority decision-making for a specific bond issue. If a certain percentage of bondholders agree to a restructuring (usually a supermajority is required), it is binding for the whole outstanding bond. CACs are a market-based solution to debt restructurings, in the sense that they require negotiations between the debtor state and private creditors and are governed by *private* contract law.

In the discussions on sovereign debt crisis resolution following the East Asian crisis, a number of drawbacks of debt workout based on CACs were discussed. First of all, CACs can only be included in new international bond issues, leading the debt stock to fall prey to the old collective action problem of hold-out creditors and free riders. As we see below in Table 5, that problem is rapidly being addressed as the percentage of international bond issues with CACs had already reached 80% in 2004. The debt stock problem will thus phase out. However, the problem did re-emerge in the Eurozone's debt crisis as domestically issued bonds do not include CACs. Ad hoc measures like including them retrospectively by the domestic legislative were needed to address this problem. A second drawback of the CACs is that the model-clauses proposed by the G10 work for only single tranches of bond issued. In other words, negotiations have to take place with bondholder committees of the different tranches separately, and these could be many. This drawback is currently being addressed by the inclusion of so-called aggregation clauses, which compile different bond issues in a debt restructuring.

Table 5 Foreign currency sovereign bond issuance by governing law 1995-2004 (US$ billion)

Governing law	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04*
New York (w/ CACs)	7.1	21.3	22.0	18.0	22.2	34.7	37.2	36.3	46.7 (21.8)	33.4 (31.1)
English	26.2	25.0	26.8	30.0	17.9	12.5	14.2	14.4	21.4	27.4
Other	26.6	34.0	25.3	31.6	17.3	16.5	13.5	2.7	6.6	13.6
Total	59.9	80.3	74.1	79.6	57.4	63.7	64.9	53.4	74.7	74.4
% of total w/ CACs	50.8	42.7	39.6	40.0	33.0	28.1	28.2	27.3	58.4	79.8

Note: * 2004 to 30 September

Source: Drage and Hovaguimian 2004: table 1, p. 3.

However, a problem which CACs – however augmented – cannot address is the aggregation of different types of sovereign debt (thus not only bonds, but also trade credit, etc.). In other words, there is still no system that deals comprehensively with the varied dimensions of a debt crisis. Thus the debt restructuring process remains cumbersome at best. Most importantly, however, the problem with CACs is that it leaves the debt restructuring process in the hands of private creditors and debtor states, while ignoring the legitimate interests of creditor states and their taxpayer-guarantors. In other words, the creditor bias mentioned above is not addressed. After all, neither creditor state governments nor their citizens are typically parties to the original lending transaction. Yet creditor states are usually heavily exposed to the risks of worsening sovereign debt crises through official rescue packages by the IMF or more recently the EU's 'troika'. This provides private creditors with an undue advantage that, as mutual and sometimes initiating parties in the original lending transaction that has gone sour, it is very questionable that they deserve.

In sum

We can conclude that 30 years of global financial integration was accompanied by a range of risks, policy challenges, trade-offs, and potential conflicts over burden sharing and costs. Most of the potential downside risks of global financial integration were as well known to the public and private sector protagonists as the upside benefits. It is not the case that the onset of the global financial crisis suddenly provided new insights for those involved in decision-making; historical experience and the literature made the information available to those who wished to know well before the pattern of market-based governance-light was established. Even major industry players warned policymakers of the problem, for example hedge fund luminary George Soros (2005) and President of State Street Bank Avinash Persaud (2000). *We knew all we needed to know in order to prevent the outcome that was achieved.* That begs the question why these lessons were so thoroughly ignored in the relevant policy processes. It is to this question that we turn now in Chapter Three.

3. The input side of financial integration and liberalisation

Chapter One demonstrated that the broad strokes of market-based 'governance-light' were sketched by the G7, while the details were delegated to 'technical' forums. Chapter Two has shown that these forums could have and should have been aware that the patterns of governance they were developing were problematic and were unlikely to achieve their goals, particularly the primary goal of financial stability. This chapter looks at why the processes that generated these policies malfunctioned. From the wide range of policy initiatives that are part of the new financial architecture, this chapter will maintain the focus of this policy report on bank capital adequacy and the regime for sovereign debt crisis resolution. These two domains are analysed from the perspective of the relationship between the 'input-side' (policy processes) and the output-side (policies), and the legitimacy of each. This chapter poses the question, how were the decisions reached? How did the demand side for these new forms of international financial governance initially emerge? Who – which agents or constituency preferences – were most influential in shaping the outcomes supplied in response, outcomes that we have analysed and found wanting? Whose interests were best served by these dysfunctional results?

It will be demonstrated firstly that financial firms and their associations have historically close and relatively exclusive relationships with elite state policymakers and with the key international organisations together responsible for the design of financial governance. Secondly, there emerged over time a private sector-state agency coalition in favour of financial liberalisation, the policy preferences of which were observable in the norms and rules of the new architecture as it developed. G7 governments generally backed the preferences of their internationally active corporate financial sectors (Baker 2006) in an increasingly transnational policy community. Thirdly, the new institutions of global financial governance, such as the BCBS and the International Organisation of Securities Commissions (IOSCO), were characterised not only by exclusive policy communities, but also by a virtual separation from accountable political processes (Underhill 1995, 1997), a problem further exacerbated by frequent recourse to self-regulation. As a result, the transnational financial system became increasingly regulated by agencies that were very responsive to specific private interests (Cerny 1996: 96–9; Porter 1999).[30] The shift of policymaking to the global level, for example to the BCBS, provided an even better opportunity for the internationally active private sector to exert influence. They had the resources and know-how to participate effectively at the global level. Global-level policymaking institutions and their national membership, on the other hand, were more than happy to engage a private sector interlocutor in the form of the IIF as their main source of technical input. Unfortunately, the result was that input in these policymaking institutions best reflected the narrow interest of private creditors. Policy input not only reflected poorly the interests of the broader public, but failed even to represent the full ‘buy’ and ‘sell’ side spectrum of the financial sector at large.

Evidence indicates that crucial IFIs, such as the IMF, were part of this constellation of interests (Wade 1998; Stiglitz 2002). Private investors have attempted to shape the investment environment in emerging market economies by pressing these countries to adopt policy frameworks favourable to their interests (Maxfield 1998; Porter 1999), even though such policies might exacerbate problems of economic development (Cassimon et al 2010) not to mention socio-political stability. The emerging system of financial governance across national and global levels was thus flawed in important ways in terms of input-side, policy-process legitimacy. Agency and central bank autonomy meant that the guardians of the monetary and financial order had become increasingly autonomous from the traditional mechanisms of (democratic) accountability and control as well

30 See also Oatley and Nabors (1998) who document how the original Basel Accord was created to respond to the rent-seeking demands of private financial firms in leading industrial nations.

as from the influence of broader social constituencies, and increasingly close to the financial sector they were supposed to be governing. The point here is not that there should be no private sector involvement in financial governance, but such involvement is problematic if it aligns notions of the public interest with those who not only profit most from financial markets, but also represent the greatest risks to the financial system as a whole.

This chapter starts with two sections dealing respectively with bank capital adequacy standards in the BCBS and with sovereign debt crisis resolution. The discussion will demonstrate that the distributional political economy of trade-offs in the policymaking process was consistently decided in favour of the internationally active financial sector (the IIF constituency, in short). The third section concludes.

Banking supervision and the Basel Committee[31]

The case of international banking supervision, which has been primarily structured around the Basel Committee on Banking Supervision (BCBS), provides an example of how cross-border integration and emerging transnational policy processes have rendered internationally active private financial institutions more influential than many sovereign members of the global financial and monetary system. The BCBS was founded in 1974[32] and consisted of the banking supervisor from the central bank[33] of each G10 member country.[34] The first Basel Capital Accord (Basel I) in 1988 was the crowning achievement of the BCBS and occurred with little formal consultation with 'outside' interests, private or otherwise. Negotiations on international capital standards had dragged on from the early 1980s. The eventual breakthrough was driven by US domestic political considerations in the aftermath of the Latin American debt crisis

31 This section draws on Claessens and Underhill 2010 and Blom 2011: ch. 4.
32 For more on the history of the BCBS, see Wood 2005.
33 If this is not the banking supervisor, then there is an additional representative of the national supervisory agency, though this does not add an extra 'vote' and the committee anyway operates on a consensus basis.
34 In fact the eleven G10 members (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the UK, and the US) plus Luxemburg and Spain.

and was developed in bilateral (US-UK) and trilateral (US-UK-Japan) negotiations that eventually saw the BCBS as a whole on board.[35] The 1988 accord imposed a capital requirement of 8% of risk-weighted assets. To determine the sum of risk-weighted assets, five categories of assets were used, with risk weights ranging from 0% to 100%.

Doubtless up until the negotiation of the 1996 Market Risk Accord amending the 1988 Basel I agreement, the Committee itself did indeed operate in a considerably more detached manner than is the case today. However, one should realise that this obscures a more prosaic reality at the national level. National central banks and financial supervisors have traditionally developed policy in close cooperation with a small community of private interests which shared more with their 'principals' than with other socio-economic constituencies. These relatively closed and exclusionary national financial policy communities were often characterised by 'business corporatism' and the delegation of public authority to private agencies via self-regulation (Coleman 1996; Moran 1984). This close relationship between regulatory agencies and their constituencies still characterises the regulatory process today, and is in fact enhanced by the distance of central banks and other autonomous agencies with supervisory responsibilities from the rough and tumble of traditional policymaking in democratic governments.

Cross-border integration meant regulatory bargains reached at the national level had to be adapted to facilitate international cooperation, and Basel I effectively achieved this in relation to capital adequacy. The outcome of the agreement meant some national banking sectors had to raise substantial amounts of new capital, sharply affecting the cost of their lending (Oatley and Nabors 1998). Calls subsequently surfaced for the BCBS to consider more closely the relative impact of its decisions on the banking sector. The result was the emergence of more BCBS consultation with the private sector,

35 See Underhill 1997: 23-8; Oatley and Nabors 1998; and Blom 2011: 112 – 126.

particularly with the Institute of International Finance (IIF) based in Washington.[36] This implied that internationally active banks – the main membership of the IIF – gained a stronger voice in the emerging global-level policymaking process, that other domestic financial lobbies were largely relegated to the back seat, while non-financial lobbies were left completely on the roadside. This process expanded as the Committee's 1993 proposals to amend Basel I to include bank securities market risks were developed (BCBS 1993).

This at first informal and until then unprecedented consultation process began when the IIF issued a position paper sharply criticising the 1993 BCBS document: the proposals "fail[ed] to create sufficient regulatory incentives for banks to operate more sophisticated risk measurement systems than those necessary to meet the regulatory minimum," (IIF 1993: 3) meaning it failed to stimulate the use of internal control mechanisms. A well-circulated and authoritative scholarly paper by Dimson and Marsh (1994) argued that such mechanisms were more effective than the Committee's proposed approach, and this added to the pressure to revamp the proposal. In two new consultative documents the approach advocated by the IIF was embraced (BCBS 1995a, 1995b). The pressure had worked, but the Committee's new and soon to become formal interlocutor was hardly representative of the range of interested parties which would be affected by the amended accord. There was no emerging market representation in the IIF or the BCBS.[37] The process did not extend beyond the traditionally close relationships between western banks and their regulators. Situated at the transnational level, one may argue, the emerging policy community became ever more distant from traditional lines of democratic accountability in the policymaking process.

Following the successful translation of IIF preferences into Committee policy, the IIF-BCBS relationship became regular practice as the Committee began to consider a

36 The IIF was originally formed as a consultative group of major US and European banks during the debt crisis of the 1980s, and became a more broadly based organisation currently representing some 450 financial conglomerates (mainly banks) worldwide.

37 Although the IIF membership did eventually include some emerging market financial institutions, and the BCBS eventually began an 'outreach' process involving emerging market economies.

revised capital accord in the face of ongoing criticisms of Basel I treatment of credit risk, which had remained unchanged. In fact, the private sector began playing an even stronger agenda-setting role than in the past. The review of Basel I began with a study group of the Group of Thirty, a private think-tank-like body of members drawn from the public official and private institutions in the financial sector alike, many of whom had held prestigious appointments in both. The group issued a report on systemic risk in the changing global financial system (G30 1997).[38] In the foreword to the report, Paul Volcker, chairman of the G30, eulogised the role of global banks in the development of international regulatory frameworks and emphasised collaborative efforts between these institutions and their supervisors as an effective and broadly acceptable contribution towards the process (G30 1997: ii).

The report also observed that management controls should play a central role in the supervision of financial systems and that 'core' financial institutions should take the initiative to develop a new system along with 'international groupings of supervisors'. In essence, financial globalisation had rendered the supervisory process increasingly difficult and beyond the reach of national supervisors alone. The conclusions of the report implied that regulatory agencies should rely more on the private institutions that they supervised and that these institutions themselves would accept the responsibility to improve the structure of, and the discipline imposed by, their internal control functions and risk management mechanisms (G30 1997: 12).

Herein lay the origins of the market-based supervisory approach contained in the three pillars of Basel II.[39] In 1998, the IIF issued its own report specifically urging the BCBS to update Basel I on the basis of banks' market-based internal rating approach (IIF 1998). Although the BCBS invited consultations on its three sets of proposals for Basel II, the IIF remained the principal interlocutor, and comments came overwhelmingly

38 The report includes the names of study group participants and members of the Group itself, pp. 47-48.

39 The three pillars consist of minimum capital requirements, supervisory review of capital adequacy, and public disclosure and market discipline. Under the three pillar system, bank supervisors will no longer be exclusively responsible for the supervisory process and specifying levels of capital adequacy; rather bank owners and risk managers, supervisors, and market forces combine to oversee banks. See the discussion in Chapter Two.

from financial institutions in Europe and North America, and to a lesser extent from officials from agencies, a few academics, chambers of commerce and industry producer associations (Table 6 below).[40]

Table 6 Responses to BCBS consultative papers (% of total)

	CP2	CP3
Supervisory authorities	18	20
Private financial actors	70	66
Private non-financial actors	3	4
Other	10	10
Total number of responses	*257*	*186*

Source: Blom 2011: table 4, p. 133.

A claim that the BCBS in the mid- and late-1990s became a victim of policy capture appears justified. The ideational agenda became accepted with little critical analysis by either public or private authorities. It became far more likely that the BCBS and its member institutions would take into the account the articulated preferences of private sector interlocutors in developed countries than the interests of developing country supervisors and their corresponding financial sectors, never mind the interests of the taxpaying public whose guarantee underpinned the system. The long-institutionalised relationship between regulators and the regulated in financial supervision, which still approximates conditions of capture, had developed at the transnational level by the mid-1990s. And Basel II derived directly from an agenda set by proposals from the private sector.

It is therefore not surprising that the distributional advantages of the accord accrued to those large internationally active banks best able to operate the advanced internal rating-based systems permitted under special circumstances by the accord and represented by the IIF. This was reflected in three principal outcomes under Basel II: (1) 'sophisticated' financial institutions would likely see their capital requirements reduced; (2) smaller

40 See the BCBS web site for the public comments on the second and third consultative papers. Responses to the first consultative paper are not publicly available.

(e.g. regional or cooperative) banks and their non-rated SME clients would incur higher costs of capital; and (3) developing countries would experience higher borrowing costs. The new approach thus allowed large, internationalised, banking institutions to hold less capital on their securities market/investment banking operations, as long as internal risk management portfolio hedging systems were approved by the supervisor. Only the most 'sophisticated' financial institutions were in a position to benefit from the measures in this way, and one might note that these were largely the very financial institutions that were to bring down the entire edifice of global finance in 2007-08.

The economic argument in support of the approach was drawn from financial economics: market forces would play a positive and indeed central role in the containment of risks taken on by individual financial institutions. The approach was also in line with the prescriptions of portfolio theory requiring internal risk management based on state-of the art VaR models; market 'transparency' based on a greater degree of corporate disclosure concerning the risk profile of an institutions; and reformed 'mark-to-market' price-based accounting practices long familiar to the US securities sector. The clear assumption was that financial institutions best understood the nature of the dynamic risks they took on, and the pressures of market competition meant that they faced the strongest incentives to avoid the difficulties of unnecessary risk-taking.[41] The strong position of the IIF in the policy process had facilitated the realisation of the use of internal risk models as a key preference of the membership.

The distributional advantages of the accord thus accrued to those large banks best able to operate the advanced internal rating-based systems permitted under special circumstances by the accord. The prospective reductions in required capital relative to Basel I were much greater under the Advanced IRB approach than under the Standard or Foundation IRB approaches (BCBS 2006b: Table 1, p. 2).[42] Note that none of the G10 large internationally active – so called 'Group 1' – banks was expected to use the

41 Which assumed that moral hazard and 'too big to fail' issues would not play an undue role in the picture.
42 The accord stipulates that Basel II should not lead to an overall increase in capital requirements compared to Basel I; but this is a requirement at the overall banking system level, not at the individual bank level.

Standardised approach anyway, whereas 33 of the 146 smaller G10 banks – 'Group 2' – were planning to do so.[43] The situation is even starker for the non-G10 countries where 90% of 'Group 2' banks were planning to employ the Standardised approach (Table 3, p. 7).[44] This would yield a 38% increase in capital charges relative to Basel I, while the Foundation IRB approach an increase of 11% (Table 5, p. 10). The impact was clear: substantial competitive and cost advantages to those large banks (mostly in developed countries) who could apply the Advanced approach. Banks (and clients) using the standard approaches would find their capital reserves more likely to rise, hurting their competitive position.

Secondly, the 'standard' approach relied on external credit assessment institutions agencies, such as CRAs and qualified export credit agencies (see BCBS 2006a: 19 – 23 for the risk weightings applied). This negatively affected the many low- or especially non-rated small banks and SME clients, even though they are not necessarily riskier, and are certainly less significant in systemic terms. Claims on highly-rated clients yields lower capital charges (e.g., AAA to AA-, only 20%; A+ to A-, 50%). While most small credit institutions and their SME clients typically have no ratings (obtaining a rating can be expensive), they are not necessarily more risky, especially when considering their smaller size. Given diversification, keeping risk per loan constant, a large pool of SME-loans will be less risky in systemic terms than a small number of large corporate loans. However, loans to unrated (SME) corporate clients are subject to a 100% risk weighting, identical to Basel I (when all claims on the private sector were assigned a 100% charge), but certainly higher than lending to highly-rated corporate borrowers under Basel II.[45] Again, Basel II thus implies a clear relative capital cost disadvantage for both rated and unrated banks specialising in lending to (low-/unrated) SMEs.

43 The criteria for Group 1 banks are: the bank has at least €3 billion in capital, is diversified, and internationally active.

44 "Non-G10" included Australia, Singapore, and 7 developing countries. There were only 6 non-G10 group 1 banks; the survey was anonymous, but given the criteria it is highly likely that these were Australian and Singaporean.

45 This final outcome was actually an improvement on earlier proposals. Earlier proposals had included a 150% charge for low (BB- and below) and unrated corporations, but strong lobbies in the EU spearheaded by smaller German banks had been effective in obtaining more favourable treatment for SMEs and banks specializing in small scale lending. See e.g. submissions on the third Consultative Paper by the German Bankenfachverband, the European Co-operative Banks, the World Council of Credit Unions, or the Kredittilsynet-Norges Bank (Norwegian central bank) submission.

Although this point was explicitly raised in written submissions to the BCBS, it did not gain much traction in the negotiations. These written submissions to the Committee (however apparently accurate) were clearly taken less seriously than IIF input – which by invitation took place in person.

A third outcome of Basel II reflects the fact that developing countries were largely excluded from the BCBS policymaking process: the situation for unrated banks or their clients in developing countries was even worse than for unrated entities in OECD countries. Many developing country sovereigns would attract a 100% (BB+ to B-) or a 150% (below B-) risk weighting, and under the rules no unrated bank or corporate client could have a risk weighting lower than that of the sovereign in which they were incorporated. For otherwise creditworthy entities within low rated countries, capital costs were thus set to increase relative to Basel I. By increasing relative to Basel I the capital requirements for loans to lower rated sovereigns or banks/firms in such economies, Basel II thus affected the cost of capital and the quantity of lending to these borrowers.[46] Developing country submissions to the BCBS indeed identified this as a problem, arguing that some banks and corporations in developing countries were sounder than the sovereign and that the ratings of the bank and corporations should be considered separately from that of the sovereign and based on the real risks of lending to the bank or corporation itself.[47] Yet their pleas were ignored. Basel II thus would have had negative implications for the cost of capital for developing countries.

A related, but more technical aspect of particular relevance for developing countries concerns the risk reduction effects of (international) portfolio diversification. As risks are not perfectly correlated, the sum of capital adequacy requirements applied to individual credits is greater than the capital required of the overall credit portfolio. Basel II acknowledges this diversification effect, but only in the IRB approaches. The capital reductions from using (low) correlations are significant and are one of the main

46 For additional literature reinforcing these points, see e.g. Persaud 2002; Griffith-Jones et al 2002, 2003.
47 See e.g. submission of the central bank of Belize and of Burundi in response to the third consultative paper.

reasons why the IRB approach requires less capital than the Standardised approach. Even within the IRB approach, Basel II (and earlier Basel I) still places insufficient emphasis on the potential risk reduction effects of diversifying portfolios across both developed and developing countries. Developing countries as a group exhibit a lower correlation with developed countries than most other assets with each other. Griffith-Jones et al (2003) show that the chance of unexpectedly large losses on a portfolio evenly distributed across developed and developing countries is some 25% lower than that of a portfolio distributed only among developed countries. Consequently, the CARs should be set lower for a well-balanced portfolio that includes developing countries. But Basel II does not allow this, which raises the cost of capital and lowers the access to external financing for developing countries.

In sum, *skewed policy input produced Basel II outcomes that consistently favoured the interests of large internationally active banks, to the detriment of unrated banks and SMEs and developing countries.* This crucial element of market-based governance-light assumed banks could best assess the risks they might take, and failure would be the ultimate sanction. And failure there was: the worst aspect of the system was that it did not work, while the costs of failure inevitably hit those segments of the economy least involved in either generating the system of governance or the financial order itself. Thus the flaws in the governance of bank capital adequacy (analysed at greater length in Chapter Two) were directly related to the policymaking process in which these standards have been developed. Skewed inputs led to ineffective outputs.

Sovereign crises and the debt resolution framework[48]

Like the 1988 Basel accords, the resolution of the 1980s Latin American debt crisis was driven by the US. Private sector lobbying on the matter remained limited with an equally limited impact, although that is not to deny that US public officials had wide

48 This section draws on Blom 2011: ch. 5. See also Helleiner 2008, 2009.

regard for the interests of the large money-centre banks most involved with lending to the emerging markets in crisis. The initial ‘Baker Plan,’ named after US Secretary of the Treasury James Baker, focused on saving the otherwise insolvent US banks that had so enthusiastically lent to these sovereigns in the 1970s. As the banks were rescued and were over time able to write down the outstanding debt that was unlikely ever to be fully repaid, somewhat more attention was paid to the painful effects of the structural adjustments imposed by the IMF on the debtor countries and their poor inhabitants. The Brady plan, developed by the new US Treasury Secretary Nicholas Brady, effectively securitised, discounted and underwrote the debts of the Latin American economies and thereby stimulated capital market financing by emerging market debtors. The apparent success of the Brady plan at containing the crisis led to complacency among policymakers. It appeared that IMF refinancing combined with domestic adjustment could be relied upon to deal with future crises. The reform of emerging market macroeconomic and development policy in response to the lessons learned would do the rest in terms of prevention.

Mexico’s sudden incapacity to fund its highly securitised sovereign debt in 1994/1995 demonstrated that the market-based governance of sovereign financing not only did not succeed in preventing unsustainable sovereign debts from building up, but moreover would necessitate increasingly large official refinancing packages once the debt dynamics spiralled out of control. The ‘tequila crisis’ did however provide new impetus to the policy reform process. The Mexican collapse underscored the new nature of sovereign debt crises and led to the realisation that the IMF’s resources were no longer adequate to fulfil its mandate in this new capital market-financed world. Ever rising amounts of taxpayer’s money would be needed to bail-out private creditors. In response, two tracks emerged in the policymaking process, one centred on the creditor states’ forum of the G10 and one centred on the IMF. The latter held preliminary discussions on a possible statutory mechanism for dealing with sovereign debt crisis – often compared to a ‘bankruptcy court’ for states.[49]

The G7 as the apex policy forum eventually chose the G10 to draft a report on the orderly resolution of crises. This meant that the technical forum dealing with sovereign debt crisis resolution consisted exclusively of creditor countries and ceded a high level of access to private actors (mainly the IIF and international bond traders). The more radical, if preliminary, IMF-based discussions on a statutory mechanism – which included the emerging markets which were the most likely targets of any new system – were suppressed.

It should therefore come as no surprise that the eventual trade-offs made in the final proposals were biased in favour of private creditors. The G10 advocated in its ‘Rey Report’ of 1996 the inclusion of Collective Action Clauses (CACs) in the foreign bond issues of emerging markets to better facilitate debt restructuring talks between bondholders and debtors (G10 1996). The G10 developed the standards for CACs in close consultation with private sector parties, as also proposed in the report. As already discussed in Chapter Two, these CACs have a number of drawbacks, and place the private sector in a strong position vis-à-vis debtor countries in crisis in the negotiations. However, the G10 initiative initially went unheeded (Drage and Hovaguimian 2004), and in the crucial US market CACs were incorporated only sparsely. The private sector apparently preferred the expected benefits of an ad hoc process without clear procedures and without supermajority voting (in effect prolonging the collective action problem which was the reason why enhanced governance was considered necessary in the first place).

Sovereign debt crises continued to occur, however. A prominent milestone was the Argentine default of 2001 that led to major losses for private creditors and a very troubled relationship between Argentina and the IMF. This led the Fund, apparently

49 IMF Archives, 1995

egged on by US Secretary of the Treasury Paul O'Neill, to restart the discussions on a statutory mechanism in the form of the SDRM. This proposal – announced with much fanfare by IMF First Deputy Managing Director Anne Krueger in November 2001 – emerged out of a concern that the IMF was consistently bailing out private creditors,[50] while emerging markets from South Korea to Argentina wondered aloud why the burden of adjustment was not shared with the financial institutions that saw fit to lend in the first place and that bolted at the first sign of trouble.

The SDRM and CAC proposals provided two separate and contrasting focal points during the subsequent debate on the direction of reform. They were not mutually incompatible, but each of the two proposals involved quite different forms of governance: a global level solution led by a major multilateral public institution (the SDRM) or more market-based standards for CACs. A third proposal that was introduced at a later stage was a 'Code of Good Conduct' for relations between debtors and creditors, resulting in the IIF's 'Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets' (IIF 2005). These were developed by the private sector in cooperation with leading debtor countries, and were mainly an attempt to ensure private sector self-regulation in the face of these two 'public-sector' oriented tracks.

The SDRM offered a comprehensive and intellectually rigorous solution to the new capital-market-based structure and was supposed to be the crowning achievement in the crisis resolution framework that emerged after the East Asian and subsequent crises. It was a form of quasi-legal international bankruptcy procedure that would grant sovereign debtors temporary relief from their creditors. Private creditors would be compelled to negotiate the workout in the calm that would follow, and so rendered more responsible for losses. The SDRM could theoretically cover all outstanding claims of a country and subject them to an integrated restructuring. Initial voices to set up independent arbiters that would decide on the extent of restructuring 'haircuts' were quickly quelled by

50 An impression confirmed by the research of de Jong and van der Veer discussed above.

creditor states. Nevertheless, the SDRM would address many of the flaws inherent in the governance pattern for sovereign financing discussed above in Chapter Two.

CACs were, on the other hand, much more limited and much less intrusive in relation to the private sector. As discussed above, CACs involve harmonising aspects of bond contracts to facilitate collective decision-making in case of bond-based debt restructuring, preventing a minority of creditors from blocking a settlement agreed by a qualified majority. They leave the outcome to negotiations between the vulnerable debtor countries (which are likely to be under pressure and possibly in a state of disarray) and the powerful private financial institutions active in the market for sovereign debt. The 'Principles' also seek to facilitate negotiations between debtors and creditors during debt crises, but are less relevant for the current argument since they focus more on the phase before a debt crisis.

As the momentum behind the SDRM apparently accelerated, the power of private interests asserted itself again: opposition from the private sector led by the IIF defeated the proposal. The private sector's opposition was strengthened by the fear of some key emerging markets that publicly embracing the proposal would endanger their access to international capital or require them to pay higher interest rate spreads on their debt and render international lending into their economies more costly. Lobbying activity by the private sector intensified in the run-up to the 2003 IMF Spring Meeting, where the decision was to be taken. In an effort to weaken the case for the SDRM, Mexico issued the first international bond under New York law with CACs. The new US Treasury Secretary John Snow was also far less enthusiastic than his predecessor. Given the opposition from different sides and faltering support, the SDRM proposal was shelved by the IMF Board of Governors.

The SDRM effort was replaced by a revival of the CACs idea developed by the G10 combined the 'Principles for Stable Capital Flows.' The principles were, of course, both voluntary and market-friendly. The one attempt in the reform of the new financial architecture that aimed to strengthen public authority over the markets and alter the historic pattern of burden sharing in debt workout had been defeated. This meant that the private sector could continue to benefit from supplying emerging market demand for credit and leave debtor countries and/or the IMF to bear a disproportionate burden in case of adverse debt dynamics.

Conclusion

This chapter tells a cautionary tale that was reflected both in the literature and on the ground. The problem of narrow, exclusionary policy communities dominated by private interests that generated the international financial architecture is anchored at the domestic level in the countries that host the principal financial centres. Skewed policy input results in a skewed balance of public versus private authority and interests in the fashioning of both supervisory/regulatory policy and the financial order itself. As a result, the output side of policy-making was flawed in terms of both legitimacy and effectiveness: liberalisation and market-based financial architecture did not improve the stability of the system, and ultimately raised the costs for ordinary citizens. Financial liberalisation and the market-based approach to financial governance constituted a process of policy-rent seeking that yielded important competitive advantages for the major international investment banks and financial conglomerates that pursued the policy in the first place. State agencies involved in financial governance also had a crucial interest in financial liberalisation and frequently made common cause with the financial sector.

This private influence at the domestic level of decision-making is based on the close relationship between private financial institutions and supervisory and regulatory agencies, with frequent delegation of oversight to self-regulatory processes. Most often statutorily independent from politicians and other state institutions, regulatory agencies have become highly responsive to the preferences of private financiers, their main domestic political constituency. In fulfilling their regulatory and supervisory functions, they draw much of their legitimacy, and work in close communion with, private financial firms. Regulators also collaborate with national firms to adopt policies that promote their competitiveness in the transnational market place. Close public-private ties are further reinforced by common professional norms, the specialised and technical nature of expertise in the financial sector, and the shared need to maintain public confidence in the financial system itself. These problems were only exacerbated when policymaking moved to the global level in response to financial integration and liberalisation. Distance from domestic non-financial stakeholders increased, further reducing their voice in the process.

The Basel II Capital Accord was perhaps the best example of the problem. The process through which Basel II was formulated was an example of policy rent-seeking by financial interests seeking liberalisation and lower regulatory charges.[51] Basel II capital requirements were formulated in a relatively exclusionary and closed policy community consisting of regulators and supervisors from the G10 leading creditor nations and their private sector interlocutors. In these networks, private market interests found respondents in finance ministries and central banks that shaped policy at the global level. The final rules and standards sanctified by Basel II tend to award competitive advantages to powerful market players with little regard for either their smaller (systemically less significant) competitors or developing and emerging market economies, while the impact of Basel II is far wider than the banking institutions and markets of G10 committee members. The bottom line is that private actors, in particular large internationally active financial institutions, had more influence on pre-crisis financial architecture reform than a range of developing country members of the Bretton Woods Institutions, and certainly than nonfinancial stakeholders.

To conclude, the regularity and persistence of crises demonstrated that a liberal financial order posed important risks to developing and developed countries alike in terms of market instability and risk management. No one denied the need for better national-level governance and greater levels of cooperation at the international level.

51 For a more substantial account of this point, see Claessens et al 2008, especially pp. 318-27.

The result however was a crisis-prone system of ‘governance-light’ that delivered material advantages to those who had proposed it and unduly constrained the policy space available to the very governments in whose name it was promulgated. Private preferences dominated the making of public policy in the new financial architecture and at the domestic level.

The previous chapter demonstrated that the scholarly literature and historical precedent had adequately warned policymakers representing the public interest of these inherent problems of and open financial order. Policymakers and private interests chose to listen instead to arguments in favour of financial integration and market-based governance, putting other people’s money and future in jeopardy. This chapter demonstrated how this pattern of governance and its outcomes were the result of an exclusionary policymaking process in which specific private sector interests have excessive influence. There was no serious evidence that untrammelled capital mobility was either universally beneficial or without downside risks; and even if beneficial, it was clear that these benefits were not straightforwardly to be achieved. Regulatory and supervisory policy change was required, but policy capture ensured that this went awry. The situation was aggravated by the shift to global-level policymaking processes. National-level stakeholders – their involvement already limited – were further distanced from the process and traditional lines of democratic accountability further stretched.

Ultimately, the costs of the system were born by poor country and developed country citizens alike through the public rescue of the banks and the recession that followed. The lesson is that well-placed private interests win out against common sense and scholarly understanding and also win out against the dispersed and unorganised interests of the general public unless specific measures to prevent such an eventuality are positively developed by those who supposedly represent them in public office. Once again this outcome should not surprise us and we were so warned by Adam Smith some 240 years ago: “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public.... (Smith 1937 (1776): 128)”

One would hope that the crisis that struck the core of the financial system in 2007 might generate a reassessment of the ideational underpinnings of the global policy community. The inherent interest in financial stability of those who ultimately bear the risks and pay for policy failure should be reflected in the content of policy. The next chapter will address the extent to which this has been done.

4. Global financial crisis and reform: rediscovering the quest for stability?

This chapter will build on the analysis in Chapter Three by examining the various post-crisis reforms.[52] The main question addressed is whether the lessons which have been elaborated in Chapter Two have been learned this time. The chapter will therefore address both changes in the policymaking institutions and the substance of the reforms debated and negotiated in the technical forums. Thereby it provides an assessment through the lens of input and output-side legitimacy and their relationship.

It will be argued that although regulatory and supervisory standards have been strengthened and more fundamental policy reforms are being discussed, at the moment there is still too much continuity with pre-crisis financial governance. While policymakers appear determined, there is little evidence that the input side of the process has been altered fundamentally, and this problem continues to constrain the effectiveness of outcomes in terms of governance reform. The financial crisis beginning in 2007 exposed the market-based system of governance as singularly unsuccessful at providing either financial stability or efficient financial governance. It is not at all clear that the institutions at the regional or global level were adequate to compensate for the evident weaknesses and co-ordination problems of financial governance at the national level. Liberalisation and market-based 'governance-light' ushered in instability and ultimately ubiquitous and serious episodes of crisis for many societies to a degree that should challenge the very foundations of this approach to global financial governance itself.

52 This chapter draws on Underhill and Blom 2012.

However, as mentioned above, it is not yet clear that in the post-reform period either the knowledge developed and available during the pre-crisis financial architecture debates or the lessons of the crisis itself have been well absorbed and/or as yet put to practical use. There is still insufficient attention to the problems posed by a liberal and globally integrated financial system, and the reform debate continues to pursue an essentially market-based approach to financial governance at the national, regional and global levels. The idea-set has been questioned but not replaced during the reform process. The approach taken in managing the Eurocrisis has in fact greatly reinforced the commitment to this idea-set, relying on fiscal austerity and market-oriented reforms targeting and adapting debtor countries (but not creditor banks or current account surplus lenders) to the highly procyclical market dynamics of capital mobility. This flies in the face of the evidence that such adjustment policies hurt economic performance, fail to remove the threat of crises, and redistribute income upwards (Vreeland 2003).

Yet, if we analyse the input side of the policymaking process, the most significant change is the replacement of the G7 by the G20 as the apex policy forum in global financial governance. The emergence of the G20 is also reflected in the expanded membership of the more technical forums (e.g. the BCBS, FSB, and IOSCO). This has significantly widened the group of states substantively involved in global financial governance and reflects the rising power of especially the BRICS countries. In this sense, the input side of the policy-making equation has been substantively improved and better outputs in the future may be expected. However, smaller, poor developing countries must still mainly rely on the weaker G24, which prepares input into the G20 and other bodies.

However, when it comes to the ideational underpinning of global financial governance, a disturbing degree of continuity can be observed despite the new G20 context. As demonstrated in the previous chapters, pre-crisis financial governance developed policy solutions based on the shared ideational preferences of a policy community of public and private constituencies. This idea-set benefitted the same actors that dominated the input side at national and international levels, while alternative approaches available through the historical and theoretical record were ignored. Despite the wider club of G20 public actors on the input side, the ideational preference-set of the pre-crisis period continues to wield significant influence in the process of reform. Without doubting their commitment, the role that will be played by state agencies in generating new departures also remains unclear at present. Institutional and ideational path-dependency remains strong.

So the changes in the international financial architecture in response to the 2007 crisis contain the potential for serious change, but the jury is still out on whether this potential will be fulfilled. The idea that the banking sector requires more and better capital hardly ranks as an innovation; Basel II had been contested all along. The emerging discourse of macroprudential oversight and the challenges to proprietary trading by banks, for example, may have significant consequences for the global financial system if fully pursued. However, the reforms have so far been limited to the incremental or the promised, such that the existing market-based approach to regulation remains largely intact. Ending the link between the deposit base and proprietary trading has the commitment of few jurisdictions, and regulatory arbitrage could undermine the effectiveness of the proposal altogether.

Substantial institutional development and innovation is required in order to operationalise the macroprudential approach that supervisors say they intend to pursue, positive signs of progress in the FSB notwithstanding. Institutionalised linkages across heretofore separate policy domains must 'join the dots' and promote coordination across monetary and exchange rate policy, debt issues, financial supervision, and macroeconomic adjustment and imbalances. The failure to develop oversight of the interactive dynamics among these policy domains has been part of the problem; financial system oversight must reflect the de facto overlap among these issue areas. The natural 'leaning against the wind' in monetary policy has to be properly balanced and coordinated with the new commitment to 'leaning against the wind' in the supervision of financial and asset markets. Rapid growth in certain products or market segments should be treated sceptically, and possibly suppressed until it is absolutely clear they do not pose risks to financial stability.[53]

This requires a more integrated institutional setting for policymaking and implementation. At the national level, mechanisms to link these policy domains are so far absent in most countries. Internationally, the FSB and the IMF have been identified as the key focus, along with the possibility of supervisory colleges. It is not clear that these changes are adequate or how they will function in practice. At the same time, the G20 as the apex policy forum likely lacks the technical expertise and/or time to sufficiently assess these interlinkages. The task will continue to fall on the technical forums.

The linkages between the input and output sides of the equation thus remain complex and problematic. In other words, although there is the appearance of improved input legitimacy, the ongoing convergence of public and private actor preference sets means that relatively little of substance in output has changed. Further evidence that reform is but incremental is observable: the phase-in period of the proposed reforms has been extended substantially by private sector pressure and by fears that the banks remain too fragile to survive overly rapid substantive change. Already, we see opposition to specific elements of Basel III on the rise.[54] The more radical elements of the reforms have been pushed into the future. This provides ample opportunity, as and if relative calm returns to financial markets, for the private sector to water down more uncomfortable measures or eliminate them altogether through a strategy of attritional lobbying during the implementation phase.

The reform of the international financial architecture once again has two main fronts on the technical level: i) the BCBS and related BIS-based efforts on capital adequacy and the coordinated supervision of the financial services industry as increasingly integrated by the banks; and ii) the macroeconomic imbalances, debt workout, and adjustment/monetary policy front led by the IMF and currently the EU, as the main trouble spot.

53 See also Underhill 2011 on financial innovation.
54 *Financial Times*, 24 September 2012.

This chapter is structured as follows. The first section consists of a general description of the reforms, particularly the advent of the G20. Sections two and three analyse respectively the policy initiatives taken by the relevant technical bodies in response to the crisis: Basel III, and the developments on the sovereign debt crisis front. The final section concludes by situating the changes in the international financial architecture in the context of input and output legitimacy, assessing the prospects of better outcomes in terms of effective governance and the provision of financial stability. This last section will provide the bridge to the final chapter of this policy report which will summarise the analysis and provide the resulting policy recommendations.

Advent of the G20

The reform process in each of the technical forums has its own distinct dynamics, but the ubiquity of capital flows implies frequent issue overlap and a need for well-oiled co-ordination across domains. The Joint Forum of supervisors and the FSF/FSB were already addressing this problem in a limited way prior to the crisis, but coordination was also facilitated by overlapping participation in these forums resulting from their domination by the national agencies of a small number of major creditor countries. Coordination of the fronts used to take place through the G7 (see Chapter Two above), that served as the input-side apex policy forum bringing together senior officials from finance ministries and central banks (sometimes at top level) to either mandate the technical bodies or endorse their efforts (Baker 2006, 2010).

As we have seen, the G7 as creditors developed a common interest in and preference for open financial markets – the better to expand their financial sectors and centres – and market-based forms of governance. Private sector partners with their allegedly superior understanding of the new market complexities steadily permeated the policy process as new institutions and forums were developed (e.g. the Capital Markets Consultative Group of the IMF). Despite their arguably continued relevance, traditional policy instruments like capital controls were routinely ignored in the discussions (Cohen

2003). Likewise, the specific interests of emerging market economies afflicted by the frequent episodes of crisis received scant attention. G7 efforts focused on adapting the system and its units to the market-based vision, e.g. through the standards and codes agenda.

The post-crisis reforms have led to a change in and a strengthening of the legitimacy of the input side. The rise of China and the other BRICS as creditors with huge currency reserves was confirmed when the 2007 crisis erupted in Wall Street, the core of the G7 financial system. If these fast-growing creditor economies were to become part of the solution, then they would have to be consulted. The G20 had been around for some years as a ministerial/central bank governor forum established after the East Asian crisis of 1997-98 and it soon emerged as the new apex policy forum meeting for the first time at summit level in November 2008 at the invitation of US President Bush. G20 membership was then extended to the technical bodies such as the FSB (April 2009) and the BCBS (June 2009).

While this notionally enhanced the input-side legitimacy of the process, the impact on the output side of these technical bodies has so far been limited (see the following sections). The first G20 summit mainly set about strengthening, accelerating, and reinforcing policy processes which had been already under way in the technical forums (sometimes as a response to the crisis, sometimes predating it), such as the development of standards and best practices in the field of credit default swaps and OTC derivatives. What has changed, however, is the attention paid to the effects of the new standards and codes on emerging markets and developing countries. Where the Basel II standards had significant adverse effects on countries which had not been part of the negotiations (see the discussion in Chapter Three), nowadays the FSB – in cooperation with the IMF and World Bank – is requested to provide a report to the G20 on the effects of regulatory reforms on emerging markets and developing countries (the 'potential unintended consequences').[55] This will likely increase the attention to the preferences of this set of countries in the development of global standards and codes.

More recently, under the influence of the 2012 Mexican presidency of the G20, the 'finance track' of the G20 focused not only on financial regulation and the international financial architecture, but also on financial inclusion, financial education, and consumer protection (next to activities on climate finance, energy and commodities markets, and disaster risk management). On the one hand, this might reflect developing country priorities, on the other hand the further expansion of financial markets in developing countries and 'unbanked' segment of western economies is still seen as beneficial. Citizens need to adapt to the requirements of sophisticated financial markets. Whereas in the post-Asia crisis emerging market *economies* had to adjust to the strictures of the global financial system, these adjustment processes are now taken to the level of the individual. This reflects the lack of ideational change underpinning the consensus amongst policymakers in the new apex forum. As Helleiner and Pagliari (2009: 283) noted:

> At the Washington meeting [of the G20 heads of state], it was hard to detect any new common intellectual vision that guided the discussions. The delegates routinely expressed their joint desire to preserve an open global economy, but they failed to lay out a novel set of ideas how the financial system could be refocused to serve new goals in light of the lessons learned from the crisis.

The next two sections will analyse in more detail to what extent the technical forums have taken new avenues in addressing the twin crises of banking and sovereign debt.

55 FSB, June 2012.

The BCBS: Third time lucky?

The Basel III Accord has emerged as the centrepiece of the post-crisis reform effort that has preoccupied the BCBS. In light of the obvious failures in the banking system, this should come as no surprise. The process began with a hasty revision of Basel II in 2009 and led to the publication of a series of Basel III consultative documents (2009-10) and the final version of a new accord (Basel III) in December of 2010 (BCBS 2010b). One should also be reminded that during this period the membership of the BCBS was expanded to include the G20 countries in addition to the original membership.[56]

Basel III builds directly on the approach developed in the Basel II framework and as such does not constitute a new departure. The then BCBS Chair Nout Wellink assessed the new agreement as comprising "a landmark achievement that will help protect financial stability and promote sustainable economic growth" (BCBS 2010c), but there has yet to be a fundamental review or rethink of the workings of the contemporary financial system itself. Certainly the market-based approach has not (yet?) been abandoned in favour of anything else, but there are significant changes that can be understood by examining the BCBS's report to the November 2010 G20 summit on the crisis fallout in Seoul. The report portrays Basel III as the first of the building blocks of a 'broad strategy' for a 'new approach' to the post crisis financial system that has a number of aims. These are: (1) to raise the quality and level of bank reserve capital, especially so-called 'Tier One' capital; (2) to increase the coverage of capital reserves to all market segments and aspects of bank financial conglomerates (e.g. the SPV or SIV affiliates that held the infamous subprime mortgage-backed securities); (3) to prevent the micro-level and systemic build-up of debt through a new and harmonised leverage ratio combined with a minimum level of overall liquidity to ensure that banks can deal with situations of financial stress; (4) to improve – in tandem with bank disclosure

56 Membership in 2011 consisted of Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

requirements – the standards of supervisory review and (macroprudential) monitoring; and (5) to develop countercyclical capital buffers which will vary inversely with boom-bust cycles (BCBS 2010a: 1-2).

Essentially the new package consists of three innovations: first, there is a considerably more rigorous definition of Tier One capital (restricted essentially to common equity and cash/retained earnings), and the level is raised from 4 to a 6% risk-weighted minimum; common equity must be at least 4.5% of risk-weighted assets at all times. The Tier One minimum is a de facto 7% with the new capital buffers, although total Tier One plus Tier Two is still the same 8% (BCBS 2010a: 12). Thus it is important to remember that some assets e.g. OECD sovereign bonds (thus Greek, Portuguese, French) remain zero risk-weighted and so require no capital reserves,57 and that asset risks can still be netted against each other in the bank's trading book. In addition, the definition of capital, risk-weightings, and the new liquidity provisions (BCBS 2010a: 8-10) have been harmonised globally to prevent regulatory arbitrage.

Secondly, banks will be required to hold capital reserves on all market segments and entities in the corporate group (derivatives, SIVs and SPVs). Thirdly, there will be macroprudential 'systemic' oversight by supervisors and bank capital will 'lean against the wind' of the financial market bubble-burst cycle (BCBS 2010a: 5-7). This latter provision is one of the most important innovations and responds to the problem of procyclicality of financial regulation which was discussed in Chapter Two. This problem manifested itself in the lead-up to the crisis wherein net capital reserves were particularly low during the rising market (bubble) phase, hiding a build-up of risk and shared large exposures to narrow market segments across the system. Capital requirements then suddenly rose dramatically as markets began to fall precisely at the moment when banks had the greatest difficulty either raising capital or covering liquidity needs and thus worsening the crisis. In other words, the new system will attend

57 Though given the impact of the Eurozone debt crisis, perhaps not for long and certainly no longer where rating agencies are concerned.

more robustly to systemic risk/interconnectedness problems and stress in individual financial institutions, linking up with the work of the FSB and Joint Forum of Financial Supervisors (insurance, securities, and banking) likewise based in Basel.

The new framework will have further building blocks in the future, on which the BCBS will continue to work: a 'fundamental' review of the 'trading book' and of the role of CRAs and the use of external ratings in banking supervision; the treatment of 'systemically important' banks (which benefitted most from Basel II yet brought the system down); of large exposures of banks to particular market segments/asset class; and eventually the institution of 'Colleges' of supervisors to enhance co-ordination (BCBS 2010: 2). Although welcome innovations, they cannot hide the fact that the basic Basel II framework and market-based system of supervision remains in place, albeit attenuated, and remains based on national systems of supervision. There is no serious institutional innovation beyond the (as yet undefined) proposal to set up supervisory Colleges to enhance supervisory coordination, and there is no explicit link between macroeconomic policymaking and financial system supervision to accompany the countercyclical measures. This last point is important; there is no institutional or policy-process innovation to realise the all-important goal of better macroprudential oversight. Given that this is the principal innovation of the post-crisis reforms, remarkably little has been done to make such an idea a reality and we must trust in future efforts. Furthermore, one should note that the Basel III measures will be phased in from 2015 with minimum standards finally in force in 2018 (BCBS 2010b: 10), which leaves plenty of time for things to go wrong yet again under the Basel II provisions.[58]

Moreover, almost absurdly, attempts have been made from within the EU to make Basel III a *maximum* instead of the minimum standard it is always supposed to have been. This would prevent particularly vulnerable countries (with a high ratio of bank assets to GDP, such as the UK, Switzerland, and the Netherlands) from 'goldplating' their

58 Some countries are known to be accelerating this timetable, but the persistence of recession and bank sector difficulties makes the ongoing transition difficult.

domestic banking supervision by setting higher capital requirements. It is thus not yet certain that bank capital adequacy standards will indeed improve significantly, and the extent to which the idea-set of certain policymakers has changed – let alone attention to the interests of the large internationalised banks – is in doubt.

Since the conclusion of Basel III at the end of 2010, the BCBS has made progress on some of the other building blocks. The new draft of the Basel Core Principles on Banking Supervision (Basel 2012) does place more weight on the issue of identifying and the timely management of systemic risk and attending to the macroeconomic context59 as well as better coordination between banks and other financial sector developments and with other national supervisors on for example home-host relationships or the consolidated supervision of conglomerates. Just how these new capacities are to be developed or institutionalised is yet to be determined, and little can alter the fact that while the standards are enhanced, the basic approach is the same as for Basel II. The focus is still predominantly on the better management of risks across the individual bank or conglomerate and the strengthening of corporate disclosure to give more meaning to pillar three.

So far the G20 or BCBS has proposed nothing along the lines of a 'Volcker rule' or UK-style 'ring-fencing'. This is a sort of modern-day 'Glass-Steagall' principle in which was enshrined one of the prime lessons from the Great Depression (see the discussion in Chapter One), that commercial banks should be prevented from drawing on their own or depositors' resources to feed proprietary trading or other activities in securities affiliates or subsidiaries or other 'related parties' as the jargon now goes. National-level reform radicalism may yet make up for some of this apparent inertia, especially in the UK (Baker 2012) but will not resolve the inherent regulatory fragmentation and

59 For example under Principle 16 on capital adequacy, clause 4 of the 'essential criteria' now reads, "The prescribed capital requirements reflect the risk profile and *systemic importance of banks in the context of the markets and macroeconomic conditions in which they operate and constrain the build-up of leverage in banks and the banking sector*" [emphasis added] (BC 2012: 45). This places somewhat more emphasis on the macroeconomic and systemic aspects than the previous version, and several of the principles have received this sort of insertion (see BCBS 2011). The modalities and specific linkages with aspects of macroeconomic policy-making are yet to be worked out.

arbitrage problems if global efforts remain as cautious as is now the case. In short, if more substantive reform is to come, particularly a shift away from the pattern of market-based governance in banking supervision, the signs of it remain faint. This may be at least in part because the inclusion of G20 members in the BCBS was too late in the process to propose significant changes. But more importantly it seems such a shift away from market-based governance is not being actively considered by G20 members or the BCBS and other technical forums. More thought needs to go into the composition of the policy community that is generating reform: new voices might bring new ideas as well.

Sovereign debt workout: The IMF and the Eurozone

The sovereign debt crisis in the Eurozone has since 2010 overshadowed the failure of either the UK or the US adequately to deal with their own imbalances or to pull resolutely out of recession. The crisis in Europe has come to resemble the trench warfare of the First World War, dragging on and on and dragging the rest of the world economy down with it. Even the successful recovery and growth in China and other emerging markets seemed to be in jeopardy at the time of writing. The Eurozone crisis is also the best example of how pre-crisis preferences and idea-sets, especially those of creditors, have changed little and are still producing negative outcomes. Although the initial phase of the crisis was unexpectedly well handled by an ECB that seemed willing to stretch the rule book essentially to breaking point, policy innovation in the sovereign debt phase in the Eurozone has been less inspiring.

The current policy stance in Europe is not working and is on the contrary making the crisis worse. Even the lessons of the Great Depression do not appear properly to have been absorbed: if one reads accounts of the collapse of financial markets and sovereign finance in the 1930s, history is not quite repeating itself but it does seem to rhyme: the discourse of debt workout is disturbingly similar in both cases (see e.g. Kindleberger 1989: 212-221). The names of the creditor and debtor countries were different then, but the debate was familiar. Creditors and (central) bankers60 evangelised on the risks of inflation as economies collapsed inwards in a deflationary spiral. According to these apostles, continued lending would weaken the currency and would only encourage further profligacy in feckless countries anyway (what we would call the 'moral hazard' problem today). Unaffordable social spending had to be dispensed with and painful downward wage adjustment undertaken to boost competitiveness in the stricken economies:

> Parties concerned for the safety of the currency protested as much against threatening budget deficits as against cheap money policies, thus opposing 'treasury inflation' as much as 'credit inflation', or, in more practical terms, denouncing social burdens and high wages… (Polanyi 2001 (1944): 227).

When the financial system began its fateful collapse and the banks and eventually central banks had to be saved, emergency lending was arranged but too little too late, and with conditionality that made matters worse by raising borrowing costs and reducing the capacity of debtors to pay. Ugly domestic political reactions set public sentiment in debtor and creditor countries savagely against one another, impairing the cross-border cooperation necessary to manage a solution. Today the discourse is not dissimilar and nor is the policy stance of the EU creditor countries towards the debtor countries. There are of course calls for growth, as there were then from what came to be the Keynesian position. The difference is that by today we have had Keynes' *General Theory*, a history of alternative policy under the Bretton Woods regime, and much else besides. We should know better. Despite constant reference to the need to avoid the horror of the *interbellum*, policy idea-sets and reactions are not as different today as one might hope and expect.

60 A crucial difference between the interwar period and today is that central banks in the 1920s were overwhelmingly privately held institutions, although they were mandated important public duties in relation to the currency, markets, and public finance.

In early 2010, after the financial sector was brought back from the brink through massive state and ECB intervention, market actors turned around and bit the hand that fed them by demanding prohibitively high risk premiums for lending to certain peripheral countries. This has made things much worse for both sets of actors, and the ongoing absence of timely and resolute public authority and action lies behind a looming collapse of the entire Eurozone. The failure to establish a proper governance mechanism capable of orderly and rapid resolution of a sovereign debt crisis – as discussed in the previous chapter – added to the uncertainty. The limited mechanisms available (CACs) were not included in most of the Greek sovereign debt. The current sovereign debt crisis is specific, however, in the fact that it takes place in a monetary union with well-established institutions – which makes a certain difference with the serial emerging market crises. Therefore, we first need to elaborate how this crisis came about.

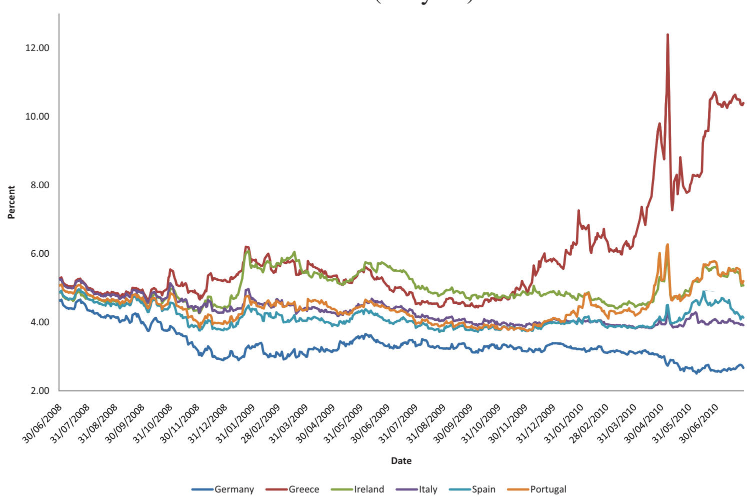
The first point is to underscore that this sovereign debt crisis was above all a direct and predictable consequence of the financial collapse of 2007-08 and the manner in which the banks were rescued. The transfer of banking sector bad debt and toxic subprime liabilities to national treasury or central bank balance sheets was a common across-the-board contributor to higher levels of national public debt. The economic slowdown caused by the financial crisis was a further blow to sovereign fiscal health. Tax revenues were down due to the recession, and this combined with the 'automatic stabilisers' of the welfare state plus calculated economic stimulus packages mandated by the G20 all contributed to a well-understood process of worsening fiscal balances. Little had been done to relieve global current account imbalances, so these liabilities also remained serious for a range of countries. The reserves of emerging market economies in Asia and Latin America were increasingly propping up the system.

Attention began to focus ominously on the sovereign debt dynamics of a number of countries in the Eurozone 'periphery'. These were soon derogatorily referred to as PIIGS (Portugal, Ireland, Italy, Greece and Spain). In addition to financial crisis dynamics, their growing difficulties were linked to patterns of intra-Eurozone current account deficits and complementary creditor country bank lending on sovereign bond and private markets during the boom. As European creditor countries were still experiencing lingering financial sector difficulties, this financial fragility tied the creditor country banks to fiscal balances and to worsening private sector risks in the 'periphery'. This 'twin crises' dynamic served to augment perceptions of future uncertainty yet more. But certainly no one should have been surprised that the fiscal problems of these and other countries worsened in the shadow of the crisis. It happened across the board, and they were not necessarily the worst performers. By 2011, the only Eurozone countries to maintain debt-to-GDP ratios in accordance with the Maastricht criteria were wealthy Luxemburg plus Slovenia, Slovakia, and Finland (Eurostat online). The G20, IMF, and other bodies had anyway accepted for some time that exceptions to normal fiscal prudence would be needed and international cooperation required to ease the burden for the hardest hit. Aid should not be cut, welfare provision would continue.

Prior to the crisis, the PIIGS presented a mixed picture in terms of fiscal rectitude. Spain and Ireland each managed annual fiscal surpluses and debt-to-GDP ratios well below the Maastricht limits, easily performing among the best in the Eurozone, and certainly better than 'benchmark' Germany that enjoyed the lowest borrowing costs. Italy's annual deficit kept close to benchmark German performance, but total debt-to-GDP was consistently over 100% in the 2000s, clearly out of line but declining until 2007. Still, Italy's annual deficits in 2010 (4.3%) and 2011 (3.9%) were hardly shocking in the middle of a crisis. Portugal and especially Greece were more serious offenders, but they remain tiny relative to the Eurozone total. Portugal had a reasonable total debt load oscillating under or just above the prescribed 60% Maastricht criteria range, but annual deficits that were steadily worsening to peak at 5.9% in 2005 though falling to 3.6% by 2008, above the Maastricht limit but again hardly shocking by international standards in a crisis. Greece, like Italy, had debt to GDP ratios of over 100%, and was consistently among the worst performers on an annual and total debt to GDP basis. And Greece did 'cheat', misreporting figures just prior to the crisis. Yet this too was nothing new and was foreshadowed by the IMF anyway, so everyone knew it was coming (IMF 2009: 20-1).

On the whole the PIIGS had not done so badly. All the major western economies and their government finances were after all in trouble, and Germany itself had persistently violated the Maastricht rules in the wake of the DotCom financial crash, indeed in league with France using its power to soften them. Even at the end of 2011, in the midst of the crisis, Spain still had an overall debt to GDP ratio *below* that of Germany but with an increasingly alarming annual deficit problem. But the debt situation for all five countries worsened dramatically from 2010, even for Italy with its rather modest annual deficits. Greek debt was above 165% of GDP by 2011, and rising in a clearly unsustainable fashion. The cost of debt service was spiralling out of control. The question was, why were these countries in such severe crisis if for the most part their sins of commission were apparently less than mortal? And what would be done about it?

Figure 2 Selected Eurozone Bond Yields (ten year) June 2008 – June 2010



Source: Jones (2011)/Global Insight

The answer to the first question was straightforward: the effects of the financial rescue and recession plus financial contagion on the bond markets and policy mistakes linked to ‘governance-light’ were driving the worsening situation. In typical procyclical fashion, the liberalised and integrated financial markets in EMU overshot severely in their 'flight to quality' (i.c. Germany). Greece (as the worst offender, especially on the 'sins of commission' front) was the first country in the dock, with crisis brewing in late 2009 when the newly elected government blew the whistle on its predecessor and announced the scandal of a significant deficit 'massage'. The markets took a patient approach to the new figures through early 2010 (see Figure 2), until they realised that the German Chancellor was serious in asserting that each country would have to keep its own house in order and satisfy the markets in terms of confidence, keeping to the 'rules' or policy standards underpinning monetary union.

So this was the answer to the second question: there would be no bail-out as per the terms of the Treaty of Maastricht, no matter how exceptional the circumstances and despite G20 exhortations. Unbelievably, it was even suggested by the Chancellery that possible official refinancing which would be provided would carry market interest rates – with the restraints on policy space which conditionality imply apparently considered a treat to the country in question. Policymakers in the creditor countries had thereby informed the markets that the resolution of sovereign debt problems, even in the case of the collectively generated outcomes of EMU, remained locked in the pattern of 'governance-light' wherein the weakest links would have to adapt and adjust internally to the functioning of the international bond market. It was no matter that this would lead to a highly procyclical policy of fiscal austerity (a point fiercely argued by Stiglitz (2002) and even partially accepted by the IMF (2003)). Greek bond spreads then rose dramatically relative to German levels (Figure 2 again), raising the cost of financing for private and public sectors alike. This put banks and thus savers in the creditor countries in further trouble amidst mutual and sometimes ugly populist recriminations. Something had to be done, and when creditor countries realised their own banks (that made the loans in the first place) were being dragged under once again, talks began in earnest. A series of packages involving the IMF and new European lending facilities were put in place to once again bail out private creditors who had lent in the good times and discovered the risks of financial instability too late.

The financial crisis had already given the IMF a new lease on life with a rapid and enormous revival of emergency lending. The G20 London summit of April 2009 increased IMF resources by US $750 billion ($500 billion in lending facilities and other instruments provided by member states, and $250 billion in new Special Drawing Rights). The BRICs (without South Africa) contributed $82 billion to this capital increase, signifying their emergence as creditor states (Schilperoort 2010: 191-192). This was later freshly augmented by temporary loans and note purchases.[61] Otherwise, IMF conditionality and debt workout policy remained unchanged.

Pressured by the European Commission, the first casualty Greece agreed in early February 2010 to an ambitious plan to reduce its deficit. This domestic adjustment would see an unprecedented level of EU surveillance, but did not include any official refinancing assistance. Domestic adjustment was still thought to be sufficient to deal with the unfolding Greek drama. Private actors in the meantime increasingly turned their eyes on Spain and Portugal as well, and driving up their funding costs as contagion accelerated. On 4 March, ahead of meetings of the Greek Prime Minister Papandreou with Merkel and Sarkozy, Greece threw in the towel and announced it was prepared to seek IMF assistance if European support was not forthcoming.[62] European leaders, especially Germany, remained hesitant to pledge official refinancing, which caused the situation in Greece to deteriorate even further.[63] In fact to the bewilderment of all, Chancellor Merkel declared that there would be no rescue until Greece's debt-financing capacity was exhausted. Even in March 2010, when panic was spreading and a bailout a foregone conclusion, Merkel insisted that the crisis should not be discussed at the EU summit because Greece had not requested help. Note in Figure 2 what happened to Greek and other bond spreads at that moment.

The German approach therefore only made the problem worse. By 11 April 2010 a €45 billion joint EU-IMF package was on the table. Too late; the 27 April ratings downgrade

61 The April 2012 G20 Communiqué mentions another 430 billion above the 2010 quota reform.
62 *Financial Times*, 4 March 2010.
63 *Financial Times*, 6 March 2010.

of Greek and Portuguese bonds to BB+ sent Greek spreads to 1200 points and the debt load skywards. A Greek bond auction failed. The next (2 May 2010) package that eventually stopped the rot was €110 billion, some €32.5 billion extra per week, plus a combined EU-IMF standby bailout fund of €750 billion (BIS 2010). Next to IMF surveillance, the ECB and European Commission (together forming the 'troika') would also make assessments of adherence to the highly intrusive conditionality. There was no private sector involvement, giving private creditors the opportunity to wind exposures down. The failure to adopt an early and appropriate workout solution also meant that the contagion consumed other member states. Policy space for the Greek government and much of the Eurozone will be constrained for years to come. The markets trump the people – especially if it is not understood that given EU financial and monetary interdependence it is only a matter of time before they are *your* people.

Instead of new debt workout mechanisms correcting the well-known faults of the system, a *de facto* European *IMF-on-steroids* was set-up. The facility would become the 'European Financial Stability Facility' (EFSF) and would be led by the German former head of the Economic and Financial Affairs Division of the European Commission, Klaus Regling. It was established for only three years (at German insistence) and was to be headquartered in Luxembourg. European leaders hoped their guarantees would be enough for a triple-A rating, which the EFSF could use to issue bonds to finance its balance of payments support element. Members would have to negotiate a memorandum of understanding with the Commission to ensure conditionality.64 In other words, official refinancing accompanied by domestic adjustment (the fiscal consolidation requirements imposed on the rescue funds) is still the combination of choice despite the lessons that should have and could have been learned, and which have been outlined in this report. Unsurprisingly, this was not sufficient to stop the rot.

In the face of continuing debt problems, France and Germany reached a deal that was supported by the ECB and European Commission. The plan was developed in close

64 *Financial Times*, 17 June 2010.

cooperation with Herman van Rompuy (chairperson of the European Council) and Jean-Claude Juncker (Prime Minister of Luxembourg) as chair of the Eurogroup. A permanent European Stabilisation Mechanism (ESM) would in 2013 replace the EFSF. Access to this Fund was to be accompanied by tough conditionality. New bonds from Eurozone governments would have to include CACs. The inclusion of CACs instead of 'automatic' haircuts was the result of French resistance to such automaticity. Although in first instance the plan had no place for debt restructurings, the ESM did leave open the possibility of standstills and haircuts as a condition to further ESM assistance if debt burdens were deemed unsustainable by the troika of IMF, ECB and Commission. However, authorities (especially the ECB and France) were keen to indicate that the ESM's rules in respect of sovereign debt restructurings did not differ from those of the IMF.[65] In this way the ESM deal has fixed the future pattern of Eurozone governance with respect to sovereign debt crisis resolution (starting in 2013), with the EFSF functioning *ad interim.*

Reality did occasionally intrude into the situation. Greece was eventually permitted a *de facto* default on a major portion of its debt to private bondholders. Meanwhile the requirements in terms of austerity have remained. Unsurprisingly, an approach that has not worked in the past was not working at the time of writing, and the focus was on Spain as a much bigger fish. In a further recognition of reality, the ECB also accepted in its 'Outright Monetary Transactions' programme that purchases of bonds on secondary markets, compatible with the ECB statutes though barely, could be unlimited if the 'monetary policy transmission mechanism' were impaired (and it clearly was: low policy interest rates were not at all reflected in the borrowing costs experienced in the PIIGS or other peripheral Eurozone economies).[66] Furthermore, intervention would not proceed unless and until a crisis country applied to the ESM for assistance, invoking the same old conditionality and restriction of policy space. One step forward, two steps back, or – the other way around – two steps forward, one step back? The crisis continues

65 *Financial Times*, 29 November 2010.
66 ECB 2012.

and economic conditions worsen: the Eurozone is as of mid-November 2012 officially in recession as a whole.

A further reform that has been proposed is 'banking union'. The aim is to fill in gaps in the supervisory oversight of national supervisory agencies by re-assigning responsibility to the ECB as a single supervisor. The original EU Council declaration included a commitment to joint deposit insurance and joint bank resolution mechanisms. This would have represented a pooling of supervisory resources the better to deal with the collectively-generated outcomes of that volatile combination of EMU and accelerated capital mobility. But this most important part of the reforms is most likely not to be: Germany has refused to honour its commitment to joint deposit insurance, and has unilaterally declared that any bank resolution mechanism would not apply to the 'legacy' items at the heart of the current crisis. Thus the meaning and impact of the banking union proposal remain unclear and inadequate to the task at hand.

Reforms: Input, output, and legitimacy

This chapter has demonstrated that there are indeed many reforms underway. Thankfully, policymakers have reacted to the need for change. Perhaps the most positive among the measures were the co-ordinated avoidance of financial meltdown and the Beijing-to-Berlin via Washington global stimulus package that followed. The rulebooks of monetary policy and lender-of-last resort orthodoxy were temporarily thrown aside. Governments that had prided themselves on their accomplishments in terms of privatisation did not hesitate to nationalise collapsing banks and pumped unlimited liquidity into the financial system for the rest. Fears of inflation were seen for the red herring that they were in the context, and public authorities intervened robustly to halt the cross-border financial contagion and mitigate the consequences for the real economy. There were solemn declarations of the need to radically alter the way in which the financial sector would be regulated and supervised. There was a robust commitment to better systemic oversight underpinned by a new macroprudential approach to supervision and macroeconomic adjustment. There was and remains little reason to doubt the original seriousness of the commitment to change.

That said, the results so far constitute far less than a thorough overhaul of the working of the financial system and/or its governance. The fundamental question, 'what sort of financial system, for what purpose, and for whom?' has yet properly to be posed and debated. Furthermore, few in official circles have posed of the optimal scale of a financial system relative to the 'real' economy: would a substantial reduction in proprietary trading and a return to more traditional forms of credit provision reduce social welfare, as is often claimed by the financial sector and some economists, or reduce only bankers' welfare? Capital adequacy standards have been raised and a number of measures introduced to attend to the problems of procyclicality and systemic risk. The standards applied to the market-based approach to financial governance has been strengthened, but remains in place even though it was identified as part of the problem. Much is promised for the future, but the absence of institutional and ideational innovation is likely to prove an ongoing constraint to genuine change. The system of debt workout remains even more anchored in past practice that was known to be dysfunctional and lacking in legitimacy well before the crisis.

This chapter has sought to expose this limited nature of the reforms so far and to explain why this worrisome degree of path dependency in policymaking has so far prevailed. So how does one account for the considerable disparity between the declaratory posture promising fundamental reform, and the more limited reality of accomplishment?

One important source of this path dependency is institutional. The input side of the policy process has included a wider range of states through the advent of the G20, leading to more attention to emerging market and developing country issues. However, at the same time the policy community remains limited to financial actors and there is little reflection on why the relatively closed system of private sector/autonomous public agency interaction needs to be shaken up. As the dust has settled and more normal conditions have returned, there has been an emerging sense of relief and indeed pride among public officials about the success of the rescue. Official personnel and indeed governments did change in places, and a number of prominent bankers associated with failure were thrown out and vilified to general applause (though for the most part retaining their staggering severance benefits). Parliaments and publics became more vocal and official agencies have had to show themselves responsive and they draw attention to the speed of the BCBS reforms as evidence of success. Supervisors, regulators, and central bankers have a genuine sense of determination to avoid capture in the future. So there is perhaps insufficient incentive to think about how capture actually works and to understand its underlying dynamics.

The failure to rethink the input side other than including a wider selection of ministers of finance and central bankers has the drawback that idea-sets and therefore a range of shared assumptions about 'how it's done' remain intact. It is in this where the true nature of 'capture' lies. Policymakers are accustomed to working within a given set of institutions and ideational assumptions that they built up over time in symbiosis with private sector interlocutors. As long as policy inputs remain limited to financial technocrats, these idea-sets are also likely to remain skewed. The private sector may have to lobby harder to achieve its goals, but the Dodd-Frank reform bill debate in Washington showed that they remain capable of doing so and are willing to pay for access to decision-makers. The need for consultation with private associations on the impact and implementation of regulations will not disappear, so the closed circuit remains unbroken. Without new input from a much wider range of stakeholders, the shared assumptions of the public-private policy club are unlikely to undergo a major transformation any time soon.

If the ideational closed circuit on the input side remains relatively intact, it should be no surprise that policy output remains overly path-dependent. The path has not been altered, no new territory explored with new guides. The commitment to macroprudential reforms remains promising, but there is much institutional change and innovation required to make it a reality, and that requires fresh thinking about the nature of the financial system itself, and what its role in relation to the real economy should be.

The sovereign crisis side of the equation is more urgent at the moment, and demonstrates far less prospect of a change in approach. The pre-crisis policy mistakes are being repeated and reinforced in a far worse economic context. The citizens of core democracies are being subjected to adjustment they are neither used to nor feel they deserve. Just as the burden of adjustment is once again falling on citizens, rescuing banks turns out to be more important to politicians and public authorities than rescuing people.

The outcomes of a monetary union, costs and benefits alike, are the product of a complex set of collective interactions shaped by the strengths and weaknesses of the political-institutional framework established. The negative outcomes of the crisis can no more be characterised as 'externalities' than they can be blamed on debtors or creditors alone. Capital mobility is inherently a potentially unstable system, and monetary union and European integration is one way of coping with it that can be made to work perfectly well if the policy mix is sound and the degree of collective action and burden sharing is sufficient. The EU appears to be looking for a functional equivalent of the lost, mythical Gold Standard: if only the rules are the right ones, and everyone (above all debtors!) behaves properly, stability will be achieved. Historical experience tells us that this is unlikely. The worst is that despite monetary union, banks were considered more important than fellow European citizens, especially those in poorer debtor economies. The poor and the 'other' too frequently appear expendable. How long will this prove politically sustainable? There are most likely yet more sombre days ahead for governance in the EU and on the global level.

What should be most clear from the analysis in this chapter is that the reforms which are clearly necessary on the output side (new regulations addressing the flaws in market-based governance light of a globally integrated and liberalised financial system), can only be achieved through simultaneously reforming the *input* side of governance. The advent of the G20 as the apex policy forum and the inclusion of the G20 members in the technical forums has already increased the attention paid to the effects of global standards and codes on the developing country and emerging markets. It remains to be seen whether the emerging market and developing country members of the G20 will succeed in translating this concern for the tensions between global standards and their domestic political economies into actual changes in the substance of global regulation and supervision. Yet the input and output aspects of legitimacy remain two sides of the same coin and must be carried further. This begs the question how these two sides are then to be reformed in substance. This question is addressed in the following, final chapter.

5. Summary and recommendations

Five years on, the crisis is clearly not over. Some analysts predict years of recession and Japanese-style stagnation, perhaps even an extended episode of deflation. Certainly there are sufficient lingering difficulties in the financial sector. These include emerging new evidence of banking scandals and systematic failures by financial institutions to conform to regulations, an unwelcome continuation of the bonus culture (that, admittedly, public disgust is challenging increasingly), and rogue trading and technical glitches too reminiscent of the pre-crisis system for comfort. Economic conditions show at best a weak recovery cum renewed recession, and the Eurozone crisis runs agonizingly on, especially for the citizen-guarantors in the debtor countries. As of the time of writing, recession had re-established itself in the Eurozone while conditions worsened in the more vulnerable economies. Time is clearly not on our side while the 'twin crises' continue to hit in particular the poorest citizens. Never in the post-war period has a new policy departure been more urgent; the commitment is there, but the required innovations have not yet materialised. This fifth and final chapter will summarise the arguments and conclusions of the analysis and present concrete policy recommendations in response. These recommendations simultaneously address the input and output sides, the policymaking process and its outcomes.

This report has drawn on a wide range of outputs from the FP7-funded 'Political Economy and Global Governance: the European Dimensions' research programme.[67] Above all, it draws on and extends the research findings of an interdisciplinary range of

67 See the separate section in the bibliography.

scholars published in 2010 (Underhill, Blom and Mügge). The analysis began with three essential points: i) the policy dilemmas and choices confronted by the contemporary system of global and European financial and monetary governance were long-standing, well-known, and there is a host of historical experience and concrete policy proposals to draw upon going forward; ii) both the potential and the more obvious flaws of the pre-crisis system of financial governance were to a large extent the consequence of the characteristics of the policymaking process dealing with financial regulation and supervision; iii) reform that is more likely to provide financial stability for the longer run requires new ideational departures drawing on established historical experience, aiming at considerable institutional innovation, and more institutionalised attention to the political legitimacy and long-run sustainability of financial openness globally and in the EU.

These three points were then supported by the analysis divided into four chapters. Chapter One offered a historical analysis demonstrating how a coalition of autonomous state agencies and private sector financial institutions came to share the ideas and policies that would underpin the emergence of financial globalisation and its system of market-based governance. State policy change was thus highly complicit in generating the problems that public authorities would later be called upon to resolve, as well as of course generating the benefits of financial integration. As cross-border finance and capital mobility produced serial crises, the new financial architecture was developed under the aegis of the G7 and mandated to a series of technical forums. The core policy issues analysed as examples throughout the report were bank capital adequacy and sovereign debt workouts. Skewed idea-sets produced in closed policy communities delivered material benefits to those insiders best able to influence the decisions taken. The codes and standards did not work, and financial stability became increasingly noted for its absence. Chapter Two demonstrated that enough was already known *ex ante* to realise that the approach adopted was likely to go wrong. Once again, the examples of capital adequacy standards issued by the Basel Committee and IMF debt workout policy were the focus. Chapter Three developed an explanation as to how and why these lessons and alternative policy advice remained ignored and marginalised, showing in detail how crucial decisions were taken and in whose interest. Chapter Four explained how and why the post-crisis reforms do not (yet?) represent the required new departure that is likely to ensure financial stability in the future. The failure to develop new policy directions is having grave consequences for the Eurozone sovereign debt crisis.

This chapter will now turn to providing recommendations addressing each of the three central starting points of the analysis, addressing first the 'input side' of global financial governance (institutional change to strengthen and alter *inputs* into the policy process) and then the 'output side' (improving the institutional framework and *effectiveness* of governance in a globally integrated financial system). The central point remains that input and output side reforms must be considered together as an integrated conceptual and policy framework if enduring financial stability is to be achieved.

Input side recommendations

Reform requires thinking about whose stakeholder interests are included in the policymaking process, whose interests *should* be primary to the functioning of the financial order, and about the asymmetrical effects of the functioning of the financial system upon them. This also includes reflecting on how a broad underlying consensus might be built, eventually establishing longer-term diffuse support for effective global financial governance. Even sound standards and policies may be unsuccessful if they are perceived as imposed by an unfair and exclusionary process. Thus, representation of and input from the diversity of interests with a stake the financial system must be a goal. Historically the dominant voice in national policy processes, alongside the public agencies legally responsible for regulation and supervision, has been that of private financial institutions. G7 governments in close consultation with the private financial sector have dominated at the international level. Unless broader stakeholder and country input can be included, skewed and ineffective policy output with a strong whiff of capture will continue. Improving the range of inputs can lead to a more balanced view of the challenges and tradeoffs inherent to financial liberalisation and integration, and focus the financial system on serving real-economy development instead of the unrelenting growth of ever more obscure financial asset classes. At the regional and international level, the 'voice' of smaller countries should be better included without constraining effective decision making. Across institutional layers, stakeholder interests beyond the financial sector itself should form a wider argument pool that would change the ideational underpinnings of the contemporary pattern of global financial governance. Concrete measures we propose are:

- *Develop and formalise the role of the G24 as a developing country caucus feeding into the G20* (as it currently is already represented in the IMFC of the IMF). This might be accompanied by a rebalancing of the G24 towards the poorest developing countries to attenuate the current overlap between G20 and G24 membership. More generally, a logical step would be to build a system of regional caucuses and/or allow regional representation in the different technical forums to complement the G20. This need not lead to a loss of decision-making efficiency if the number of European Union seats at the table is reduced (see the next recommendation).
- *Strengthen single EU or Eurozone representation in various forums, while simultaneously improving internal coordination in the EU.* With the increasing institutionalisation of EU economic and financial governance, including the single currency and prospective banking union, prominent developing countries are arguably in more need of representation in international forums than the current range of European states. This also implies a reshuffling of current 'constituencies' in the IFIs, which are disproportionally led by EU members.
- *Increase the range of stakeholder interests that influence national agencies and their representatives in global forums*, so as to counteract the 'insider' influence of the private financial sector on their highly autonomous official sector partner agencies. In particular, the users of financial services, from SMEs and larger real economy firms, to pension funds and their labour-market constituencies, to depositors and savers. These currently have too little say in the making of policy

yet are all significantly affected by the decisions taken. An institutionalised system of 'corporatist' representation of stakeholders could bring the interests of these constituencies to bear on financial supervision and regulation and the establishment of global or regional standards. Technical forums should be required to go beyond placing consultative papers on their website and wait for responses, towards *actively* soliciting a prescribed range of stakeholder responses instead. This would also imply that the technical forums provide stakeholders with the necessary technical assistance to deliver this input.

- *Public oversight of autonomous agencies should be enhanced and accountability and transparency in the policymaking process improved.* Further institutional change is required to achieve this and in doing so both reduce the potential for capture *and* institutionalise a process of policy learning. This involves formalising two elements of an 'accountability phase' in the policy process: i) accountability for how the input side of the policy process has functioned and whose preferences constituted inputs into policy; and ii) accountability for actual outcomes achieved. The first involves full transparency on the involvement of lobbyists and social partners, allowing parliamentarians to judge whether an adequate balancing of stakeholder interests has taken place in technical forums. The second involves holding public sector agencies and private financial institutions accountable for outcomes achieved in terms of corporate governance, financial stability, and the balanced real economy growth and development that the financial sector is meant to serve.
- *The institutions of policy making at national and international levels must properly 'join the dots' among interrelated policy domains that have so far been treated too separately*: global imbalances and macroeconomic adjustment; monetary policy in relation to asset markets; multilateral surveillance mechanisms; debt loads (public and private); financial system monitoring; firm level risk management. The current G7/G20 framework is too distant to accomplish this adequately; institutional innovation on the input side is required to realise these goals of the new macroprudential approach to financial stability. The input side needs to consider

data on the relationships mentioned and to reflect upon how the financial system should operate, and in whose interest and for what purpose in the broader real economy. This issue is taken up again below on the 'output side'.

Output side recommendations

The most promising development on the output side is the international commitment to 'macroprudential oversight', which rightly addresses the relationship of firm-level risk management and financial system stability to macroeconomic adjustment processes, monetary and exchange rate issues, and public and private debt loads in the economy. However, there is so far little indication as to the underlying policy substance or institutional form that the approach requires. Successfully operationalising the concept requires institutional change and new policy approaches across national and international levels both to 'join the dots' among policy domains currently treated as separate, and to fill the remaining gaps in the global financial architecture. Supervisors and market agents still need to develop better tools to assess financial systems as a whole, including the dynamic relationships among risk management in individual banks, the procyclicality of credit, the nature of business cycles, and the links between individual risks, the monetary policy stance and global imbalances. Concretely, this implies (moving from the technical to more general issues):

- *The system of bank capital adequacy standards should be based on several intersecting gauges of risk that lead to a better linkage between firm-level risk management and emerging problems at the systemic level. Moreover, bank capital adequacy requirements should aim to err on the side of caution*. The singular Basel II focus on model-based micro-level risk-weighted capital neglected the build-up of risks elsewhere (e.g. off-balance sheet activities) and at the systemic level. Although more stringent capital adequacy standards might lower bank profits in good times, more importantly it reduces the chance of tax-payer funded bailouts in bad times, and may reduce the risk of financial-sector driven asset bubbles. On the firm level several gauges of risk should be used in determining the capital requirement, for example balance sheet (a gearing ratio), the current risk-weighted liabilities, and bank income. The actual capital requirement should then be based on the *highest absolute level* of capital coming out of these 'three anchors'. Basel III is a limited move in this direction with its addition of a countercyclical buffer, a leverage ratio and liquidity standard, but these 'anchors' should be established more firmly in the banking supervisory framework and should be better combined to reflect the potential accumulation of risks.

- *Supervisory coordination needs to be strengthened and home-host responsibilities need to be clearly defined – including the fraught question of the sharing of costs when things go wrong.* The proposal to establish supervisory Colleges to enhance supervisory coordination seems to lack courage. There is little indication as to the required institutional framework or the distribution of home-host responsibilities in terms of consolidated supervision, or sharing of the costs when bank resolution is required. The principle should be that whatever falls under the bank or holding company of the financial consortium, from SIV to derivatives affiliate to commercial bank or Non-Bank Financial Institution (NBFI), from London to Hong Kong to the Cayman Islands, should be subject to the rules of consolidated supervision and to the new minimum capital adequacy standards. The institutional mechanisms to ensure such an outcome still require much work and definition. One of the elements to be defined is how to impose losses in case of bailouts: on bank shareholders, but also on (senior) bondholders through haircuts or forced roll-overs and failed management through claw-back clauses. The EU 'Single Supervisory Mechanism' under the recently proposed banking union is a positive but still incompletely defined contribution in this direction. Some EU national governments have recently retreated from key commitments in terms of joint deposit insurance and bank resolution.
- *The international system of supervision must have the capacity to ensure that all countries apply this consolidated supervision with agreed consistency, and to intervene when shortcomings become evident.* It is neither clear how discipline will

be enforced, nor how the inevitable excuses based on claims of sovereign autonomy will be confronted. If countries do not apply the consolidated supervisory standards, opportunities for regulatory arbitrage will continue and the system will break down. This applies especially to offshore financial centres. In short, global coordination as is now taking place in the Joint Forum and FSB is a necessary condition for a stable global financial system, but should be strengthened considerably and requires better institutional anchors. Again, the EU's 'banking union' proposals may well go some way in this direction, though the proposals are far from final and the political ground remains soft.

- *The entire, so far only imagined edifice of 'macroprudential oversight' requires concrete manifestation.* Systemic monitoring implies more than an intensely-fixed gaze upon the banks and financial markets that separates financial supervision and regulation from overlapping policy domains such as macroeconomic adjustment issues. There is as yet no mechanism for linking financial supervisory measures to policy action to deal with global imbalances, exchange rate issues, cross-border capital flows, monetary policy issues and asset price inflation, debt loads or the multilateral surveillance and macroeconomic standards process. The pre-crisis piecemeal incoherence relying on market signals and voluntary commitments to common standards, seldom commonly interpreted, still remains in place and does not suffice. While a number of emerging market countries in Latin America and elsewhere have dynamic policy recipes that are generally recognised as embodiments of the macroprudential idea (the approach of the Central Reserve Bank of Peru comes to mind), at the global level the notion lacks both real substance and consistency.
- *The IMF should be 'regionalised' by complementing it with regional funds along similar lines like the World Bank-regional development banks structure. This should not dilute the IMF's capacity for global oversight, and would thus require a high degree of co-ordination.* The global financial and monetary system has become more complex and regionalised over time, and reform of the financial architecture

needs to account for this trend. It has long been recognised that the IMF requires a governance structure that grants more 'voice' to the emerging market economies and developing countries. 'Regionalising' the IMF – without diluting its capacity for global oversight - would be a solution to both difficulties. The ESM and Asian monetary cooperation are *de facto* developments along these lines, but with insufficient formal co-ordination mechanisms. The reforms should also be combined with formal recognition of the principles of Keynes' 'Clearing Union' proposal: imbalances are a joint problem to be resolved through *simultaneous and required* adjustment by both surplus and deficit countries. Debtor state austerity alone is self-defeating – as even the IMF nowadays acknowledges.

- *A comprehensive workout process to deal with sovereign debt restructurings should be established so as to limit the exposure of creditor and/or debtor states' taxpayers to problems that too often begin in the private sector.* This could be a beefed up version of the IMF's original proposal for a SDRM and should include debt standstills, independent arbitrage, comparability of treatment, and private sector involvement (PSI) through haircuts and mandatory roll-overs. State-led rescues of the financial sector combined with automatic fiscal stabilisers and co-ordinated global stimulus policies, positive and necessary moves in themselves, have resulted in unsustainable debt burdens and dangerous contagion dynamics on sovereign bond markets. Current workouts produce skewed burden sharing between private creditors and taxpayer guarantors in both debtor and creditor countries. Our research finds little evidence that the current structural adjustment process yields positive results, while conditionality remains highly restrictive of policy space for debtor governments (see below). The European Union should establish with urgency such a mechanism as one of the steps towards creating collective machinery for the tensions inherent in the single currency. This measure is crucial in relation to political legitimacy – political support from both creditor and debtor nations for the current pattern of adjustment is wearing thin.

- *A sustainable policy commitment to financial openness requires other forms of policy support as well, in particular public health provision and social welfare compensation to mitigate the risks to individuals of market dynamics.* The current approach emphasising ever-tighter and intrusive rules and conditionality for debtor countries in exchange for emergency lending (that only adds to debt burdens) has a long history of dysfunctionality dating from the 19th century Gold Standard and the 1930s. Our research indicates that *the global financial architecture needs formally to recognise the importance of providing the required 'policy space' to respond to domestic social and political imperatives by enhancing the 'room to move' for national governments*, e.g. promoting judicious use of controls on short-term capital flows or in the European context enhancing the capacities of the ECB and EIB to come to the aid of states faced with austerity demands. This also involves rebalancing the obligations of debtors and creditors in a context of capital mobility: both the positive and the more negative results of capital mobility are collectively produced through market interaction, so they must be collectively owned and burdens must be shared by public and private debtors *and* creditors alike.

Why do these measures matter? The answer has to do with the long-run sustainability and legitimacy of financial openness and capital mobility and whether we wish to have continued access to the benefits it offers. Financial liberalisation is better sustained in economies that mitigate the risks of liberalisation through welfare and other forms of compensation for the vulnerable. Nurturing financial openness requires the very policy space that austerity is closing down. Electorates are rebelling against solutions that 'pool' sovereignty just at the moment that market integration and crisis makes national policy less effective. Failure to think systematically about the emerging legitimacy deficit is generating centrifugal populist political forces. This context potentially undermines the ability of states to co-operate so as to sustain liberal finance at all. In short, we need a financial system and Eurozone that demonstrably places citizens above banks!

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